



# OECD Economic Surveys MALAYSIA

AUGUST 2024





# OECD Economic Surveys: Malaysia 2024

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Member countries of the OECD.

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

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

Note by the Republic of Türkiye

The information in this document with reference to “Cyprus” relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Türkiye recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Türkiye shall preserve its position concerning the “Cyprus issue”.

Note by all the European Union Member States of the OECD and the European Union

The Republic of Cyprus is recognised by all members of the United Nations with the exception of Türkiye. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

**Please cite this publication as:**

OECD (2024), *OECD Economic Surveys: Malaysia 2024*, OECD Publishing, Paris, <https://doi.org/10.1787/e45ca31a-en>.

ISBN 978-92-64-65098-5 (print)  
ISBN 978-92-64-40707-7 (PDF)  
ISBN 978-92-64-66963-5 (HTML)  
ISBN 978-92-64-31772-7 (epub)

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

OECD Economic Surveys: Malaysia  
ISSN 2959-4944 (print)  
ISSN 2959-4952 (online)

**Photo credits:** Cover © Efired/Shutterstock.com. Foreword © szefei/Shutterstock.com.

Corrigenda to OECD publications may be found at: <https://www.oecd.org/en/publications/support/corrigenda.html>.

© OECD 2024



Attribution 4.0 International (CC BY 4.0)

This work is made available under the Creative Commons Attribution 4.0 International licence. By using this work, you accept to be bound by the terms of this licence (<https://creativecommons.org/licenses/by/4.0/>).

**Attribution** – you must cite the work.

**Translations** – you must cite the original work, identify changes to the original and add the following text: *In the event of any discrepancy between the original work and the translation, only the text of original work should be considered valid.*

**Adaptations** – you must cite the original work and add the following text: *This is an adaptation of an original work by the OECD. The opinions expressed and arguments employed in this adaptation should not be reported as representing the official views of the OECD or of its Member countries.*

**Third-party material** – the licence does not apply to third-party material in the work. If using such material, you are responsible for obtaining permission from the third party and for any claims of infringement.

You must not use the OECD logo, visual identity or cover image without express permission or suggest the OECD endorses your use of the work.

Any dispute arising under this licence shall be settled by arbitration in accordance with the Permanent Court of Arbitration (PCA) Arbitration Rules 2012. The seat of arbitration shall be Paris (France). The number of arbitrators shall be one.

# Foreword

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries. The draft report was discussed at a meeting of the Economic and Development Review Committee on 11 June 2024, with participation of representatives of the Malaysian authorities.

The 2024 OECD Economic Survey of Malaysia was prepared by Randall Jones and Ken Nibayashi, under the supervision of Jens Arnold. The Survey also benefitted from contributions at various stages by Alice Berggrun, Bert Brys, Luiz de Mello, Balázs Egert, Andrea Garnero, Andrea Goldstein, Alberto González Pandiella, Mohd. Fairuz Bin Azmi, Isabell Koske, Apurva Sanghi, Nur Syairah Husna Mohd Ridzuan, Matthew Wai-Poi, Mohd Zhafry bin Zainol. Tony Huang provided statistical assistance and Emily Derry provided editorial support.

The previous Survey of Malaysia was issued in August 2021. Information about the latest as well as previous Surveys and more information about how Surveys are prepared is available at <https://www.oecd.org/en/topics/sub-issues/economic-surveys.html>.





# Table of contents

Foreword	3
Executive Summary	10
<b>1 Macroeconomic developments and policy challenges</b>	<b>17</b>
The economy has weathered recent shocks fairly well	18
Amid weaker global trade in 2023, growth has lost momentum	18
Inflation has slowed	21
Growth is projected to gain momentum, but downside risks remain	22
The risks to the outlook appear skewed to the downside	23
Monetary policy should maintain its neutral stance	24
Monetary policy has tightened	24
Coping with exchange rate fluctuations	25
Financial-sector risks appear well-contained, though vulnerabilities remain	26
Fiscal consolidation should be pursued as planned	29
Deficits and debt have risen above the pre-pandemic period	29
A new fiscal framework law is expected to strengthen fiscal sustainability	31
Public debt will rise without new fiscal measures	33
Mobilising more revenues for future spending needs	35
Strengthening institutions to achieve more effective public spending	41
References	46
<b>2 Towards more inclusive growth</b>	<b>49</b>
Malaysia has made substantial progress in social inclusion	50
Poverty rates have reached low levels following years of decline	50
Income inequality remains high in international comparison	51
Taxes and transfers have relatively small redistributive effects	53
Cash transfers could do more to support vulnerable and poor households	55
Pension coverage is narrow and inadequate	56
Labour market efficiency is hampered by skills mismatch and informality	60
Many people work in occupations that do not match their skills	60
Wage growth has been slow but broadly in line with productivity	63
Tackling informality requires policy action on several fronts	66
Gender inequalities in the labour market hold back women’s potential	68
Policies to reduce gender gaps and improve equal opportunities	69
References	74
<b>3 Addressing climate challenges</b>	<b>78</b>
Climate change increases the exposure to natural disaster risks	79
Finding the right policy mix to accelerate emission reductions	81
Greenhouse gas emissions have increased	81
Phasing out fossil fuel subsidies	84
Moving towards mandatory carbon pricing	86

Applying stricter standards and regulations	88
Changing the energy mix to transition toward a low carbon economy	90
Boosting solar energy	92
Further developing biomass and hydrogen as sources of energy	93
Other policies to reduce emissions	94
Accelerating climate change adaptation	95
References	99
<b>4 Making micro, small and medium-sized enterprises an engine of growth</b>	<b>102</b>
MSMEs can help lift Malaysia to high-income status	103
Government policies for micro, small and medium-sized enterprises	105
The challenge of boosting productivity	107
Scaling up MSMEs to boost productivity	110
What types of firms are most likely to become scalers and high-growth firms?	113
What factors are most likely to trigger a high-growth episode?	115
A strategy to promote the scaling up of MSMEs	116
Supporting MSMEs in taking advantage of digitalisation and technology	117
Small firms lag behind in digitalisation	119
Creating a more favourable digital economy ecosystem	120
Upgrading technology and human skills	125
Addressing other obstacles to MSME growth	129
Providing financing for MSMEs	130
Enhancing MSMEs role in international trade	137
Regulatory reform to facilitate the scaling up of MSMEs	141
Improving the insolvency framework can promote the scaling up of firms	146
Reducing the role of state-owned enterprises to facilitate the scaling up of MSMEs	147
Reforming state-owned enterprises	149
The role of government-linked investment companies	150
References	153

## Tables

Table 1. Growth is picking up	11
Table 1.1. Macroeconomic indicators and projections	22
Table 1.2. Low-probability events that could lead to major changes to the outlook	24
Table 1.3. Illustrative impact of selected structural reforms on GDP per capita	35
Table 1.4. Indicative fiscal costs (-) and revenues (+) over a horizon of 3-5 years	40
Table 1.5. Past recommendations on macroeconomic policies	40
Table 1.6. Past recommendations on public sector integrity	44
Table 2.1. Past Recommendations on social inclusion	59
Table 2.2. Policy recommendations from this chapter (Key recommendations in bold)	73
Table 3.1. Selected indicators of exposure and management capacity of climate risks from Inform <sup>3</sup> 2024	80
Table 3.2. Southeast Asian countries have pledged to reduce GHG emissions	83
Table 3.3. Past recommendations on green growth	88
Table 3.4. Policy recommendations from this chapter (Key recommendations in bold)	98
Table 4.1. Targets set for MSMEs in the government's 2012-20 and 2023-30 plans	106
Table 4.2. The main catalysts for MSME growth included in the MSME Strategic Plan 2030	106
Table 4.3. The likelihood of two consecutive high-growth periods for firms is small in Indonesia	115
Table 4.4. Bumiputera's share of equity ownership remains below the 30% target	132
Table 4.5. Malaysia's government-linked investment companies	150
Table 4.6. Past recommendations on creating a more dynamic business sector	151
Table 4.7. Recommendations from this chapter (Key recommendations in bold)	152

## Figures

Figure 1. Malaysia has outperformed peers	10
Figure 2. Fiscal consolidation is underway	12
Figure 3. Inequality reductions are small	13
Figure 4. Greenhouse gas emissions are increasing	14
Figure 5. Few small firms are exporters	15
Figure 1.1. Recent macroeconomic developments	19
Figure 1.2. Malaysia is deeply integrated into the international trading system	20
Figure 1.3. Exports of goods by destination and products	20
Figure 1.4. Inflation was moderate compared with regional peers and is declining	21
Figure 1.5. The food and beverage and transport sectors have driven inflation	21
Figure 1.6. Inflation has declined amid gradual monetary tightening	25
Figure 1.7. Many Asian countries have experienced currency depreciation amid capital outflows	26
Figure 1.8. The banking sector's capital and liquidity buffers appear adequate	27
Figure 1.9. The growth of bank loans and their share of GDP have edged down	28
Figure 1.10. Bank loans to the private sector are relatively high while non-performing loans are low	29
Figure 1.11. The fiscal deficit and public debt increased due to policy responses to the pandemic	30
Figure 1.12. The government has increased subsidies, particularly for fossil fuels	31
Figure 1.13. The population is ageing rapidly	33
Figure 1.14. The expected rise in public social spending calls for offsetting fiscal measures	34
Figure 1.15. Government spending is about half of the OECD average	36
Figure 1.16. Tax revenue to GDP has declined amid a high share of corporate income tax revenues	37
Figure 1.17. Corruption perception has improved but related indicators remain stagnant	42
Figure 1.18. Malaysia performs well in transparency and anti-money laundering	43
Figure 2.1. Poverty is low in international comparison	50
Figure 2.2. Poverty has fallen	51
Figure 2.3. Income inequality is high	52
Figure 2.4. The income distribution shows many households with low incomes and a thin middle	53
Figure 2.5. Taxes and transfers could do more to reduce inequalities	54
Figure 2.6. While taxes are progressive, transfers do little to reduce inequalities	55
Figure 2.7. Coverage of mandatory pension schemes is low	57
Figure 2.8. The effective retirement age is low in international comparison	58
Figure 2.9. Labour force participation has increased and unemployment declined	60
Figure 2.10. Skills mismatch is significant and has been increasing	61
Figure 2.11. Performance in mathematics, reading and science in PISA 2022	62
Figure 2.12. Wage growth has been weak	63
Figure 2.13. Wage growth has been broadly in line with productivity over recent years	64
Figure 2.14. The minimum wage is high in international comparison	64
Figure 2.15. Collective bargaining coverage is the lowest among comparable economies	66
Figure 2.16. Gender employment and participation gaps remain large	68
Figure 2.17. Women are better educated	69
Figure 2.18. Girls have better learning outcomes than boys	69
Figure 2.19. Women spend more time on unpaid family work	71
Figure 2.20. Less women work in high-skilled occupations	72
Figure 2.21. The share of women in top management is rising and exceeds Asian peers	72
Figure 3.1. Flood is the most significant threat to Malaysia	79
Figure 3.2. Greenhouse gas emissions are increasing	81
Figure 3.3. CO2 emissions remain high	82
Figure 3.4. Energy consumption is correlated with economic growth	82
Figure 3.5. Energy and transport emissions are increasing	83
Figure 3.6. Subsidies increased following the COVID pandemic	84
Figure 3.7. Government spending on energy subsidies in Indonesia	85
Figure 3.8. Effective carbon rates and coverage	87
Figure 3.9. Environmental policies are less stringent than in OECD countries, China and India	89
Figure 3.10. Malaysia's fossil-fuel dependence is higher than in peer countries	91
Figure 3.11. The cost of solar energy has decreased	93
Figure 4.1. Rapid economic development has boosted Malaysia close to high-income status	103
Figure 4.2. Most firms in Malaysia are MSMEs and they are concentrated in the service sector	104
Figure 4.3. MSMEs in agriculture and construction account for half of output in those sectors	104

Figure 4.4. Malaysia's labour productivity level is approaching that in advanced economies	107
Figure 4.5. Malaysia's labour productivity growth rate has slowed during the past few decades	108
Figure 4.6. Labour productivity in MSMEs in Malaysia is around two-thirds of that of large firms	108
Figure 4.7. Service sector productivity in Malaysia lags far behind that in manufacturing	109
Figure 4.8. Services' share of Malaysian GDP is low	110
Figure 4.9. Firms that scale up are major drivers of employment	111
Figure 4.10. High-growth firms account for at least half of the growth in many economies	112
Figure 4.11. High-growth firms in Indonesia scale up employment during high-growth episodes	113
Figure 4.12. Mature firms account for the largest share of scaler firms and gross job creation	114
Figure 4.13. Most scaler firms are in less knowledge-intensive services	115
Figure 4.14. Firms adopting digital tools in Malaysia achieve higher labour productivity	117
Figure 4.15. Malaysia performs well in digital competitiveness	118
Figure 4.16. The ICT sector and firms' use of digital solutions has greatly increased in Malaysia	119
Figure 4.17. Larger firms are more likely to invest in digital solutions, leading to better outcomes	120
Figure 4.18. MSME programmes in Malaysia are targeted at firms meeting certain eligibility criteria	121
Figure 4.19. The key obstacles to digitalisation cited by MSMEs	122
Figure 4.20. Mobile broadband subscriptions are widely available but the price is high	123
Figure 4.21. Malaysia's restrictions on telecommunications and computer services trade are high	124
Figure 4.22. ICT use by firms varies widely between regions in Malaysia	125
Figure 4.23. R&D expenditures have fallen since 2016 and are low compared to OECD countries	126
Figure 4.24. Malaysia's scores in the World Innovation Index show room for improvement	127
Figure 4.25. The share of small and medium-sized firms participating in R&D in Malaysia is low	127
Figure 4.26. MSMEs' share of outstanding and new bank loans has edged down	131
Figure 4.27. MSME loans are primarily to small and medium firms and most exceed MYR 1 million	131
Figure 4.28. Young firms rely primarily on internal funds for financing	134
Figure 4.29. Malaysia's share of venture capital deals is low relative to the size of its economy	135
Figure 4.30. Only a few small firms are exporters	138
Figure 4.31. MSMEs' exports account for a small share of Malaysia's exports and the share has fallen	138
Figure 4.32. Malaysia is relatively open to digital trade	141
Figure 4.33. MSMEs need assistance to comply with regulations	142
Figure 4.34. Product market regulation in Malaysia is more stringent than in most OECD countries	143
Figure 4.35. Malaysia has high administrative burdens on start-ups	144
Figure 4.36. Labour productivity in retail in Malaysia is less than half of the national average	145
Figure 4.37. Retail sector regulations in Malaysia are more restrictive than the OECD average	145
Figure 4.38. Price controls are prevalent in Malaysia compared to OECD countries	146
Figure 4.39. The scale of public ownership and the scope of SOEs is high in Malaysia	148

## Boxes

Box 1.1. Fiscal Councils in emerging economies: the Chilean case	32
Box 1.2. Structural reforms will support long-term growth	35
Box 1.3. Malaysia's taxes on goods and services	38
Box 2.1. Malaysia's performance in education	62
Box 3.1. Cutting energy subsidies while shielding the most vulnerable – the Indonesian experience revisited	85
Box 3.2. OECD Environmental Policy Stringency Index	90
Box 3.3. Financial responses to the 2021 flood event	96
Box 3.4. The French natural disaster fund	97
Box 4.1. Overview of Malaysia's micro, small and medium-sized enterprise sector	104
Box 4.2. Malaysia's targets for the micro, small and medium-sized enterprise sector	106
Box 4.3. Why is it crucial for SMEs to scale up?	111
Box 4.4. Tax measures by OECD countries to support R&D spending by SMEs	128
Box 4.5. Upgrading digital and managerial skills: the cases of Mexico and Canada	129
Box 4.6. Malaysia's policies to improve the economic status of Bumiputera	132
Box 4.7. Export consortia: the case of Italy	140

## Basic statistics of Malaysia, 2023

Numbers in parentheses refer to the OECD average<sup>1</sup>

LAND, PEOPLE AND ELECTORAL CYCLE					
Population (million, 2022)	33.9		Population density per km <sup>2</sup> (2022)	103.3	(39.0)
Under 15 (% , 2022)	22.7	(17.2)	Life expectancy at birth (years, 2021)	74.9	(78.7)
Over 65 (% , 2022)	7.5	(18.0)	Men (2021)	72.7	(75.9)
International migrant stock (% of population, 2020)	10.5	(13.2)	Women (2021)	77.4	(81.7)
Latest 5-year average growth (%)	1.2	(0.4)	Latest general election	November	2022
ECONOMY					
Gross domestic product (GDP)			Value added shares (% , 2022)		
In current prices (billion USD)	400.9		Agriculture, forestry and fishing	9.0	(2.8)
In current prices (billion MYR)	1 822.9		Industry including construction	39.5	(28.0)
Latest 5-year average real growth (%)	2.8	(1.6)	Services	51.5	(69.2)
Per capita (thousand USD PPP, 2020, OECD: 2022)	27.2	(60.2)			
GENERAL GOVERNMENT					
Per cent of GDP					
Expenditure (2022)	24.7	(43.0)	Gross financial debt (2022)	65.6	(114.5)
Revenue (2022)	19.9	(39.6)			
EXTERNAL ACCOUNTS					
Exchange rate (MYR per USD, 2022)	4.40		Main exports (% of total merchandise exports, 2021)		
PPP exchange rate (USA = 1, 2022)	1.58		Machinery and transport equipment	43.9	
In per cent of GDP			Mineral fuels, lubricants and related materials	12.4	
Exports of goods and services	68.6	(31.2)	Miscellaneous manufactured articles	12.3	
Imports of goods and services	63.5	(31.4)	Main imports (% of total merchandise imports, 2021)		
Current account balance	1.5	(-0.2)	Machinery and transport equipment	42.6	
Net international investment position (2022)	3.5		Mineral fuels, lubricants and related materials	12.4	
			Chemicals and related products, n.e.s.	10.9	
LABOUR MARKET, SKILLS AND INNOVATION					
Employment rate (aged 15 and over, %, 2022)	66.5	(58.0)	Unemployment rate, Labour Force Survey (aged 15 and over, %, 2022)	3.9	(4.8)
Men (2022)	78.8	(65.6)	Youth (aged 15-24, %, 2022)	11.7	(10.6)
Women (2022)	53.5	(50.8)	Long-term unemployed (1 year and over, %, 2022)	0.3	(1.2)
Participation rate (aged 15 and over, %, 2022)	69.3	(60.9)	Tertiary educational attainment (aged 25-64, %, 2019, OECD: 2022) <sup>2</sup>	20.3	(40.7)
Mean weekly hours worked (2022)	44.7	(37.0)	Gross domestic expenditure on R&D (% of GDP, 2020, OECD: 2021)	1.0	(3.0)
ENVIRONMENT					
Total primary energy supply per capita (toe, 2021, OECD: 2022)	2.8	(3.8)	CO <sub>2</sub> emissions from fuel combustion per capita (tonnes, 2021, OECD: 2022)	6.7	(7.8)
Renewables (% , 2021, OECD: 2022)	4.3	(12.0)	Renewable internal freshwater resources per capita (1 000 m <sup>3</sup> , 2020)	17.5	
Exposure to air pollution (more than 10 µg/m <sup>3</sup> of PM 2.5, % of population, 2020)	99.2	(56.5)			
SOCIETY					
Income inequality (Gini coefficient, 2021, OECD: latest available)	0.407	(0.316)	Education outcomes (PISA score, 2022)		
Poverty gap at USD 6.85 a day (2017 PPP, %, 2021)	0.4		Reading	388	(476)
Public and private spending (% of GDP)			Mathematics	409	(472)
Health care (2020, OECD: 2022)	4.1	(9.2)	Science	416	(485)
Education (% of GNI, 2021)	3.9	(4.4)	Share of women in parliament (% , 2022)	13.6	(32.5)

1. Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries.

2. For Malaysia, data refers to aged 25 and over.

Source: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organisation, International Monetary Fund, United Nations, World Bank, CEIC, Department of Statistics Malaysia.

# Executive Summary

## Malaysia is on the verge of becoming a high-income economy

Sustained rapid and inclusive economic growth for half a century has brought Malaysia close to the threshold of high-income status.

**The economy has achieved an impressive average yearly growth of over 6% since the 1960s.** Malaysia has been ahead of regional peers in terms of per capita incomes and has been able to consolidate this lead (Figure 1). While incomes were only one-third of the World Bank's threshold for high-income countries in 1989, it is set to surpass that threshold by 2028.

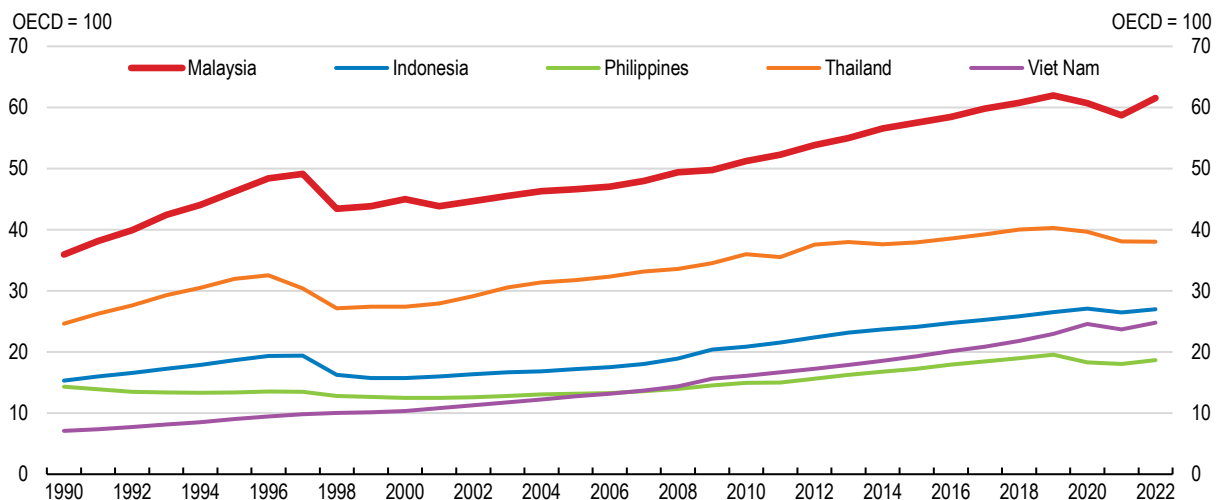
**Significant policy reforms in the 1980s allowed Malaysia to attract large inflows of foreign direct investment, turning it into a global chips and electronics manufacturer.** Growth and productivity could be strengthened further by easing restrictive regulations and creating a more level playing field between state-owned enterprises and private firms. This would bring particular benefits for services and for small and medium enterprises.

**With higher incomes, however, surging demands for better public services require different policies from those that were successful in the past.** The public sector will have to deliver more and become more effective, which calls for improved economic governance.

**Filling the substantial gaps in the current social protection requires increased expenditure.** Population ageing will add to these pressures, as an increasing share of the population will be unable to provide for their own basic needs. The transition to a greener and more sustainable economy also calls for large investments. Providing solid financing for these spending needs by mobilising additional tax revenues is likely to be one of the major challenges in coming years, and an area where visible progress has yet to materialise.

### Figure 1. Malaysia has outperformed peers

GDP per capita relative to the OECD average, at PPP



Source: World Bank, World Development Indicators database.

StatLink  <https://stat.link/2migwl>

## Growth is gaining momentum

Growth is accelerating, mostly driven by expanding domestic demand. Exports are set to rebound amid stronger external demand. Inflation has fallen below historical averages and but is expected to rise as energy subsidies are withdrawn.

**The economy has shown resilience in the face of shocks**, including the pandemic, supply chain bottlenecks and the economic implications of Russia's war of aggression against Ukraine. Amid weaker export demand in 2023, growth has been driven by domestic consumption, supported by low unemployment (Table 1).

**Both headline and core inflation fell below 2% in the latter part of 2023** following an acceleration in 2021-22. Inflation is expected to remain moderate amid easing global supply constraints and commodity prices, despite the necessary withdrawal of energy subsidies.

**Growth is projected to reach 4.9% in 2024 and then 4.7% in 2025.** Buoyant domestic demand and new opportunities in technology-intensive sectors and the expected rebound in exports will

encourage private investment despite higher financing costs. Export developments are subject to geopolitical risks, which could affect Malaysia's economy given its strong exposure to foreign markets.

**Monetary policy tightening has led to a broadly neutral policy stance.** Monetary authorities started a tightening cycle in 2022 as inflation approached 5%, driven by global energy prices and currency depreciation. With inflation near its 2% long-term average, the current monetary policy stance seems adequate and provides room to accommodate a temporary increase in inflation as energy subsidies are withdrawn. At the same time, monetary authorities should stand ready to raise rates to counter possible second-round effects from higher energy prices.

### Table 1. Growth is picking up

Annual growth rates, %, unless specified

	2021	2022	2023	2024	2025
Real GDP	3.3	8.9	3.6	4.9	4.7
Private consumption	1.8	11.3	4.7	6.1	5.2
Public consumption	5.8	5.1	3.3	3.3	3.8
Investment	-0.7	6.8	5.5	10.0	5.4
Exports	18.5	14.5	-8.1	8.7	5.5
Imports	21.2	16.0	-7.4	9.1	5.5
Unemployment rate (% of labour force)	4.6	3.8	3.4	3.2	3.1
Inflation (CPI)	2.5	3.4	2.5	2.8	2.7
Government budget balance (% of GDP)	-6.4	-5.6	-5.0	-4.6	-4.6
Government debt (% of GDP)	69.3	60.3	64.3	66.2	66.6

Note: Government figures refer to the federal government.

Source: OECD Economic Outlook 115 database and OECD projections.

## Fiscal policy will need to consolidate

The new fiscal framework provides a good basis for the needed fiscal consolidation, but rising spending needs require mobilising additional tax revenues.

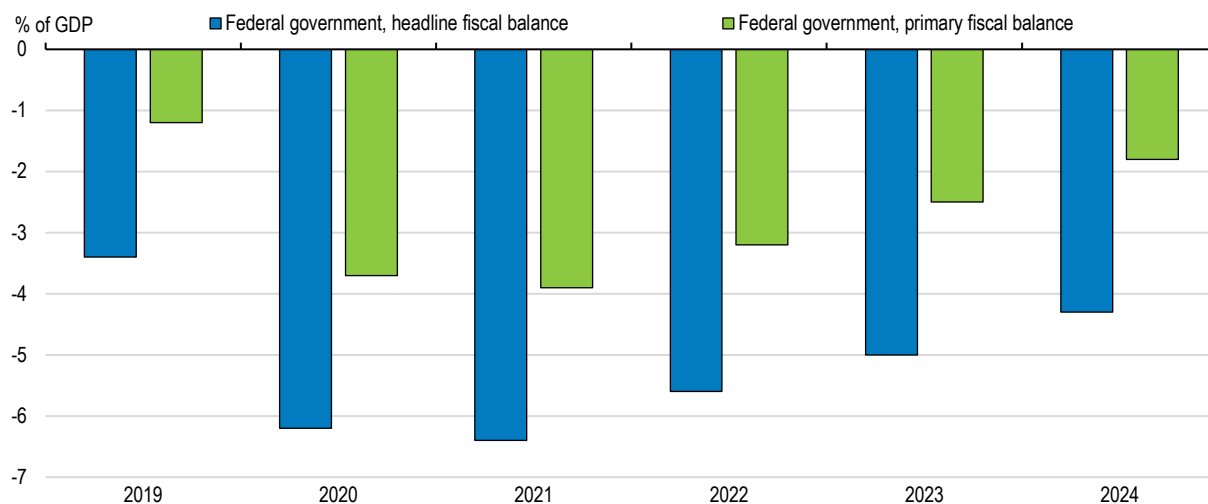
**Fiscal policy started to consolidate as growth recovered from the pandemic shock** (Figure 2). However, one obstacle to more decisive progress has been a threefold rise in subsidies to 3.5% of GDP in 2023. While government spending has risen, tax revenues remain low at around 12% of

GDP. Spending needs could be most efficiently financed by raising additional revenues through a well-designed value added tax, a broader personal income tax base and improvements in tax administration.

The 2023 fiscal framework is a major step towards stronger fiscal accounts, maintaining a prudent debt level and more effective fiscal risk management. The underlying institutional

framework, however, could be made stronger by expanding the fiscal framework to cover the consolidated public sector and contingent liabilities.

Figure 2. Fiscal consolidation is underway



Source: Ministry of Finance.

StatLink  <https://stat.link/dlr0ni>

## Towards more inclusive growth

Improving the targeting of social protection while raising social assistance coverage and benefit levels would allow stronger reductions of poverty and inequality. Better access to childcare and a better alignment of tertiary education curriculums with labour market needs would allow more workers, including women, to participate in the labour market and find jobs that match their skills.

**Strong growth has propelled impressive social progress over recent decades.** But public policies could do more to provide better opportunities for all. The impact of taxes, transfers and subsidies on inequality is less than in peer economies (Figure 3). Benefit levels are often too low to make a real difference for the livelihoods of vulnerable households.

**Social assistance is fragmented and poorly targeted.** Different programmes are managed by multiple agencies at different levels of government, leading to benefit duplication. Subsidies are particularly ineffective as a social policy tool, as more affluent households receive a larger share of the subsidies than those at the bottom of the income distribution. Shifting social spending from subsidies to well-targeted and unified social assistance benefits would support improvements in social inclusion.

**Pension coverage is narrow and inadequate.** More than 60% of the population are not covered by any pension scheme, and those who are often fail to receive a decent pension. Rapid population ageing will reinforce the need for stronger and more sustainable pensions. Non-contributory social assistance pensions could help fill current coverage gaps in the future, but they currently have low coverage and low benefit levels.

**Labour market reforms could improve job quality and strengthen productivity.** Many people, particularly recent tertiary graduates, work in occupations that do not match their skills. Better alignment of tertiary education with labour market needs, a reorganisation of vocational education and training and more investment into adult education could help to reduce skills mismatches. Strengthening collective wage bargaining institutions may help to give workers and

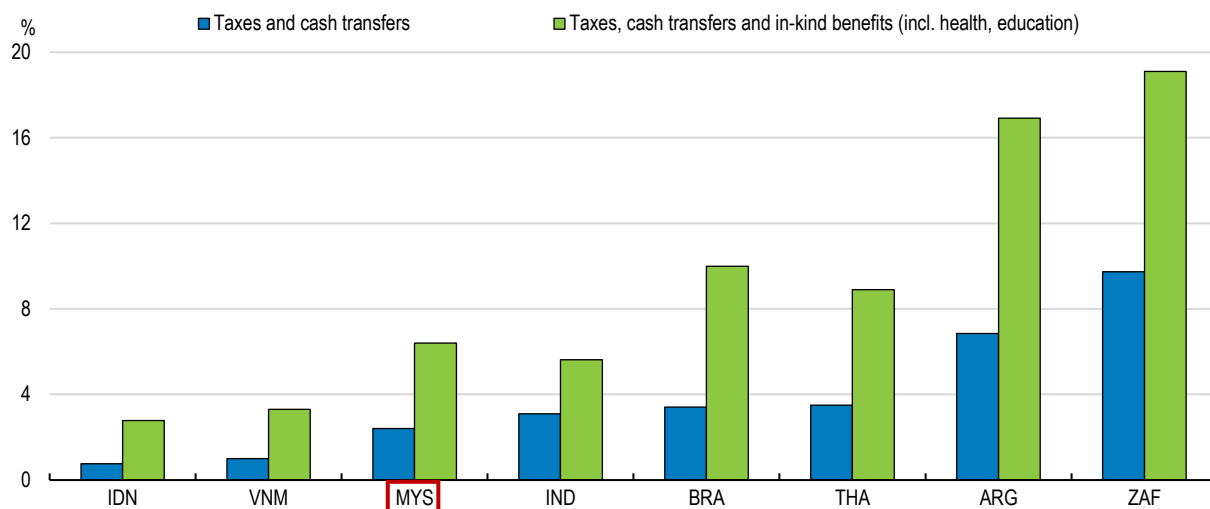
employers a more equal voice in negotiations and accelerate slow wage growth.

**Informality affects more than one in four workers in Malaysia, particularly older and less educated ones.** Stronger enforcement could be coupled with improved incentives, such as less rigid labour market regulations and exempting low-wage workers from mandatory contributions to contributory old-age pensions.

**The gender employment gap is high.** Improving access to affordable childcare facilities would allow more women to work. Women outperform men in tertiary enrolment, but remain underrepresented in management positions, despite some encouraging recent trends among listed companies.

### Figure 3. Inequality reductions are small

Impact of public policies on income inequality



Source: World Bank (2023); Commitment to Equity Institute (2023).

StatLink  <https://stat.link/b7641s>

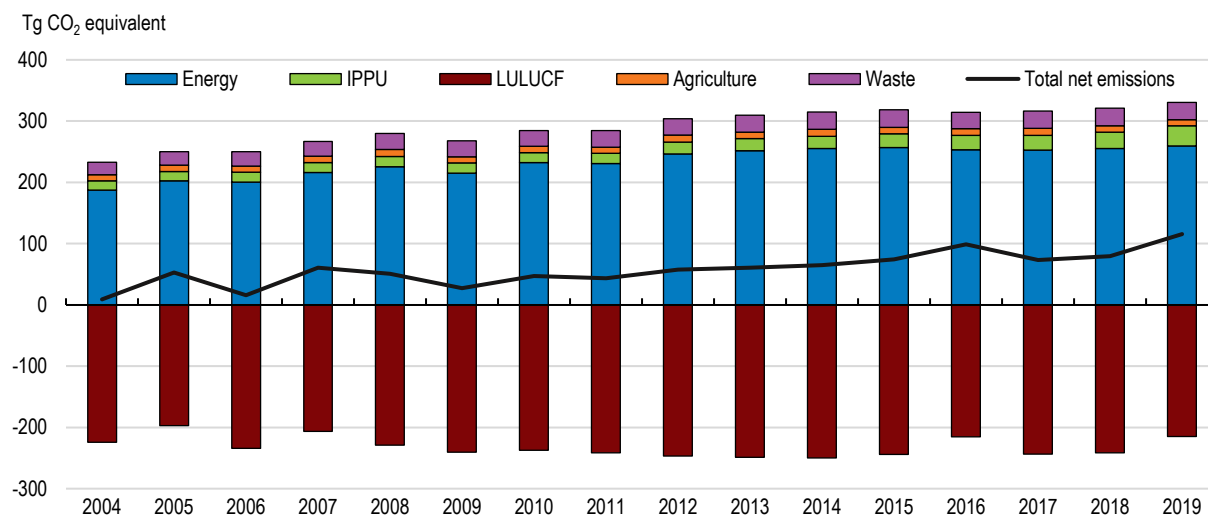
### Addressing climate change

Addressing climate change requires phasing out fossil fuel subsidies and a stronger role for carbon pricing, complemented by stricter regulations. Better disaster risk financing and insurance could bolster adaptation efforts.

**Mitigation efforts should rely on both carbon pricing and regulation.** Malaysia currently has no mandatory carbon pricing measures or fuel tax. Instead, subsidies have encouraged energy consumption and promoted rising emissions (Figure 4). A gradual introduction of carbon pricing through taxes or emission trading systems could be complemented by more stringent regulations, while targeted transfers could cushion their social impact and facilitate political support.

**The energy sector remains the largest source of emissions.** Electrification and renewable energy sources will need to be expanded.

**Malaysia faces significant climate risks including floods, heat waves and storms.** Developing a strategy for disaster risk financing and insurance could strengthen resilience.

**Figure 4. Greenhouse gas emissions are increasing**

Note: IPPU: Industrial Processes and Product Use; LULUCF: Land Use, Land Use Change and Forestry.

Source: Ministry of Natural Resources, Environment And Climate Change, Malaysia (2022), FOURTH BIENNIAL UPDATE REPORT

StatLink  <https://stat.link/6rgd59>

## Making micro, small and medium enterprises an engine of growth

Average productivity in micro, small and medium enterprises is low. Changes in regulations, finance and digitalisation can help, while current policy support for MSMEs is fragmented and often narrowly focused.

**Malaysia has hundreds of programmes to support MSMEs, many of which are targeted based on sectors, location or ownership.** Scaling up MSMEs is a key to increase their productivity, but it is difficult to determine which firms will be able to achieve high-growth episodes. Risks associated with policy mistakes would be minimised by shifting the focus towards creating framework conditions that enable a wide range of firms to achieve stronger growth.

**The ability to harness digitalisation is a distinctive feature of firms that scale up.** For MSMEs, digitalisation is a game-changer, allowing them to compete on a more even footing with larger firms. Stronger competition in telecommunications could improve the limited take-up of digital solutions among MSMEs.

**MSMEs lag behind with respect to innovation and technology.** Only 6% of small firms and 20% of medium-sized firms invest in R&D. Better access to government research institutes and tax incentives could promote R&D among MSMEs.

**Successful export activities are often a good predictor of MSMEs' ability to scale up.** Relative

to regional peers, fewer of Malaysia's small firms manage to export (Figure 5). The potential benefits of recent trade agreements for MSME exports could be maximised by reducing remaining trade restrictions in telecommunications, computer and digital services to improve access to competitively priced services inputs.

**Obtaining financing is usually more complicated for MSMEs than for larger firms,** reflecting limited collateral and credit histories. Malaysia uses direct lending and credit guarantees to alleviate financing constraints for MSMEs. Despite their merits, these may create incentives for over-reliance on public financing options and may delay the exit or restructuring of nonviable MSMEs, thus limiting the scope for the entry of new firms and the expansion of innovative firms. Fostering venture capital and equity crowdfunding would help MSMEs grow.

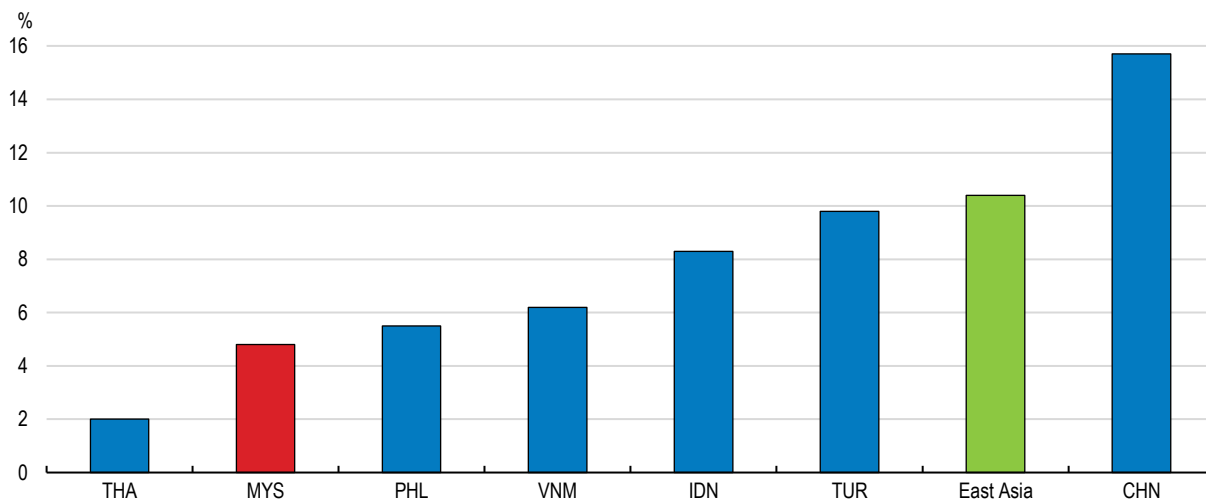
**Burdensome regulations can limit MSMEs' ability to scale up and challenge larger incumbents.** Compliance costs with licenses and permits, estimated at 2.3% of GDP, fall disproportionately on smaller firms and can be an obstacle to formalisation. Malaysia's product

market regulations are more restrictive than in peers, limiting competition and entry. Further regulatory reforms to ease these barriers would strengthen competition, especially in services such as retail trade.


**A large state-owned enterprise (SOE) sector remains an obstacle to competition, particularly**

**for MSMEs.** Preferential treatment and subsidies can crowd out private investment, especially in industries where SOEs are dominant. Fear of state expropriation may prevent some firms from scaling up. Levelling the playing field between SOEs and private firms would support growth prospects for MSMEs.

**Figure 5. Few small firms are exporters**



Source: World Bank (2022c).

StatLink  <https://stat.link/jbezi3>

## Main findings and key recommendations

Main findings	Key recommendations
<b>Macroeconomic developments and policy challenges</b>	
Headline and core consumer price inflation have fallen below 2%, the average during the past decade.	Maintain the current monetary policy stance in the short term and adjust rates as appropriate.
The 2023 Public Finance and Fiscal Responsibility Act mandates a decline in the headline deficit from 5% of GDP in 2023 to 3% by 2028.	Accelerate the pace of fiscal consolidation to reduce Malaysia's vulnerability to economic shocks and spending pressures.
While the central government deficit fell in 2023, the deficit of the consolidated public sector deficit, which includes general government and non-financial public corporations, rose.	Expand the fiscal framework to cover the consolidated public sector and contingent liabilities.
Tax revenue amounts to only 12% of GDP. The Goods and Services Tax (GST), a value-added tax, was launched in 2015 but abolished in 2018.	Re-introduce the Goods and Services Tax at a low rate while compensating low-income households with targeted transfers.
Only 15% of the labour force pay personal income taxes. Relative to regional peers, the top marginal rate is lower and starts at higher income percentiles and the number of tax brackets is high.	Broaden the tax base of personal income taxes, reduce thresholds from which higher tax rates are applied.
A strong tax administration will be key for raising additional tax revenues.	Further improve tax administration and enforcement.
<b>Strengthening governance and fighting corruption</b>	
Political appointments in state-owned enterprises reduce the quality of management and raise integrity concerns.	Require a systematic disclosure of assets for high-level members of the executive and for legislators.
Protecting whistle-blowers often plays a key role for the disclosure of high-profile corruption cases.	Ensure that appointments in state-owned enterprises are based on merit by establishing minimum qualification requirements and mandatory cooling-off periods for former officials.
<b>Towards more inclusive growth</b>	
Social spending is small, fragmented and lacks targeting, while blanket subsidies are inefficient for reducing inequalities. As a result, social policies have only small effects on inequalities.	Unify fragmented social protection programmes and improve their targeting, while phasing out subsidies. Raise social spending once additional revenues have been mobilised.
A large share of the workforce is in informal employment and does not have access to social insurance benefits including old-age pensions.	Exempt low-wage workers from mandatory contributions to the contributory pension scheme EPF after expanding non-contributory old-age pensions to prevent old-age poverty.
High costs and the limited availability of childcare services are important obstacles to a further increase of female labour force participation.	Improve access to affordable childcare by expanding public childcare facilities, strengthening public support for childcare costs and expanding incentive schemes for employer-provided childcare facilities.
<b>Addressing climate challenges</b>	
Malaysia lacks a long-term strategy on how to attain mitigation targets.	Develop a long-term low emissions development strategy.
Carbon pricing can reduce greenhouse gas emissions efficiently but may reduce the real purchasing power of low-income households.	Phase out fuel subsidies and introduce carbon pricing through a carbon tax or emission trading scheme, protecting vulnerable households with targeted transfers.
Greenhouse gas emissions from energy are partly the result of a strong reliance on fossil-fuel energy.	Further encourage the expansion of renewable energy sources. Streamline licensing procedures and expand the use of auctions.
Climate risks require enhancing financial resilience and risk sharing among stakeholders, including through insurance mechanisms.	Develop a disaster risk financing and insurance strategy and create stable framework conditions for flood insurance.
<b>Making micro, small and medium enterprises an engine of growth</b>	
Around 80 central government ministries and agencies administer around 275 MSME programmes, leading to considerable overlap.	Streamline and consolidate MSME programmes to reduce duplication, increase efficiency and reduce confusion among the beneficiaries.
Growth-friendly framework conditions can help MSMEs to scale up.	Create firm-neutral, growth-episode friendly framework conditions that enable the creation and expansion of MSMEs.
MSMEs operating in rural areas and in East Malaysia face inadequate digital infrastructure and connectivity.	Increase access to digital services for vulnerable and rural populations to narrow the digital divide.
Young start-ups rely mostly on internal funding sources, given the difficulty of obtaining bank loans or equity investments. Venture capital (VC) markets are small, and the public sector provides most VC funding.	Boost investment in MSMEs through equity crowdfunding and peer-to-peer financing, and crowd-in more private venture capital funds by improving tax incentives and the legal and regulatory framework.
Young start-ups rely primarily on internal funding sources, given the difficulty of obtaining bank loans and or equity investments.	Boost investment in MSMEs through new channels, such as equity crowdfunding and peer-to-peer financing.
Labour productivity in the retail, food and beverage sectors is low. Retail sector entry regulation is stringent and subject to many permits.	Reduce the regulatory requirements on retail stores, including the price ceilings set on essential goods.
Eight of the 10 listed companies with the highest market value are SOEs. Together, SOEs comprise 42% of stock market capitalisation and have 68 000 subsidiaries.	Re-evaluate the costs and benefits of SOEs in sectors where the private sector is operating efficiently and create a more level playing field for MSMEs by improving SOE governance.

# 1 Macroeconomic developments and policy challenges

Randall Jones

Ken Nibayashi

---

Growth is projected to strengthen during 2024 and 2025, primarily driven by domestic demand although exports are also projected to pick up. Inflation has come down, but in light of a necessary withdrawal of energy subsidies, it is expected to rise again, subject to considerable uncertainty. Monetary policy should remain vigilant to the potential inflation pressures resulting from these policy changes. Fiscal policy will need to continue the ongoing budget consolidation, supported by an improved fiscal framework. The new budget targets can be achieved by a combination of reducing some spending items such as subsidies and making spending more efficient, but also by mobilising additional sources of revenue. Upcoming spending pressures related to population ageing will only exacerbate this need to raise additional revenues. Economic governance has improved, but space for further improvement remains in the area of tax administration, the governance of state-owned enterprises, whistleblower protection and systematic asset disclosures by high-level officials and parliamentarians.

---

## The economy has weathered recent shocks fairly well

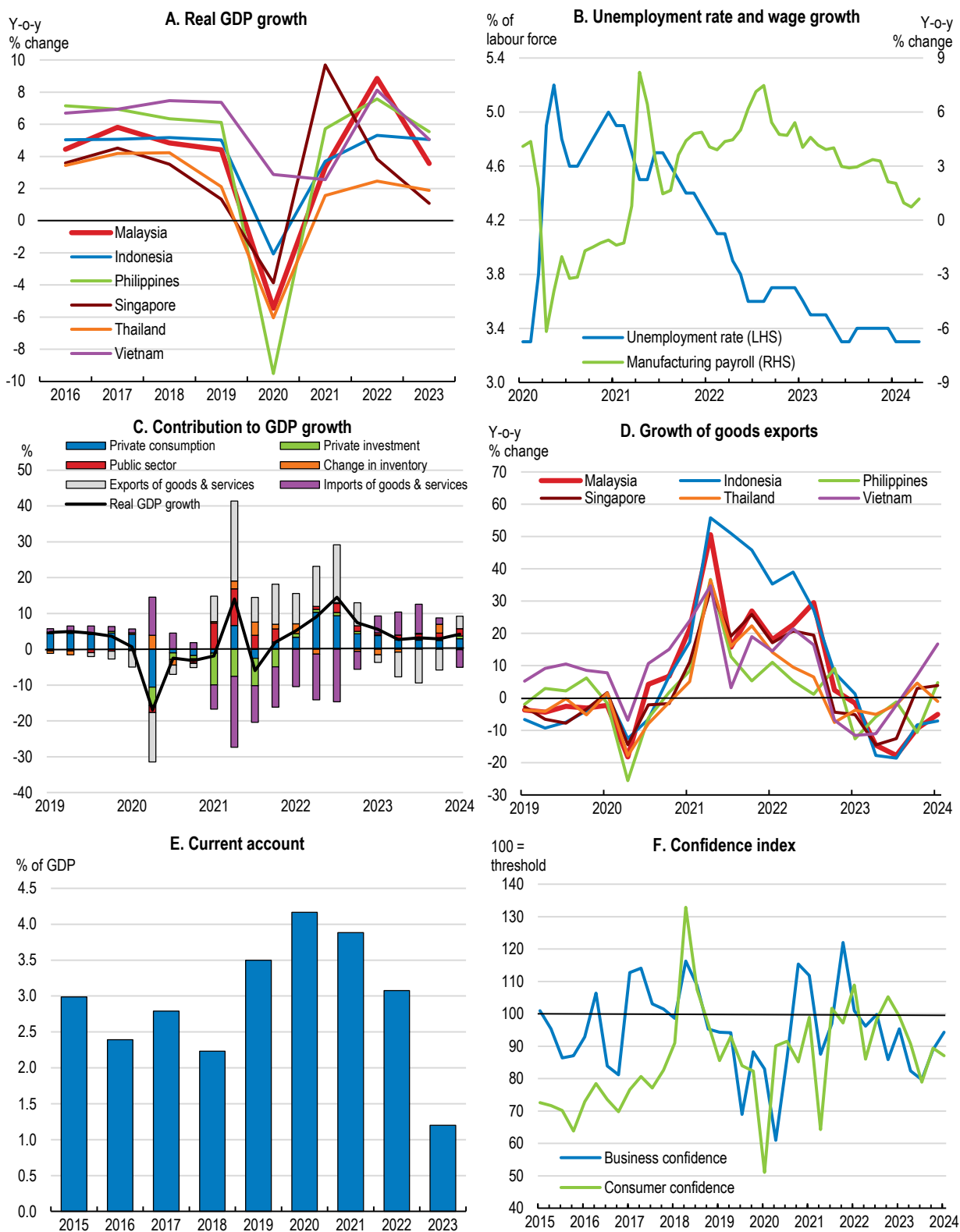
### *Amid weaker global trade in 2023, growth has lost momentum*

Malaysia's economy has weathered recent shocks relatively well, including the pandemic, supply chain bottlenecks and the economic implications of the Russian invasion of Ukraine. After plummeting by 5.5% in 2020, growth turned positive at 3.3% in 2021, followed by 8.9% in 2022. A robust fiscal response supported the strong rebound from the pandemic downturn. The government launched five stimulus packages in 2020, amounting to 3.9% of GDP, and four packages in 2021 provided another 1.8% of GDP of support (OECD, 2021<sup>[1]</sup>).

Growth moderated to a more sustainable 3.6% in 2023 (Figure 1.1, Panel A), driven by domestic demand in the face of a significant drop in exports in 2023. Improving labour market conditions supported private consumption during the year's first three quarters. Indeed, the unemployment rate fell from a peak of 5.1% during the pandemic to 3.4% in 2023, matching its pre-pandemic level (Figure 1.1, Panel B). Gross fixed investment increased 5.5%, led by a pick-up in the public sector.

Malaysia is exposed to external shocks, given that it is a highly open economy with exports amounting to around three-quarters of GDP (Figure 1.2), though this is lower than the 120% in 2000. Exports of goods and services surged at double-digit rates in 2021 and 2022 amid strong world trade growth before declining by 8.1% in 2023 as global trade growth stalled. This pattern was in line with the experience of several peers in the region (Figure 1.1, Panel D). In 2023, exports of goods in value terms fell by 8.0% (in Malaysian ringgits), mainly reflecting lower external demand for key products and global declines in oil and food prices. Indeed, palm oil and LNG exports dropped by double-digit rates, while electrical and electronic products decreased by around 3%. Exports to China fell by 8.7%, whereas shipments to the United States declined by only 3.6%, reflecting their larger share of final goods rather than parts. In stark contrast to goods, service exports rebounded in 2023, reflecting a revival of tourism. Although imports also declined, net exports made a significantly negative contribution (0.6 percentage points) to GDP growth and the current account surplus narrowed from 3.2% of GDP in 2022 to 1.5% in 2023 (Figure 1.1, Panel E).

Figure 1.1. Recent macroeconomic developments

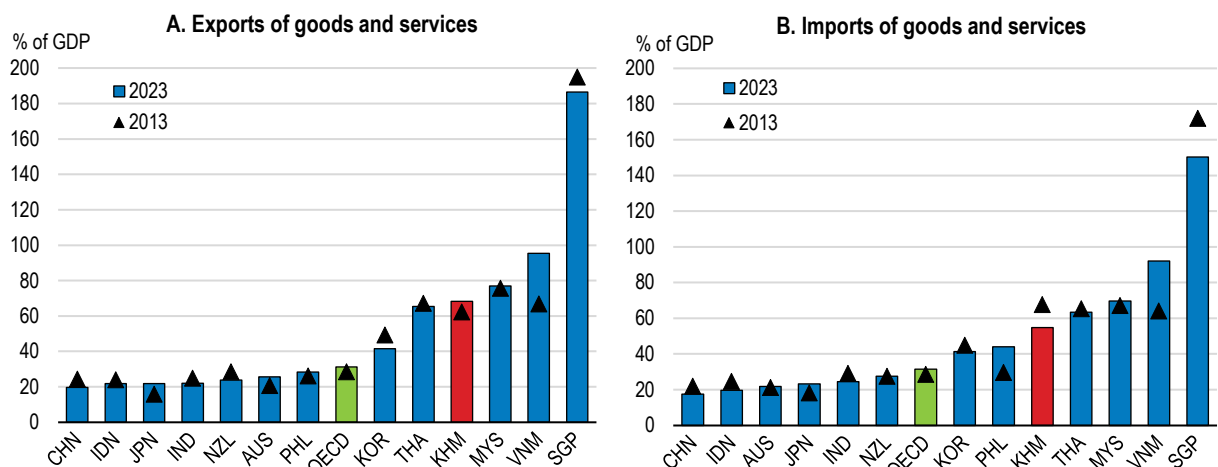


Note: In panel C, the public sector consists of government consumption and public investment.

Source: CEIC; DOSM; and Bank Negara Malaysia.

StatLink  <https://stat.link/k05i8e>

**Figure 1.2. Malaysia is deeply integrated into the international trading system**



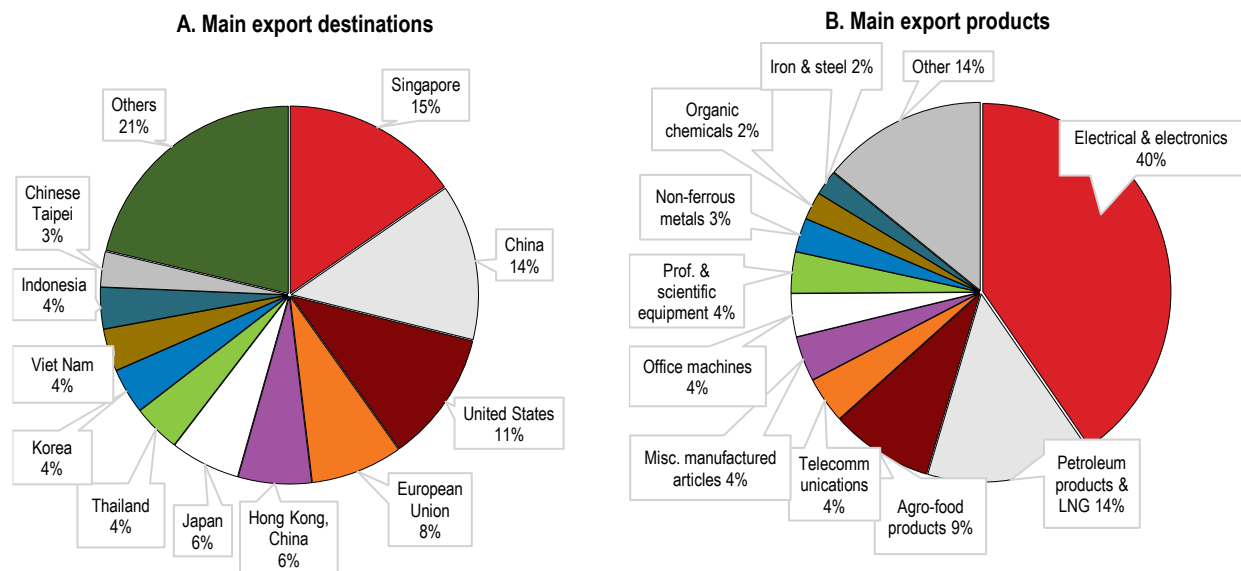
Source: OECD, *Economic Outlook database*; World Bank, *World Development Indicators database*; CEIC.

StatLink <https://stat.link/6f1i4j>

Other Asian economies (Singapore, China, Hong Kong, China, Japan, Thailand, Korea, Viet Nam, Indonesia and Taipei, China) accounted for 59.4% of Malaysia’s exports in 2023 (Figure 1.3, Panel A). The United States and the European Union accounted for another one-fifth. By product category, electrical and electronic products had the largest share at 40.4%, followed by petroleum products and LNG at (14.2%) (Figure 1.3, Panel B). Exports of agro-food products, such as palm oil and energy, account for about a quarter of Malaysia’s exports.

**Figure 1.3. Exports of goods by destination and products**

Share of total exports, 2023



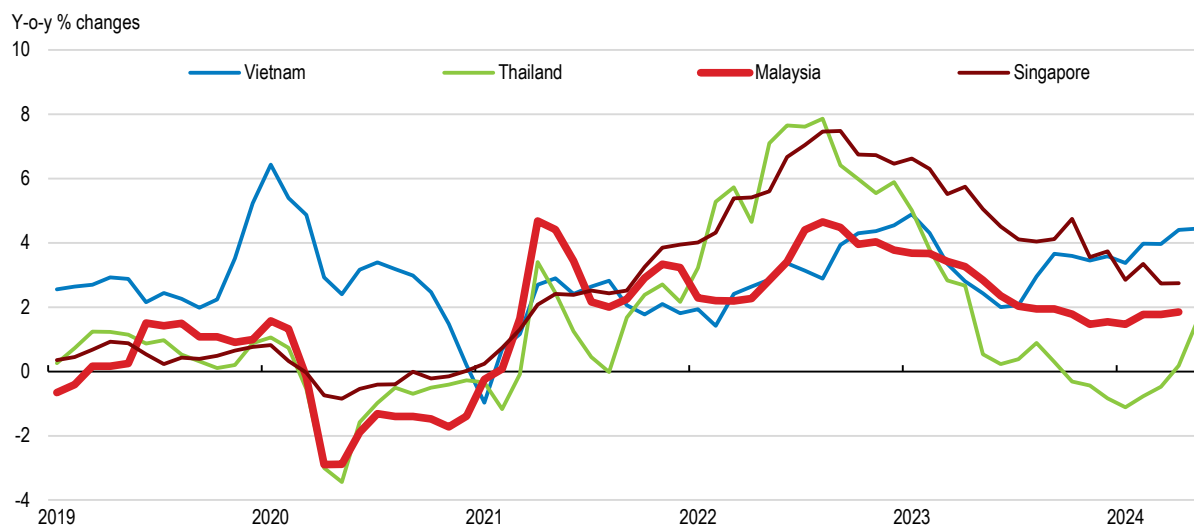
Source: Department of Statistics Malaysia; and OECD calculations.

StatLink <https://stat.link/a643hz>

### Inflation has slowed

Inflation took off in early 2021, driven by global supply chain bottlenecks, soaring global energy and commodity prices, and the depreciation of Malaysia’s currency. Headline inflation peaked at 4.7% in April 2021, driven by rising transport costs, and again in August 2022, led by food and beverage prices. However, inflation remained below that in regional peers, such as Thailand (7.9%) and Singapore (7.5%) (Figure 1.4), reflecting Malaysia’s subsidies to reduce consumer prices. In particular, fuel subsidies contained the pass-through of surging global energy prices. In addition, price controls limit hikes in fuels and staple foods. By some estimates, Malaysia’s headline inflation in 2022 would have been almost 5 percentage points higher without fuel subsidies (8.1% instead of 3.3%) (AMRO, 2023<sup>[2]</sup>). However, this has come at a significant fiscal cost and has created distortions, defying efforts to reduce carbon emissions. With falling inflationary pressures from the food and beverage sector and transport (Figure 1.5), headline inflation fell to 2.5% in 2023, while core inflation (excluding fresh food, energy and administered prices) fell to 3.0%.

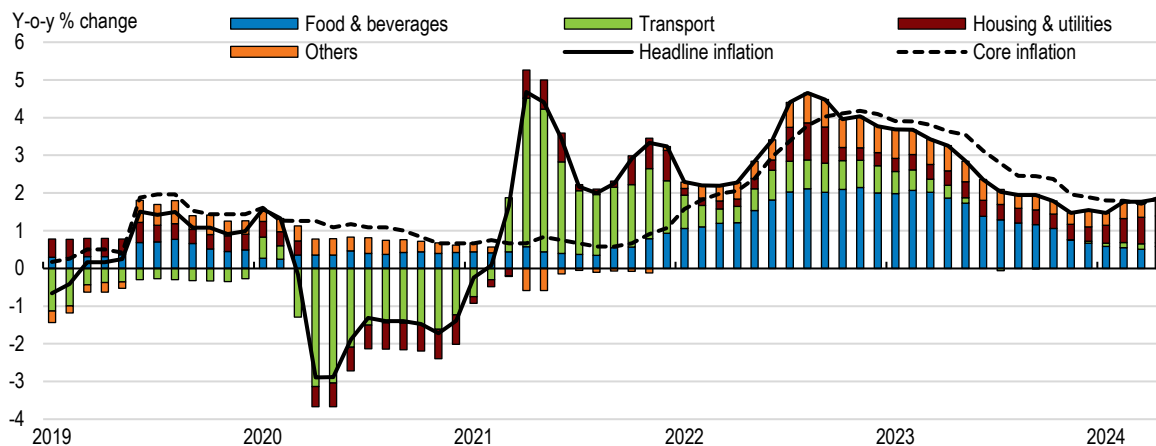
**Figure 1.4. Inflation was moderate compared with regional peers and is declining**



Source: CEIC.

StatLink <https://stat.link/86zm05>

**Figure 1.5. The food and beverage and transport sectors have driven inflation**



Source: CEIC; and OECD calculations.

StatLink <https://stat.link/deyj4s>

## Growth is projected to gain momentum, but downside risks remain

Output increased steadily in the first two quarters of 2024, with year-on-year growth accelerating to 5.9% in the second quarter, thanks to double-digit growth in gross fixed investment and steady increases in private consumption and exports of goods and services. Output is projected to increase by 4.9% in 2024 (Table 1.1). Domestic demand will be the primary driver of growth, although the fiscal policy stance will be mildly restrictive as the government seeks to achieve its deficit reduction targets. Monetary policy remains neutral (see below). Private consumption is likely to remain robust, with inflation declining to low levels and favourable labour market conditions. The labour force participation rate has risen to an all-time high and wage growth is stable at around 4¼ per cent in the manufacturing sector (Figure 1.1, Panel B), supporting household income growth. The unemployment rate is expected to continue declining to close to 3%.

**Table 1.1. Macroeconomic indicators and projections**

Per cent changes from previous year unless specified

	2021	2022	2023	2024	2025
<b>Output and demand</b>					
Real GDP	3.3	8.9	3.6	4.9	4.7
Consumption	2.5	10.1	4.4	5.6	5.0
Private	1.8	11.3	4.7	6.1	5.2
Public	5.8	5.1	3.3	3.3	3.8
Gross fixed investment	-0.7	6.8	5.5	10.0	5.4
Private	2.8	7.2	4.6	10.1	5.0
Public	-11.0	5.3	8.6	10.0	6.6
Exports of goods and services	18.5	14.5	-8.1	8.7	5.5
Imports of goods and services	21.2	16.0	-7.4	9.1	5.5
Net exports (contribution to GDP growth, % point)	-0.3	-0.1	-0.9	0.2	0.2
<b>Inflation</b>					
Consumer price inflation	2.5	3.4	2.5	2.8	2.7
Core consumer price inflation	0.7	3.0	3.0	2.7	2.7
Unemployment (% of labour force)	4.6	3.8	3.4	3.2	3.1
<b>Public finances (% of GDP)</b>					
Federal government fiscal balance	-6.4	-5.6	-5.0	-4.6	-4.6
Expenditures	21.4	22.0	20.1	18.9	18.6
Revenues	15.1	16.5	15.1	14.2	13.9
Oil-related revenues	2.8	4.6	3.4	2.7	2.4
Federal government debt	69.3	60.3	64.3	66.2	66.6
<b>External sector and memorandum items</b>					
Current account balance (% of GDP)	3.9	3.1	1.5	4.4	5.4
Trade balance (% of GDP)	16.4	14.3	11.7	11.0	10.8

Source: OECD Economic Outlook 115 database and OECD projections.

Announced government policies aim to raise wages on the lower end of the distribution, with a stated policy objective of boosting the median wage by 3.8% between 2023 and 2025 through financial incentives for employers to pay higher wages. Such direct interventions in wage-setting may not be the most effective way to improve wages and could affect future export competitiveness if the resulting wage increases are not in line with productivity growth.

Gross fixed investment growth is projected to be robust in 2024. New opportunities in technology-intensive sectors and the expected rebound in exports will encourage private investment despite the impact of higher interest rates on financing costs. Infrastructure projects and investment by public corporations will support public investment.

Recent changes in the configuration of global value chains in the context of trade and geopolitical tensions may turn out beneficial for inward investment flows and exports. As multinational companies are seeking to create more resilient value chains and diversify the location of their production, Malaysia is emerging as one of the destinations for such relocations. This is particularly the case in the electronics and semiconductor industries, where Malaysia's 50-year experience is helping to attract further foreign direct investment inflows and expand production capacity and exports. This process that is likely to continue.

Stronger external demand is expected to boost Malaysia's export growth to between 8.7% in 2024 and 5.5% in 2025 and a similar rebound is likely for imports, in line with strong domestic demand. The contribution of net exports to GDP will be around zero, while the current account surplus is expected to rise to 4.4% of GDP in 2024 and 5.6% in 2025.

Easing global supply constraints and lower commodity prices will put downward pressure on headline consumer price inflation in 2024-25. By some estimates, oil prices are projected to fall 2.3% in 2024 and non-fuel commodity prices by 0.9% (IMF, 2024<sup>[3]</sup>). Inflation trends in Malaysia also depend on the progress in reducing and retargeting the subsidies intended to mitigate increases in the prices of energy and food items. In 2022, government subsidies nearly tripled to 2.9% of GDP, before reaching 3.5% in 2023. Subsidies are set to be reduced and better targeted in 2024. This will put upward pressure on inflation in the short run but is an important first step towards strengthening the efficiency of public spending and making better use of scarce fiscal resources.

The OECD inflation projection of around 2.75% in 2024 and 2025 in Table 1.1 rests on the assumption that progress in reducing subsidies will put upward pressure on inflation. This also assumes that price ceilings on petrol and diesel are adjusted. Other price ceilings are assumed to remain in place until the end of 2025, limiting inflation while continuing to create distortions and shortages. The yet uncertain pace of the subsidy withdrawal casts considerable uncertainty on inflation for 2024, reflected in the fact that even official projections by the central bank cover a fairly wide range of 1.5 percentage points.

### ***The risks to the outlook appear skewed to the downside***

With a trade-to-GDP ratio of 147% (Figure 1.2), Malaysia is vulnerable to changes in the global economic environment. Geopolitical risks related to ongoing conflicts are a concern, in part because they could add to shipping costs or even spark commodity price shocks. Malaysia would be affected, as commodities still play an important role in its exports (Figure 1.3). This could also lead to spikes in global risk premia, resulting in capital outflows from emerging markets. In addition, the pace of disinflation in major economies remains uncertain. Faster inflation declines would accelerate the anticipated easing of monetary policy, boosting world output growth, while stubborn core inflation could lead to additional monetary tightening. Economic developments in China, Malaysia's second-largest trading partner, are another source of uncertainty. Effective reforms in the Chinese property sector could lead to faster growth, while failure to address these issues could result in a further slowing in China's growth.

A key domestic downside risk relates to the uncertainty around inflation. Persistent inflation above the 2% norm, resulting from weakness in the Malaysian ringgit and subsidy reform, could restrain private consumption, particularly by low-income households, which have been disproportionately affected by recent price increases. In addition, it could prompt additional monetary policy tightening. The slow pace of planned fiscal consolidation to meet the medium-term targets leaves public finances vulnerable to economic shocks and spending pressures. Accelerated digitalisation and productivity gains in micro, small and medium-sized enterprises (MSMEs), which account for nearly half of employment, is an important upside risk (Chapter 4). Besides these risks, there are also low-probability events that could lead to changes in the economic outlook (Table 1.2).

**Table 1.2. Low-probability events that could lead to major changes to the outlook**

External shocks	Potential impacts
Climate-related disasters	Extreme weather events such as floods or abnormally high temperatures due to El Niño could overwhelm the existing coping capacity and bring about wide-ranging dislocation of economic activity, including cuts in electricity supply and shortage of food, as well as higher international commodity prices.
Geopolitical tensions	The escalation of tensions would entail long-lasting supply chain disruptions and deteriorate sentiment of foreign investors.
Pandemic	The emergence of new deadly diseases or fatal variants of COVID-19 would dent the overall economy, especially in the tourism sector, and cause large-scale social distress.

## Monetary policy should maintain its neutral stance

### *Monetary policy has tightened*

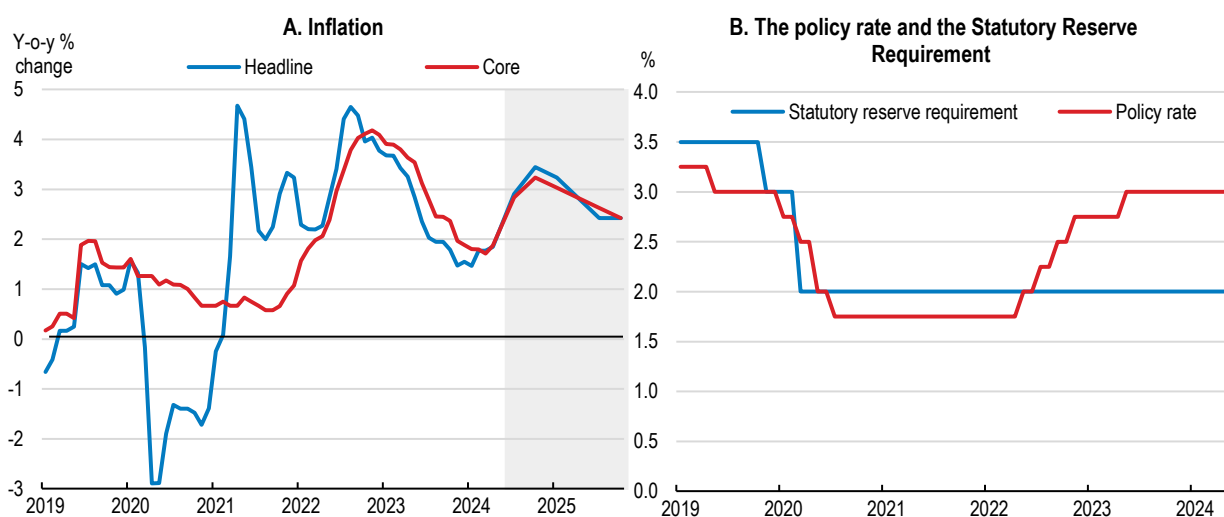
The objective of the Bank Negara Malaysia (BNM) is to maintain price stability “while remaining supportive of growth”. As the central bank, it is also responsible for financial system stability. The BNM, which is legally independent, uses an overnight interest rate as “the sole indicator used to signal the stance of monetary policy”. Unlike many central banks, the BNM does not set a specific inflation target. Inflation has averaged 1.8% over the past ten years, indicating that the BNM has successfully maintained price stability.

When prices and output plunged following the outbreak of the COVID-19 crisis (Figure 1.6, Panel A), the BNM reacted promptly, cutting its policy rate by 125 basis points in 2020 to a historic low of 1.75% (Figure 1.6, Panel B) and providing cashflow relief to individuals and businesses. As the economy rebounded and headline inflation approached 5%, the BNM started a tightening cycle in May 2022 that increased the overnight rate to the broadly neutral pre-pandemic level of 3.0% by May 2023, where it remains. However, the statutory reserve requirement (SRR), which was cut during the pandemic to ease lending conditions, remains well below pre-pandemic levels.


With headline inflation at 1.5% and core at 1.8% in January 2024, the March 2024 Monetary Policy Statement assessed the current policy stance to be consistent with the BNM’s evaluation of inflation and growth prospects (Bank Negara Malaysia, 2024<sup>[4]</sup>). The inflation broadness index, which measures the diffusion of inflation by counting the percentage of items in the CPI index rising more than a certain threshold, has declined continuously during the past year, and inflation expectations remain well anchored. The output gap is positive but less than 1% and the monetary policy stance is broadly neutral based on the real policy rate (IMF, 2024<sup>[3]</sup>).

Although inflation is currently below its long-run average, there are significant risks around its future trajectory that warrants caution. In particular, the inflation effects of the planned subsidy withdrawal are highly uncertain. In the best case, the reform will increase inflation temporarily as energy prices move to a higher level, but there could also be more enduring second-round effects and more widespread upward pressures on inflation. Against this background, it is important to avoid a premature easing of the monetary stance and to respond quickly to any inflationary pressures that could result from the planned reform of subsidies. While temporary inflationary pressures would typically not require a monetary policy reaction, the BNM should be prepared to counter the effects of the subsidy withdrawal and adjust rates as appropriate.

**Figure 1.6. Inflation has declined amid gradual monetary tightening**



Source: CEIC.

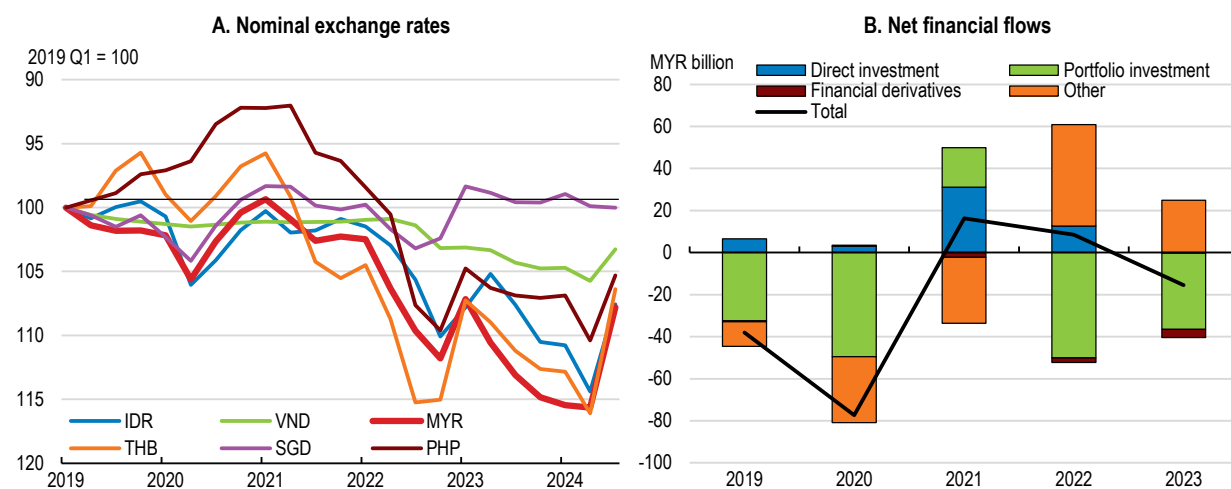
StatLink  <https://stat.link/w23vkj>

Effective communication by the central bank is essential, particularly during this period of high uncertainty. The introduction of the “Monetary Policy Statement (MPS) Snapshot” by the BNM in 2022, constitutes important progress in communication and transparency around monetary policy decisions. Publishing the minutes of monetary policy committee meetings, in line with the current practice of most major central banks, may also be helpful.

### ***Coping with exchange rate fluctuations***

As monetary policy has tightened in major advanced economies since 2022, emerging market economies, including Malaysia, experienced capital outflows and downward pressure on their currencies (Figure 1.7). In addition, the weakness in the renminbi had a negative impact on the ringgit, given that the deepening economic links between China and Malaysia have led to a correlation between their currencies. The Malaysian ringgit depreciated more than any other currency in the region over 2021-23, falling 15% against the US dollar. At the beginning of 2024, the currency fell to its lowest level since 1998 in the context of the Asian Financial Crisis. The government and the central bank viewed the level of ringgit as undervalued, particularly as Malaysia’s economic fundamentals continued to be strong and its economic prospects are positive, while some estimates suggest that the real effective exchange rate was undervalued by 27% to 30% (IMF, 2024<sup>[3]</sup>). The BNM intervened in the foreign exchange market in the past in line with its policy of using intervention to curb excessive short-term exchange rate volatility (Bank Negara Malaysia, 2023<sup>[5]</sup>). Since July 2024, however, the ringgit has recovered all the losses incurred during the previous 12 months (Figure 1.7).

Although inflation is low, renewed depreciation of the ringgit could stoke inflationary pressure, and past inflation could push up prices with a lag. Still, foreign exchange interventions are not a substitute for needed policy adjustments and should not be an instrument to lean against exchange rate pressures that are driven by fundamentals, although they may have a temporary role in addressing disorderly market conditions. Malaysia’s flexible exchange rate regime has been and should continue to be the first line of defence against external shocks.

**Figure 1.7. Many Asian countries have experienced currency depreciation amid capital outflows**

Source: CEIC; and Bank Negara Malaysia.

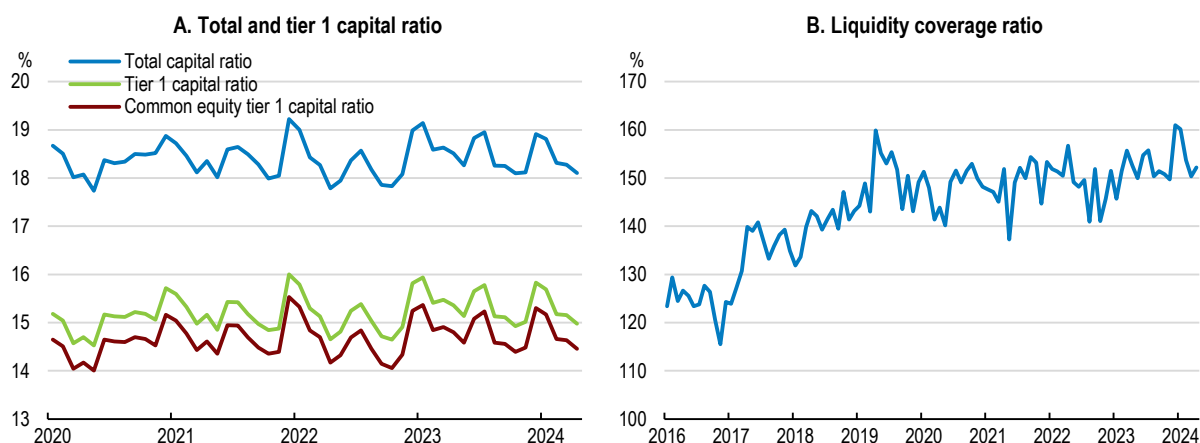
StatLink  <https://stat.link/m5dcqa>

The expected monetary policy easing in the United States and Europe during 2024 should continue to ease downward pressure on the ringgit. The Ministry of Finance plans to encourage more capital flows to Malaysia. One of its strategies is stepping up coordination with state-owned companies (SOEs), including government-linked investment companies (GLICs), to encourage them to repatriate foreign investment income and convert that income into ringgit more consistently to support the ringgit (Bank Negara Malaysia, 2024<sup>[4]</sup>). However, this may run counter to the commercial strategies of SOEs. Over the medium term, structural reforms to increase potential growth and address the fiscal imbalance would provide the most enduring support to the ringgit. In addition, policies to further liberalise and deepen the foreign exchange market, notably by gradually phasing out capital flow management measures, would help limit exchange rate volatility. While average daily turnover in the foreign exchange market increased to USD 15.5 billion in 2023, compared to USD 12.1 billion over the preceding five years, further easing of controls on capital flows would help in this regard.

### Financial-sector risks appear well-contained, though vulnerabilities remain

The banking sector has maintained adequate capital buffers, even during the severe downturn caused by the pandemic in 2020. At the end of January 2024, the Total Capital Ratio (18.6%), the Tier 1 Capital Ratio (15.5%), and the Common Equity Tier 1 Capital (CET1) ratio (15.0%) stood well above Basel III minimum regulatory levels (8.0%, 6.0%, 4.5%, respectively) (Figure 1.8, Panel A). Banks also have strong liquidity positions that create significant buffers against potential liquidity stress. Bank balance sheets contain large amounts of liquid assets that can be easily and immediately converted into cash at little or no loss of value (IMF, 2024<sup>[3]</sup>). The liquidity coverage ratio (LCR), which compares high-quality liquid assets to the expected net cash outflows of the banking system over the next 30 calendar days, has been stable at around 150% (Panel B), although banks' liquid reserves in 2022 were only 8.9% of their assets, compared to Thailand (17.4%), the United States (19.0%), East Asia and Pacific countries (20.7%) and Indonesia (26.3%) (World Bank, 2024<sup>[6]</sup>).

**Figure 1.8. The banking sector's capital and liquidity buffers appear adequate**



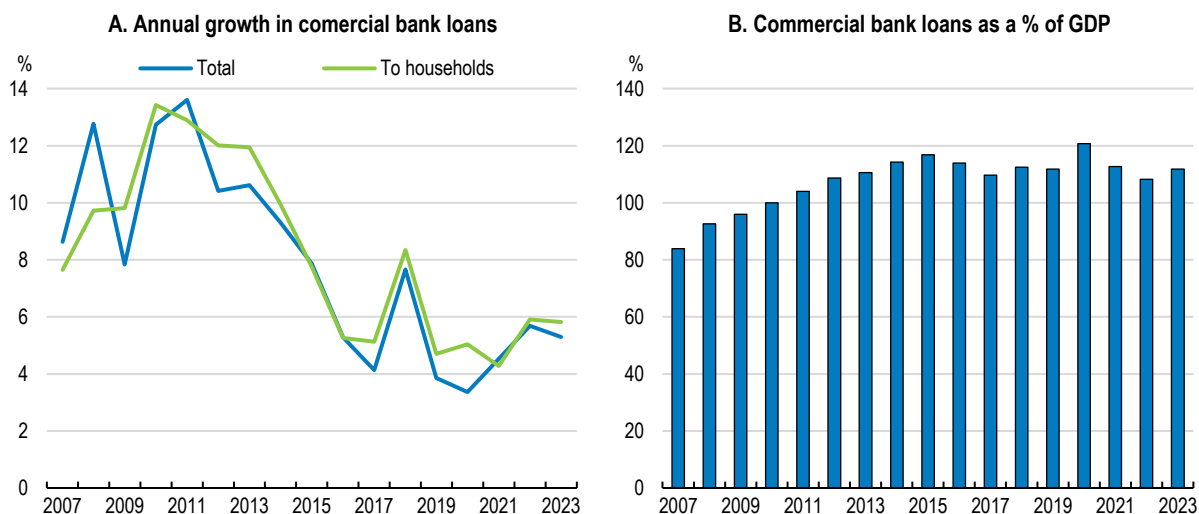
Note : Panel A – capital levels are shown as a percentage of risk-weighted assets. The minimum requirements under Basel III are 8.0% for total capital, 6.0% for tier 1 capital and 4.5% for common equity, Panel B – the liquidity coverage shows high-quality liquid assets as a percentage of expected total net cash outflows over the next 30 calendar days.

Source: Bank Negara Malaysia.


StatLink  <https://stat.link/dbpo8w>

The robustness of the financial system is also confirmed by the stress tests conducted by the central bank, which covered a three-year horizon up to the end of 2025 (Bank Negara Malaysia, 2023<sup>[7]</sup>). One scenario of these stress tests assumes a temporary but severe disruption in the operating environment, including a sharp contraction in the Malaysian economy, significant job losses, and tighter credit conditions. The second assumes a less severe but more prolonged economic contraction. The stress test affirmed that banks could withstand significant macroeconomic and financial shocks and sustain lending to businesses and households. Over 80% of banks in Malaysia would be able to maintain capital ratios above their internal targets. However, 24 out of 54 banks (with a cumulative share of 25% of total banking system assets) would report losses in at least one year during the stress test horizon.

The growth in commercial bank loans to the private, non-financial sector has decelerated during the past decade (Figure 1.9, Panel A). In particular, it failed to keep pace with nominal GDP over 2020-22 before rebounding in 2023 as growth slowed (Figure 1.9, Panel B). Loans to households from the banking sector fell from 76.8% of GDP in March 2021 to 69.5% at the end of 2023 and have mainly financed purchases of residential properties and vehicles, in addition to credit card spending.

**Figure 1.9. The growth of bank loans and their share of GDP have edged down**

Source: CEIC; and OECD calculations.

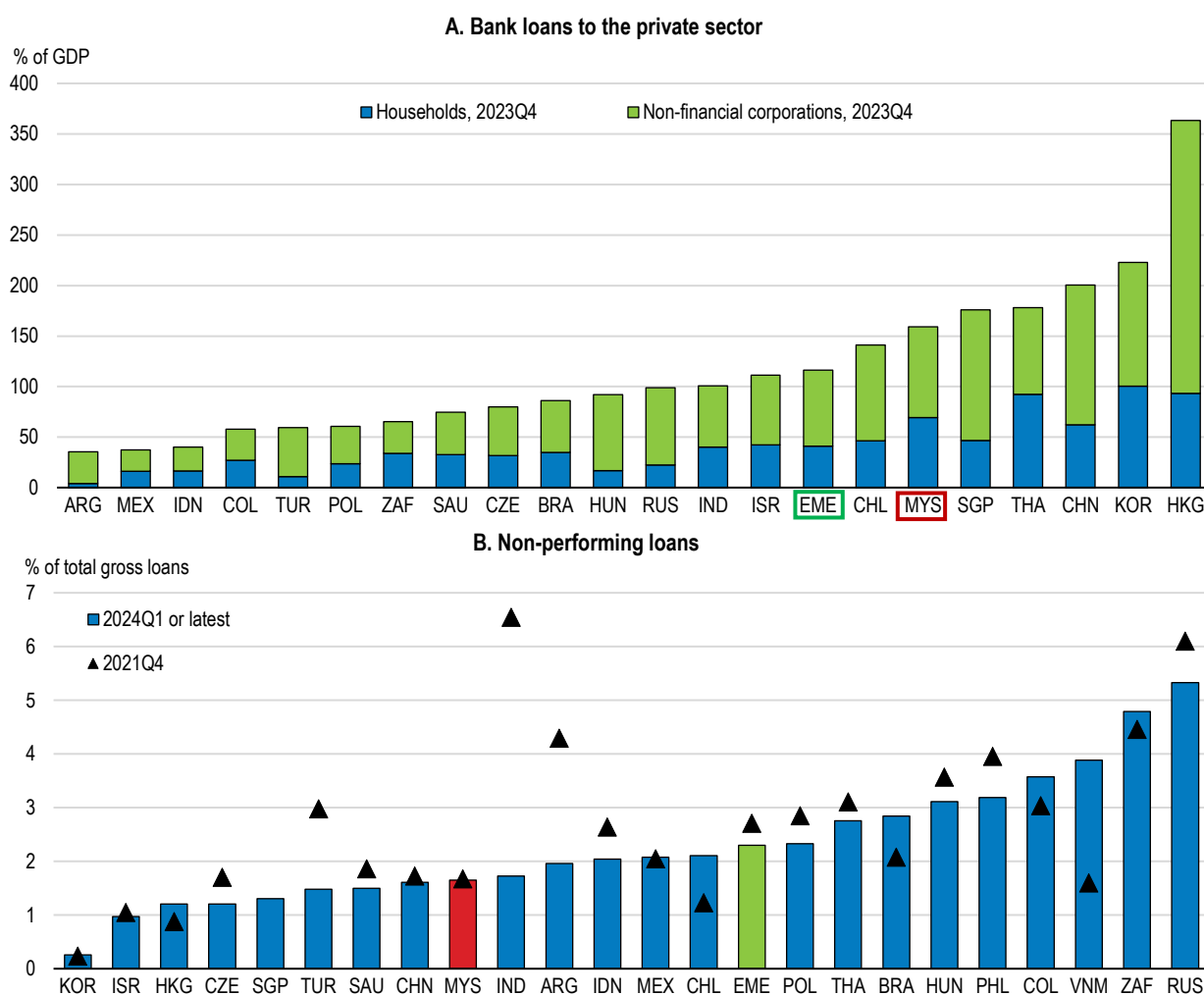
StatLink  <https://stat.link/wqv0rg>

Malaysia's banking sector is relatively deep compared to many other emerging markets, including Indonesia, although less so than Thailand and China (Figure 1.10, Panel A). The size of capital market is double Malaysia's GDP. Non-performing loans, which reached 9.4% of total loans in 2005, have remained below 2.0% since late 2013, including during the pandemic and post-pandemic periods. In the third quarter of 2023, non-performing loans were 1.7% of total loans, only 0.1 percentage point higher than the pre-pandemic period of 2015-2019. Malaysia's non-performing loan ratio has remained lower than in its regional peers (Figure 1.10, Panel B).

Nonetheless, part of the household loan portfolio will require particular vigilance by financial supervisors. At the end of 2023, a quarter of household borrowers had a debt-service ratio (DSR) above 60%. More than two-thirds of high-DSR debt is held by middle and high-income borrowers, who typically have larger financial buffers to sustain loan repayments in the event of financial shocks, according to Central Bank data. Consequently, even though interest rates have risen since 2022 and 78.3% of outstanding of household debt was at floating rates at the end of 2023, the impairment ratio among high-DSR borrowers has remained low and stable at 1.2%. Against this background, a wider use of macroprudential tools, such as loan-to-value regulations, may help to fine-tune risks affecting household loan portfolios of the banking sector. House prices have been broadly stable since early 2023.


Parallel to the conventional financial system, Malaysia has developed a competitive, liberal and globally recognised Islamic finance ecosystem that operates alongside the conventional financial system, and Islamic banking assets currently amount to around one third of total banking assets. From a global perspective, Malaysia hosts approximately one sixth of global Islamic finance activities and accounted for 40% of the total Islamic bonds (sukuk) outstanding globally, as the country has become a global multi-currency sukuk hub (Fitch Ratings, 2023<sup>[8]</sup>). Islamic finance operates according to the principles of Islamic law, which prohibits usury and promotes risk-sharing and participatory asset-backed financing. Malaysia has extensive experience in financing major infrastructure projects through sukuk, which can lower the cost of financing compared to conventional lending, as the structure of sukuk products is well suited to long-term investments. The emphasis on risk-sharing of Islamic finance reduces the overall debt exposure of the financial system and provides a potentially valuable example for other economies. Innovative sukuk structures have also been introduced, to finance sustainable and responsible investments, for example into green technology.

**Figure 1.10. Bank loans to the private sector are relatively high while non-performing loans are low**



Note: EME in Panel A is comprised of Argentina, Brazil, Chile, China, Colombia, Czechia, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey. EME in Panel B adds the Philippines and Viet Nam. Household debt and non-financial corporation debt are those from banking institutions.

Source: BIS; and IMF.

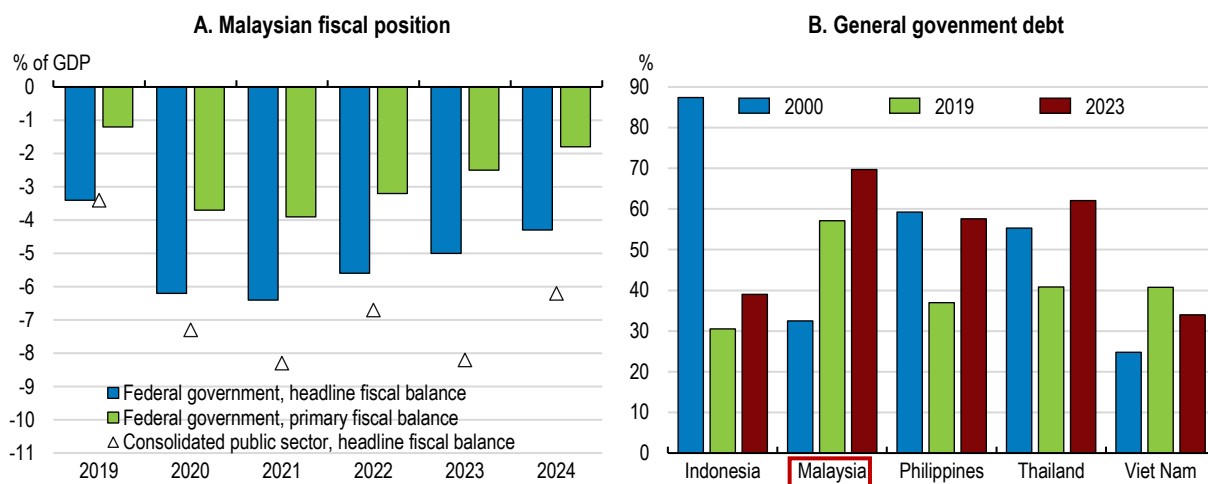
StatLink  <https://stat.link/urng62>

## Fiscal consolidation should be pursued as planned

### *Deficits and debt have risen above the pre-pandemic period*


As in many countries, Malaysia's fiscal deficit increased significantly in 2020 and 2021 as the government took measures to limit the economic fallout from the pandemic in many sectors. The federal government balance, including the COVID-19 fund, deteriorated by 3.0 percentage points of GDP between 2019 and 2021, reaching 6.2% of GDP (Figure 1.11, Panel A). The fiscal deficit narrowed somewhat in 2022, reflecting robust growth of 8.7% and the decline in social expenditures, especially in the health sector, as a share of GDP. Progress continued in 2023 when after two years of fiscal consolidation, the federal government deficit was 5.0% of GDP. The primary deficit, which does not contain interest payments, fell to 2.5% of GDP in 2023, but this is still more than double the pre-pandemic level.

**Figure 1.11. The fiscal deficit and public debt increased due to policy responses to the pandemic**



Note: Consolidated public sector consists of general government and non-financial public corporations.

Source: Ministry of Finance, *Fiscal Outlook and Federal Government Revenue Estimates 2024*; IMF, *World Economic Outlook database*.

StatLink  <https://stat.link/4n9mar>

One obstacle to a more decisive fiscal consolidation has been a rise in government expenditures since 2021, reaching 22.4% of GDP in 2023. This was preceded by almost a decade of decline since 2012, including during the COVID-19 pandemic years (Figure 1.12, Panel A).

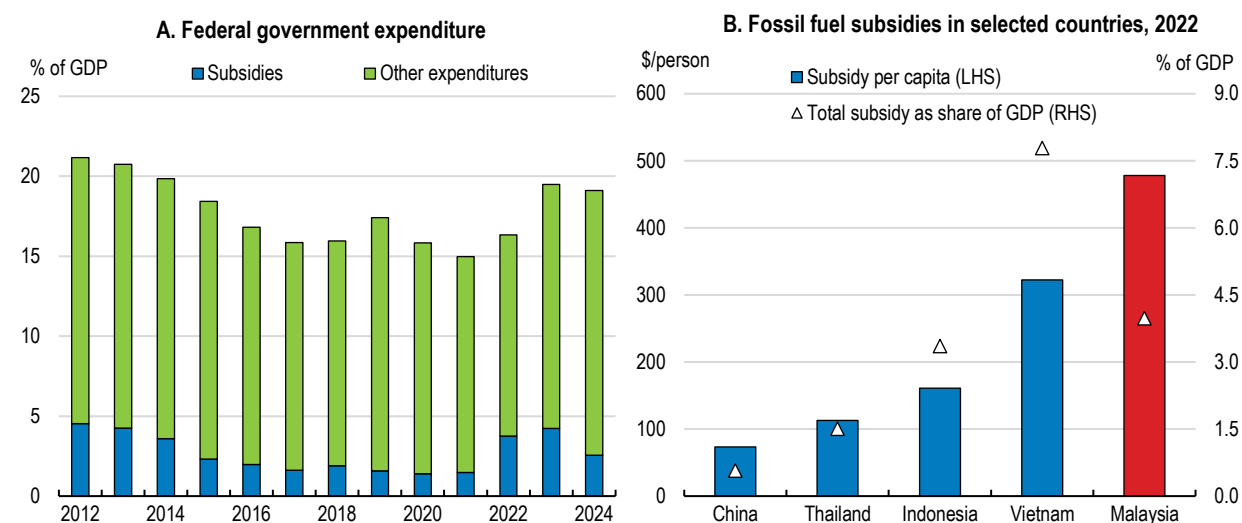
The spending increase over 2022-2023 is related to rising subsidies, which expanded by a factor of 2.5 over that biennium, boosting their share of total spending to over 20% (Figure 1.12, Panel A). The most significant component was the fuel subsidy, which accounted for three-quarters of the total. While many countries initially increased fuel subsidies to reduce the impact of the recent sharp increase in global crude oil prices on consumers, Malaysia's fuel subsidy was larger than that of regional peers, reaching USD 478 per person (Figure 1.12, Panel B). The subsidies impose a high fiscal cost and encourages fuel consumption, making it inconsistent with the country's decarbonisation strategy (Chapter 3). Prolonged energy price caps run counter to climate change mitigation objectives by distorting market signals. This reduces incentives to shift to renewables and lower energy demand. Subsidies have been ineffective as a social policy tool due to its poor targeting. Estimates suggest that while the poorest decile received only 6% of the amount spent on these subsidies, the richest 10% of households in Malaysia received about 15% of the total amount spent on subsidies (World Bank, 2023<sup>[9]</sup>).

Spending on the budget category that comprises subsidies and social assistance is set to be cut in the 2024 budget, decreasing their share of total spending from 23.1% in 2023 to 17.4%. This reflects a recognition that energy subsidies have not been effective in achieving policy objectives and is a step in the right direction, but there is scope to go much further. Further reducing subsidies and relying on cash transfers targeted at low-income households most affected by rising prices would be a key ingredient for achieving the consolidation needed for compliance with the new fiscal framework and promoting social inclusion and sustainability at the same time.

Higher deficits since the pandemic have left their mark on government debt. The rise in federal government debt from 52.4% of GDP in 2019 to 63.3% in 2021 forced the government to lift its statutory debt limit from 55% to 65%. On a general government basis, Malaysia's government debt rose by more than 10% of GDP over that period to 69.7% in 2023 (Figure 1.11, Panel B). This is about half of the debt increase experienced by the Philippines and Thailand. Relative to GDP, however, Malaysia's general government debt level exceeds that of regional peers.

The fiscal positions of entities outside the federal government need to be monitored closely, as extra-budgetary entities and state-owned enterprises, which contribute around 35% of GDP, have been mobilised to provide various support measures in the pandemic stimulus packages. These outlays are included in the consolidated public sector, defined as the general government and non-financial public corporations. Large non-financial public corporations include major entities such as Malaysia Airlines, Petronas and Telekom Malaysia. In 2019, the public sector deficit was on par with the federal government at 3.4% of GDP (Figure 1.11, Panel A). By 2021, however, the public sector deficit had risen to 8.3%, while the federal government deficit had a smaller increase to 6.4%. Both state and local governments and non-financial public corporations contributed around two thirds to the rise in the public sector deficit over 2019-21, a development that should be watched closely in the future.

**Figure 1.12. The government has increased subsidies, particularly for fossil fuels**



Note: The data for 2023 is a government estimate and 2024 is based on the 2024 budget and the OECD projection of GDP in 2024.

Source: Ministry of Finance; and IEA, *Fossil Fuel Subsidies database*.

StatLink  <https://stat.link/24iqg5>

Furthermore, the consolidated public sector does not include public financial corporations, which the government uses to provide guarantees to businesses. The total assets under the control of the seven government-linked investment companies (GLICs) are almost the size of Malaysia's GDP. Government guarantees, a quasi-fiscal tool administered under the Loans Guarantee Act, reached 20.8% of GDP in 2020, dropping to 17.2% in the third quarter of 2023. Adopting an integrated fiscal framework covering the entire public sector, including contingent liabilities, would strengthen fiscal monitoring and promote sustainability.

### ***A new fiscal framework law is expected to strengthen fiscal sustainability***

The Public Finance and Fiscal Responsibility Act (FRA), approved by Parliament in October 2023, is a major step towards a stronger fiscal framework. It is based on the principles of ensuring macroeconomic stability, maintaining a prudent debt level and establishing effective fiscal risk management. The FRA requires the Minister of Finance to provide a Medium-Term Fiscal Plan over a three-to-five-year period that includes numerical targets for the federal government. These targets must include a headline budget deficit not to exceed 3% of GDP, federal government gross debt below 60% of GDP in the medium term, government guarantees below 25% of GDP and a minimum development expenditure of 3% of GDP. The latter is focused on infrastructure investment and reducing poverty. However, these multiple targets, and potential conflicts between them, may make monitoring of compliance with the framework more complex,

while simple fiscal rules are often more effective in ensuring fiscal sustainability (Debrun et al., 2018<sup>[10]</sup>). The FRA also incorporates transparency provisions, including several mandatory reports, such as a mid-year budget performance report and a tax expenditure statement. It also requires a comprehensive fiscal risk statement and a rigorous process for granting and monitoring of government guarantees, which aims to decrease the government's exposure.

Temporary deviations from the fiscal objectives are allowed in the case of sudden shocks, provided the Cabinet approves the minister's fiscal adjustment plan in response to the shock. The 2024 budget aims to reduce the federal government deficit from 5.0% of GDP in 2023 to 4.3% in 2024, a step toward the Medium-Term Fiscal Framework's objective of cutting it to 3.0% by 2028. Moreover, the Framework targets an average deficit of 3.5% over 2024-26. The OECD projects that the deficit will fall to 4.6% of GDP in 2024 and remain at that level in 2025 (Table 1.1).

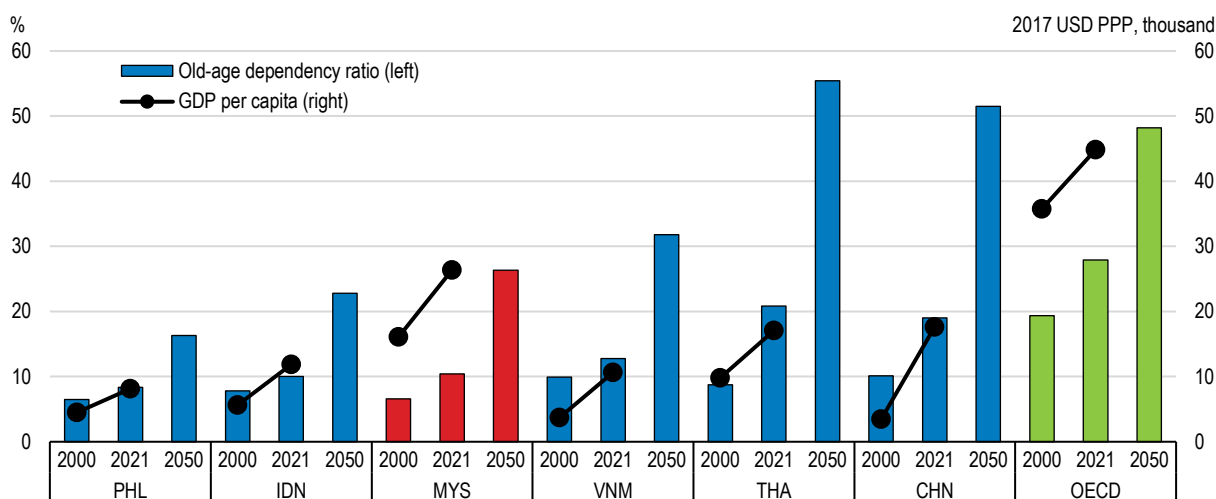
A strong institutional framework will be needed to underpin the successful implementation of the FRA and fiscal consolidation in the long run. To ensure this success, Malaysia could consider establishing an independent fiscal institution (IFI) to monitor compliance with the FRA and provide independent analysis of fiscal policy and performance, thus promoting fiscal transparency, sound fiscal policy and sustainable public finances.

IFIs typically have a mandate to critically assess, and in some cases provide non-partisan advice on, fiscal policy and performance, supporting greater transparency and accountability. There has been a surge in the number of IFIs over the years, with IFIs now in place in 29 OECD countries (OECD, 2023<sup>[11]</sup>). While fiscal decision-making is ultimately the responsibility of democratically elected officials, IFIs can, often in complement with credible fiscal rules, help countries to address bias towards spending and deficits and more generally enhance fiscal discipline and trust in fiscal prudence while promoting greater fiscal transparency and accountability (OECD, 2017<sup>[12]</sup>; OECD, 2023<sup>[11]</sup>; OECD, 2014<sup>[13]</sup>). Recent positive experiences with IFIs in Brasil, Chile or Portugal have demonstrated the potentially valuable role that IFIs can play to raise the quality of the fiscal policy debate (Box 1.1).

### **Box 1.1. Fiscal Councils in emerging economies: the Chilean case**

Chile has been gradually strengthening its fiscal framework over the last decades, which has contributed to sustain economic growth and keep public debt relatively low. A fiscal rule helped to shield public spending from the copper boom, generating savings that proved crucial when the country faced negative shocks, such as the global financial crisis. A key additional step forward was the creation of an autonomous fiscal council in 2019 (OECD, 2021<sup>[14]</sup>). The council is composed of five members nominated by the President and approved by the Senate. It has own resources and the mandate of the members do not coincide with the government term to foster independence. It is tasked, among other things, with evaluating the calculation of the structural revenues, monitoring the compliance with the structural balance targets, proposing mitigating measures, and evaluating and proposing changes to the fiscal rule. The institutional framework of the council is in line with OECD good practices.

The new fiscal framework established by the Public Finance and Fiscal Responsibility Act will also be instrumental for facing the significant fiscal challenges related to population aging. In 2020, only 7% of Malaysia's population was aged 65 and above. The share is projected to rise to 14% by 2044 and to 20% by 2056. This will have significant implications for pension and health expenditures, as the old-age dependency ratio, which measures the number of persons aged 65 and over relative to those in working age, will more than double by 2050 (Figure 1.13). While this increase is less than what some other Asian societies like Viet Nam, Thailand and China will experience, it will nonetheless imply challenges for long-run fiscal sustainability.

**Figure 1.13. The population is ageing rapidly**

Note: The old-age dependency ratio is defined as the number of persons aged 65 and over relative to the 15-64 years old population.

Source: United Nations, Department of Economic and Social Affairs, Population Division (2022). World Population Prospects 2022, Online Edition; World Bank, World Development Indicators database.

StatLink  <https://stat.link/3y2ke5>

### **Public debt will rise without new fiscal measures**

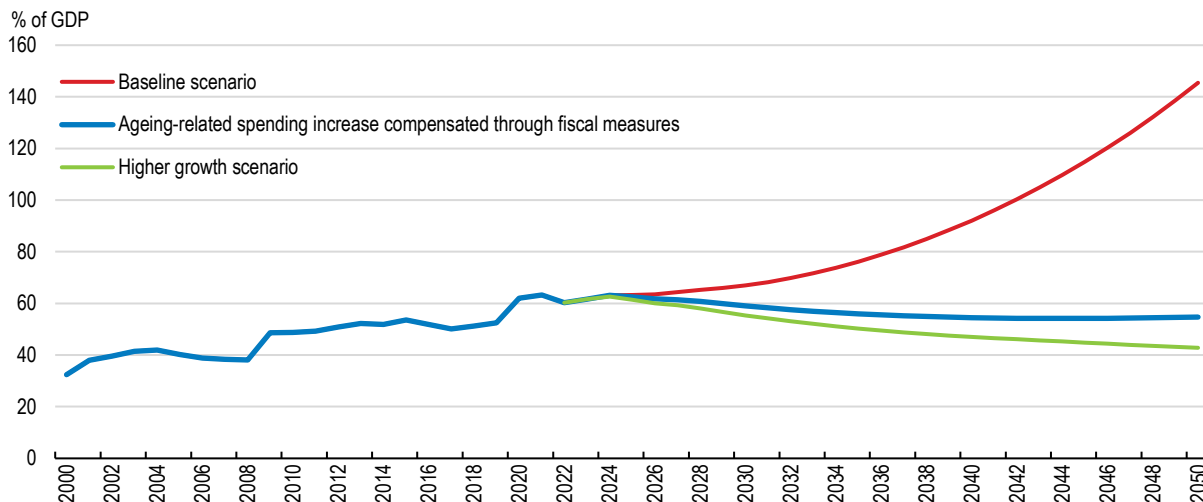
The costs of population ageing will have significant effects on the trajectory of public debt. Assessing the additional fiscal burden from population ageing is subject to significant uncertainties, including related to the political demand for better social protection, which is generally weak at present and will leave many future retirees without any or without adequate pensions (Chapter 2).

By some estimates, it is likely that public social spending would rise from its 2019 level of 5.5% of GDP to approximately 10% of GDP by 2050, including due to the underfunded contributory pension system that would require funding from the government budget once its assets are depleted, which is estimated to occur around 2035 (IMF, 2024<sup>[3]</sup>). Some of this effect may be mitigated by parametric adjustments to the pension system and by raising activity rates among older workers, as currently only 45% of the population aged 55 to 64 population is in employment. Nonetheless, ageing alone would require sizeable additional government revenues in order to comply with the current deficit target of 3%. Assuming that social spending rises to 10% of GDP and that there would be no additional fiscal measures to compensate for this increase in ageing-related spending, government debt would approach 145% of GDP by 2050 in the baseline scenario (Figure 1.14, red line). In other words, current revenue levels are clearly not compatible with fiscal sustainability considering population ageing.

Raising spending without compensatory measures, however, would not be in line with the new fiscal framework. The Public Finance and Fiscal Responsibility Act and its resulting medium-term fiscal plans call for the headline budget deficit to be reduced to 3% of GDP by 2028, the target in the new fiscal framework, and kept there through 2050. In the face of future ageing costs, achieving these targets would imply significant additional fiscal measures, both on the spending but probably more so on the revenue side of public accounts. While Malaysia has room to mobilise additional revenues and raise spending efficiency to face these future challenges, the implementation of these additional fiscal measures requires establishing the necessary political consensus for their approval, which cannot be taken for granted and is subject to risks. If these additional measures can be implemented and the fiscal targets will be met, the government debt-to-GDP ratio would decline from its current level of 61.5% to around 55% by 2050 (Figure 1.14, blue line).

**Figure 1.14. The expected rise in public social spending calls for offsetting fiscal measures**

Federal government debt scenarios



Note: All three scenarios assume that social assistance spending will reach 10% of GDP by 2060. In the baseline scenario (the red line), there are no compensating measures to maintain a constant fiscal deficit. The second scenario (blue line) assumes that the headline deficit remains constant at the 3% mandated by the FRA, as ageing costs are compensated by higher revenue measures and potential reductions of other expenditures. The first two scenarios (the red and blue lines) assume that real GDP grows as in Table 1.1 until 2025, then at current potential growth of 3.9% between 2026 and 2030 before declining gradually to 2.5% between 2030 and 2050. The third scenario (green line) differs from these scenarios by assuming a stronger growth trajectory as of 2026 due to the implementation of all growth-enhancing structural reforms as outlined in the long-term scenario of Box 1.2, in which growth is on average 1 percentage point higher than in the baseline. In all scenarios, the GDP deflator grows at a constant 2.4% per year and the interest rate is maintained at 4.2%.

Source: OECD calculations.

StatLink  <https://stat.link/7b28g4>

Another important factor for the future trajectory of public debt relative to GDP is economic growth, which can be strengthened through structural reforms in several areas. An illustration of the potential growth impact of structural reforms advocated in this Survey is presented in Box 1.2. A third debt scenario represented by the green line in Figure 1.14 assumes that all growth-enhancing structural reforms presented in that box raise the economy's potential growth trajectory, and that the fiscal targets of the new fiscal framework can be met. Under this scenario, the debt-to-GDP ratio would decline to 43% by 2050.

### Box 1.2. Structural reforms will support long-term growth

Some of the structural reform measures proposed in this Survey are expected to have significant positive effects on future growth and incomes, and this box provides tentative quantifications of these effects. The exercise draws on the OECD reform quantification framework (Égert and Gal, 2016<sup>[15]</sup>; Égert, 2017<sup>[16]</sup>), which relies on a production function approach. The influence of policies on GDP is typically assessed through their impact on supply-side components: labour productivity and employment. Each in turn can be further decomposed, the former into capital intensity and multi-factor productivity, and the latter into labour force participation and unemployment. Within the framework, the impact of structural reforms is quantified from a range of cross-country reduced-form panel regressions on three channels: i) multifactor productivity, ii) capital deepening, and iii) employment. The overall impact on GDP per capita is obtained by aggregating the policy effects of the various channels through a production function.

The estimated effects derived in this framework are used to simulate the impact of reforming policies in Malaysia towards OECD average values (Table 1.3). The effects of the policy variables are in principle additive, since in the quantification framework, the effects of each policy variable are estimated by controlling for those from other policies. However, this does not hold for some policy variables, in particular, institutional indicators from the World Bank Worldwide Governance Indicators, which display significant correlation among each other. Empirical work indicates that the quality of institutions matters to a large extent both over time and across countries (Égert, 2017<sup>[16]</sup>).

**Table 1.3. Illustrative impact of selected structural reforms on GDP per capita**

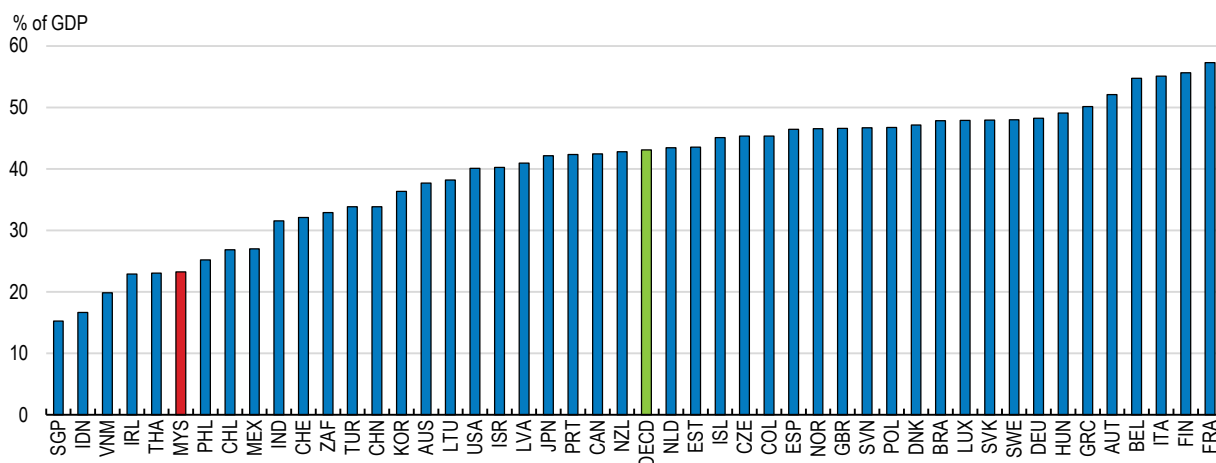
Policy area	Policy actions	Cumulative effect on GDP per capita after:		
		5 years	10 years	Long term
Improve economic governance and integrity	Raise the control of corruption from the current 0.25 to the OECD average of 1.10.	4.3%	6.9%	8.9%
Raise female labour participation	Raise the employment rate of prime age women (ages 25-54) by 10 percentage points in 10 years. In the long term, reduce the gender employment gap, currently at 22 percentage points, to the OECD average of 11 percentage points.	1.6%	3.2%	6.8%
Ease regulatory burdens to strengthen competition	Reduce the overall regulation to the level of the OECD average.	1.7%	2.3%	4.3%
Reduce the role of state-owned enterprises	Reduce public ownership to the level of the OECD average.	1.6%	2.1%	4.1%

Source: OECD calculations.

This table only shows the results for the policy measures discussed in this survey whose impacts can be estimated using the above-mentioned framework, while other reforms fall outside of the model. The quantification exercise is meant to serve as an illustration of the potential impact of reforms and the results should not be considered as OECD projections.

### Mobilising more revenues for future spending needs

Malaysia's government is small in international comparison, both with respect to expenditures and revenues. Spending was 22% of GDP in 2022 on a general government basis, about half of the OECD average (Figure 1.15). This is small even in comparison with regional peers such as Thailand (25%), Cambodia (25%) or the Philippines (26%), although higher than in Indonesia (18%).

**Figure 1.15. Government spending is about half of the OECD average**

Note: Data for 2022.

Source: OECD Economic Outlook database; IMF World Economic Outlook database.

StatLink  <https://stat.link/352yds>

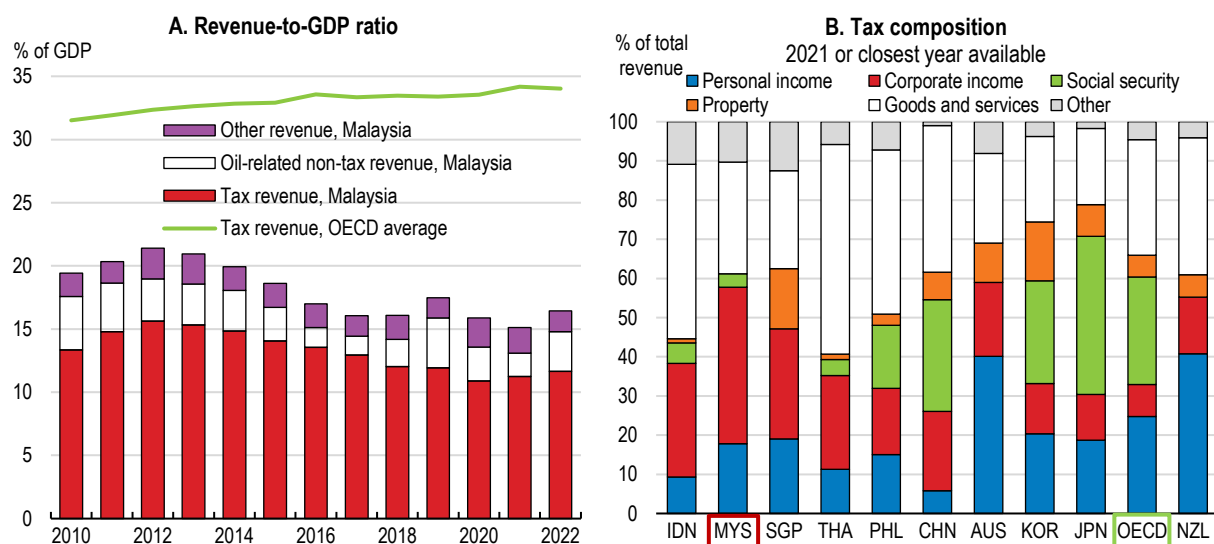
The current size of Malaysia's public sector may not be well-suited to face upcoming spending pressures related to social protection, education, health and long-term care and pensions (Chapter 2), and also the costs of climate change adaptation and mitigation (Chapter 3). Facing these challenges will first of all call for reviewing spending patterns, with a view towards identifying those areas where spending could be reduced in line with changing priorities. The top priority is to continue reducing subsidies and replacing them with better-targeted transfers to vulnerable populations. Social spending at 5.5% of GDP is only about a quarter of the OECD average at noted above. The low level reflects the low share of elderly at 7% of the population in 2020. However, that share is projected to reach 14% by 2044 and 20% by 2056. Limiting the growth of ageing-related spending is thus one part of the strategy to ensure Malaysia's fiscal sustainability. Measures to promote healthy ageing and increase the co-payment charges for high-income persons would limit the growth in public healthcare spending. Raising the withdrawal age from individual accounts in the private-sector pension fund EPF to 65 years would boost income for older persons (Chapter 2). Even after measures to reduce wasteful spending and limit the growth of social spending, however, there will still be a need for more public revenues to finance growing needs while promoting economic growth, social inclusion and the environment.

Government revenues have been on a declining trend, falling from 21.4% of GDP in 2012 to 17.5% in 2019 and further to 15.1% in 2021 (Figure 1.16, Panel A). While Malaysia collects about 3.9% of GDP from non-tax revenues, mainly consisting of petroleum-related revenues, the area where it stands out particularly is the low tax revenue relative to GDP, which dropped to 11.2% in 2021, only one-third of the OECD average (Figure 1.16, Panel B). While Malaysia shares the feature of low tax revenues with other countries in the region, only Indonesia has an even lower tax intake than Malaysia. Moreover, the recent trajectory suggests that Malaysia is not following the general upward trend experienced by regional peers as the 16.4% rise in its total tax revenue between 2011 and 2021 was far below that in Indonesia (71.5%), the Philippines (110.0%) and Viet Nam (111.6%).

In 2023, total government revenues grew 7.0% in nominal terms, exceeding the average increase of 5.4% since 2010. In 2024, the government introduced new tax measures, but these will only result in additional tax revenues of around 0.2% of GDP. These include a luxury goods tax at a rate of 5% to 10% on items such as jewellery and watches, a 10% capital gains tax and a hike in the service tax rate from 6% to 8%, while excluding sectors like food and beverages. The government also plans to implement the global minimum tax (OECD, 2024<sup>[17]</sup>) and enforce e-invoicing for large companies to improve tax collection. The

growth of government revenues declined to 2.3% in the 2024 budget, reflecting a smaller contribution from oil-related earnings, which account for about one-fifth of government revenue. The latter reflects a diminishing reliance on petroleum-driven income streams, which is in line with the ongoing global shift away from fossil fuels.

**Figure 1.16. Tax revenue to GDP has declined amid a high share of corporate income tax revenues**



Note: Value-added tax and sales tax are classified in general taxes on goods and services.  
Source: Ministry of Finance; DOSM; OECD, Tax Revenue Statistics database.

StatLink  <https://stat.link/o1h835>

Looking ahead, Malaysia will need to mobilise additional tax revenues, not only to meet its 3% deficit target in the short run, but also to finance future spending needs. This will require changes to the tax system so that it can provide more revenue to finance growing needs while promoting economic growth, social inclusion and the environment. While the degree to which the public sector should expand to meet future needs is ultimately a political decision, estimates suggest that Malaysia can collect up to 3 percentage points of GDP in additional tax revenues in the short term (IMF, 2024<sup>[3]</sup>), and up to 16 percentage points of GDP in the long term (OECD, 2022<sup>[18]</sup>; Gupta and Jalles, 2023<sup>[19]</sup>).

Taxes on goods and services can play a central role in this endeavour. The revenue share of taxes on goods and services fell after the end of the goods and services tax in 2018 (Box 1.3). In 2021, they accounted for 25.1% of tax revenue or 2.8% of GDP, compared to the OECD average of 31.3% of revenues or 10% of GDP (Figure 1.16, Panel B). Consumption taxes are a relatively stable revenue source and are often less harmful to economic growth, as they impose fewer distortions on employment and investment (Johansson et al., 2008<sup>[20]</sup>). In principle, general taxes on goods and services, notably value-added taxes (VAT), are relatively simple to enforce and difficult to avoid, and compared to advanced economies, many emerging market economies are raising more revenues from them than from personal income taxes.

A well-designed VAT is a tax on consumption whose main benefits are its neutral effects on the decisions of households and firms. The reason for this is that a VAT is levied on all sales of goods and services at every stage of production. Firms using intermediate inputs receive a credit for taxes paid by the producers of these inputs, which can be deducted from the taxes due on their own sales. This avoids distortions towards vertical integration of production. These distortions do arise in the case of a tax levied on turnover or sales, which taxes market transactions higher than value-added generated in-house. A VAT also generates positive dynamics from the perspective of tax administration, as producers at different stages of the production process have incentives for their upstream suppliers to comply with the VAT, to ensure that the input tax can be deducted. From a dynamic perspective, a VAT is neutral with respect to savings

decisions, provided that the VAT rate does not change over time, so that the VAT applies the same tax rate on current and future consumption.

Increasing taxes on goods and services could be accomplished by re-introducing the GST, which was removed in 2018 (Box 1.3). The rate should initially be kept low to avoid the problems that marred its initial introduction in 2015. The potential regressive distributional effects of higher value-added taxes could be offset through well-targeted social transfers to vulnerable households, whose real purchasing power could be affected by the tax. Such a policy would be much more effective than exemptions and reduced rates, including those for food and other basic necessities, as the bulk of the monetary benefits from these exemptions tend to accrue to high-income households, reflecting their higher spending levels (OECD/KIPF, 2014<sup>[21]</sup>). In addition, exemptions and reduced rates raise administrative and compliance costs, especially for SMEs, provide opportunities for fraud through the misclassification of items and reduce tax neutrality.

### **Box 1.3. Malaysia's taxes on goods and services**

Malaysia has undergone significant changes in its consumption tax system, shifting from a single-stage tax system (i.e., imposed only at one stage in the supply chain) to a value-added tax system:

#### **Sales tax and service tax (SST)**

The single-stage tax system consisted of two independent taxes: the 1972 sales tax (imposed on goods) and the 1975 service tax. The sales tax is generally an ad valorem tax with a standard rate of 10%, with certain goods taxed at 5%. Other goods are taxed at specific rates or are exempted. The ad valorem tax rate on services is 6% for all taxable services, including digital services, except for charge card or credit card services, which are taxed at a specific rate of MYR 25 (USD 5.20) annually.

#### **Goods and Services Tax (GST)**

In April 2015, Malaysia introduced the GST, a broad-based multi-stage consumption tax, to replace the existing SST. This value-added tax was aimed at streamlining the tax structure to make it more efficient, effective, transparent and business-friendly while reducing government deficits and debt. The GST, which had a 6% standard rate, enhanced revenue collection and reduced tax evasion. However, implementation issues undermined public support for the GST, notably high compliance costs borne by smaller firms and delays in providing tax refunds to businesses. In addition, the burden of higher inflation, particularly on low-income households, increased public discontent (Narayanan and Latiff, 2024<sup>[22]</sup>). In preparation for the GST, the government had introduced the Price Control and Anti-Profitteering Act to protect consumers from excessive price hikes. It also made the GST less regressive by exempting certain essential items and services. Nevertheless, the unpopular GST was abolished in June 2018, partly because of its burden on low-income households.

#### **Sales Tax and Service Tax (SST)**

Following the abolishment of the GST, the government reinstated the SST in September 2018, but on a substantially smaller tax base. In services, the number of registered tax persons and establishments fell 79% from 476 023 under the GST to 100 405 under the SST. Moreover, the list of exempted items was ten times larger than in the GST. The share of the SST in total tax revenue was 15.3% in 2019, down from GST's 24.9% in 2017 (OECD, 2019<sup>[23]</sup>). However, the government remains reluctant to re-introduce the GST. Instead, it raised the service tax rate in the 2024 budget to 8%. The Price Control and Anti-Profitteering Act aimed at protecting consumers from price hikes following the GST introduction has not been phased out despite its negative impact on competition and business dynamism (Chapter 4). Preserving competition in product markets is crucial, and international surveys show that price controls are considered to be an important risk for investing in Malaysia (World Bank, 2021<sup>[24]</sup>).

Taxes on goods and services also include environmentally-related taxes and health-related taxes such as those on tobacco, alcohol and sugar-sweetened beverages. These also present scope for further expansion, although often their focus is just as much on improving incentives as on collecting revenues. By imposing a direct cost on the polluter, taxes provide incentives for pollution abatement and also encourage innovation to seek out new products and processes that can reduce the polluters' tax burden. Environmentally-related tax revenues can be used to finance targeted transfers to low-income households to compensate them for the resulting loss in purchasing power. As of 2021, none of Malaysia's greenhouse gas emissions were subject to a carbon tax (Chapter 3). Improving the incentives provided by the tax system to reduce pollution and emissions will of course also depend on reductions in fossil fuel subsidies, which act as a negative tax on emissions and effectively reduced the price of 21.7% of emissions in 2021 (OECD, 2022<sup>[25]</sup>).

Personal income taxes are paid by only 15% of Malaysia's labour force. In 2021, they accounted for 15.6% of tax revenues, far below the OECD average of 24.4%, largely due to a high basic allowance below which no personal income taxes are due. Personal income tax revenues amount to 1.75% of GDP, compared to an OECD average of 8.3%. Malaysia's personal income tax system has 12 rates, ranging from 1% to 30%, while OECD countries have less than 5 brackets on average, and the top marginal rate is relatively low compared to the OECD average of 43%.

Narrow tax bases are one prominent explanation for Malaysia's low tax revenues. In 2019, around 63% of personal income taxes, social contributions and indirect taxes, came from the 10% highest income earners, and another 15% from the population decile with the second-highest incomes (World Bank, 2023<sup>[9]</sup>). Personal income taxes concern mostly the top income decile. Despite its progressive distributional effect, this narrow tax base could be expanded without placing more of a burden on poor and vulnerable households.

At the same time, even those in the top decile of the income distribution effectively only contribute 14% of their market income in taxes, after accounting for the transfers, benefits and subsidies they receive. The net contribution of the second top-earning decile is approximately 7% (World Bank, 2023<sup>[9]</sup>). The top rate of 30% applies only from almost 60 times the average wage, much higher than in Thailand and Viet Nam where top rates are applied from 25 and 15 times the average wage, respectively. This suggests scope for reducing the taxable income thresholds at which top personal income tax rates are levied.

Moreover, there is also scope to reduce the number and extent of tax expenditures in personal income taxes, which often bring greater benefits to those with higher incomes. Individuals can claim a maximum of 17 deductions from their personal income, including for medical expenses, support for parents, private childcare, education and retirement schemes. Finally, incomes such as investment income from bank deposits or securities, pensions, capital gains and dividends are currently not taxed at the personal level. Malaysia could introduce a dual income tax at which capital income is taxed separately from labour income or it could tax labour and capital income jointly under the personal income tax. Over time, Malaysia could introduce a capital gains tax (OECD, 2006<sup>[26]</sup>). All of these measures would help to raise revenues and to tax personal incomes in ways that are more fair and less distortive.

Raising social security contributions, currently at 2.9% of tax revenue compared to the OECD average of 26.4%, would strengthen the sustainability of the pension fund, but at the same time, it is essential to keep the tax wedge low to encourage labour force participation and the formalisation of employment (Chapter 2). This applies particularly to low-income earners, among whom informal work is typically more prominent than among those with higher incomes.

Corporate income tax accounted for around 40% of Malaysia's tax revenue, substantially above the OECD average of less than 10% (Figure 1.16, Panel B). A stronger reliance on corporate income taxes is not unusual among emerging market economies, given the relatively moderate administrative challenges in collecting corporate taxes compared to other taxes. Malaysia's 24% statutory corporate income tax rate is close to the OECD average, but above neighbouring economies, such as Hong Kong, China (16.5%),

Singapore (17%) and Taipei, China, Thailand and Viet Nam (20%). At the same time, tax expenditures like investment incentives reduce revenues from corporate taxes. Relative to GDP, Malaysia raises almost 6% of GDP from corporate income taxes, compared to 2.75% in the OECD area. There may be scope for streamlining tax incentives after subjecting them to a thorough evaluation.

The recommendations in this Survey are expected to affect both the expenditure and the revenue side of public accounts, although not all of them can be quantified with sufficient certainty. The fiscal impact of selected recommendations made in this survey, including in the following chapters, is presented in Table 1.4. The effect is estimated over the next 3-5 years, while longer-term spending needs in the context of population ageing and the green transition are likely to be larger.

**Table 1.4. Indicative fiscal costs (-) and revenues (+) over a horizon of 3-5 years**

	% of GDP
Reduce energy subsidies	+3.5
Re-introduce the Goods and Services Tax	+1.8
Broaden the tax base of personal income taxes, reduce the basic allowance, reduce and streamline tax expenditures, tax personal capital income and further improve tax administration and enforcement.	+1.2
Raise social spending including cash transfers and non-contributory pensions	-4.1
Introduce carbon pricing while compensating low-income households with targeted transfers	+0.5
Streamline and consolidate MSME programmes	+0.1
<b>Total fiscal impact</b>	<b>+3.0</b>

Source: OECD estimates.

**Table 1.5. Past recommendations on macroeconomic policies**

Recommendations	Actions taken since August 2021
Keep providing sufficient and targeted support to the affected households and sectors until the recovery is well established.	Aid and social assistance programmes for poor and vulnerable households and specific target groups amounted to MYR 64.2 billion.
Prepare a post-COVID19 integrated medium-term fiscal strategy to reduce public debt and contingent liabilities.	The Public Finance and Fiscal Responsibility Act (FRA), which requires the Minister of Finance to provide a Medium-Term Fiscal Plan, was approved by Parliament in October 2023.
Accelerate the vaccination programme by strengthening the partnership with the private sector.	The partnership with the private sector continued as the COVID-19 vaccination program expanded to include adolescents in September 2021, booster doses from October 2021 and children in 2022. To further enhance vaccination uptake, private health facilities were allowed to procure COVID-19 vaccines from vaccine suppliers.
Maintain an accommodative monetary policy, until the recovery is well under way.	An accommodative monetary policy was maintained until May 2022, when the economy had recovered well.
Consider the re-introduction of the Goods and Services Tax as part of the medium-term fiscal strategy.	No action has been taken.

## Strengthening institutions to achieve more effective public spending

Raising additional revenues to finance future spending needs and spending these additional funds in the most effective way to achieve policy objectives will also require improvements in institutions and economic governance. While Malaysia has made progress in this regard, strengthening institutions is a gradual process. As incomes rise, citizens and businesses generally become more demanding with respect to the quality of economic governance, and cross-country comparisons typically point to a positive correlation between incomes and the quality of institutions and governance. Malaysia's march towards high-income status provides an opportunity for further progress in this important domain, which will in turn feed into stronger economic performance.

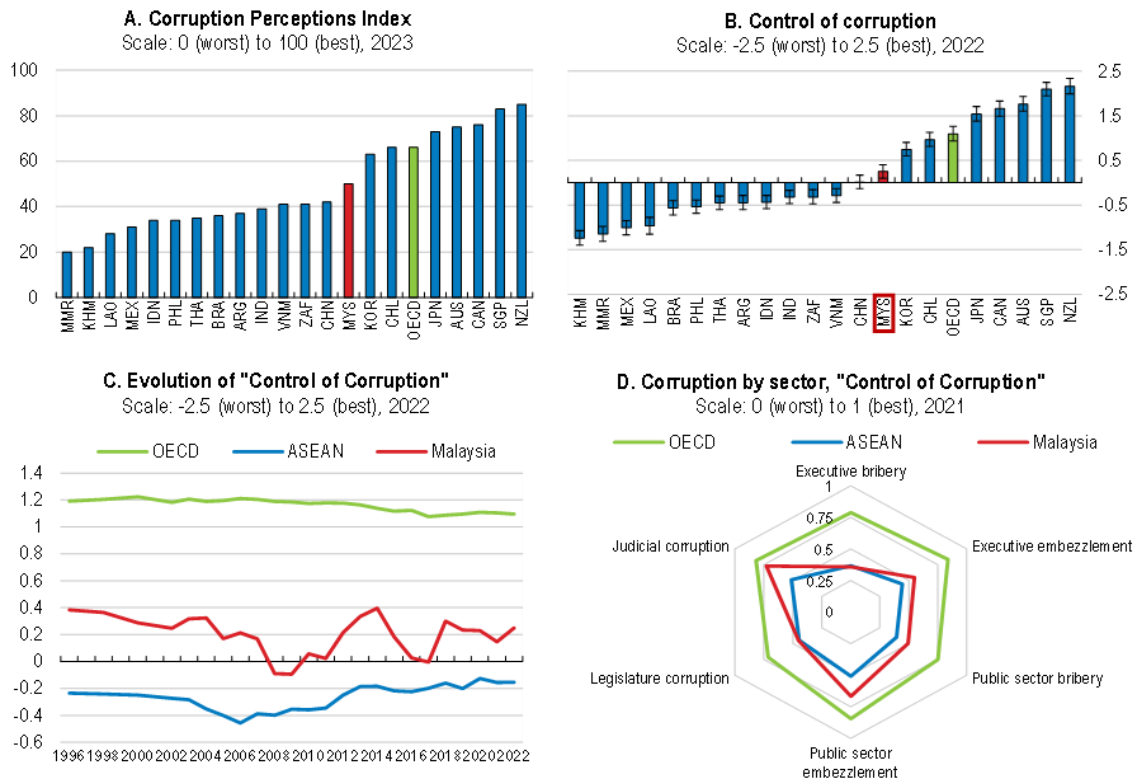
The quality of the tax administration will be an important determinant of Malaysia's future success with raising additional tax revenues. Besides changes in the tax code, a stronger enforcement of existing rules and better tax administration could lead to further revenue improvements now and in the future. Enforcement also has a role to play in reducing informal employment, particularly when coupled with better incentives for compliance through better policy design (Chapter 2).

One way to strengthen tax compliance would be to harness digital technologies, which could reduce the cost of enforcement for the authorities and lower the compliance burden for taxpayers. Malaysia is well-prepared to make further inroads on tax enforcement through digital means. The government plans to enforce e-invoicing for large companies to improve tax collection. Greater adoption of digital technologies in the government sector would allow strong synergies across different areas, notably, tax collection and social protection. Digital tools and digitally integrated administrative data including tax registries can improve the targeting of various benefits and facilitate formalisation. Digitalisation of government services would also be useful for regulatory reforms, such as streamlining administrative procedures.

Integrity is a cornerstone of a system of sound public governance. Public sector integrity is essential to establish trust in government, which in turn helps promote higher compliance of citizens with laws, including the payment of taxes. Corrupt practices and weak governance can waste public resources, increase the perception of political and litigation risk, deteriorate the investment climate of a country and exacerbate income inequalities by allowing relatively prosperous public officials and businesspeople to divert taxpayer resources. Malaysia's Auditor General's Report 2022 on the activities of federal government ministries and agencies, published in November 2023, quantified the amount of waste of public funds at 0.2% of total expenditure in 2022. A recent study points to challenges in the implementation of anti-corruption measures, a culture of cronyism between political figures and business elites, and political interference into enforcement action against corruption offenders (Jones, 2022<sup>[27]</sup>).

Comparative indicators of corruption perceptions point to further room for improvement in economic governance. Malaysia's corruption perceptions and control of corruption performance were better than most ASEAN countries but inferior to major OECD countries in 2023, following a slight improvement from 2022 (Figure 1.17, Panel A, Panel B). According to the Global Corruption Barometer, 71% of respondents in Malaysia consider government corruption a big problem (Transparency International, 2020<sup>[28]</sup>). Malaysia's performance in control of corruption has fallen short of the OECD average, albeit exceeding the ASEAN average, with a minor uptick in recent years (Figure 1.17, Panels C and D). On the other hand, in terms of tax transparency and anti-money laundering, Malaysia's performance is comparable to neighbouring countries and OECD countries (Figure 1.18).

**Figure 1.17. Corruption perception has improved but related indicators remain stagnant**



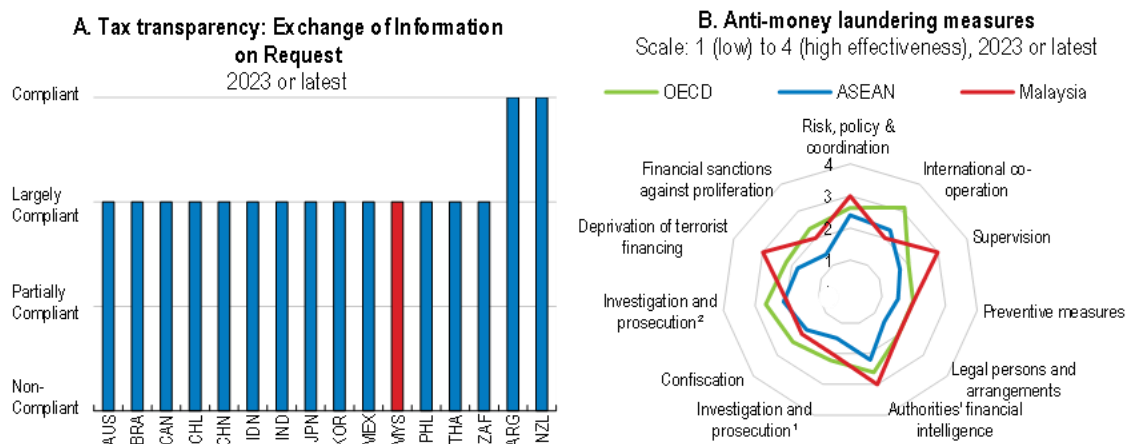
Note: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the “Control of Corruption” indicator by the Varieties of Democracy Project.  
Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Project, V-Dem Dataset v12.

StatLink <https://stat.link/uic913>

Malaysia has made significant efforts to combat corruption and foster integrity in society. The National Anti-Corruption Plan (NACP) 2019-2023 contains 115 initiatives categorised in areas such as political governance, public sector administration, public procurement, corporate governance, law enforcement and legal and judicial reforms. 62 initiatives had been completed by the end of 2022 and 39 were expected to be completed by the end of 2023. Nonetheless, some initiatives in the NACP seem to have lost momentum or lack visible progress.

One way to enhance transparency and prevent illicit enrichment of member of government is a systematic and mandatory asset disclosure. While all civil servants are obliged to declare their assets once every five years, there are no such rules for high-ranking member of the executive branch or Members of Parliament. Relevant initiatives in the NACP have not been followed up. In practice, only a small share of high-level members of the executive and members of parliament have disclosed their assets.

**Figure 1.18. Malaysia performs well in transparency and anti-money laundering**



Note: Panel A summarises the overall assessment on the exchange of information in practice from peer reviews by the Global Forum on Transparency and Exchange of Information for Tax Purposes. Peer reviews assess member jurisdictions' ability to ensure the transparency of their legal entities and arrangements and to co-operate with other tax administrations in accordance with the internationally agreed standard. The figure shows results from the ongoing second round when available, otherwise first round results are displayed. Panel B shows ratings from the FATF peer reviews of each member to assess levels of implementation of the FATF Recommendations. The ratings reflect the extent to which a country's measures are effective against 11 immediate outcomes. "Investigation and prosecution" refers to money laundering. "Investigation and prosecution<sup>2</sup>" refers to terrorist financing.

Source: OECD calculations based on Global Forum on Transparency and Exchange of Information for Tax Purposes; and OECD, Financial Action Task Force (FATF).

StatLink  <https://stat.link/gl8fyb>

Around the world, governance challenges are often particularly pronounced in state-owned enterprises (SOEs), in part due to their vulnerability to political influence. Political appointments for board and chairman positions in SOEs, i.e. appointments that are not based on merit or qualification, remain common in Malaysia, while a previous OECD recommendation had suggested to avoid this practice. Such appointments are inconsistent with the aspirations stated in the Twelfth Malaysia Plan 2021-2025, which calls for a more stringent process for the appointment of board members of SOEs. Minimum qualification requirements, such as a relevant degree or work experience, and mandatory cooling-off periods may reduce the scope for political appointments. OECD work has encouraged countries to develop frameworks that clarify and ensure boards have the necessary authority, diversity, competencies, and objectivity to autonomously carry out their function with integrity (OECD, 2023<sup>[29]</sup>). Malaysia may wish to consider the experience of Brazil where the 2016 SOE Statute has helped reduce political interference in the management of SOEs and advance the professionalisation of its boards by establishing clear rules for the appointment of directors, including minimum experience, academic background, and morality requirements, as well as a minimum "cooling off" period if coming from political office (Vitale et al., 2022<sup>[30]</sup>). Malaysia could also consider regulating the financing of political campaigns and parties to fend off the possibility of SOEs being used as a conduit for financing political activities (Noor Mohamed, 2022<sup>[31]</sup>).

Protecting whistle-blowers and officials involved in anti-corruption investigations against the criminalisation of and retaliation for their activities is crucial and often plays a key role for the disclosure of high-profile corruption cases. Most OECD countries have dedicated whistle blower protection laws, like the one implemented by Australia in 2019 (OECD, 2016<sup>[32]</sup>). Malaysia's 2010 Whistleblower Protection Act could be amended to enhance whistleblower protection and open up new avenues for disclosing information about offences.

Public procurement is usually one of the government activities most at risk to waste, mismanagement, collusion and corruption (OECD, 2016<sup>[33]</sup>). Reducing collusion will reduce the prices paid by public authorities and opportunities to corrupt the collusion process (OECD, 2012<sup>[34]</sup>). Efforts to combat corruption should include a thorough assessment of how public procurement laws could be improved further and

implemented thoroughly. The mandatory use of centralised purchasing bodies, which are less prone to corruption, could be expanded, together with systematic training of procurement officials on effective tender design and effective detection of collusive practices (OECD, 2016<sup>[33]</sup>; OECD, 2012<sup>[34]</sup>). A November 2023 report by the Auditor General's on federal government ministries and agencies activities reported that losses and waste of public funds reached 0.2% of total government expenditure in 2022 due to a lack of compliance with procurement rules, as well as a lack of planning and monitoring. The annual report by Auditor General has regularly uncovered similar challenges, but an effective remedy for the problem is still outstanding. The planned enactment of a new Government Procurement Act in 2024 will be an opportunity to make further progress on fighting corruption and bid-rigging in public procurement.

Strong watchdogs and enforcement institutions are also an important element of an anti-corruption strategy. Malaysia's Anti-Corruption Commission (MACC) was established in 2009 with an intent to empower the previous anti-corruption body with greater independence and autonomy to investigate cases. Since 2023, the MACC not only oversees enforcement, but also serves advisory functions related to governance and integrity. The MACC's strong mandate was further strengthened in 2020 when a change in the underlying law facilitated legal action by commercial organisations or associated persons if charged for committing corruption offences for the benefit of their organisations. The governance of the MACC, however, could be strengthened further by securing its budget and isolating it against political interference, but also by improving the appointment procedure for the MACC Chief Commissioner. At present, the incumbent is appointed by the King upon the advice of the Prime Minister, but the process could be made more transparent if a parliamentary committee could recommend the nomination, and the tenure were established for a fixed period of time (OECD, 2021<sup>[1]</sup>).

**Table 1.6. Past recommendations on public sector integrity**

Recommendations	Actions taken since August 2021
Establish an appointment procedure of Chief Commissioner of the Malaysian Anti-Corruption Commission that involves the Parliament.	No action has been taken.

## Recommendations on macroeconomic policies (Key recommendations in bold)

MAIN FINDINGS	RECOMMENDATIONS
<b>Monetary and financial policies</b>	
Headline and core consumer price inflation have fallen below 2%, the average during the past decade.	<b>Maintain the current monetary policy stance in the short term and adjust rates as appropriate .</b>
Given the absence of an inflation target, market participants may have difficulties anticipating monetary policy decisions.	Ensure effective communication by the central bank in part by publishing the minutes of monetary policy committee meetings.
The currency has depreciated to its lowest level to the US dollar since the 1997 Asian Financial Crisis, which triggered foreign exchange interventions.	Continue to rely on the flexible exchange rate as a shock absorber of first resort.
The central bank has eased restrictions that have increased the size of the foreign exchange market.	Further deregulate and deepen the foreign exchange market to reduce exchange rate volatility.
Higher interest rates and the use of floating rates may increase the risks for households, a quarter of which faced debt service in excess of 60% in 2022.	Consider broadening the use of macroprudential tools, such as loan-to-value regulations.
<b>Fiscal and tax policies</b>	
The 2023 Public Finance and Fiscal Responsibility Act mandates a decline in the headline deficit from 5% of GDP in 2023 to 3% by 2028.	<b>Accelerate the pace of fiscal consolidation to reduce Malaysia's vulnerability to economic shocks and spending pressures.</b>
While the central government deficit fell in 2023, the deficit of the consolidated public sector (general government and non-financial public corporations) rose.	<b>Expand the fiscal framework to cover the consolidated public sector and contingent liabilities.</b>
The new fiscal framework established a 3–5 year Medium-Term Fiscal Plan with quantitative targets but did not establish an independent oversight body.	Establish an independent fiscal council to provide ex-ante and ex-post monitoring of compliance with the fiscal framework.
Subsidies for electricity and diesel, have risen sharply which counters carbon-mitigation efforts and mostly benefits high-income households.	<b>Reduce energy subsidies and use part of the savings for targeted cash transfers to low-income households.</b>
Price controls are an ineffective way to protect low-income consumers, limit competition, risk shortages and are considered a risk by foreign investors.	Phase out price controls gradually to improve resource allocation and avoid shortages.
Tax revenue amounts to only 12% of GDP. The Goods and Services Tax (GST), a value-added tax, was launched in 2015 but abolished in 2018.	<b>Re-introduce the Goods and Services Tax at a low rate while compensating low-income households with targeted transfers.</b>
Only 15% of the labour force pay personal income taxes. Relative to regional peers, the top marginal rate is lower and starts at higher income percentiles and the number of tax brackets is high.	<b>Broaden the tax base of personal income taxes, reduce thresholds from which higher tax rates are applied.</b>
A strong tax administration will be key for raising additional tax revenues.	<b>Further improve tax administration and enforcement.</b>
<b>Strengthening governance and fighting corruption</b>	
Asset disclosures can enhance transparency and prevent illicit enrichment of members of government.	<b>Require a systematic and regular asset disclosure for all high-level members of the executive and for legislators.</b>
Political appointments in state-owned enterprises reduce the quality of management and raises integrity concerns.	<b>Ensure that appointments in state-owned enterprises are based on merit by establishing minimum qualification requirements and mandatory cooling-off periods for former officials.</b>
Protecting whistle-blowers often plays a key role for the disclosure of high-profile corruption cases.	Amend the Whistleblower Protection Act to enhance whistleblower protection and open up new avenues for disclosing information about offences.
The appointment of the Chief Commissioner of the Malaysian Anti-Corruption Commission is based on the Prime Minister's advice and the duration of his tenure is not pre-determined.	Establish an appointment procedure of Chief Commissioner of the Malaysian Anti-Corruption Commission that involves the Parliament.

## References

- AMRO (2023), *AMRO Annual Consultation Report*. [2]
- Bank Negara Malaysia (2024), *Statement by the Financial Markets Committee on the Ringgit Foreign Exchange Market*, <https://www.bnm.gov.my/-/fmc-stmt-mar2024>. [4]
- Bank Negara Malaysia (2023), *2022 Financial Stability Review Second Half*, [https://www.bnm.gov.my/documents/20124/10150236/fsr22h2\\_en\\_book.pdf](https://www.bnm.gov.my/documents/20124/10150236/fsr22h2_en_book.pdf). [7]
- Bank Negara Malaysia (2023), *Annual Report 2022*, <https://www.bnm.gov.my/ar2022>. [5]
- Debrun, X. et al. (2018), “Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability”, *Staff Discussion Notes*, No. 2018/004, <https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2018/04/12/Second-Generation-Fiscal-Rules-Balancing-Simplicity-Flexibility-and-Enforceability-45131> (accessed on 14 April 2024). [10]
- Égert, B. (2017), “The quantification of structural reforms: Extending the framework to emerging market economies”, *OECD Economics Department Working Papers*, No. 1442, OECD Publishing, Paris, <https://doi.org/10.1787/f0a6fdcb-en>. [16]
- Égert, B. and P. Gal (2016), *The quantification of structural reforms in OECD countries: a new framework*, <https://www.oecd.org/competition/reform/The-quantification-of-structural-reforms-in-OECD-countries-a-new-framework.pdf>. [15]
- Fitch Ratings (2023), *Global Sukuk Market Dashboard: 3Q23*, <https://www.fitchratings.com/research/islamic-finance/global-sukuk-market-dashboard-3q23-11-10-2023> (accessed on 15 April 2024). [8]
- Fitch Ratings (2023), *Malaysia’s Islamic Financing Growth to Continue Outperforming Conventional Banks*, Fitch Ratings. [37]
- Gupta, S. and J. Jalles (2023), “Priorities for Strengthening Key Revenue Sources in Asia”, *Asian Development Review (ADR)*, Vol. 40/02, pp. 271-303, <https://doi.org/10.1142/S0116110523500178>. [19]
- IMF (2024), *Malaysia: 2024 Article IV Staff Report*, International Monetary Fund, Washington, DC, <https://www.imf.org/en/Publications/CR/Issues/2024/03/08/Malaysia-2024-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-546087> (accessed on 15 April 2024). [3]
- IMF (2024), *World Economic Outlook Update, January 2024*, <https://doi.org/10.5089/9798400259708.081>. [36]
- IMF (2023), *Malaysia: 2023 Article IV Consultation-Press Release and Staff Report*, International Monetary Fund, Washington, DC, <https://www.imf.org/en/Publications/CR/Issues/2023/05/31/Malaysia-2023-Article-IV-Consultation-Press-Release-and-Staff-Report-533968> (accessed on 16 May 2024). [38]
- Johansson, Å. et al. (2008), “Taxation and Economic Growth”, *OECD Economics Department Working Papers*, No. 620, OECD Publishing, Paris, <https://doi.org/10.1787/241216205486>. [20]

- Jones, D. (2022), "Challenges in combating corruption in Malaysia: issues of leadership, culture and money politics", *Public Administration and Policy*, Vol. 25/2, pp. 136-149, <https://doi.org/10.1108/PAP-01-2022-0002>. [27]
- Narayanan, S. and A. Latiff (2024), "The Untimely Demise of the Goods and Services Tax (GST) in Malaysia: A Postmortem and the Way Forward", *Asian Economic Papers*, Vol. 23/1, [https://doi.org/10.1162/asep\\_a\\_00883](https://doi.org/10.1162/asep_a_00883). [22]
- Noor Mohamed, K. (2022), *Political Funding Or Corruption?*, Blog, Malaysia Anti-Corruption Commission, [https://www.sprm.gov.my/index.php?page\\_id=103&contentid=2618&cat=BKH&language=en](https://www.sprm.gov.my/index.php?page_id=103&contentid=2618&cat=BKH&language=en) (accessed on 27 March 2024). [31]
- OECD (2024), *Update of the economic impact assessment of the Global Minimum Tax - OECD*, <https://www.oecd.org/tax/beps/webinar-economic-impact-assessment-two-pillar-solution.htm> (accessed on 20 May 2024). [17]
- OECD (2023), *Government at a Glance 2023*, OECD Publishing, Paris, <https://doi.org/10.1787/3d5c5d31-en>. [11]
- OECD (2023), *Safeguarding State-Owned Enterprises from Undue Influence: Implementing the OECD Guidelines on Anti-Corruption and Integrity in State-Owned Enterprises*, Corporate Governance, OECD Publishing, Paris, <https://doi.org/10.1787/47444e1c-en>. [29]
- OECD (2022), *Pricing Greenhouse Gas Emissions: Turning Climate Targets into Climate Action*, OECD Series on Carbon Pricing and Energy Taxation, OECD Publishing, Paris, <https://doi.org/10.1787/e9778969-en>. [25]
- OECD (2022), *Revenue Statistics in Asia and the Pacific 2022: Strengthening Tax Revenues in Developing Asia*, OECD Publishing, Paris, <https://doi.org/10.1787/db29f89a-en>. [18]
- OECD (2021), "Carbon pricing in Malaysia", *Pricing Greenhouse Gas Emissions*. [35]
- OECD (2021), *OECD Economic Surveys: Chile 2021*, OECD Publishing, Paris, <https://doi.org/10.1787/79b39420-en>. [14]
- OECD (2021), *OECD Economic Surveys: Malaysia 2021*, OECD Publishing, Paris, <https://doi.org/10.1787/cc9499dd-en>. [1]
- OECD (2019), *OECD Economic Surveys: Malaysia 2019*, OECD Publishing, Paris, <https://doi.org/10.1787/eaaa4190-en>. [23]
- OECD (2017), "Ensuring fiscal sustainability in the context of a shrinking and ageing population", in *OECD Economic Surveys: Japan 2017*, OECD Publishing, Paris, [https://doi.org/10.1787/eco\\_surveys-jpn-2017-6-en](https://doi.org/10.1787/eco_surveys-jpn-2017-6-en). [12]
- OECD (2016), *Committing to Effective Whistleblower Protection*, OECD Publishing, Paris, <https://doi.org/10.1787/9789264252639-en>. [32]
- OECD (2016), *Preventing Corruption in Public Procurement*, <http://www.oecd.org/gov/public-procurement/publications/Corruption-Public-Procurement-Brochure.pdf> (accessed on 15 September 2020). [33]

- OECD (2014), *Recommendation on Principles for Independent Fiscal Institutions*, OECD, Paris, <https://www.oecd.org/gov/budgeting/recommendation-on-principles-for-independent-fiscal-institutions.htm> (accessed on 15 April 2024). [13]
- OECD (2012), *OECD Recommendation on Fighting Bid Rigging in Public Procurement*, <https://www.oecd.org/competition/oecdrecommendationonfightingbidrigginginpublicprocurement.htm> (accessed on 8 January 2020). [34]
- OECD (2006), *Fundamental Reform of Personal Income Tax*, OECD Tax Policy Studies, No. 13, OECD Publishing, Paris, <https://doi.org/10.1787/9789264025783-en>. [26]
- OECD/KIPF (2014), *The Distributional Effects of Consumption Taxes in OECD Countries*, OECD Tax Policy Studies, No. 22, OECD Publishing, Paris, <https://doi.org/10.1787/9789264224520-en>. [21]
- Transparency International (2020), *Global Corruption Barometer ASIA 2020*, <https://www.transparency.org/en/gcb/asia/asia-2020> (accessed on 9 May 2024). [28]
- Vitale, C. et al. (2022), “Product Market Regulation in Brazil”, *OECD Economics Department Working Papers*, No. 1735, OECD Publishing, Paris, <https://doi.org/10.1787/ea3dd09e-en>. [30]
- World Bank (2024), *Bank liquid reserves to bank assets ratio (%) | Data*, <https://data.worldbank.org/indicator/FD.RES.LIQU.AS.ZS> (accessed on 15 April 2024). [6]
- World Bank (2023), *Malaysia Economic Monitor, October 2023: Raising the Tide, Lifting All Boats*, Washington, DC: World Bank, <https://doi.org/10.1596/40441>. [9]
- World Bank (2021), “Aiming High – Navigating the Next Stage of Malaysia’s Development”, *Country Economic Memorandum, Washington, DC: The World Bank*, Vol. 159/17. [24]

# 2 Towards more inclusive growth

Jens Matthias Arnold

Ken Nibayashi

---

Malaysia has achieved impressive declines in poverty over recent decades on the back of strong growth, but social benefits could play a more decisive role to alleviate poverty by targeting those most in need, while considering an expansion of social protection in the medium term. This would also help to address inequalities in incomes and opportunities. The labour market has been resilient, but significant skill mismatches limit people from seizing opportunities, and many workers are trapped in informal jobs. As a result, the economy is not making the best possible use of its human resources, hampering productivity improvements. Women still have lower employment rates, despite progress made in the past.

---

## Malaysia has made substantial progress in social inclusion

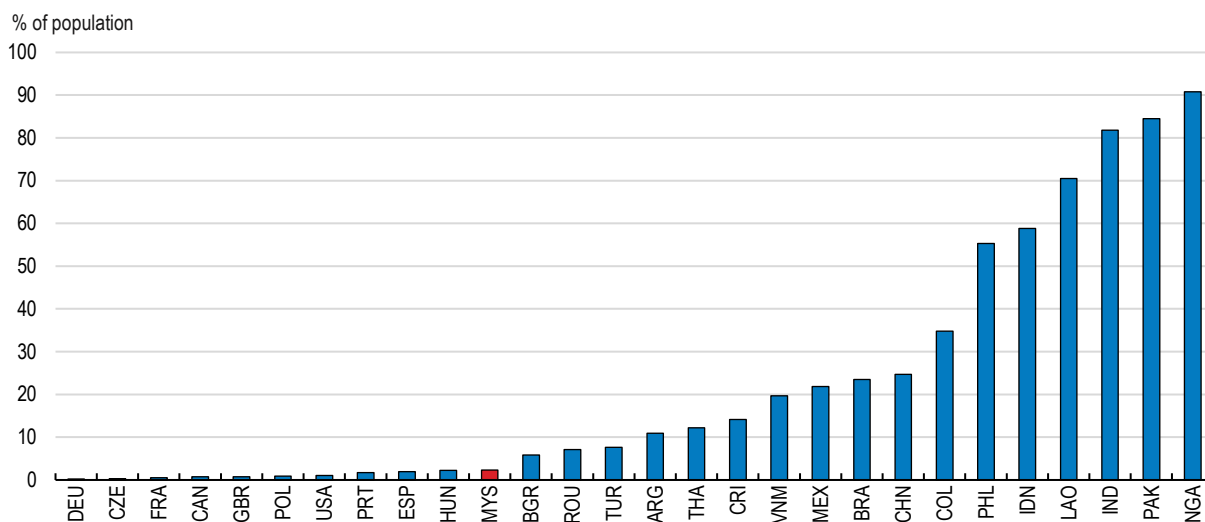
In many respects, Malaysia is a success story of social inclusion. Poverty has declined consistently to low levels over the last decades, and poverty rates have narrowed across different ethnic groups. Income inequality has also fallen but remains at high levels relative to peers. Labour force participation has trended upwards over the last two decades, although it remains some 26 percentage points lower among women than among men. Similarly, noticeable gender gaps in employment and wages continue to put women at a disadvantage. Labour informality affects more than one in four workers in Malaysia. These workers are highly vulnerable as they are generally not covered by any social insurance scheme and have no access to social security benefits like an old-age pensions.

### **Poverty rates have reached low levels following years of decline**

Malaysia's poverty rates are substantially lower than those of many peer economies. Using the international USD 6.85 at purchasing power parity (PPP) poverty line, typically used for upper middle-income countries, Malaysia's absolute poverty rate was 2.3% in 2021, a low number that compares favourably with peers in the Southeast Asia region and beyond (Figure 2.1).

### **Figure 2.1. Poverty is low in international comparison**

Poverty line of USD 6.85 PPP, 2023 or latest



Note: Poverty lines are defined in 2017 USD at purchasing power parity.

Source: World Bank.

StatLink  <https://stat.link/xak804>

The low poverty incidence reflects substantial declines in poverty over the last 50 years, amid strong growth that improved earnings opportunities, including for those at the lower end of the income distribution. The national poverty line is defined at the level of household income and the resulting national absolute poverty rate is depicted in Figure 2.2. While almost half of households were living in poverty in 1970, this rate had decreased to 0.4% in 2016, based on the official poverty line applied until that year.

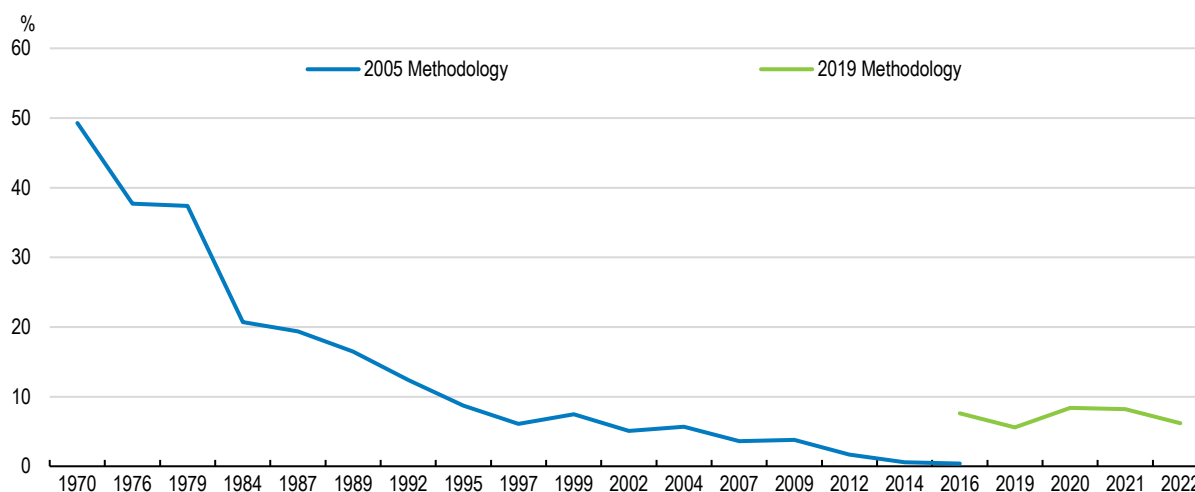
A revised, and more demanding definition of the absolute poverty line applied as of 2016 shows continued declines in poverty until 2020, when the COVID-19 pandemic affected many households' incomes. Following the pandemic-related increase in poverty, poverty fell again during the recovery, to reach 6.2% in 2022, according to the 2022 national poverty line of MYR 2 589 per household and month, which

corresponded to around USD 13 per day in 2017 USD at purchasing power parity. This, however, is still slightly above the pre-pandemic level of 5.6% measured at the 2019 poverty line of MYR 2 589.


Nationwide poverty rates hide significant regional disparities (DOSM, 2023<sup>[1]</sup>). Some regions have a substantially higher incidence of poverty than the national average of 6.2%, especially the states of Sabah (19.7%), Kelantan (13.2%), Sarawak (10.8%). By contrast, states and federal regions around the capital Kuala Lumpur have poverty rates of less than half the national average. Differences in poverty across ethnic groups have declined steadily over the last two decades but remain visible, with poverty rates among ethnic Chinese amounting to 1.9%, while the Bumiputera ethnic group, defined as ethnic Malays, the Orang Asli of Peninsular Malaysia, and various indigenous peoples of East Malaysia, has a poverty rate of 7.9%. Malaysians of Indian (5.4%) and other ethnicities (6.5%) have poverty rates close to the nationwide average of 6.2%.

## Figure 2.2. Poverty has fallen

Absolute poverty rate, %



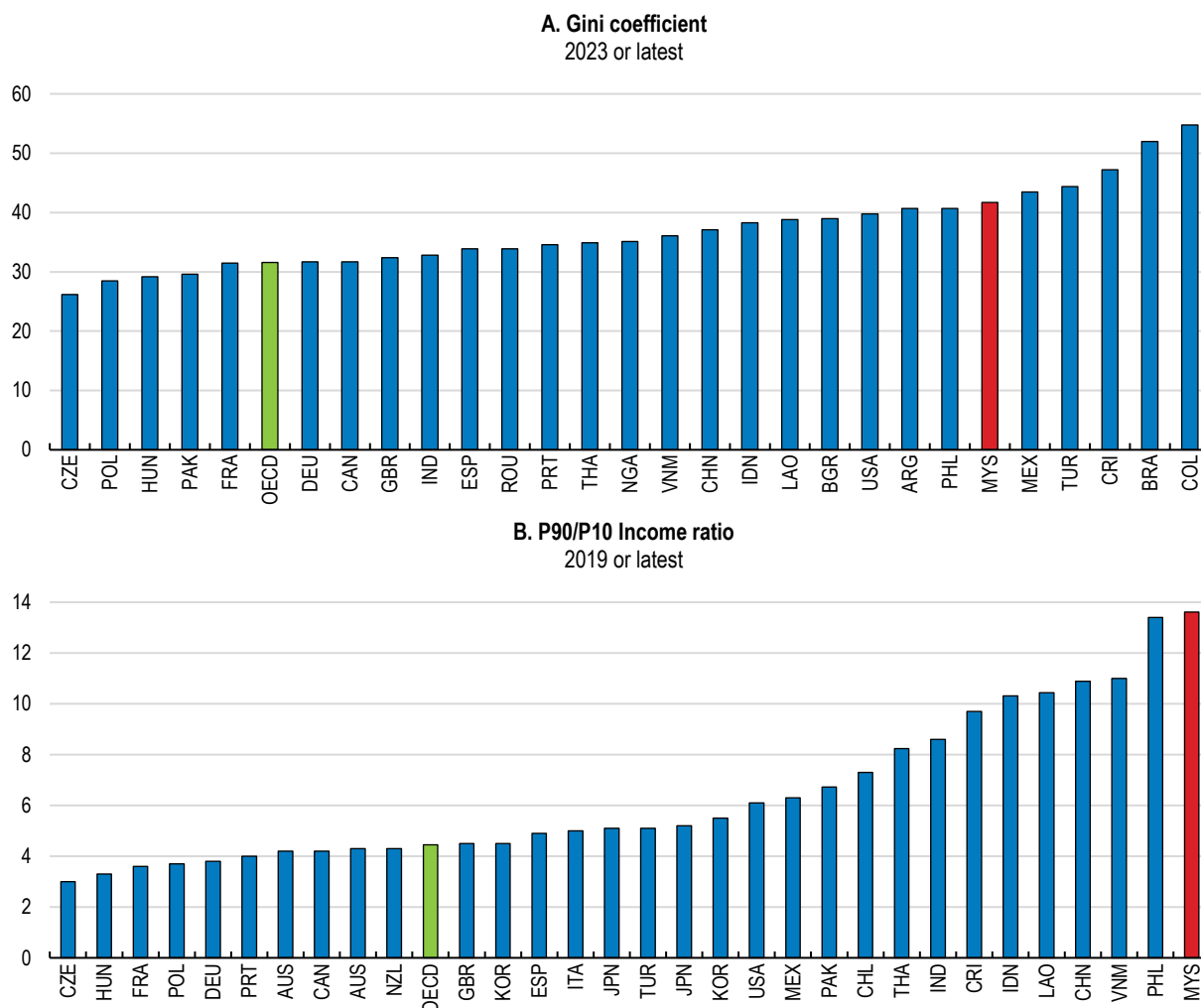
Source: Ministry of Economy, [Jadual 8 Insiden kemiskinan mutlak mengikut kumpulan etnik ketua isi rumah, strata & negeri, Malaysia, 1970–2022.pdf \(ekonomi.gov.my\)](#), World Bank.

StatLink  <https://stat.link/19d4f8>


## ***Income inequality remains high in international comparison***

While Malaysia has a low poverty rate, it also has relatively high income inequality. The Gini coefficient, which is one widely measure of income inequality, remains high relative to most peer countries (Figure 2.3, Panel A). Another measure of income inequality is the P90/P10 ratio which is the ratio of the upper bound value of the ninth decile (i.e. the 10% of people with highest income) to that of the first decile, measured on the basis of disposable incomes of the working-age population. According to this measure, Malaysia had very high-income inequalities in 2019 (Figure 2.3, Panel B).

Figure 2.3. Income inequality is high



Source: World Bank, OECD Income Distribution Database.

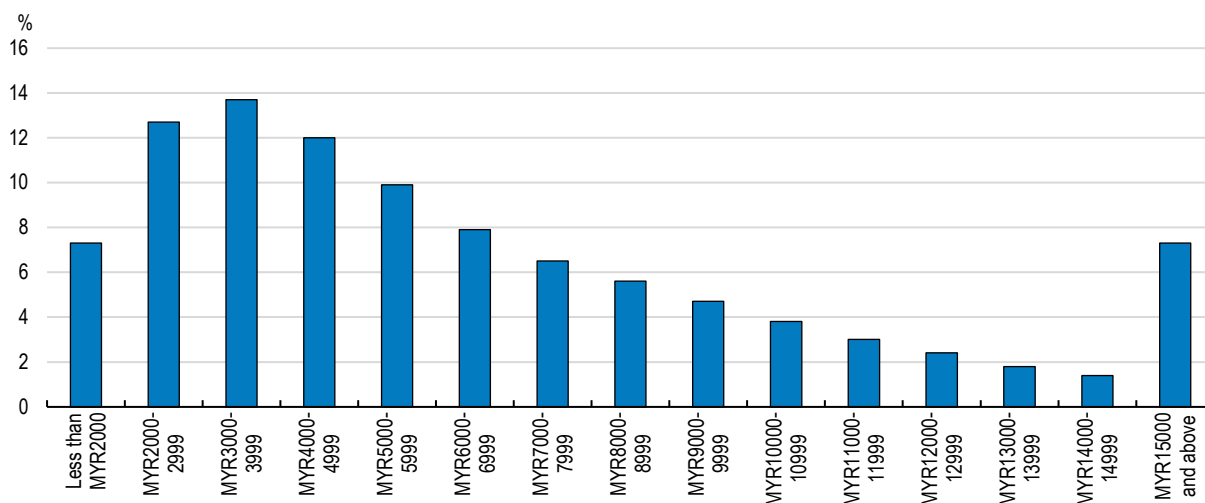
StatLink  <https://stat.link/i9egu7>

One way to reconcile the relatively low poverty rate with high inequality is to look at the income distribution around the poverty line. Median household disposable income amounted to MYR 5 413 in 2022 (USD 1 135), for an average household size of 3.8 persons. Household incomes are concentrated in the range below MYR 5 000 (USD 1 048), which account for almost half of Malaysian households, while the density of the household income distribution gets increasingly thinner for income classes above that, except for the broader income class of household incomes above MYR 15 000 (USD 3 144), which accounts for around 7% of Malaysian households (Figure 2.4).

The recent trajectory of inequality over time suggests that while the Gini coefficient has fallen from a high of 56 in 1976 to 40 by 2014, the decline has stalled since then and the Gini coefficient stood at 40 in 2022. The COVID-19 pandemic is likely to have a lasting impact on income inequality. To the extent that children from low-income households were precluded from education for longer than those from better socio-economic backgrounds, particularly related to difficulties in accessing remote education during the pandemic, COVID-19 may have exacerbated income inequalities even in the longer run. At the same time, the pandemic also had particularly negative effects on other vulnerable groups such as senior citizens, persons with disabilities and women.

**Figure 2.4. The income distribution shows many households with low incomes and a thin middle**

Share of households according to household disposable income



Source: Household Income Survey Report 2022, Department of Statistics Malaysia (DOSM).

StatLink  <https://stat.link/gjavy3>**Taxes and transfers have relatively small redistributive effects**

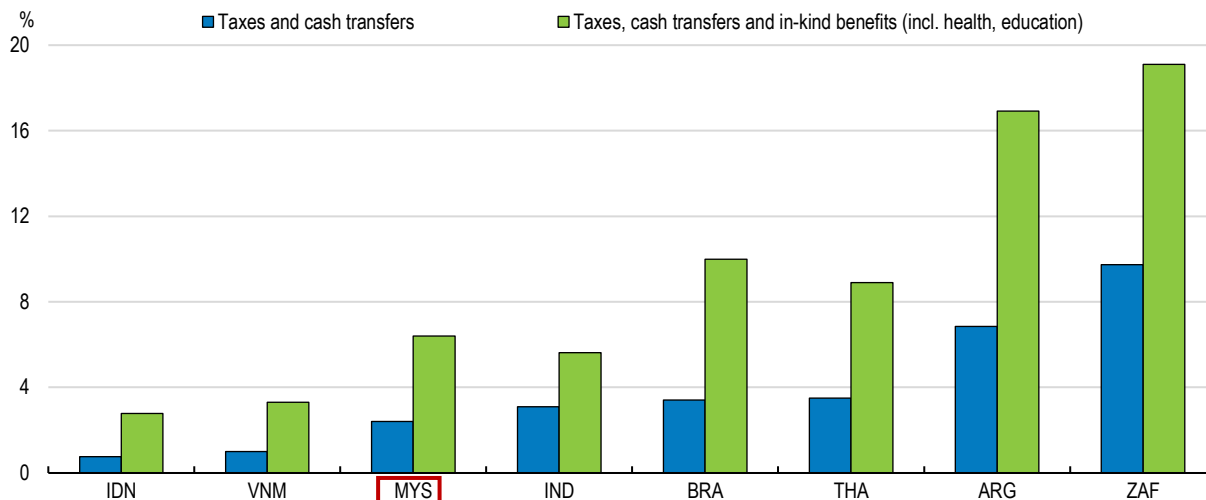
The strong inequalities hint at scope for public policies to step up efforts to address inequalities and provide better opportunities for all. While in the long run, strong education and training policies are probably the most effective lever to open up better earning opportunities and enhance material living standards, in the shorter run taxes, transfers, public services and subsidies can play an important role for reducing inequalities.

An analysis of the distributional impact of taxes and benefits on the basis of 2019 data suggests that fiscal policy, including most taxes, monetary transfers and subsidies, could do much more to alleviate income inequalities (World Bank, 2023<sup>[2]</sup>). Taxes, transfers and subsidies reduce the Gini coefficient by 2.4 points from 43.3 to 40.9 (Figure 2.5). This reduction in inequality is more than what Indonesia and Viet Nam achieve, but it falls short of the 3.5 points in inequality reduction that taxes and transfers achieve in Thailand, and is much less than in the average OECD country.

This analysis can be taken one step further by estimating the monetary value of in-kind services provided by the public sector, such as healthcare services and public education (World Bank, 2023<sup>[2]</sup>). This analysis is obviously sensitive to the assumptions made in the estimations of monetary values, in contrast to the previous exercise, but the results can nonetheless give interesting insights. When accounting for the equivalent monetary value of health and education benefits in addition to taxes, transfers and subsidies, Malaysia's inequality reduction of 6.4 points is also below the 8.9 points of inequality reduction in Thailand, while countries like Brazil, Argentina and South Africa lessen inequality by around 10, 17 and 19 Gini points, respectively. On the whole, while Malaysia's public policies do more to reduce income inequalities than in some regional comparators, other countries achieve significantly higher equalising effects of taxes, transfers and public services such as education and healthcare.

## Figure 2.5. Taxes and transfers could do more to reduce inequalities

Reductions in the GINI coefficient through public policies, in points of the Gini



Note: The methodology applied here follows Lustig, N. (ed.) (2022). *The Commitment to Equity Handbook 2<sup>nd</sup> edition: Estimating the Impact of Fiscal Policy on Inequality and Poverty*, CEQ Institute at Tulane University and Brookings Institution Press, Washington, DC.

Source: Malaysia: World Bank (2023). *Malaysia Economic Monitor* Oct. 2023. Thailand: World Bank (2023). *Thailand Public Spending and Revenue Assessment*, May 2023, Viet Nam: World Bank (2016). *Systematic Country Diagnostic Viet Nam, 2016*, Other countries: *Commitment to Equity Institute* (2023). *Standard Indicators*, May 2023.

StatLink  <https://stat.link/i3rejy>

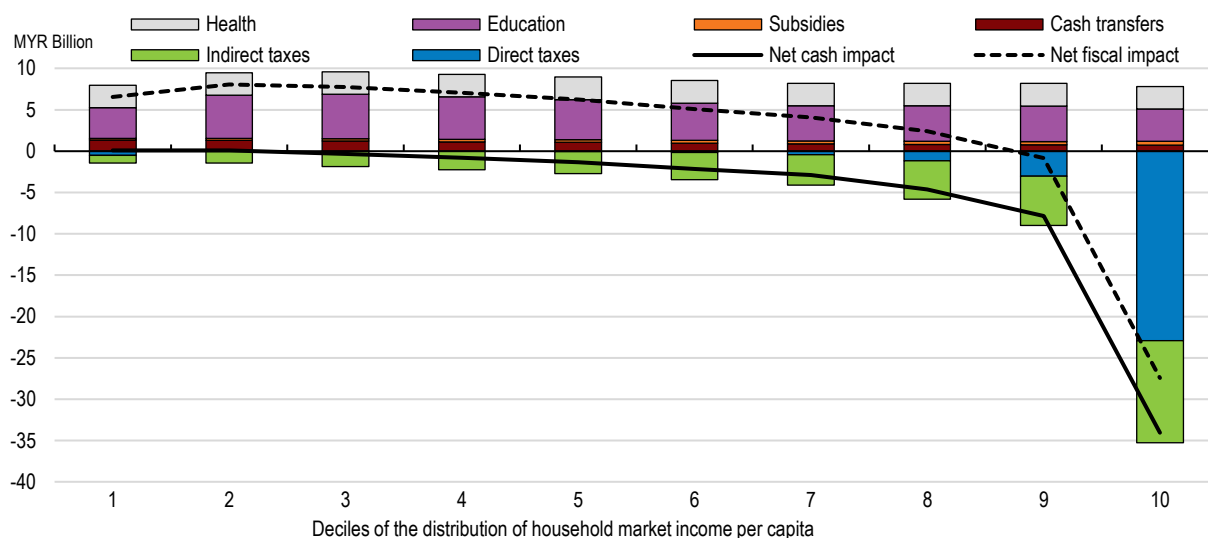
One feature that sets the stage for the equalising impact that Malaysia's public sector can have is its small size, often related to narrow tax bases (Chapter 1). Tax revenues are low at 11.9% of GDP, even in a regional comparison, placing limits on the amount of redistribution that can be achieved.

Beyond their mere size, however, the composition and design of Malaysia's social expenditures is not particularly progressive. While the equalising effect of social spending would generally be maximised by targeting benefits towards the bottom end of the income distribution, all parts of the income distribution are receiving surprisingly similar shares of public benefits in absolute values, even if relative to total income the benefits are more substantial for low-income earners (World Bank, 2023<sub>[2]</sub>). For households in the lower deciles of the income distribution this means that even if they may not pay much taxes, but they do not get a disproportionate share of the benefits either, so that overall, they do not reap strong net benefits from fiscal policy interventions (Figure 2.6).

Benefit levels are generally too low to make a real difference for reducing inequalities. Even for the lowest income decile, cash transfers only augment market incomes by around 13%, while in many other emerging market economies, cash transfers constitute the bulk of income for lowest-income households. In Brazil, for example, the bottom decile of the income distribution gets about 27% of its gross income from social benefits (SEAE, 2017<sub>[3]</sub>). Only in-kind services like public education and healthcare have a significant effect on the lower half of the income distribution when comparing the monetary value of these public services to their market incomes before public intervention (World Bank, 2023<sub>[2]</sub>). The incidence of subsidies is particularly unfavourable for those with low incomes: While the bottom decile appropriates about 6% of the total amount of subsidies spent, the top decile gets around 15%. Shifting resources from broad subsidies to well-targeted social assistance benefits, for example, would strongly improve the progressive distribution effect of public spending. Subsidies amounted to 3.5% of GDP in 2023, while social assistance benefits amounted to only 1% of GDP. Amid rising fuel prices in 2022, the value of subsidies exceeded total public health spending and reached 72% of public education expenditure.

Besides public expenditures, the design of taxes can also shape the income distribution. Given its low tax intake and high present and future spending pressures, Malaysia will have to mobilise additional tax revenues, and several avenues for this are discussed in Chapter 1. With respect to reducing income inequalities, lowering the basic allowance in personal income taxes and making larger parts of the middle class pay personal income taxes would be one avenue for future action. Starting higher marginal rates at lower incomes than at present would be another way to sharpen the redistributive effect, as would taxing personal capital income and a systematic review of tax expenditures, many of which tend to bring greater benefits to those with higher incomes.

**Figure 2.6. While taxes are progressive, transfers do little to reduce inequalities**



Note: The analysis in the chart covers all indirect taxes, personal income taxes and social security contributions, and almost all social spending and subsidies.

Source: World Bank (2023) based on 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) [StatLink !\[\]\(b6ef56fa296999ede58894c7fe9d297e\_img.jpg\) https://stat.link/qyg3ln](https://stat.link/qyg3ln)

### **Cash transfers could do more to support vulnerable and poor households**

A large part of the fiscal outlay for social protection, around 1.1% of GDP in 2019, is spent on social safety nets for those in working age, which consist of a fragmented set of programmes managed by multiple agencies at both Federal and State Government levels. At the federal level alone, the number of federal social assistance and subsidy programmes reached 154 in 2023. These programmes often lead to overlaps, leakages and benefit duplication. Based on different databases managed by multiple agencies, verification and enforcement is a challenging task. Recent efforts by the Malaysian Social Protection Council MySPC have led to progress in establishing a mapping of programmes by different types of support across the federal and state government and organisations.

Social safety net programmes are characterised by weak targeting towards the poor, which can be traced back to weaknesses in the design of these programmes. As a result, 78% of Malaysians report receiving some sort of social assistance benefit.

At the same time, benefit levels are low and insufficient to ensure that the most vulnerable households are able meet minimum living standards. The largest flagship programme is the Sumbangan Tunai Rahmah (STR), formerly known as BSH, BPR and BR1M, provides cash handouts to around 8.2 million households. Benefit levels are largely determined by household incomes and do not take full account of the household size, which diverges from common practice in other countries and could be fully refocused on household income per capita instead. Households with incomes below MYR 2 500 (USD 525), approximately the per-

household poverty line of MYR 2589 (USD 543), receive a monthly benefit of MYR 500 (USD 105), while households with incomes below MYR 5 000 (USD 1 050) receive between MYR 100 (USD 21) and MYR 300 (USD 63). Although the official objective of the programme is to support the bottom 40% of the income distribution, this population segment received only 12% of the total allocation in 2019 (BNM, 2020<sup>[4]</sup>). By contrast, around 11% of those in the bottom 40% of the income distribution do not get a benefit (World Bank, 2021<sup>[5]</sup>; BNM, 2020<sup>[4]</sup>).

Improving targeting will be crucial, while consolidating the different programmes to avoid overlaps and duplications. Simulations suggest that refocusing the current spending on social assistance benefits on the 40% poorest, based on a proxy means test in the absence of actual data on incomes, would raise the poverty reduction achieved by social assistance benefits from 0.9 percentage points to 2.0 percentage points, more than doubling the poverty reduction effect. An additional budget increase from 1.0% of GDP to 1.5% of GDP spent on social assistance would raise the poverty reduction effect further to 3.1 points (World Bank, 2023<sup>[2]</sup>).

Several countries with successful cash transfer programmes have combined the handout with incentives for low-income households to invest in human capital, by conditioning the handout on school attendance of children living in the household or regular medical visits and pre-natal care. These conditional cash transfers combine short-term poverty relief with efforts to lift families out of poverty in the longer run to reduce benefit dependence. Malaysia could consider introducing such conditionalities, and also reach out to STR beneficiaries offering training or employment counselling services.

Efforts to improve targeting will also hinge on unifying the databases or social registries used to deliver social protection benefits. Current transfers rely on three separate registries (eKasih, eBantuan and STR). Malaysia has a unique person identifier number on which the unification and creation of a single digital social registry could build. Many countries have made significant progress in creating single registries of poor and vulnerable households, including Brazil, Chile and the Philippines. Malaysia has recently started an initiative to construct a single administrative database called PADU (Pangkalan Data Utama), which encompasses individual and household data for citizens and permanent residents of Malaysia, consolidating different sources of government data. Building a single registry for social benefit delivery on the basis of PADU would be a promising way to improve targeting.

Moving towards a well-targeted and less fragmented social protection system would also require stronger coordination among different public-sector institutions. Giving a strong coordinating role for social protection policies to a single institution, for example the Internal Coordination Unit at the Prime Minister's office, would help to reduce overlap and fragmentation.

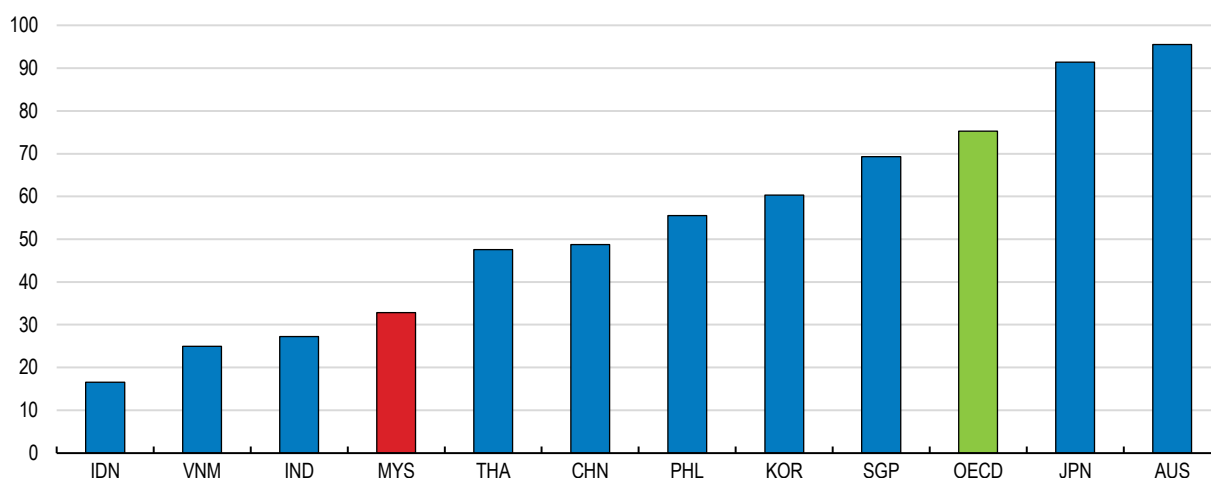
### ***Pension coverage is narrow and inadequate***

Public pensions are one area of social protection with significant scope for building on past efforts to reduce inequalities. Despite the economic expansion in the past decades, access to and coverage of old-age retirement schemes in Malaysia remains low. Overall pension coverage with mandatory pension schemes is around one-third of the population aged 15 to 64, which is substantially lower than other countries (Figure 2.7). In other words, two-thirds of the people in that age group, including informal, self-employed or unemployed workers, are not covered by social insurance schemes.

Malaysia's main contribution-based public pension system is the Employees Provident Fund (EPF), a defined contribution scheme responsible for collecting mandatory contributions from employees and employers in private companies and non-profit organizations. Contributions to individual EPF member accounts amount to 12-13% of wages for employers and 11% for employees, depending on wage levels. Around 49% of workers contribute to his system during some part of their working life, although transitions between formal and informal jobs imply that many do not contribute during their whole working history.

**Figure 2.7. Coverage of mandatory pension schemes is low**

% of population aged 15 to 64



Source: OECD (2022), Pensions at a Glance Asia/Pacific 2022.

StatLink  <https://stat.link/xt5kdn>

However, the fact that private sector employees with formal labour contracts are covered under the EPF does not mean they are well prepared for retirement. Early withdrawal opportunities exist below the age of 50 up to MYR 50 000 for education, home purchases or medication, then again between age of 50 and 54 of the same amount, before receiving their remaining balance as a lumpsum at the retirement age of 55. As a result, EPF balances are on average higher for members aged 45-49 than for those approaching the retirement age of 55 (EPF, 2023<sup>[6]</sup>). Among OECD countries, early pension withdrawals are typically limited to complementary occupational pension plans, like in Australia, France and Sweden at age 55 (OECD, 2021<sup>[7]</sup>).

Early withdrawals leave many contributors with insufficient saving balances upon reaching retirement age. The EPF recommends its members to have basic savings of at least MYR 240 000 at the age of 55. However, at end December 2022, the median savings of active members aged between 50 and 54 were only MYR 134 926, in part related to exceptional withdrawal opportunities during the COVID-19 pandemic. Two out of three active EPF contributors are projected to have insufficient retirement savings to meet a minimum pension of MYR 1 000 per month, approximately half the current poverty line (EPF, 2018<sup>[8]</sup>). Estimates based on a hypothetical conversion of balances into annuities suggest that over 40% of EPF contributors will be left with monthly benefits below MYR 420, which is close to the current level of non-contributory social assistance pensions (World Bank, 2021<sup>[9]</sup>).

Looking ahead, there are several avenues for the EPF to provide better pension benefits to its members. Now that the pandemic is over, early withdrawals should be limited so as to prioritise the accumulation of pension savings. Given that early withdrawals of the EPF balance are currently the only recourse that some households may have in emergency cases, limiting early withdrawals also calls for strengthening the social safety net and devising other insurance mechanisms for households hit by a severe shock, without jeopardising their old-age pension. Households across the world are typically short-sighted when it comes to financial planning and tend to underestimate their financial needs during retirement, which is one reason why mandatory pension schemes exist in the first place. This argument would also call for paying out EPF balances on a monthly basis or obliging households to convert them into annuities, as practised in the United Kingdom over many years.

The current pension withdrawal age of 55 is significantly below the current OECD average of 65 years (Figure 2.8). The remaining life expectancy at age 65 in Malaysia is 24.5 years, which is longer than the time span during which many people contribute to the EPF, given transitions between formal and informal

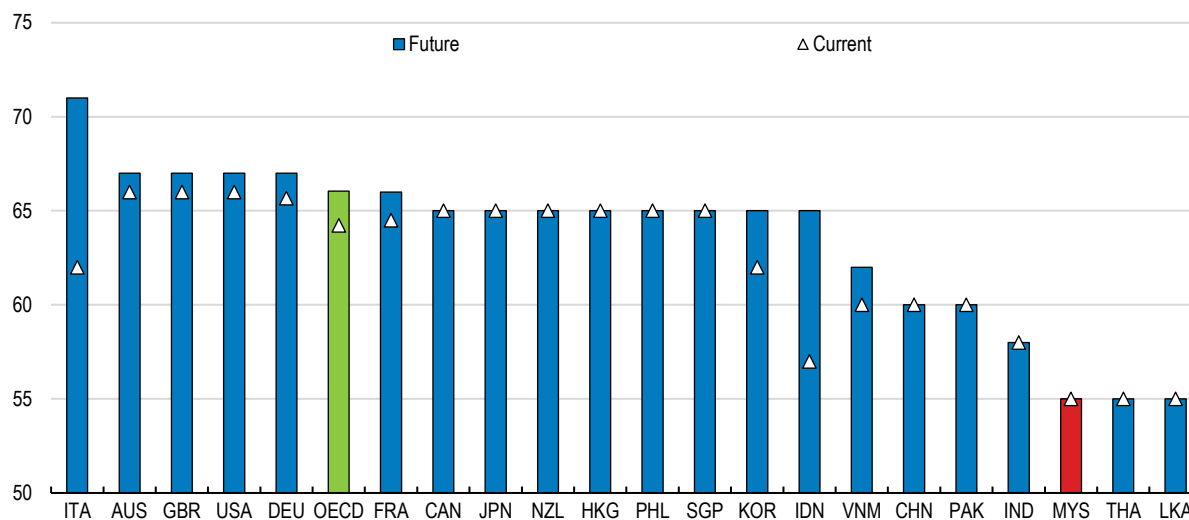
employment (World Bank, 2021<sup>[5]</sup>). The mandatory retirement age in Malaysia was raised from 55 to 60 in 2013, but full EPF withdrawals are still allowed at the age of 55, and contributions from age 55 to 60 can be withdrawn at age 60. In most Asian countries, people retire later, including the Philippines (65), Singapore (62) and South Korea (65). Indeed, surveys suggest that most Malaysians continue to work much beyond the age of 55, and life expectancy rose to 75 in 2023. A gradual increase in the EPF withdrawal age will likely increase retirement savings, providing individuals with additional working years to contribute to their retirement savings. Estimates suggest that raising the withdrawal rate to the age of 65 could almost double balances that most EPF beneficiaries would receive upon retirement (World Bank, 2021<sup>[5]</sup>).

Civil servants, currently 5.6% of the working-age population, are covered by the Malaysian Public Sector Pension Scheme, a defined-benefit scheme that is managed by Kumpulan Wang Persaraan (KWAP). Its budget costs are expected to rise four-fold between 2022 and 2040. Already, the share of pension liabilities in total federal government operating expenditure has increased to 9.8% in 2019 from 6.5% in 2009 (BNM, 2023<sup>[9]</sup>). Discussions are ongoing about phasing out this scheme and enrolling newly hired civil servants in the EPF instead. Given how costly the civil servant scheme is, this is a necessary step that should go hand in hand with improvements in the EPF and in social assistance pensions. There is also a small scheme for armed forces personnel covering 0.6% of the working-age population (Hamid et al., 2021<sup>[10]</sup>).

Over 60% of the working-age population are not protected by either of the three mandatory schemes, reflecting those in informal jobs, contract-for-service workers and self-employed individuals (Hamid et al., 2021<sup>[10]</sup>). These can voluntarily become EPF members, and the government tops up their contributions, but the take-up of this voluntary scheme has been very low, as highlighted in the 2021 OECD Economic Survey of Malaysia (Table 2.1). Median savings of members who voluntarily register with the EPF but have not contributed for at least one year are merely 4% of the balances that the EPF recommends its members to have at 55.

### Figure 2.8. The effective retirement age is low in international comparison

Current and future refer to retiring 2020 and entering the labour market in 2020, respectively



Source: (OECD, 2022<sup>[11]</sup>)

StatLink  <https://stat.link/ljqw8b>

Social assistance pensions that do not rely on contributions are one way to fill the insufficient pension coverage from the EPF and other contributory systems. The fact that a large share of the population is excluded from social security benefits is a common feature across many emerging-market and developing economies, not only in Asia but also in Latin America and Africa. Many governments have complemented

formal social security with non-contributory social assistance benefits over the last two decades, and this has also been the case in Malaysia.

A means-tested, tax-financed allowance for older individuals, known as Bantuan Warga Emas (BWE), covers around 4.2% of the total population aged over 60 with a benefit of MYR 500 (USD 105) per month. Its current fiscal cost is approximately 0.04% of GDP (Hamid et al., 2021<sup>[10]</sup>). However, it covers only around 26% of elderly Malaysian with incomes in the bottom 20%. At present, social assistance pensions fail to provide a consistent minimum protection for poor and vulnerable households.

Against the background of significant labour informality and low participation rates in the EPF, the most realistic avenue towards achieving universal old-age pension coverage would probably be to build on the non-contributory pillar and expand it gradually towards universal coverage of all those aged 65 and above with no pension or income from other sources. This would allow Malaysia to essentially eradicate old-age poverty at an estimated fiscal cost of approximately 1.7% of GDP (Hamid et al., 2021<sup>[10]</sup>). For comparison, Malaysia spent 3.5% of GDP on subsidies in 2023, which are ineffective as a redistribution mechanism and counter environmental objectives (Chapter 3).

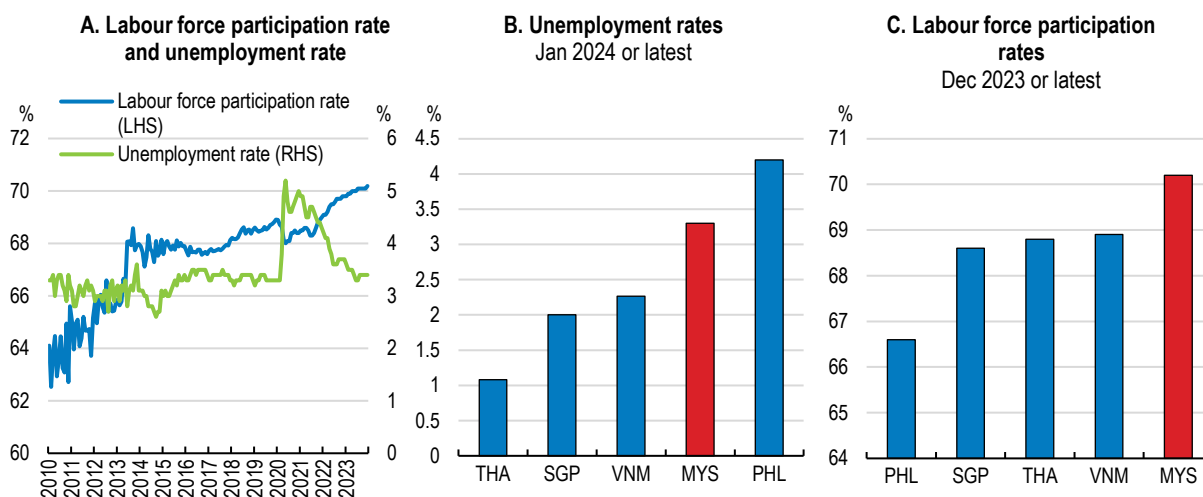
**Table 2.1. Past Recommendations on social inclusion**

Recommendations	Actions taken since August 2021
Include dependent “self-employed workers” into the pension scheme under the Employees Provident Fund.	No action taken.
Expand the coverage of employment injury insurance for the self-employed to more sectors.	Effective January 2020, the coverage of employment injury insurance has been extended to 19 other sectors.

## Labour market efficiency is hampered by skills mismatch and informality

Malaysia's labour market has shown resilience in the face of subsequent shocks, and the current unemployment rate of 3.4% has returned to pre-pandemic levels (Figure 2.9, Panel A). Recent declines in unemployment have been mostly driven by those below the age of 35, although in levels, unemployment among those aged 15-24 remains more than 3 times the national average. In a regional comparison, Malaysia's unemployment rate takes a middle position, while the level of labour participation exceeds that of regional peers (Figure 2.9, Panels B and C). Labour force participation has been on an upward trend over the last two decades, with notable gains during 2022 and 2023, reaching a record high of 70.2% in December 2023. The gender gap in labour participation is substantial and one of the highest in the Southeast Asia region, while the gender gap with respect to unemployment is low (see below).

**Figure 2.9. Labour force participation has increased and unemployment declined**



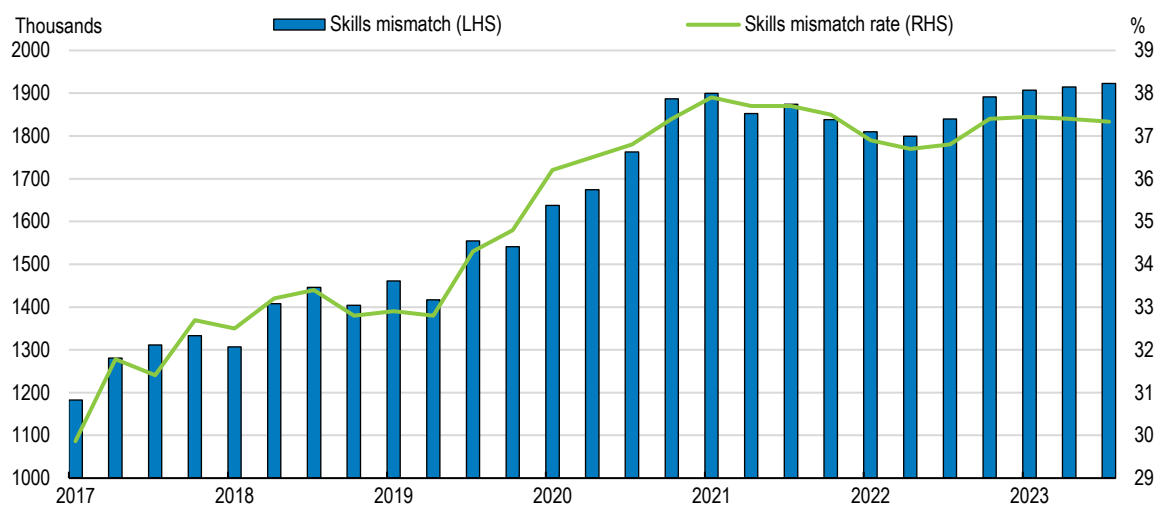
Source: DOSM

StatLink  <https://stat.link/h78w60>

### **Many people work in occupations that do not match their skills**

A deeper look into the structural features of Malaysia's labour market, however, reveals significant challenges, which are partly related to the high youth unemployment mentioned above. The labour market is characterised by significant skills mismatch, meaning that workers work in jobs that do not require – and in which they cannot use all the skills and qualifications they have acquired. This is particularly the case for workers with tertiary education, 37% of whom are working in mid-skilled and low-skilled occupations (Figure 2.10). This skills mismatch increased during the pandemic and has remained high afterwards.

Skills mismatch affects particularly recent university graduates, of which more than 40% work in jobs with low skills requirements. This may be related to a mismatch between what universities teach and what employers expect in terms of skills, according to survey data (Ma'rof and Nordin, 2023<sup>[12]</sup>) (Holidi and Seman, 2023<sup>[13]</sup>). At the same time as tertiary graduates work in jobs that require lower skills, businesses are facing difficulties in finding the skills they need. Better coordination between tertiary education providers and employers may be a first reasonable step to align curriculums better with labour market needs, especially as the structure of the economy and skills expectations change. The current situation where young people invest in acquiring skills that are ultimately not appreciated as much as they could be by their future employers appears inefficient and may be holding back productivity growth, besides risking to reduce the incentives for tertiary education in the longer run.

**Figure 2.10. Skills mismatch is significant and has been increasing**

Note: Skills mismatch is measured as those with tertiary education working in semi-skilled and low-skilled occupations. The skills mismatch rate is measured as skills mismatch relative to employment.

Source: DOSM

StatLink  <https://stat.link/8snmve>

Coordinating a better match may also be facilitated by gathering information on skills requirements by industries, for example by incorporating information on skills requirements into the Malaysia Standard Classification of Occupations (MASCO) to establish a comprehensive and dynamic national skills framework, which could be used as the foundation for the development of the national skills registry. The Malaysia National Skills Registry (MyNSR) launched its pilot project in 2023, covering 68 occupations. This could be expanded to cover more of the 147 minor occupation groups and 6 630 minor unit occupation groups in MASCO (Ministry of Human Resources (MoHR), 2020<sub>[14]</sub>).

Technical and Vocational Education and Training (TVET) institutions also play a vital role in developing a wide range of high-level skills for the labour market. While on average TVET graduates receive lower starting salaries than university graduates, this does not apply to those with higher qualifications among them (Rahim and Suhaimi, 2022<sub>[15]</sub>). The effectiveness of TVET hinges crucially on its ability to deliver courses and provide skills that match firms' needs and are directly applicable on the workplace. Malaysia's TVET system could benefit from a reorganisation and streamlining, given that currently, ten ministries oversee various TVET programmes (Shamsunahar, Harith and Mohamad, 2023<sub>[16]</sub>). Both public agencies and private organisations provide TVET and in the absence of a single rating system for TVET programmes or a comprehensive register of programmes offered, different certifications and accreditations are often confusing, reflecting an overall lack of direction of Malaysia's TVET strategy. Some of the factors behind the observed skills mismatch may also have their roots earlier on in education, where Malaysia's performance is weaker than that of some regional peers (Box 2.1).

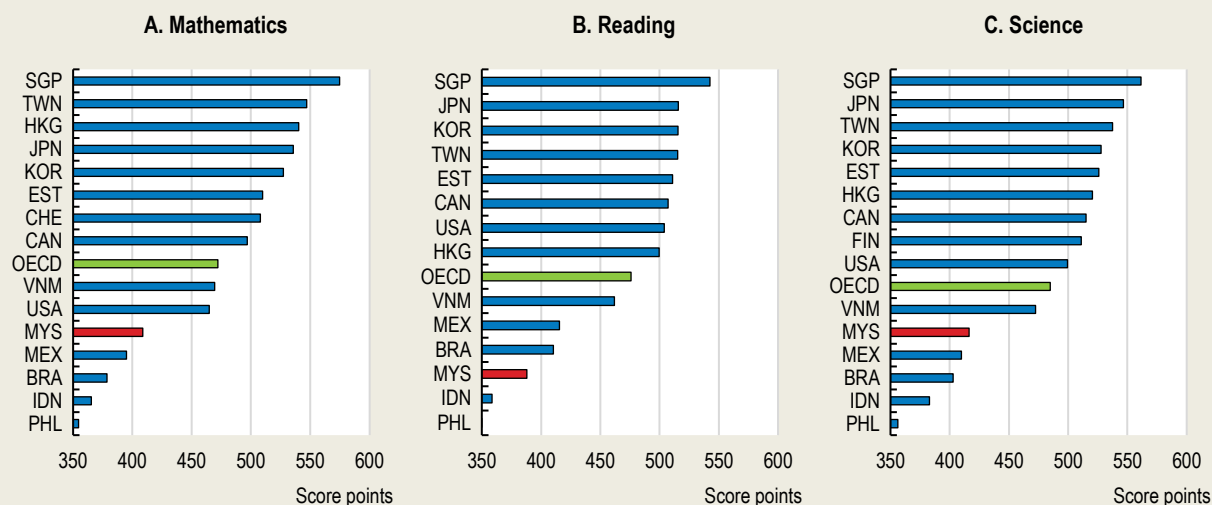
Adult or lifelong learning is also essential to support the career progression of individuals and allow them to move into more qualified jobs. Lifelong learning programmes attract interest, as 61% of surveyed workers indicated an interest in upgrading their technical skills, and a similar fraction was interested in developing soft skills (Kamarulbahri and Abdullah, 2023<sub>[17]</sub>). However, Malaysia's lifelong learning system could benefit from better coordination and monitoring at the national level. Overlaps between these programmes should be avoided to maximise learning outcomes and make better use of public support for such training. Expanding financial support for such programmes may have significant benefits for addressing skills mismatches and skill shortages. The recognition of workplace training courses could be better integrated into the Malaysian qualifications framework, as this could strengthen incentives for workers to engage in training. Wider use of lifelong learning courses would also provide substantial benefits

to employers who report difficulties in finding the necessary workforce skills. In Malaysia, only 36% of employers provided training and development for their employees (Kamarulbahri and Abdullah, 2023<sup>[17]</sup>). Especially small- and medium-sized enterprises could become more involved in lifelong learning as one avenue for raising their productivity and giving their workers better opportunities.


### Box 2.1. Malaysia's performance in education

Malaysia's education system has made significant progress over the last decades, supported by a National Education Blueprint (2013-2025). Public education spending averaged 4.4% of GDP over 2013-2022, higher than in regional peers and close to the OECD average of 5.0%. Access to education has improved and enrolment rates have essentially reached 100% from primary education onwards. Public education has played a significant role in this, as 95% of students attend primary schools run by the Ministry of Education (World Bank, 2024<sup>[18]</sup>). However, learning outcomes reveal scope for improvement. Malaysia's performance in the 2022 OECD's Programme for International Student Assessment (PISA) exceeded neighbouring Indonesia and the Philippines, but weaker than in other regional peers such as Viet Nam; Hong Kong, China; Chinese Taipei and top performer Singapore, and also significantly below the OECD (Figure 2.11). As in many countries, Malaysia's average 2022 PISA results below those of 2018, but while Malaysia moved up to the middle third of countries in 2018, it fell back into the bottom third in 2022 (OECD, 2023<sup>[19]</sup>; World Bank, 2024<sup>[18]</sup>).

Figure 2.11. Performance in mathematics, reading and science in PISA 2022



Source: OECD PISA 2022 database.

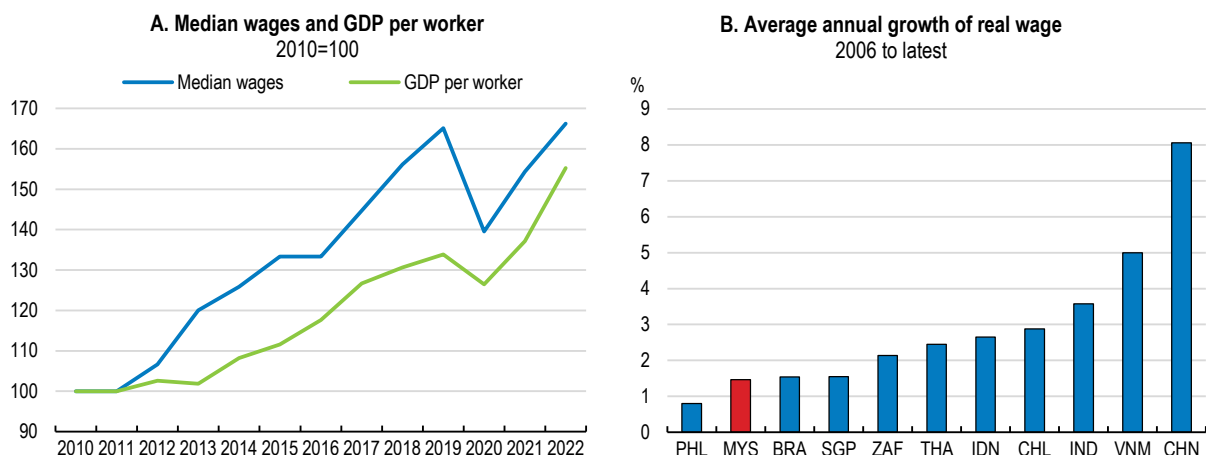
StatLink  <https://stat.link/u0reoz>

Some of the roots of these performance gaps may be found even before children start primary school, as weaknesses in early childhood are likely to hamper skills development later on. Almost a quarter of children lack school readiness skills upon entering primary schools, hampering their learning progress later on (World Bank, 2024<sup>[18]</sup>). This is particularly the case for children from low-income households, among which over 35% of first graders lack these skills. This strengthens the case for further investments into access and quality of early childhood education, including through offering free public preschool education from earlier years of age, improving teacher training and establishing more systematic evaluations of education outcomes (World Bank, 2024<sup>[18]</sup>).

## Wage growth has been slow but broadly in line with productivity

Besides skills mismatch, low wage growth has been a traditional feature of the Malaysian labour market. Median wages have grown broadly in line with labour productivity (Figure 2.12, Panel A). Compared with other countries, Malaysia's real wage growth has been one of the lowest (Figure 2.12, Panel B). Slow wage growth has particularly affected young university graduates, of whom around half earned less than MYR 1500 (USD 320) in their first year of employment during 2019 and 2020, relative to a minimum wage of MYR 1200 in those years (Rahim and Suhaimi, 2022<sup>[20]</sup>).

**Figure 2.12. Wage growth has been weak**

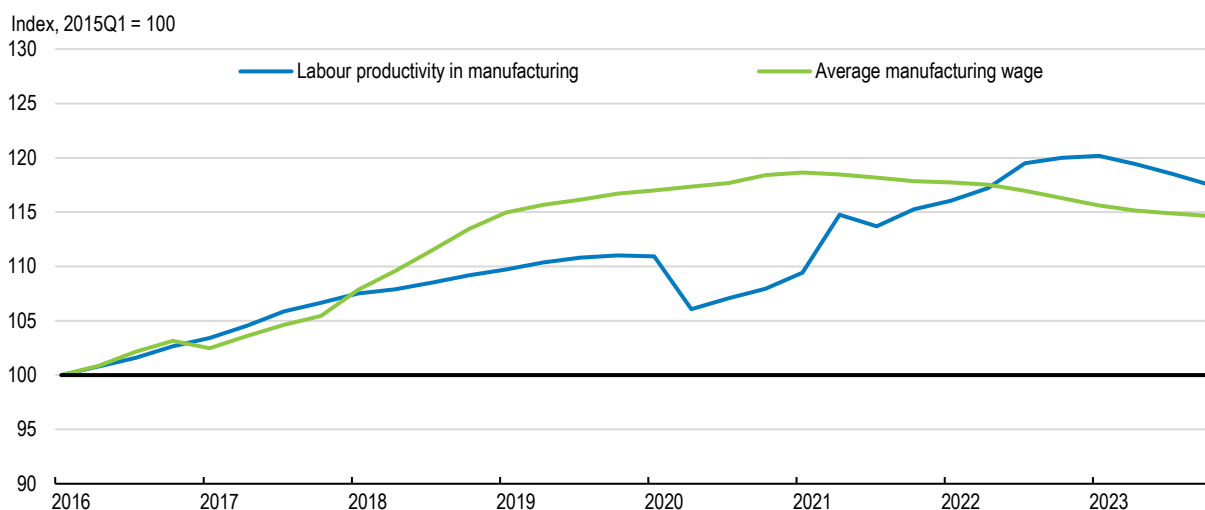


Source: DOSM, ILO Global Wage Report Data.

StatLink  <https://stat.link/lv5sdc>

Over a longer horizon, developments in labour productivity are a useful benchmark for judging the pace of wage growth as only productivity improvements can ensure scope for sustainable wage increases without jeopardising competitiveness or the employment prospects of workers. Focusing on Malaysia's manufacturing sector, Figure 2.13 suggests that wages moved in line with productivity between 2016 and 2018, then outpaced productivity until approximately early 2022. Since 2022, manufacturing wages in Malaysia have lagged behind productivity, including due to a notable decline in wages during 2023. At the same time, such temporary divergences are not unusual, and over a longer horizon of the last 8 years, wages and productivity seem to have broadly moved in tandem.

**Figure 2.13. Wage growth has been broadly in line with productivity over recent years**



Note: Labour productivity is deflated by output deflators, while manufacturing wages are deflated using the consumer price index. Based on quarterly data, using rolling four-quarter averages.

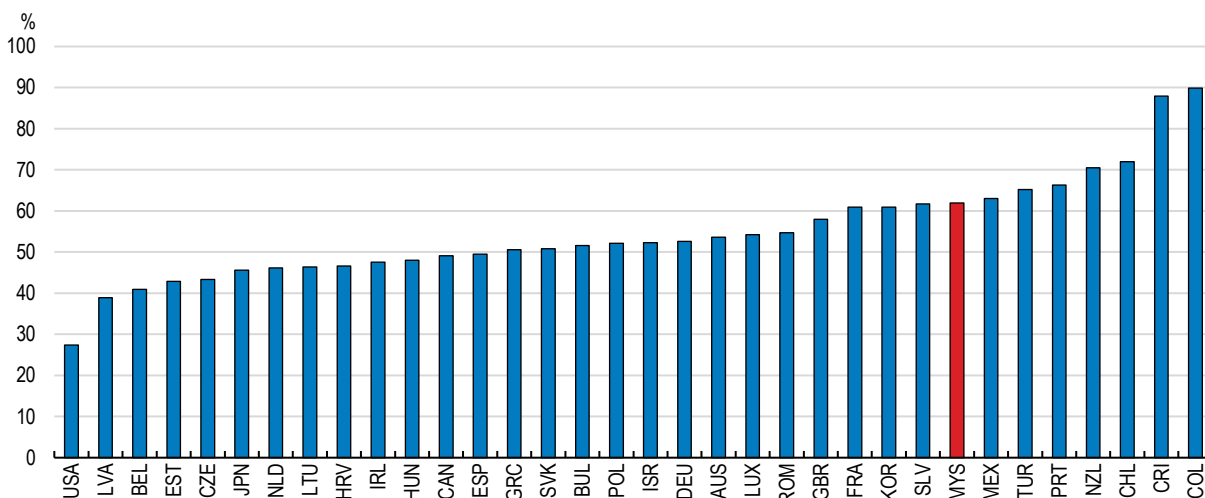
Source: Malaysia Department of Statistics, CEIC.

StatLink  <https://stat.link/qp4bw6>


Malaysia established a monthly minimum wage in 2014, which reached MYR 1500 or USD 320 in 2022, after several gradual increases, and is set for revision in 2024. The median monthly wage in 2022 was MYR 2424 (USD 543), so the minimum amounted to 62% of the median wage. Evidence suggests that the minimum wage has been broadly successful in boosting wage growth for low-wage workers, although the data underlying this analysis excludes population groups with weaker attachment to the labour market such as domestic workers, part-time and temporary workers, and foreign workers (Muthusamy, Khalidi and Rahim, 2023<sup>[21]</sup>). However, this conclusion may not continue to hold in the future, given that the current minimum wage is high in international comparison, when compared to median wages (Figure 2.14).

**Figure 2.14. The minimum wage is high in international comparison**

Minimum wages relative to median wage, 2022



Source: OECD Employment and Labour Market Statistics, <https://doi.org/10.1787/lfs-data-en>, and Malaysia Department of Statistics.

StatLink  <https://stat.link/q6nu5r>

The Mid-term Review of the Twelfth Malaysia Plan proposed introducing a “progressive wage model” to achieve better living standards and reduce brain drain in the long run (Ministry of Economy, 2023<sup>[22]</sup>). A progressive wage model is a type of job-specific minimum wage where salaries rise based on training and strategies to boost productivity. It is used primarily in jobs such as retail and maintenance sectors where salaries tend to rise slowly because productivity is difficult to increase. This system, which originated in Singapore, is based on the principle that wages should increase if workers enhance their skills and hence increase their productivity.

In Malaysia, the proposed scheme would be voluntary and provide incentives for training and raising productivity. Essentially, the state would partially compensate firms for raising the wages of low-wage employees who participated in training. A pilot project involving 1 000 companies in specified sectors is set to begin in June 2024, and the objective is to boost the median wage by 3.8% between 2023 and 2025. It would be available on a first-come-first-served basis, with an expected fiscal cost of 0.1% to 0.3% of GDP, leading to larger-scale implementation in 2025 (Williams, 2023<sup>[23]</sup>). One potential upside of the programme is that it may trigger an analysis of training needs, with a focus on semi-skilled entry level jobs.

If the progressive wage model is followed through, it should be subjected to regular impact evaluations to determine whether it is successful in achieving policy objectives. There are several potential challenges involved in this strategy. First, it would be difficult to verify that firms have, in fact, raised employee wages under the progressive wage model. It has been difficult in Malaysia to enforce minimum wages or to ensure that companies meet registration and licensing requirements. Second, the policy could encourage firms to rely on subsidies rather than focusing on organisational improvements or reducing economic slack and thus may not affect productivity much. Third, it could be expensive, while the benefits are uncertain. Another approach, which would not require government outlays, would be to require companies participating in government supply chains to verify that they have implemented a progressive wage system (Williams, 2023<sup>[24]</sup>).

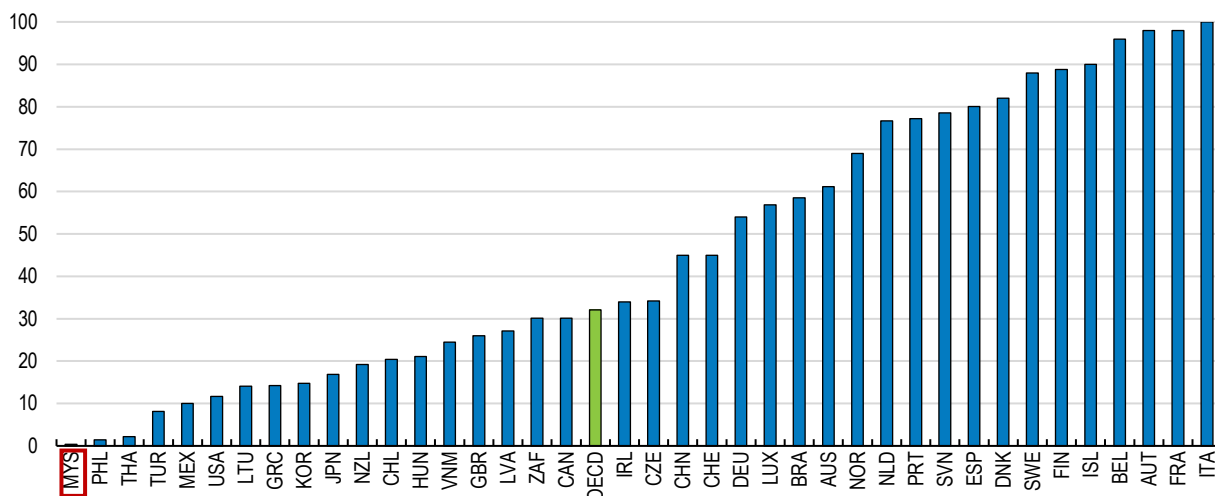
Even without direct interference in the wage-setting process, there are several avenues for public policies to affect the process indirectly, for example by strengthening the position of workers and unions in the wage bargaining process. One way to rebalance bargaining power is to enhance wage transparency. Mandatory disclosures of information about wages could strengthen the relative bargaining power of workers. This would allow workers to seek new opportunities if they think that their pay is low compared to market wages. Wage transparency has a number of additional advantages, such as promoting fairness and equity by revealing wage disparities based on gender or ethnicity. In addition, it can motivate workers to excel, thereby raising productivity. Implementing a Wage Transparency Act would empower workers to make informed decisions about salary offers, strengthen the bargaining position of workers and enhance the efficiency of the wage-setting process.

In addition, measures to enhance the role of collective bargaining may also help to give workers more voice. Malaysia stands out for a low collective bargaining coverage, defined as the proportion of workers covered by collective wage agreements in force. Collective bargaining coverage of 0.4% in 2018 was well below the OECD average of 32.1% and is the lowest among comparable countries (Figure 2.15). Oddly, collective bargaining coverage is much lower than union membership of 8.7% in 2020, suggesting that the role of unions in promoting collective bargaining agreements could be strengthened.

Collective bargaining gives employers and workers a more equal voice in negotiations through the process of dialogue. It can also contribute to sound industrial relations and help prevent costly labour disputes (Hayter, 2011<sup>[25]</sup>). Collective bargaining plays a key role in the labour market in many OECD countries and tends to generate wage premiums for workers covered by such agreements. Moreover, they tend to improve the work environment by fostering lower work intensity, more training options and better prospects for career advancement (OECD, 2018<sup>[26]</sup>). Collective bargaining also fosters social partners' engagement in occupational safety and health, working time, management practices, and the prevention of workplace intimidation and discrimination (OECD, 2019<sup>[27]</sup>).

**Figure 2.15. Collective bargaining coverage is the lowest among comparable economies**

Proportion of workers covered by collective wage agreements, 2018 or 2017



Source: OECD stats and ILO database.

StatLink  <https://stat.link/pay5i6>

The government could promote collective bargaining by setting the right framework conditions, including supporting the organisation of unions and employer's associations as well as mechanisms for arbitration, mediation and conciliation. Public procurement could be leveraged to create incentives for firms to respect the terms of collective wage agreements where these exist. Upon South Africa's transition to democracy, for example, a new labour relations act included the promotion of collective bargaining and the effective resolution of labour disputes (ILO, 2011<sup>[28]</sup>). Malaysia's adherence to the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) in 2022 required revision of labour laws, including the 1959 Trade Unions Act, which may enhance workers' bargaining power in the future.

### **Tackling informality requires policy action on several fronts**

Labour informality is a multi-faceted challenge that has many causes and consequences. Formal workers are typically defined as those that have access to at least one social insurance scheme or employment benefit, which are directly tied to contributions and/or a declared employer-employee relationship (World Bank, 2024<sup>[29]</sup>). Self-employed workers can be formal if they register their business activity and contribute to social insurance schemes. Many, however, choose not to contribute, including workers in the gig economy facilitated through digital platforms. Malaysia's share of informal work falls between advanced countries, where informal workers account for an average of 14% of the labour force, and emerging market and developing economies, where the average is 42% (Ohnsorge and Shu, 2021<sup>[30]</sup>).

Based on this definition 26.8% of total employment in Malaysia was informal in 2022, down from 38.2% in 2009 (World Bank, 2024<sup>[29]</sup>). If the agriculture sector is excluded, the share drops to 23.3%. The rate of informal employment is higher among older persons – 50% of workers aged 55-64 are informal; those with less education – 83% do not have tertiary education and skills; and among those with low skills – only 18% are classified as high-skilled, compared to 28% of formal employment. Informal workers are more concentrated at the bottom of the income distribution, as 80% of those in the bottom income decile are informal compared to 14% in the top. Hourly wages for formal workers are 17% higher for men and 41% for women, relative to informal workers. Informal workers are also more likely to be in high-risk jobs. At the same time, informal workers put in fewer hours on average than formal workers. In addition, more than a third of informal workers work from home.

The distinction between formality and informality also applies to firms. Formal firms and entrepreneurs are those that have registered their business with the Companies Commission of Malaysia and complied with other licensing and permit requirements. Not all employees of formal firms are necessarily formal workers, while all employees of informal firms - mostly small, unregistered entities - are typically informal. Scaling up of micro, small and medium enterprises (MSMEs), as discussed in Chapter 4, can often lift these firms and their workers out of informality, typically raising their productivity and the prospects for better wages.

Informality is unlikely to disappear in the short run or be solved by economic growth alone, and tackling it calls for policy action along several dimensions. The 2023 Formalisation Programme for Informal Enterprises (Ministry of Entrepreneur and Cooperatives Development (MECD), 2023<sup>[31]</sup>) includes strategies to enhance incentives for firms and entrepreneurs to formalise the status of workers while improving the enforcement of laws governing business operations. However, while enforcement clearly has a role to play, too heavy-handed enforcement risks destroying jobs and businesses instead of bringing them into the formal sector. In addition to enforcement, improving incentives for formal job creation can play a crucial role.

Improving incentives for formalisation can entail several dimensions. One dimension relates to the rigid labour regulations governing formal employer-employee relationships. For example, the maximum work week is set at 45 hours, recently reduced from 48, which may still be more than what some workers wish to work, especially given that informal workers tend to work fewer hours. Reducing these weekly working hours, or at least providing the option for workers to work fewer hours, may be one way to entice some workers to join the formal sector.

Scope for strengthening formalisation incentives also exists with respect to non-wage labour costs, which can make it more convenient for business to hire informally rather than creating formal jobs, especially when the odds of getting caught by authorities are low. Non-wage labour costs include the mandatory 25% of wages in contributions to the social security fund EPF, which are paid jointly by businesses and workers. Workers may also feel inclined not to pay these contributions, given that EPF currently fails to provide sufficient retirement benefits for many of them.

One reform to consider would be to exempt low salaries in the vicinity of the minimum wage from mandatory contributions to the EPF, which currently fails to provide adequate protection against old-age poverty for most low-income workers in any case. Instead, these workers could be covered by tax-financed non-contributory pension benefits, which would have to be expanded significantly. This is not the only possible approach but it may be the more promising avenue than the EPF for many low-income earners and would strengthen the redistributive effect of social protection. Building on the Bantuan Warga Emas (BWE) as a basic universal but means-tested first pillar of the pension system for low-income earners may be one way to fight old-age poverty while reducing non-wage labour costs and promoting formalisation. Basic tax-financed or low-contribution benefits could also make it easier to provide protections for an increasing number of platform workers.

In parallel, improving and strengthening the EPF would allow turning it into a second, savings-based pension pillar for those with higher capacity to contribute, whose aim would be to provide old-age pensions that constitute a reasonable fraction of working-life incomes. Similar multi-tier social protection setups are currently under discussion in several Latin American countries (Levy and Cruces, 2021<sup>[32]</sup>; Tuesta and Bhardwaj, 2023<sup>[33]</sup>), and have also been recommended in OECD Economic Surveys on Colombia, Chile, Peru and Thailand (OECD, 2022<sup>[34]</sup>; OECD, 2022<sup>[35]</sup>; OECD, 2023<sup>[36]</sup>; OECD, 2023<sup>[37]</sup>).

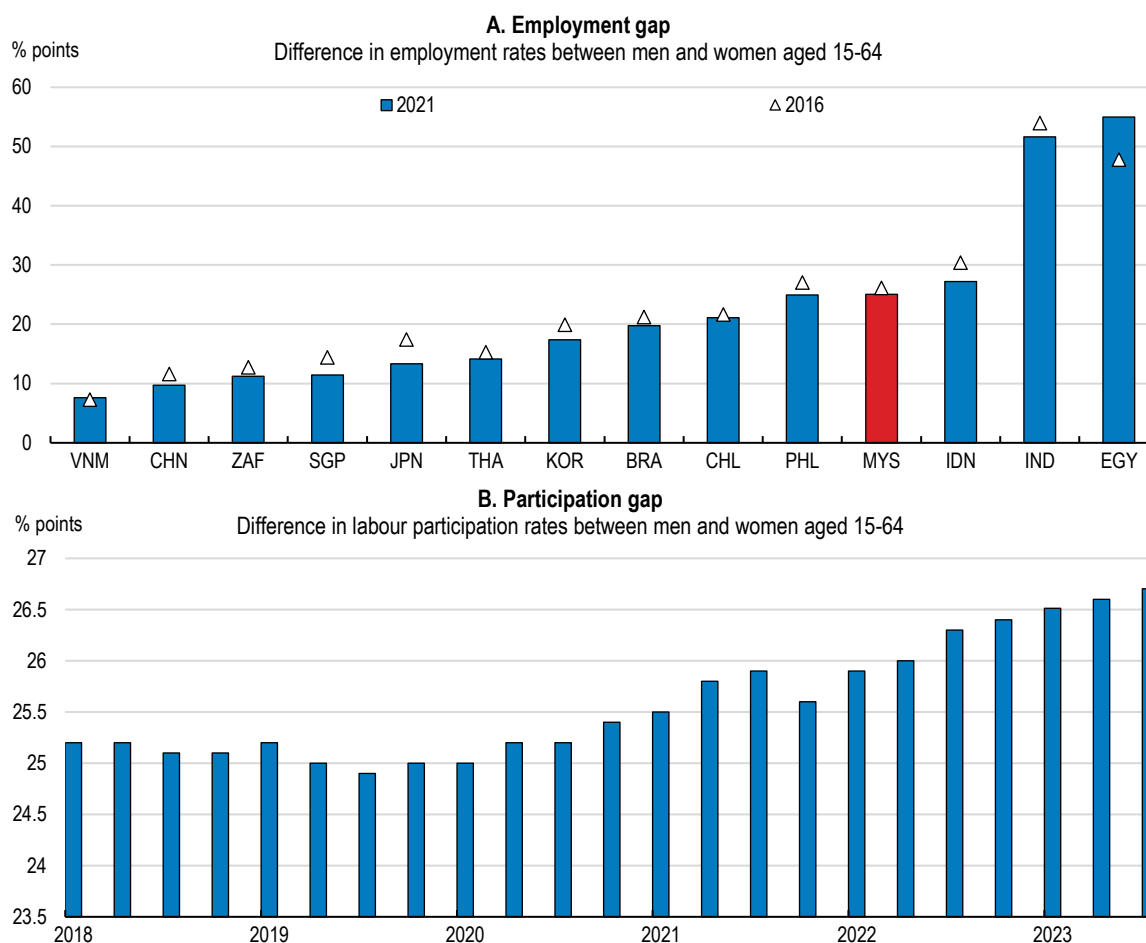
A more central role of this tax-financed basic benefit tier, focused on poverty reduction, for fighting old-age poverty would hinge on the ability to raise more tax revenues (Chapter 1). While this may be politically challenging, it could still be an avenue worth pursuing. A 2012 reform in Colombia that reduced some social contributions shows that reducing non-wage labour costs can help to reduce informality. In the aftermath of the reform, labour informality declined visibly. Available impact evaluations suggest that the

reform led to a reduction in the informality rate of several percentage points (Kugler, Kugler and Prada, 2017<sup>[38]</sup>) (Morales and Medina, 2017<sup>[39]</sup>) (Fernández and Villar, 2017<sup>[40]</sup>) (Bernal et al., 2017<sup>[41]</sup>).


## Gender inequalities in the labour market hold back women's potential

The labour market is characterised by significant gender gaps, particularly with respect to employment and labour force participation. The gender employment gap is high in a regional context and has been widening in the last five years (Figure 2.16, Panel A). Labour participation is more than 26 percentage points higher among men than among women, one of the largest gaps in the region. This gap has widened further since 2018, reflecting rising participation since 2020 while female participation rates have been hovering around 56% (Figure 2.16, Panel B).

**Figure 2.16. Gender employment and participation gaps remain large**

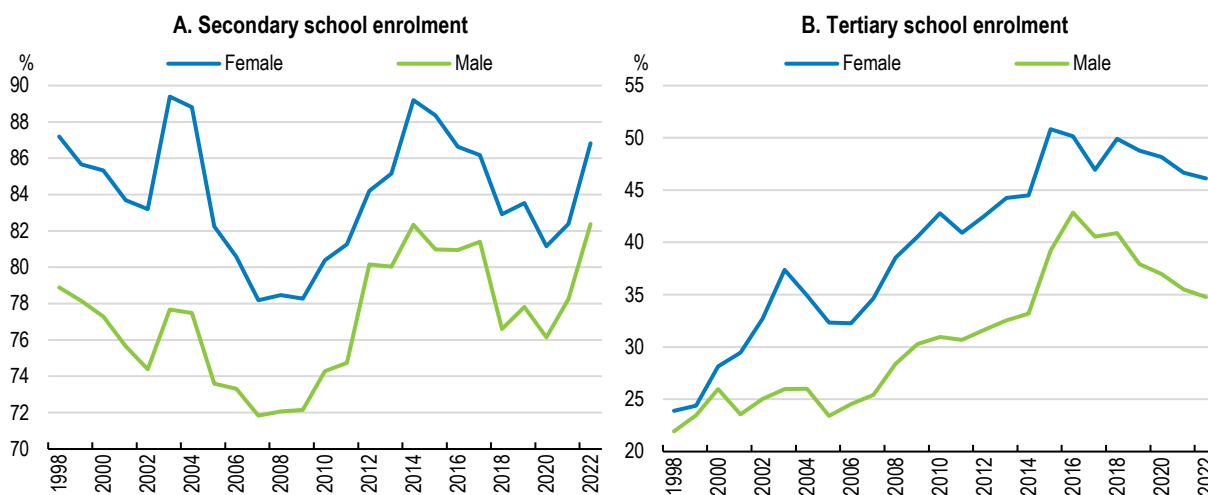


Source: World Bank, DOSM.

StatLink  <https://stat.link/jpau25>

Gender differences in the labour market cannot be explained by differences in education. Gross enrolment rates for women at the secondary and tertiary levels have been consistently higher than those of men, suggesting that there is no dearth of skilled women in the labour market (Figure 2.17). Labour statistics show that, among employees with tertiary education, the share of women was about 50%.

**Figure 2.17. Women are better educated**

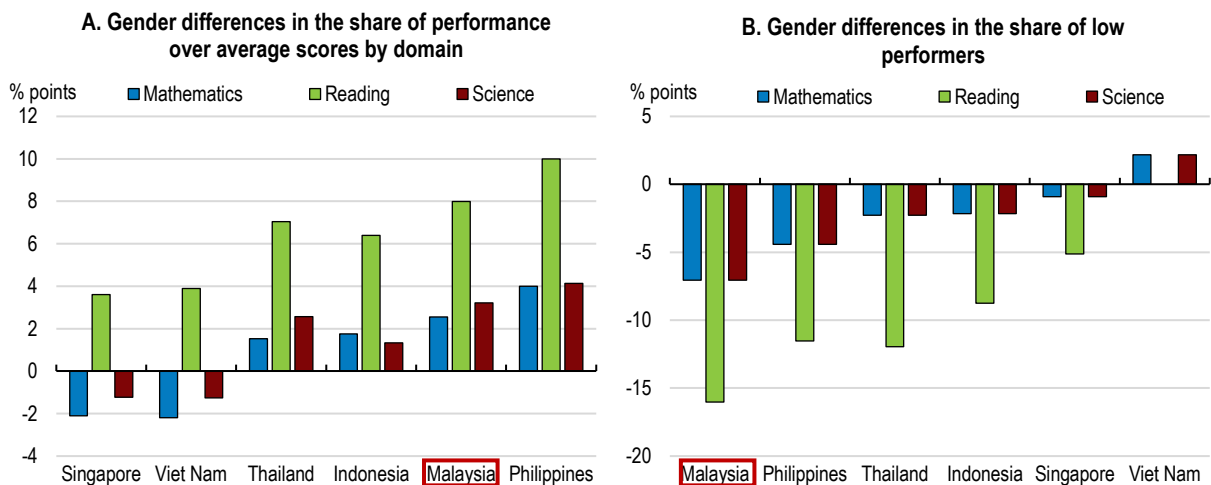


Source: World bank.

StatLink <https://stat.link/k1prve>

The stronger performance of women in education is likely to remain for some time. Results of OECD’s Programme for International Student Assessment (PISA) suggests that girls outperformed boys in many aspects. Girls scored 10 score points higher than boys in mathematics, 31 score points in reading and 13 score points in science. These differences were among the highest in the region (Figure 2.18, Panel A). Furthermore, the shares of low performers (students with score points below level 2) in all areas were all larger among boys than girls (Figure 2.18, Panel B).

**Figure 2.18. Girls have better learning outcomes than boys**



Note: Gender differences are defined as the outcomes of girls minus the outcomes of boys.  
Source: OECD PISA 2022 Results.

StatLink <https://stat.link/8e271s>

**Policies to reduce gender gaps and improve equal opportunities**

One of the main barriers for women with respect to participation in economic activities is the heavy burden of unpaid care work, such as childcare, care for elderly relatives, or domestic work. Women spend 3.2 times longer hours than men on unpaid care work compared to an OECD average of 2.1 times longer

(Figure 2.19). This burden reduces the time they can devote to economic activities and hampers their productivity in the formal labour market. A more equal sharing of this burden between men and women would be one way to encourage and enable more women to join the labour force.

The availability of affordable childcare services is still limited in Malaysia, and this is one obstacle to a further increase of female labour force participation (Schmillen et al., 2019<sup>[42]</sup>). Empirical evidence suggests that the lack of unpaid childcare reduces the hours worked by women (Choong et al., 2019<sup>[43]</sup>), while the presence of grandparents in the household raises the probability of a woman participating in the labour market (Salleh and Mansor, 2022<sup>[44]</sup>). In an expert survey conducted by the World Bank in 2024, 60% of respondents considered that affordable and quality childcare services are only available to half of women or less, suggesting significant bottlenecks (World Bank, 2024<sup>[45]</sup>).

In Malaysia, most providers of care for children aged 0 to 4 are private. The largest public provider is the Community Development Department under the Ministry of Rural Development, which currently operates 499 childcare centres, out of a total of 5420 in 2021. A means-tested childcare fee subsidy is available for parents of children aged 2 to 4. In addition, a tax deduction for childcare fees for children below the age of 6 is available, but only to households who are subject to personal income taxes, which excludes low-income households (see chapter 1). Tax-incentive schemes also encourage employers to provide on-site childcare facilities and support.

Further efforts will be needed to improve access to affordable childcare, including for low-income mothers and those working in small or informal firms that cannot provide on-site childcare facilities. For this group, subsidies or direct public provision are likely to be the most effective ways forward, as tax deductions and employer-provided childcare will not be able to reach many low-income mothers. Evidence suggests that paternity leave is one way to engage fathers more in unpaid work within their family and can lead to improvements in the communication and closeness between children and fathers (OECD, 2023<sup>[46]</sup>). This in turn has shown positive effects on mothers' employment rates.

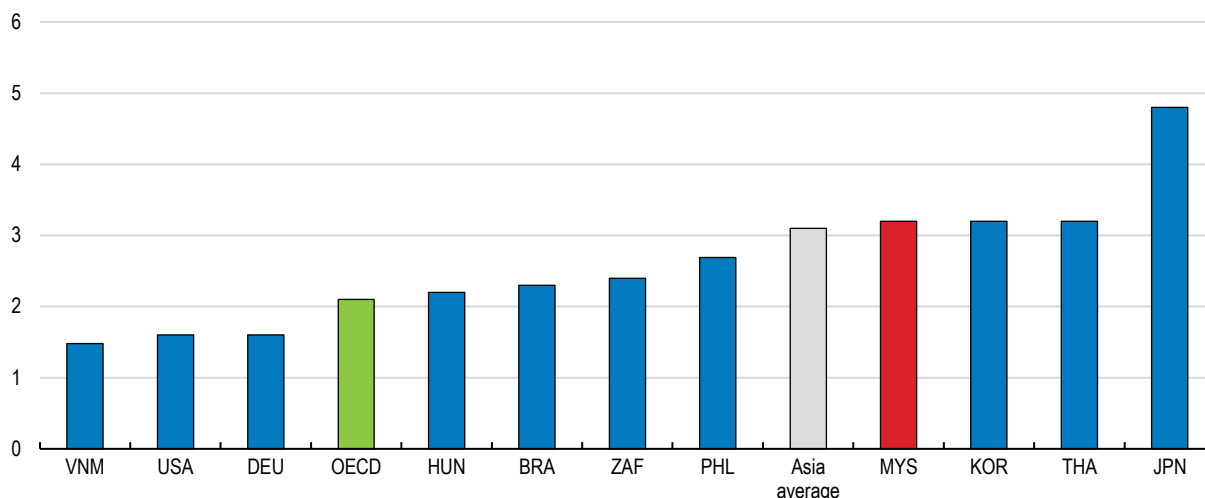
Under the amended Employment Act of 2023, paid paternity leave of 7 days was introduced for the first time in 2023. In parallel, the minimum duration of maternity leave was increased from 8.5 weeks to 14 weeks. This also makes it easier for women to reconcile employment with motherhood and is consistent with recommendations in past OECD Economic Surveys of Malaysia (OECD, 2019<sup>[47]</sup>).

Malaysia has room to build on this recent progress, as the lengths of maternity and paternity leaves are still below most OECD countries. Across the OECD, statutory rights to paid maternity leave are provided with an average length of 18.5 weeks as of April 2022. The average length of statutory rights to paid paternity is 2.3 weeks (OECD, 2023<sup>[46]</sup>). In addition to paid leave entitlements for fathers and mothers directly around childbirth, many OECD countries also grant parents paid parental leave and/or home-care leave, which allows fathers and/or mothers to take longer periods of paid employment-protected leave to care for their children during their first years of life (OECD, 2023<sup>[46]</sup>). For example, Japan has a generous shared parental leave policy of up to 12 months, which is structured to maximise flexibility by allowing leave to be taken in four instalments. Similar provisions could also be considered in Malaysia.

Ensuring that policies generate the right incentives for women to work is another unfinished agenda. Childcare assistance benefits of around MYR 180 per child are available only to families with an income per capita of less than MYR 800, compared to a minimum wage of MYR 1 500. While this low-income threshold improves the targeting of the benefit, which is in principle desirable in light of limited fiscal resources, it may discourage some women from working. There may be advantages for female labour participation from raising this threshold. Simulation results suggest that a conditional care allowance of MYR 100 could increase female labour participation from 54.4% to 56.0% and stimulate real GDP growth by 0.4% (Khazanah Research Institute, 2019<sup>[48]</sup>).

## Figure 2.19. Women spend more time on unpaid family work

Female-to-male ratio of average time spent on unpaid domestic, care and volunteer work, 2023 or 2019



Note: 1. 2019 data.

2. The ratio shows the number of hours women spent on unpaid domestic, care and volunteer work within a day over the number of hours men spent on unpaid domestic, care and volunteer work within a day.

Source: OECD Gender, Institutions and Development Database (GID-DB), 2023 and 2019

StatLink  <https://stat.link/q4tk7u>

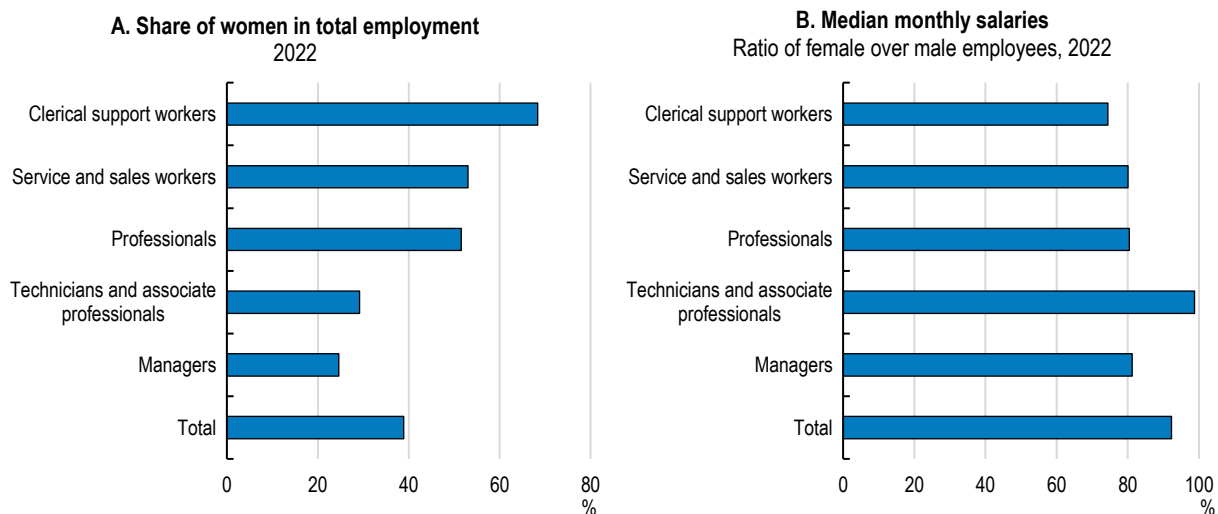
Strengthening the incentives for women to seek employment also implies improving their prospects of obtaining high quality and well-paid jobs when they do join the labour force. Scope for further improvements in this area exists along several dimensions.

Women are typically more affected by the labour market skills mismatch challenges described above. As a result, addressing skills mismatch also has a gender dimension. In 2023, 43% of women with tertiary education were not working in occupations that match their educational backgrounds, compared with 33% for male counterparts. To some extent, the skills mismatch is related to labour informality, which is higher among women. In that light, efforts to bring more workers and firms into the formal economy would also help to improve opportunities for women (OECD, 2023<sup>[49]</sup>).

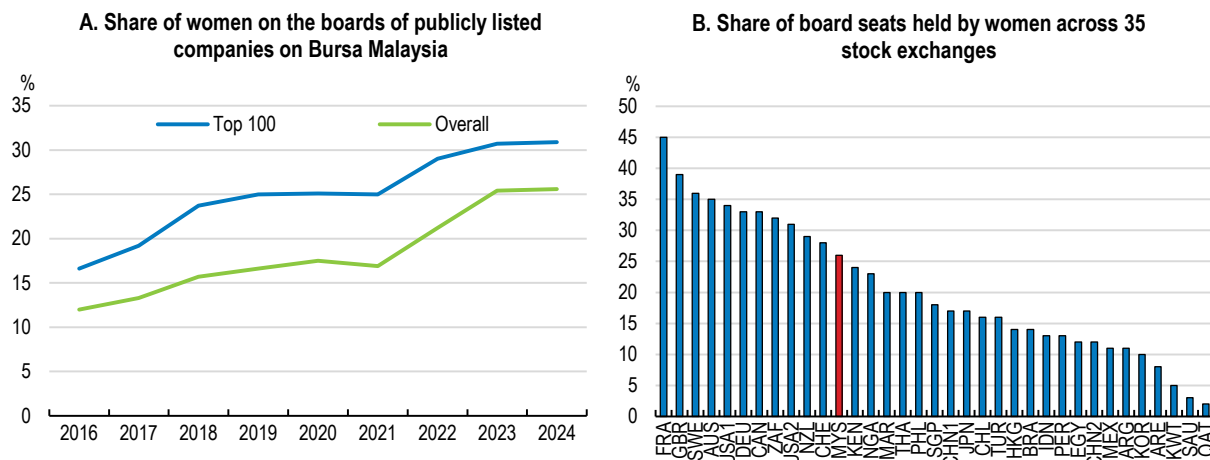
Strong action against gender pay discrimination can help to ensure equal pay for similar work. One approach adopted by many OECD countries is mandatory gender pay gap reporting and equal pay auditing requirements for private sector firms. Over half of OECD countries (21 of 38) now require private sector employers to report pre-defined gender-disaggregated pay information to stakeholders like workers, workers' representatives, the government, and/or the public (OECD, 2023<sup>[50]</sup>).

Inequalities of opportunity with respect to career progression may discourage women from joining the labour market. Women are particularly underrepresented in management positions. While they represent 39% of the total employed persons, only 25% of workers in management positions are women (Figure 2.20, Panel A). Only 33% of Malaysian companies are headed by women (OECD, 2024<sup>[51]</sup>). This is particularly hard to reconcile with the higher average educational attainments of women. Even when women make it into management positions, they earn only 81% of their male counterparts (Figure 2.20, Panel B).

Recent trends in corporate leadership are encouraging, however. The share of women on boards of public listed companies on the Bursa Malaysia stock exchange has been rising steadily and is higher among top 100 companies (Figure 2.21, Panel A). This share is higher than elsewhere in Asia, and not too far from some European and North American markets (Figure 2.21, Panel B).


**Figure 2.20. Less women work in high-skilled occupations**

Source: DOSM.

StatLink  <https://stat.link/hn49ul>**Figure 2.21. The share of women in top management is rising and exceeds Asian peers**

Note: In Panel A, the 2024 figure refers to 1 January 2024. In Panel B, USA1 is New York Stock Exchange (NYSE) and USA2 is Nasdaq. CHN1 is Shenzhen Stock Exchange (SZSE) and CHN2 is Shanghai Stock Exchange.

Source: Securities Commission Malaysia, United Nations Sustainable Stock Exchanges (SSE).

StatLink  <https://stat.link/3nzqp5>

Formal procedures to prevent gender discrimination in the labour market will also have a role to play. The amended Employment Act includes a provision for discrimination disputes, which is a first welcome step against gender discrimination, although it is a relatively weak provision at present. The amendment provides for a mechanism to investigate and settle such disputes at the discretion of labour authorities, and it remains to be seen to what extent this is an effective dispute settlement mechanism. Regular impact evaluations of this amendment could guide future refinements, if needed. Furthermore, opening such disputes would be facilitated if the law defined what is meant by “discrimination” and made it an offence, in addition to defining specific remedies in the case of conviction. Discrimination can only be investigated during a labour relationship, and not with respect to the hiring process. Strengthening the provisions that outlaw gender discrimination and improving the scope for prosecuting discriminatory practices would further improve the economic opportunities for women who decide to join the labour market.

**Table 2.2. Policy recommendations from this chapter (Key recommendations in bold)**

MAIN FINDINGS	RECOMMENDATIONS
<b>Social Protection</b>	
Social spending is small, fragmented and lacks targeting, while blanket subsidies are inefficient for reducing inequalities. As a result, social policies have only small effects on inequalities.	<b>Unify fragmented social protection programmes and improve their targeting, while phasing out subsidies.</b> <b>Raise social spending once additional revenues have been mobilised.</b>
The responsibility for social protection policies is scattered across different public sector institutions and lacks coordination.	Assign a strong coordinating role for social protection policies to a single institution.
Early withdrawals from the general private-sector pension fund EPF lead to low savings before retirement.	Limit possibilities for early withdrawals from the EPF pension fund and raise the withdrawal and retirement age to 65 years.
EPF savings are paid out as a lump-sum, which provides little coverage against longevity risks.	Consider converting EPF savings into an annuity with monthly payments.
A small civil servant pension scheme creates disproportionate fiscal costs, which are projected to rise sharply as the population ages.	Phase out the civil servant pension scheme and enrol new civil servants in the general private-sector scheme EPF.
Over 60% of the working-age population are not protected by any contributory pension scheme and will have no retirement pension.	Expand the coverage of means-tested non-contributory pensions towards all those with no old-age pension from other sources.
<b>Labour market</b>	
Tertiary graduates often lack relevant skills and struggle to find jobs commensurate with their qualifications.	Strengthen collaboration between universities and businesses to align curriculums with labour market needs.
Information about the required skills content of different occupations is often untransparent. Malaysia launched a pilot project in 2023 to map skills to 68 occupations.	Expand the national skills registry with standardised information that covers more occupations and skills.
The technical and vocational education and training (TVET) system is fragmented and overseen by ten different ministries.	Reorganise and streamline the TVET system and ensure that it provides skills needed at the workplace.
Mandatory disclosures of information about wages could strengthen the relative bargaining power of workers and enhance the efficiency of the wage-setting process.	Implement a wage transparency act to require mandatory disclosures of information about wages.
Only 0.4% of workers are covered by collective wage bargaining agreements, which is low in international comparison.	Strengthen collective wage bargaining institutions to give workers more voice.
A large share of the workforce is in informal employment relationships and does not have access to social insurance benefits including old-age pensions.	<b>Exempt low-wage workers from mandatory contributions to the EPF after expanding non-contributory old-age pensions to prevent old-age poverty.</b>
<b>Bridging gender gaps</b>	
High costs and the limited availability of childcare services are important obstacles to a further increase of female labour force participation.	<b>Improve access to affordable childcare by expanding public childcare facilities, strengthening public support for childcare costs and expanding incentive schemes for employer-provided childcare facilities.</b>
Better wage transparency can help to ensure equal pay for women and men for the same level of qualification.	Require firms to report gender-disaggregated pay information.
Statutory maternity and paternity leave periods remain significantly below those in OECD countries.	Consider further extensions to paid maternity and paternity leave periods.
Family allowances can raise female labour participation but are only available to households with per-capita incomes below approximately half a minimum wage.	Consider raising the eligibility threshold for family allowances.
Labour discrimination disputes between employers and employees are now possible, but provisions are insufficiently defined and labour authorities are in charge of enforcement.	Clarify and evaluate the impact of new anti-discrimination rules in the labour act.

## References

- Bernal, R. et al. (2017), “Switching from Payroll Taxes to Corporate Income Taxes: Firms’ Employment and Wages after the 2012 Colombian Tax Reform”, *Economía*, Vol. 18/1, pp. 41-74, <https://www.jstor.org/stable/90017435>. [41]
- BNM (2023), *Economic & Monetary Review 2023*, Bank Negara Malaysia, <https://www.bnm.gov.my/publications/emr2023> (accessed on 29 March 2024). [9]
- BNM (2020), “A Vision for Social Protection in Malaysia”, in *Economic & Monetary Review 2020*, <https://www.bnm.gov.my/publications/emr2023> (accessed on 29 March 2024). [4]
- Choong, C. et al. (2019), *Time to Care: Gender Inequality, Unpaid Care Work and Time Use Survey*, <http://creativecommons.org/licenses/by/3.0/Under>. [43]
- DOSM (2023), *POVERTY IN MALAYSIA 2022*. [1]
- EPF (2023), *EPF MAINTAINS THE INTEGRITY OF MEMBER DATA*. [6]
- EPF (2018), *Social Protection Insights*, KWSP-EPF, <https://www.kwsp.gov.my/corporate/news-highlights/publications> (accessed on 29 March 2024). [8]
- Fernández, C. and L. Villar (2017), “The Impact of Lowering the Payroll Tax on Informality in Colombia”, *Economía*, Vol. 18/1, pp. 125-155, <https://www.jstor.org/stable/90017437>. [40]
- Hamid, H. et al. (2021), *Building Resilience: Towards Inclusive Social Protection in Malaysia*, Khazanah Research Institute, [https://www.krinstitute.org/Publications-@-Building\\_Resilience-;\\_Towards\\_Inclusive\\_Social\\_Protection\\_in\\_Malaysia.aspx](https://www.krinstitute.org/Publications-@-Building_Resilience-;_Towards_Inclusive_Social_Protection_in_Malaysia.aspx) (accessed on 29 March 2024). [10]
- Hayter, S. (2011), *The Role of Collective Bargaining in the Global Economy: Negotiating for Social Justice*, International Labour Organisation, [http://www.ilo.org/global/publications/ilo-bookstore/order-online/books/WCMS\\_153443/lang--en/index.htm](http://www.ilo.org/global/publications/ilo-bookstore/order-online/books/WCMS_153443/lang--en/index.htm) (accessed on 31 March 2024). [25]
- Holidi, N. and N. Seman (2023), “A Study of Employability Skills: From the Employers and Youth Perspectives”, *Journal of International Business, Economics and Entrepreneurship; Vol 8 No 1 (2023): June 2023 Issue* DO - 10.24191/jibe.v8i1.23141, <https://myjms.mohe.gov.my/index.php/JIBE/article/view/23141>. [13]
- ILO (2011), *Promoting collective bargaining Convention No. 154*, International Labour Organisation, Geneva, [https://www.ilo.org/wcmsp5/groups/public/---ed\\_dialogue/---dialogue/documents/publication/wcms\\_172186.pdf](https://www.ilo.org/wcmsp5/groups/public/---ed_dialogue/---dialogue/documents/publication/wcms_172186.pdf) (accessed on 31 March 2024). [28]
- Kamarulbahri, N. and M. Abdullah (2023), “Prepping the nation for skills-based hiring”, in *Where do we go workwise? Malaysia’s Labour landscape*, Talent Corporation Malaysia Berhad. [17]
- Khazanah Research Institute (2019), *Time to Care: Gender Inequality, Unpaid Care Work and Time Use Survey*, Khazanah Research Institute, [https://www.krinstitute.org/assets/contentMS/img/template/editor/Publications\\_Time%20to%20Care\\_Full%20report.pdf](https://www.krinstitute.org/assets/contentMS/img/template/editor/Publications_Time%20to%20Care_Full%20report.pdf). [48]

- Kugler, A., M. Kugler and L. Prada (2017), *Do Payroll Tax Breaks Stimulate Formality? Evidence from Colombia's Reform*, National Bureau of Economic Research, Cambridge, MA, <https://doi.org/10.3386/w23308>. [38]
- Levy, S. and G. Cruces (2021), "Time for a New Course: An Essay on Social Protection and Growth in Latin America", *UNDP Latin America and the Caribbean Working Paper Series*, No. 24, United Nations Development Programme, [https://www.latinamerica.undp.org/content/rblac/en/home/library/human\\_development/time-for-a-new-course--an-essay-on-social-protection-and-growth-.html](https://www.latinamerica.undp.org/content/rblac/en/home/library/human_development/time-for-a-new-course--an-essay-on-social-protection-and-growth-.html) (accessed on 21 September 2021). [32]
- Ma'rof, A. and F. Nordin (2023), *Sector-Focused Industry-Academic Collaboration Workshop Report Volume 1*, Talent Corporation Malaysia Berhad. [12]
- Ministry of Economy (2023), *The Mid-Term Review of the Twelfth Malaysia Plan*. [22]
- Ministry of Entrepreneur and Cooperatives Development (MECD) (2023), *FORMALISATION PLAN FOR INFORMAL ENTREPRENEURS*. [31]
- Ministry of Human Resources (MoHR) (2020), *MASCO Malaysia Standard Classification of Occupation*, [https://jtksm.mohr.gov.my/sites/default/files/2022-12/MASCO\\_2020\\_BI\\_Edaran.pdf](https://jtksm.mohr.gov.my/sites/default/files/2022-12/MASCO_2020_BI_Edaran.pdf). [14]
- Morales, L. and C. Medina (2017), "Assessing the Effect of Payroll Taxes on Formal Employment: The Case of the 2012 Tax Reform in Colombia", *Economía*, Vol. 18/1, pp. 75-124, <https://doi.org/10.1353/eco.2017.a676997>. [39]
- Muthusamy, N., J. Khalidi and M. Rahim (2023), *The Returns to Malaysian Labour - Part I Wage growth and inequality from 1995 to 2019*, Khazanah Research Institut, [https://www.krinstitute.org/Working\\_Paper-@-The\\_Returns\\_to\\_Malaysian\\_Labour\\_%E2%80%93\\_Part\\_I-;\\_Wage\\_growth\\_and\\_inequality\\_from\\_1995\\_to\\_2019.aspx](https://www.krinstitute.org/Working_Paper-@-The_Returns_to_Malaysian_Labour_%E2%80%93_Part_I-;_Wage_growth_and_inequality_from_1995_to_2019.aspx). [21]
- OECD (2024), *SIGI 2024 Regional Report for Southeast Asia: Time to Care*, Social Institutions and Gender Index, OECD Publishing, Paris, <https://doi.org/10.1787/7fc15e1c-en>. [51]
- OECD (2023), *Joining Forces for Gender Equality: What is Holding us Back?*, OECD Publishing, Paris, <https://doi.org/10.1787/67d48024-en>. [46]
- OECD (2023), *OECD Economic Surveys: Peru 2023*, OECD Publishing, Paris, <https://doi.org/10.1787/081e0906-en>. [36]
- OECD (2023), *OECD Economic Surveys: Thailand 2023*, OECD Publishing, Paris, <https://doi.org/10.1787/4815cb4b-en>. [37]
- OECD (2023), *OECD Skills Strategy Southeast Asia: Skills for a Post-COVID Recovery and Growth*, OECD Skills Studies, OECD Publishing, Paris, <https://doi.org/10.1787/923bfd03-en>. [49]
- OECD (2023), *PISA 2022 Results: Factsheets - Malaysia*, <https://www.oecd.org/publication/pisa-2022-results/country-notes/malaysia-1dbe2061/>. [19]
- OECD (2023), *Reporting Gender Pay Gaps in OECD Countries: Guidance for Pay Transparency Implementation, Monitoring and Reform*, Gender Equality at Work, OECD Publishing, Paris, <https://doi.org/10.1787/ea13aa68-en>. [50]

- OECD (2022), *OECD Economic Surveys: Chile 2022*, OECD Publishing, Paris, [35]  
<https://doi.org/10.1787/311ec37e-en>.
- OECD (2022), *OECD Economic Surveys: Colombia 2022*, OECD Publishing, Paris, [34]  
<https://doi.org/10.1787/04bf9377-en>.
- OECD (2022), *Pensions at a Glance Asia/Pacific 2022*, OECD Publishing, Paris. [11]
- OECD (2021), *Pensions at a Glance 2021: OECD and G20 Indicators*, OECD Publishing, Paris, [7]  
<https://doi.org/10.1787/ca401ebd-en>.
- OECD (2019), *Negotiating Our Way Up: Collective Bargaining in a Changing World of Work*, OECD Publishing, Paris, [27]  
<https://doi.org/10.1787/1fd2da34-en>.
- OECD (2019), *OECD Economic Surveys: Malaysia 2019*, OECD Publishing, Paris, [47]  
<https://doi.org/10.1787/eaaa4190-en>.
- OECD (2018), “The role of collective bargaining systems for good labour market performance”, in *OECD Employment Outlook 2018*, OECD Publishing, Paris, [26]  
[https://doi.org/10.1787/empl\\_outlook-2018-7-en](https://doi.org/10.1787/empl_outlook-2018-7-en).
- OECD (n.d.), *Malaysia Student performance (PISA 2022)*, [55]  
<https://gpseducation.oecd.org/CountryProfile?plotter=h5&primaryCountry=MYS&treshold=5&opic=PI> (accessed on 13 June 2024).
- Ohnsorge, F. and Y. Shu (2021), *The Long Shadow of Informality: Challenges and Policies*, [30]  
 World Bank Group, Washington, DC,  
<https://www.worldbank.org/en/research/publication/informal-economy> (accessed on 9 July 2024).
- Rahim, M. and S. Suhaimi (2022), *Fresh Graduate Adversities: A Decade’s Insight on the Graduate Tracer Study*, Khazanah Research Institute, Kuala Lumpur. [15]
- Rahim, M. and S. Suhaimi (2022), “Fresh Graduate Adversities: A Decade’s Insight on the Graduate Tracer Study.”, Khazanah Research Institute, Kuala Lumpur, [20]  
[https://www.krinstitute.org/assets/contentMS/img/template/editor/20221207\\_GTS%20Working%20Paper\\_ver4.5\\_Published.pdf](https://www.krinstitute.org/assets/contentMS/img/template/editor/20221207_GTS%20Working%20Paper_ver4.5_Published.pdf) (accessed on 29 March 2024).
- Salleh, S. and N. Mansor (2022), “Women and Labour Force Participation in Malaysia”, [44]  
*Malaysian Journal of Social Sciences and Humanities (MJSSH)*, Vol. 7/7,  
<https://doi.org/10.47405/mjssh.v7i7.1641>.
- Schmillen, A. et al. (2019), *Breaking Barriers : Toward Better Economic Opportunities for Women in Malaysia*, World Bank Group, Washington, DC, [42]  
<https://documents.worldbank.org/en/publication/documents-reports/documentdetail/734461569247873555/breaking-barriers-toward-better-economic-opportunities-for-women-in-malaysia> (accessed on 13 June 2024).
- SEAE (2017), *Efeito Redistributivo da Política Fiscal no Brasil*, Ministério da Fazenda, Brasília, [3]  
[http://www.fazenda.gov.br/centrais-de-conteudos/publicacoes/boletim-de-avaliacao-de-politicas-publicas/arquivos/2017/efeito\\_redistributivo\\_12\\_2017.pdf/view](http://www.fazenda.gov.br/centrais-de-conteudos/publicacoes/boletim-de-avaliacao-de-politicas-publicas/arquivos/2017/efeito_redistributivo_12_2017.pdf/view).

- Shamsunahar, I., J. Harith and J. Mohamad (2023), “Challenges in Hiring and Talent Upskilling in Malaysia as an Upper Middle Income Country: Paving the Way Forward for a Resilient, Skilled Workforce in the Manufacturing and Services Sectors”, *Brief IDEAS*, Vol. No. 37. [16]
- Tuesta, D. and G. Bhardwaj (eds.) (2023), *Pensiones para todos. Propuestas para sistemas de pensiones más inclusivos en Latinoamérica*, pinbox Solutions, Singapore, <https://www.pinboxsolutions.com/resources/books/book-latin-america/> (accessed on 23 July 2023). [33]
- Williams, G. (2023), *Can a progressive wage model work?*, <https://www.freemalysiatoday.com/category/opinion/2023/05/17/can-a-progressive-wage-model-work/>. [23]
- Williams, G. (2023), *Is the progressive wage dead on arrival?*, <https://www.freemalysiatoday.com/category/opinion/2023/09/27/is-the-progressive-wage-dead-on-arrival/>. [24]
- World Bank (2024), *Bending Bamboo Shoots: Strengthening Foundational Skills, Malaysia Economic Monitor (April)*, World Bank Group, Washington, DC, <https://www.worldbank.org/en/country/malaysia/publication/bending-bamboo-shoots-strengthening-foundational-skills> (accessed on 13 June 2024). [18]
- World Bank (2024), *Informal Employment in Malaysia: Trends, Challenges and Opportunities for Reform*, <https://documents.worldbank.org/en/publication/documents-reports/documentdetail/099022124104015011/p1810931e836170db184871b5fe7b37157c> (accessed on 29 March 2024). [29]
- World Bank (2024), *Malaysia Economic Monitor - Bending Bamboo Shoots : Strengthening Foundational Skills*, <https://www.worldbank.org/en/country/malaysia/publication/bending-bamboo-shoots-strengthening-foundational-skills>. [53]
- World Bank (2024), *Women, Business and the Law 2024 - Country note Malaysia*. [45]
- World Bank (2023), *Raising the Tide, Lifting All Boats. Malaysia Economic Monitor (October)*, World Bank, Washington, DC, <https://www.worldbank.org/en/country/malaysia/publication/raising-the-tide-lifting-all-boats> (accessed on 17 March 2024). [2]
- World Bank (2021), *Aiming High: Navigating the Next Stage of Malaysia’s Development*, <https://www.worldbank.org/en/country/malaysia/publication/aiminghighmalaysia> (accessed on 14 April 2024). [5]
- World Bank (n.d.), *Government expenditure on education, total (% of government expenditure) - Malaysia*, <https://data.worldbank.org/indicator/SE.XPD.TOTL.GB.ZS?locations=MY> (accessed on June 13, 2024). [54]
- World Economic Forum (2023), *Global Gender Gap Report 2023*. [52]

# 3 Addressing climate challenges

Falilou Fall

---

Malaysia faces significant climate change risks, which require bold policy action both in the areas of mitigation and adaptation. Phasing out untargeted fossil fuel subsidies and moving towards carbon pricing will be key for this. While a carbon tax or an emission trading scheme is the economically most efficient approach to reduce emissions, mitigation efforts should rest on a mix of pricing and regulations. Decarbonising energy, industry and transport calls for a substantial increase in renewable energy supply coupled with measures to raise energy efficiency. Promoting renewable energy sources like solar and bioenergy will demand investments in energy storage solutions, upgrading the transmission grid, and promoting electrification, including in transportation. Developing a national adaptation strategy would mitigate the fragmentation of current adaptation policies across various sectoral policies and ministries. Enhancing disaster risk management and preparedness will bolster prevention efforts and diminish existing disaster risks by addressing and managing hazard conditions, exposure, and vulnerability. Establishing a framework for disaster risk financing and flood insurance is necessary to enhance the financial resilience of all stakeholders through ex-ante funding or the transfer of residual risk.

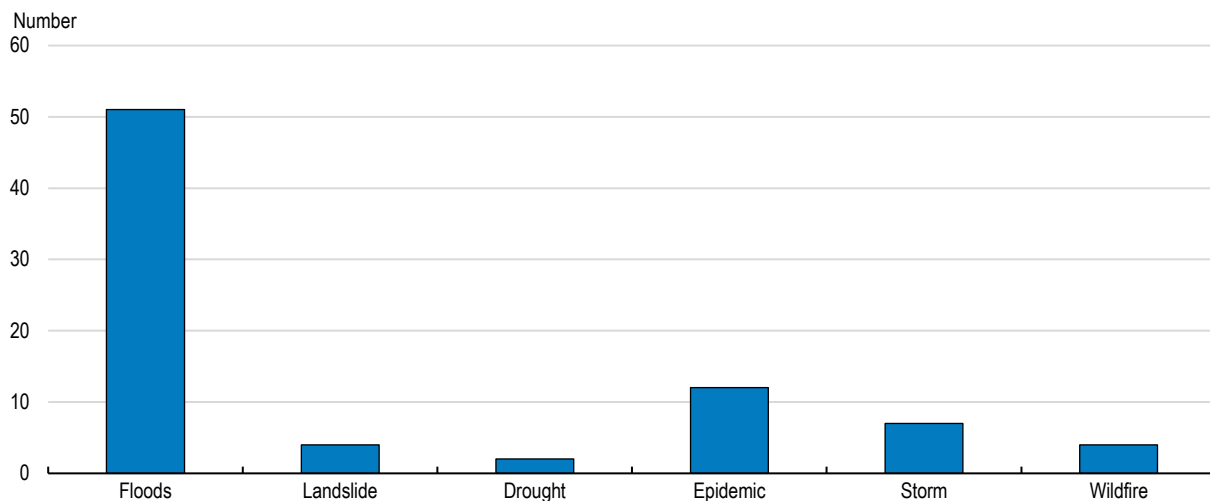
---

## Climate change increases the exposure to natural disaster risks

Malaysia faces escalating climate hazards, including floods, droughts, heatwaves, and storm surges, with profound impacts on the economy, communities, and infrastructure. Since 1975, over 80 natural disasters have occurred in Malaysia, with floods being the most frequent (Figure 3.1). Floods are typically associated with extreme rainfall events and rising temperatures.

### Figure 3.1. Flood is the most significant threat to Malaysia

Natural Disasters in Malaysia between 1975 and 2020



Source: CRED, EM-DAT: The International Disaster Database, Brussels, <http://emdat.be>

StatLink  <https://stat.link/t0xmh3>

Projected changes in temperature and precipitation patterns in Malaysia are expected to exacerbate these climate risks. The El Niño-Southern Oscillation (ENSO) significantly influences interannual temperature variations in Malaysia, leading to warmer weather across all regions. The current mean annual temperature stands at 25.4°C, with Peninsular Malaysia experiencing a surface mean temperature increase of 0.14°C–0.25°C per decade over the period 1970–2013 (UNFCCC, 2015<sup>[1]</sup>). By 2040–2060, average daily temperatures are projected to rise by 0.9 to 1.6 degrees Celsius, depending on emission scenarios. While precipitation projections carry high uncertainty, all emission scenarios include a small projected increase in average annual precipitation by the 2090s.

More frequent and intense heatwaves are expected as a result of these climate changes. Heatwaves, defined as periods of three or more days with temperatures above the long-term 95th percentile, are projected to become increasingly common. The median probability of heatwaves in a given year is forecasted to rise from 2% currently to 93% by 2090 in the most adverse scenario. Consequently, annual daily maximum temperatures may increase from 33°C to 34–37°C by the 2090s across various emissions pathways. Heat stress adversely affects human health, labour productivity, and increases energy consumption for cooling systems. Heatwaves and droughts also accelerate the degradation of transport infrastructure.

Malaysia is also expected to experience more frequent droughts in the future. Although the current probability of drought is relatively low, it is expected to double by the end of the century. The Inform 2024 Risk Index suggests that Malaysia's exposure to droughts ranks in the median range compared to neighbouring countries, with a ranking of 100 out of 191 countries (Table 3.1). Regions such as the

Kelantan River Basin are particularly susceptible to severe droughts, often occurring during El Niño events, leading to reduced agricultural productivity and freshwater supply.

**Table 3.1. Selected indicators of exposure and management capacity of climate risks from Inform<sup>3</sup> 2024**

	Range	Indonesia	Japan	Malaysia	Philippines	Thailand	Viet Nam
<b>HAZARD &amp; EXPOSURE</b>	<b>(0-10)</b>	<b>6.7</b>	<b>5.5</b>	<b>2.6</b>	<b>7.7</b>	<b>5.6</b>	<b>4.6</b>
Earthquake	(0-10)	8.9	9.7	1.9	9.7	1.7	3.5
River Flood	(0-10)	8.3	7.8	6.8	6.7	9.8	9.9
Tsunami	(0-10)	9.3	10	5.4	9.4	5.8	5.9
Tropical Cyclone	(0-10)	1.5	9.2	0	9.2	1.6	5.9
Coastal flood		8.1	9.4	6.4	8.9	5.5	9.6
Drought	(0-10)	2.2	0.6	2.8	3.3	5.2	3.4
<b>VULNERABILITY</b>	<b>(0-10)</b>	<b>3.3</b>	<b>1.5</b>	<b>3.4</b>	<b>4.6</b>	<b>3.8</b>	<b>2.7</b>
<b>LACK OF COPING CAPACITY</b>	<b>(0-10)</b>	<b>4.4</b>	<b>1.5</b>	<b>2.9</b>	<b>4.2</b>	<b>3.9</b>	<b>4</b>
Institutional	(0-10)	4.4	2.2	3.4	4.7	5.1	4.7
DRR (2)	(0-10)	3.3	1.9	2.6	3.5	4.7	4.2
Governance	(0-10)	5.4	2.5	4.2	5.8	5.5	5.1
Infrastructure	(0-10)	4.3	0.8	2.4	3.7	2.4	3.3
<b>Rank</b>	<b>(1-191)</b>	<b>47</b>	<b>151</b>	<b>116</b>	<b>29</b>	<b>54</b>	<b>78</b>

Note: 1. For the sub-categories of risk (e.g. "Flood") higher scores represent greater risks. 2. DRR stands for Disaster Risk Reduction. 3. INFORM is a collaboration of the Inter-Agency Standing Committee Reference Group on Risk, Early Warning and Preparedness and the European Commission. The European Commission Joint Research Centre is the scientific lead of INFORM.

Source: INFORM. 2023. INFORM Risk Index 2024. <https://drmkc.jrc.ec.europa.eu/inform-index>.

Malaysia faces significant exposure to flooding, with both river and coastal flood risks being high (Table 3.1). The frequency and severity of flood events have been on the rise in recent decades, and this trend is expected to continue with ongoing global warming. This could lead to an increased incidence of flash floods and associated hazards such as landslides. Projections indicate that by 2035–2044, the population affected by extreme river floods (90th percentile) could increase by approximately 102 290 people, representing a 140% rise from the population exposed to extreme flooding between 1971–2004.

In December 2021, several Malaysian states were struck by devastating floods, forcing over 400 000 people to evacuate their homes and resulting in overall losses amounting to MYR 6.1 billion or 0.4% of the country's nominal GDP. Since 2000, Malaysia has experienced an average of 1 to 2 large-scale flood events per year, with more frequent occurrences approximately once every seven years (World Bank and Bank Negara Malaysia (BNM), 2024<sup>[2]</sup>). Notably, large-scale floods have become more frequent since 2020. Historical data indicates that floods have been the most prevalent natural disaster in Malaysia, surpassing storms (7% of all disasters) and landslides (6%).

Coastal zones, urban areas, and transport infrastructure are increasingly vulnerable to rising sea levels. Historical data indicates an average sea-level rise of approximately 3.3 mm per year in eastern Malaysia and 5.0 mm per year in the west between 1993 and 2015 (World Bank Group and Asian Development Bank, 2021<sup>[3]</sup>). Projections suggest a rise of 0.4–0.7 meters by 2100, with Sabah-Sarawak facing greater risks (Ercan, Bin Mohamad and Kavvas, 2013<sup>[4]</sup>). These rising sea levels pose significant threats to agriculture in Malaysia's coastal zones. About six percent of palm oil production and four percent of rubber production are currently at risk. The effects of climate change are causing significant economic losses for Malaysia, which could be reduced by raising preparedness through better adaptation measures. The health impacts of observed ambient air pollution in Malaysia were estimated to result in an annual economic cost of 20% of GDP in 2019 (CREA, 2022<sup>[5]</sup>).

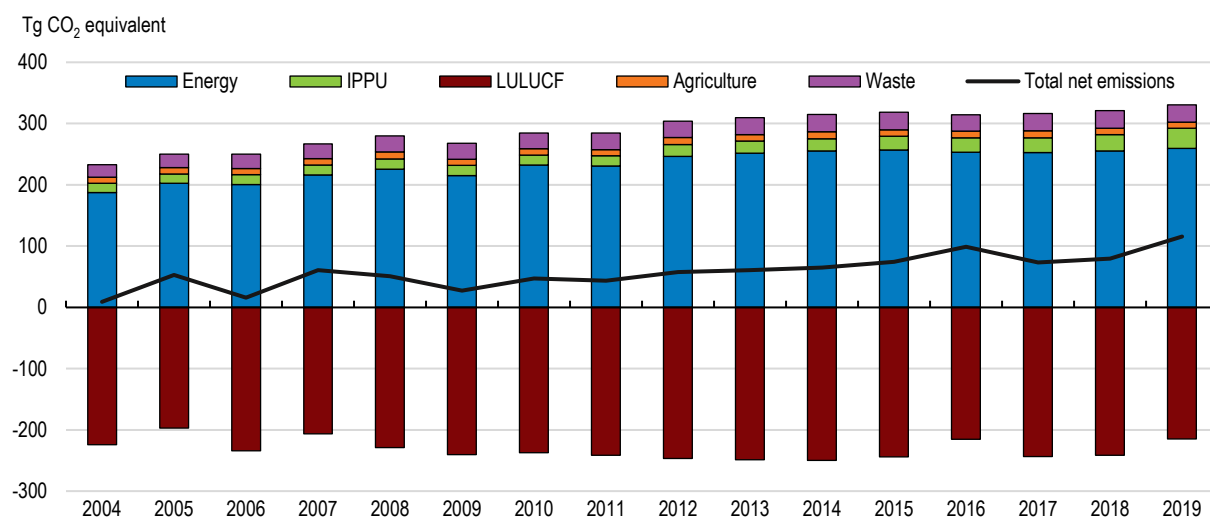
Looking ahead, Malaysia will need to do more both with respect to mitigation and adaptation strategies to address the challenges that come with climate change. Global mitigation efforts, and Malaysia's success in reducing its own emissions, will be key to rein in global warming, while adaptation efforts can make the economy more resilient to adverse climate events and reduce future losses. Policy success will hinge on achieving more coherent sectoral policies and finding the most effective policy mix. Phasing out energy subsidies will be a first important step, on which mandatory carbon pricing policies can build, while compensating low-income households through targeted transfers. Carbon pricing can be complemented by regulatory measures and sectoral policies. Developing a national adaptation strategy would mitigate the fragmentation of adaptation policies across various sectoral policies and ministries.

## Finding the right policy mix to accelerate emission reductions

### Greenhouse gas emissions have increased


Greenhouse gas (GHG) emissions have been rising in Malaysia in recent years. Energy usage remains the primary source of GHG emissions, accounting for approximately 80% of emission (Figure 3.2. ). However, land and forestry practices absorb CO<sub>2</sub>, helping to mitigate net emissions.

Figure 3.2. Greenhouse gas emissions are increasing



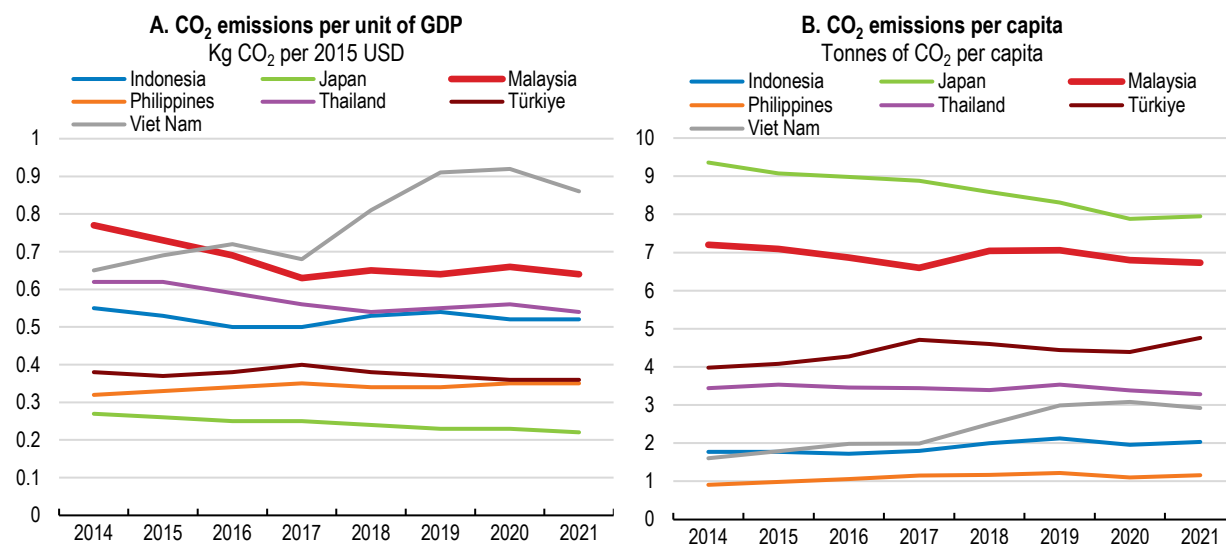
Note: IPPU: Industrial Processes and Product Use; LULUCF: Land Use and land Use Change and Forestry

Source: Ministry of Natural Resources, Environment And Climate Change, Malaysia (2022), *FOURTH BIENNIAL UPDATE REPORT*

StatLink  <https://stat.link/6rgd59>

Malaysia's CO<sub>2</sub> emissions remain high compared to peer countries. Emissions per unit of GDP showed improvement up to 2017, but since then, they have plateaued at a high level (Figure 3.3, Panel A). The decline in per capita emissions, which was observed until 2017, has reversed (Figure 3.3, Panel B).

**Figure 3.3. CO2 emissions remain high**

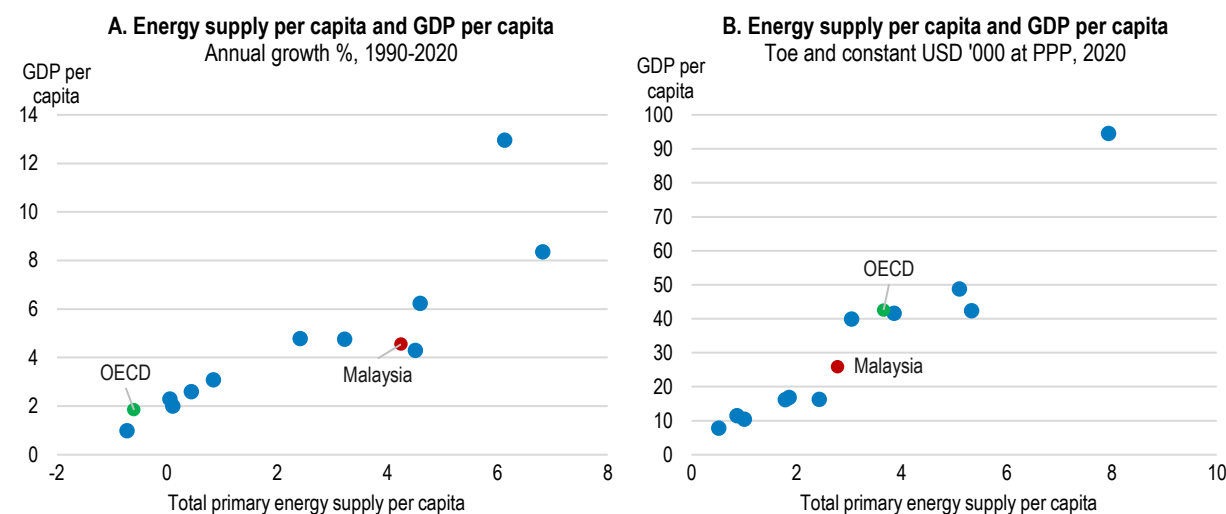


Source: IEA Greenhouse Gas Emissions from Energy.

StatLink <https://stat.link/841lsx>

For an economy that is experiencing rapid growth like Malaysia’s, strong energy demand and an increase in associated emissions should come as no surprise. Energy demand typically increases as activity expands and incomes rise (Figure 3.4, Panel A) and there is a strong correlation between a country’s income level and energy use (Figure 3.4, Panel B). Sustaining Malaysia’s high economic growth will require further increases in energy supply, while supply bottlenecks would constrain economic growth (Stern, 2011<sup>[6]</sup>). This underscores the need for Malaysia to transition to a greener energy mix to ensure that future growth does not exact an irreversible toll on future generations.

**Figure 3.4. Energy consumption is correlated with economic growth**



Source: OECD Green Growth Indicators; and World Bank World Development Indicators.

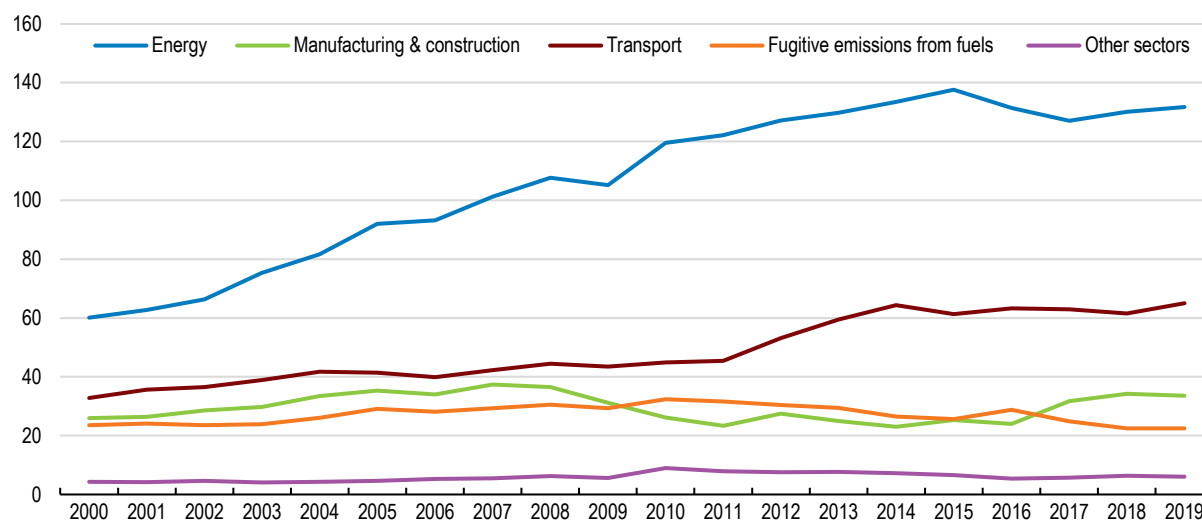
StatLink <https://stat.link/8wtybk>

The largest source of emissions are energy and transport. GHG emissions from these sectors have shown continuous upward trends over the past twenty years (Figure 3.5). Within industrial activities, mineral and metal industries stand out as significant sources of emissions (Ministry of Natural Resources, Environment

And Climate Change , Malaysia, 2022<sup>[7]</sup>). Waste management is also an important emission source, notably through industrial wastewater treatment and discharge, as well as solid waste disposal.

### Figure 3.5. Energy and transport emissions are increasing

Greenhouse gas emissions, Tg CO<sub>2</sub> equivalent



Source: Ministry of Natural Resources, Environment And Climate Change , Malaysia (2022), *FOURTH BIENNIAL UPDATE REPORT*  
[S https://stat.link/f3csg7](https://stat.link/f3csg7)

Malaysia has made significant progress in its climate commitments. In its revised Nationally Determined Contribution (NDC) submitted in July 2021, Malaysia increased its mitigation ambition aiming to reduce carbon intensity against GDP by 45% by 2030 compared to the 2005 level. This unconditional target represents a substantial improvement from the initial NDC, which had an unconditional emissions reduction target of 35%, with an additional 10% conditional on external support. The revised NDC expands the scope to cover seven greenhouse gases, compared to the three considered in the first NDC. Although the NDC does not explicitly mention a net-zero target, the Twelfth Malaysia Plan for long-term economic and sustainable development has set the goal of achieving net-zero GHG emissions as early as 2050. Future updates of the NDC could align carbon emissions reduction with the net-zero objective. As of November 2023, 37.4% of countries, including Thailand, have incorporated absolute emission reduction targets into their NDCs (Table 3.2).

**Table 3.2. Southeast Asian countries have pledged to reduce GHG emissions**

Country	Nationally Determined Contribution under the Paris Agreement
Indonesia	An unconditional reduction target of 31.89% and a conditional reduction target up to 43.20%, subject to availability of international support for finance, technology transfer and development and capacity building.
Malaysia	An unconditional 45% reduction of carbon intensity (against GDP) by 2030 compared to 2005 level.
Philippines	GHG emissions reduction and avoidance of 75%, of which 2.71% is unconditional and 72.29% is conditional.
Singapore	Peak emissions at 60 metric tons of carbon dioxide equivalent (MtCO <sub>2</sub> e) by 2030.
Thailand	A 30% reduction of GHG emissions from the projected business-as-usual (BAU) level by 2030. Efforts in its challenge to meet the long-term goal of carbon neutrality by 2050 and net-zero greenhouse gas emission by 2065.
Viet Nam	An unconditional 15.8% reduction and a conditional 43.5% reduction of total GHG emissions by 2030 compared to BAU.

Source: UNFCCC, NDC Registry.

Effectively transitioning to net-zero GHG emissions requires implementing robust mitigation policy strategies. In this context, a long-term low emissions development strategy (LT-LEDS), as recommended in the Paris Agreement, can play a pivotal role by ensuring coherence among various sectoral policies and

instruments. Malaysia has developed a National Energy Transition Roadmap and a Renewable Energy Roadmap to guide energy policies aimed at mitigating climate change. The Malaysian government is currently developing an LT-LEDS, presenting an opportunity to consolidate and align policies addressing various emission sources. Malaysia's LT-LEDS should prioritise the transition to low-carbon energy sources, incentivising industries to reduce emissions, and promoting the protection and conservation of forests, as well as reforestation and afforestation.

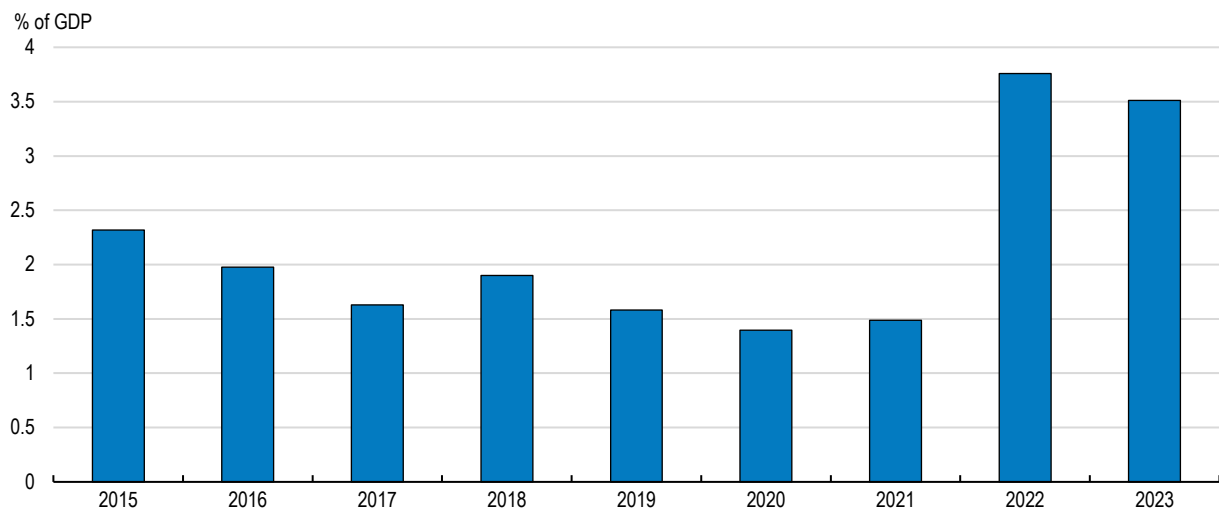
### **Phasing out fossil fuel subsidies**

Large energy subsidies remain perhaps the most salient obstacle to pricing GHG emissions in line with achieving mitigation targets. Subsidies also lead to significant policy inconsistencies, as they pull in the opposite direction of raising carbon prices or other mitigation efforts such as promoting electric vehicles. Subsidies are predominantly directed towards the transport sector for fuel consumption and amounted to 3.0% of GDP in 2023 (Figure 3.6). Liquefied petroleum gas (LPG) cylinders, widely used for cooking purposes, also benefit from subsidies. In addition, electricity tariffs in Malaysia remain among the lowest in comparison to neighbouring countries, with residential usage cross-subsidised by the commercial and industrial segments.


Although they helped to maintain relatively low inflation amid escalating global energy prices as of 2022, these subsidies have discouraged energy efficiency efforts and distorted consumption patterns towards more energy use. At the same time, energy subsidies fail to achieve one of their stated objectives, which is to protect the purchasing power of low-income earners, as those with high incomes benefit more from these subsidies than those in need of support (Chapter 2).

**Figure 3.6. Subsidies increased following the COVID pandemic**

Central government spending on subsidies



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

StatLink  <https://stat.link/8tdfp0>

While the negative economic effects of energy subsidies are widely understood, the political economy of getting rid of them is often difficult. The economic incidence of these subsidies is often poorly understood, with many people wrongly thinking that subsidies are an effective social policy tool. At the same time, those who consume large amounts of energy find it convenient to maintain them. Neighbouring Indonesia is an example of a successful reduction of energy subsidies, albeit also with a few ups and downs (Box 1.1). The experience of Indonesia may be instructive for Malaysia's efforts to phase out subsidies. Strong

communication, including about what the newly gained fiscal space could finance, may also help to convince wider parts of the population of the need to phase out subsidies.

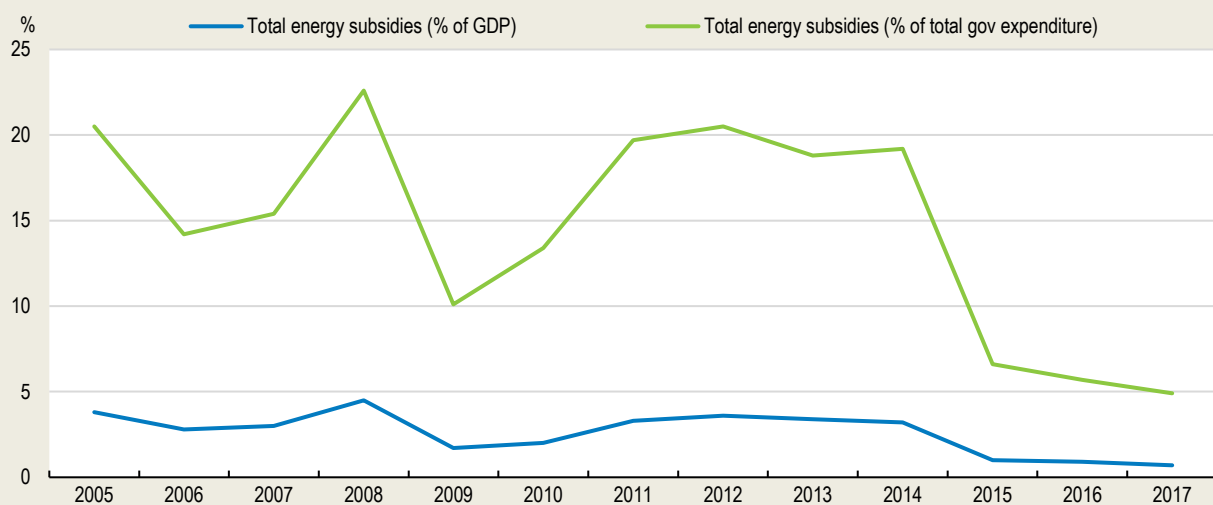
Malaysia currently plans to convert energy subsidies into targeted support for low-income households and has started an initiative to construct a single administrative database called PADU (Pangkalan Data Utama), which encompasses individual and household data for citizens and permanent residents of Malaysia, consolidating different sources of government data. While stronger targeting of subsidies would certainly be an improvement over the status quo, a better approach would be to phase out subsidies altogether and make any targeted transfers independent of energy consumption, while integrating them into broader and coordinated efforts to strengthen the social safety net (Chapter 2).

### Box 3.1. Cutting energy subsidies while shielding the most vulnerable – the Indonesian experience revisited


Until the mid-2010s, Indonesia subsidised fuel and electricity prices to keep energy affordable for the poor and to raise their purchasing power. In the early 2010s fuel subsidies were absorbing over 20% of government spending. But the subsidies did not work as intended, as 40% of subsidy benefits went to the top income decile and less than 1% reached the poorest. Fuel subsidies were reduced in June 2013 and again in November 2014. At the beginning of 2015, the government grasped the opportunity offered by falling world oil prices and abolished the petrol and diesel price-setting regime. Both domestic petrol and diesel prices were linked to world prices through a semi-automatic formula, with only diesel getting a fixed subsidy of IDR 1 000 (at the time, USD 0.08) a litre. In the original formulation, the 2015 budget earmarked more than 13% of total government expenditure to fuel subsidies, but the share was eventually whittled down to 5% (Figure 3.7).

The subsidy cuts were matched by a substantial increase in spending on other areas of the state budget linked to social protection and infrastructure. Most of the sectors that received increased funds are associated with higher economic growth and rates of employment than fuel subsidies. A key positive outcome is that the budget has become much less vulnerable to fiscal risk following the reform, largely because smaller fuel subsidies made the budget less prone to unpredictable variation as a result of world oil price fluctuations and currency changes.

**Figure 3.7. Government spending on energy subsidies in Indonesia**



Source: Ministry of Finance Indonesia.

StatLink  <https://stat.link/j14py6>

In March 2018, the government increased the subsidy again to keep oil prices stable over the following two years. The subsidy-related government budget saw a 39% rise for the year 2021, reaching IDR 243 trillion. In 2022, the soaring cost of this measure led policymakers to redirect the fuel support component to low-income consumers, with:

IDR 9.6 trillion towards 14.6 million workers with monthly wages below USD 230.

IDR 12.4 trillion as cash assistance to 20.7 million households, each receiving USD 10.

IDR 2.2 trillion for public transport assistance, online bike taxi assistance and fishermen.

In 2023, the subsidies reached IDR 211 trillion for fuel, LPG and electricity to cushion the volatility of commodity prices, but the direct cash assistance towards low-income households was not renewed.

Indonesia still spends USD 110 million to support coal and USD 3.2 billion to support the oil and gas sector and faces challenges in terms of transparency, commitment, and the implementation of subsidies. Only the electricity subsidy policy for low-income households is well targeted, as households are categorised according to their scale of consumption when electricity prices are set. It is mainly upper-middle income households that benefit from subsidies for fossil fuels.

### ***Moving towards mandatory carbon pricing***

Implementing a positive carbon price to drive GHG emission reductions efficiently would be a natural next step. Most countries, including less developed countries, already have some form of positive carbon rates (Figure 3.8). These can result from an explicit carbon tax or an emission trading scheme, but in fact, the most common source of positive carbon rates is simply a fuel excise tax that raises the price of fossil fuels at the pump. Malaysia is an outlier in this regard, given that it has no positive carbon rate at all, not even a fuel tax, as highlighted in the 2021 OECD Economic Survey of Malaysia (Table 3.3).

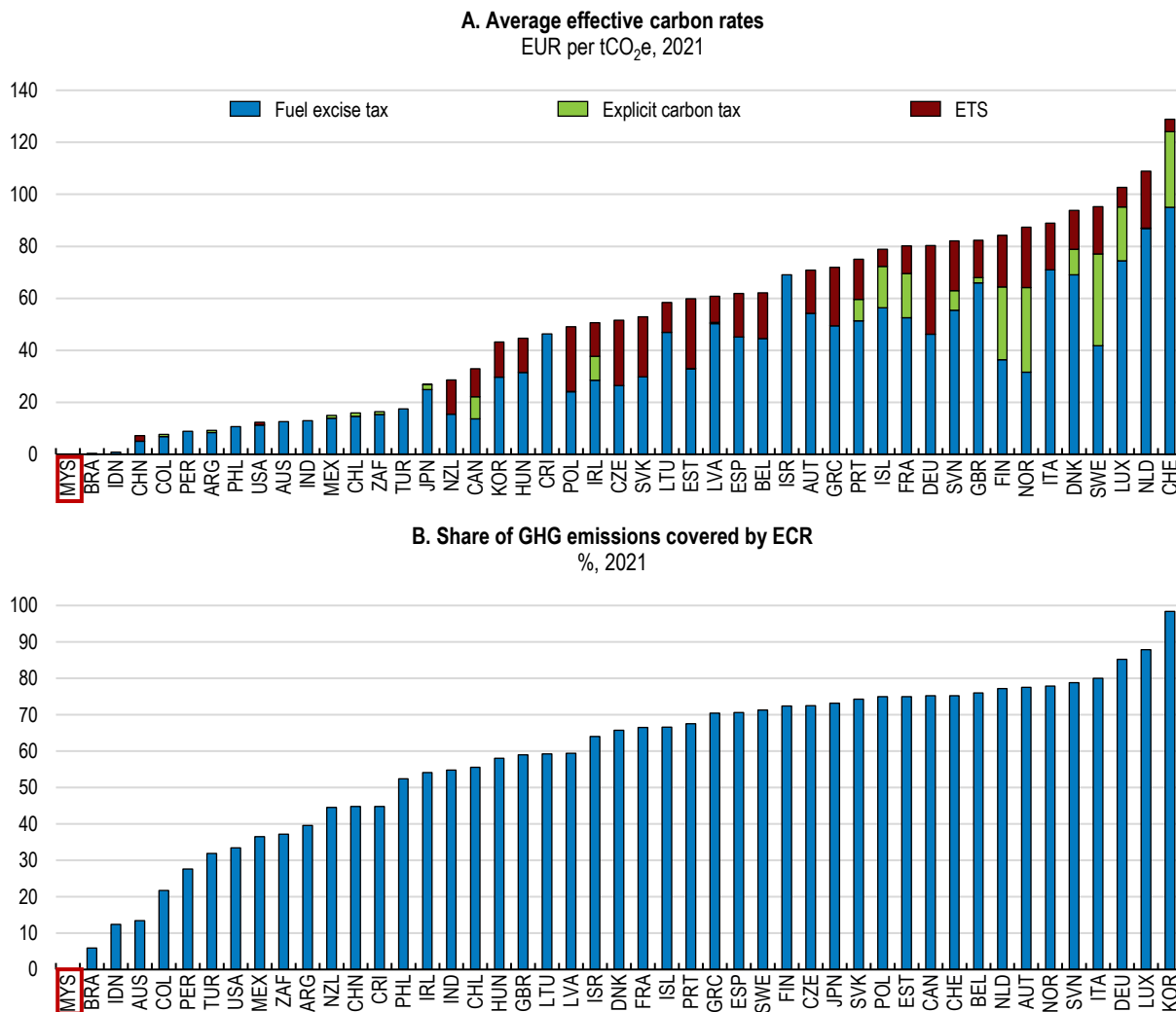
Carbon pricing can take the form of a carbon tax, which typically requires lower administrative capacities but may face more political challenges, or an Emissions Trading System (ETS), which demand more sophisticated monitoring but may encounter fewer political barriers. Hybrid approaches are also possible, with some sectors covered by an ETS while some of the remaining sectors may be covered by carbon taxes. If well engineered, such a hybrid solution can generate a largely uniform carbon price across the economy, which would equalise abatement costs across different mitigation options and would be an economically efficient approach. The government has recently initiated a feasibility study on carbon pricing, which considers both a carbon tax and an emission-trading scheme.

Malaysia developed a voluntary carbon market inaugurated by the capital market regulator, Bursa Malaysia, in December 2022. This market allows firms to produce, purchase, and trade carbon credits, aiding them in fulfilling their climate commitments and targets. It serves as an initial platform for discovering carbon prices and could pave the way for the implementation of a domestic emissions trading scheme or a carbon tax. The average price of carbon credits in the voluntary market was approximately USD 3.8 per ton of CO<sub>2</sub>e in 2021. The government is extending financial support for the development of this market, allowing expenses for measurement, reporting, and verification related to carbon credit projects to be deducted from revenues obtained from carbon credits traded on the voluntary market, up to MYR 300 000.

Implementing proper carbon accounting is crucial for raising awareness and enabling credible monitoring, reporting, and verification of GHG emissions. Accurately measuring carbon emissions is essential for fair pricing based on emission targets. The GHG Protocol offers a standardised method for companies to measure and mitigate GHG emissions in accordance with the Paris Agreement, categorising emissions into three scopes: Scope 1 (Direct Emissions), Scope 2 (Indirect Emissions), and Scope 3 (Value Chain Emissions). While many companies in Malaysia have started tracking emissions under Scope 1 and 2, few have progressed to monitoring Scope 3. Tracking emissions is particularly vital for large companies

involved in global value chains. Mandating carbon accounting, beginning with large corporations, and establishing a classification and metric framework can significantly impact GHG emissions reduction efforts.

**Figure 3.8. Effective carbon rates and coverage**



Source: OECD (2023), Effective Carbon Rates 2023: Pricing Greenhouse Gas Emissions through Taxes and Emissions Trading, OECD Series on Carbon Pricing and Energy Taxation, OECD Publishing, Paris.

StatLink <https://stat.link/vgat4>

As high prices of fossil fuels and carbon-intensive goods and services entailed by carbon pricing could disproportionately affect low-income households, it is crucial that fiscal revenues from carbon pricing are available to support those who would be affected (D'Arcangelo et al., 2022<sup>[8]</sup>). Large income inequalities may hinder the green transition through low public support, which could particularly be the case in emerging market economies like Malaysia. In emerging market economies, consumption of fossil fuels typically has a larger share in total expenditure for high-income households than for low-income households due to differences in car ownership rates and availability of traditional biomass, such as firewood (Dorband et al., 2019<sup>[9]</sup>). This would give carbon pricing a more progressive footprint, although the impacts may differ across countries and fuels (Steckel et al., 2021<sup>[10]</sup>). The negative effects on low-income households could

be exacerbated by associated increases of food prices as food accounts for a large share of low-income households' spending.

Support could go beyond households. Switzerland, for example, recycles most of the revenues of its carbon tax on fossil fuels introduced in 2008. Two thirds of the tax revenue are redistributed to households on per capita basis and to businesses based on payroll and the rest is used to an energy efficiency programme and a technology fund (Hintermann and Zarkovic, 2020<sup>[11]</sup>). Singapore introduced a CO<sub>2</sub> emission tax on the energy and industrial sectors in 2019. Although not directly linked to the carbon tax revenues, the Singaporean government at the same time provides strong support to business investments in energy efficiency, especially to SMEs, recently raising the grant rate from 50% of the investment costs to 70%. Part of the revenues from carbon pricing can also be used for other purposes, such as to smooth the job transition of those whose jobs are expected to disappear as the economy shifts away from high-emission activities. Recycling revenues from carbon pricing does not necessarily require earmarking these revenues, as long as they are allocated to the above-mentioned purposes.

**Table 3.3. Past recommendations on green growth**

Recommendations	Actions taken since August 2021
Introduce a carbon tax and gradually rising its rate over time, while mitigating its impacts on vulnerable households.	No action taken. The Ministry of Finance is conducting a feasibility study on carbon pricing in collaboration with the World Bank, which is expected to conclude in 2025.

### ***Applying stricter standards and regulations***

Standards and regulations can drive technology adoption and emission reduction as a complement to price signals. A balanced mix of pricing and regulation proves cost-efficient in curbing GHG emissions. Policies promoting green technology development complement those fostering business dynamism, facilitating the adoption of low-carbon technologies (D'Arcangelo et al., 2022<sup>[8]</sup>). Measures like emission quotas, green certifications, and technology mandates effectively restrict high-emitting activities. They address challenges such as household non-responsiveness to energy price changes and coordination issues in the retrofitting of dwellings. Combining carbon pricing with emission norms and regulations, especially in high-polluting industries, can equalise emission reduction costs across sectors and bolster compliance in Malaysia.

Tighter environmental regulations could help Malaysia reduce GHG emissions. One example for this is regulations on air pollutants. While high-pollution sectors will be penalised by more stringent environmental regulations, many highly dynamic sectors and firms would likely fare well despite strict regulations (OECD, 2021<sup>[12]</sup>). At the macro level, the adverse effects of more stringent environmental regulations on economic activity would likely be modest. Moreover, regulations, such as strict pollution standards, could induce innovation and stimulate demand for innovative products (OECD, 2011<sup>[13]</sup>). As energy-related air pollutants and CO<sub>2</sub> emissions often stem from the same sources, an integrated approach to tackle both would be highly beneficial (IEA, 2021<sup>[14]</sup>).

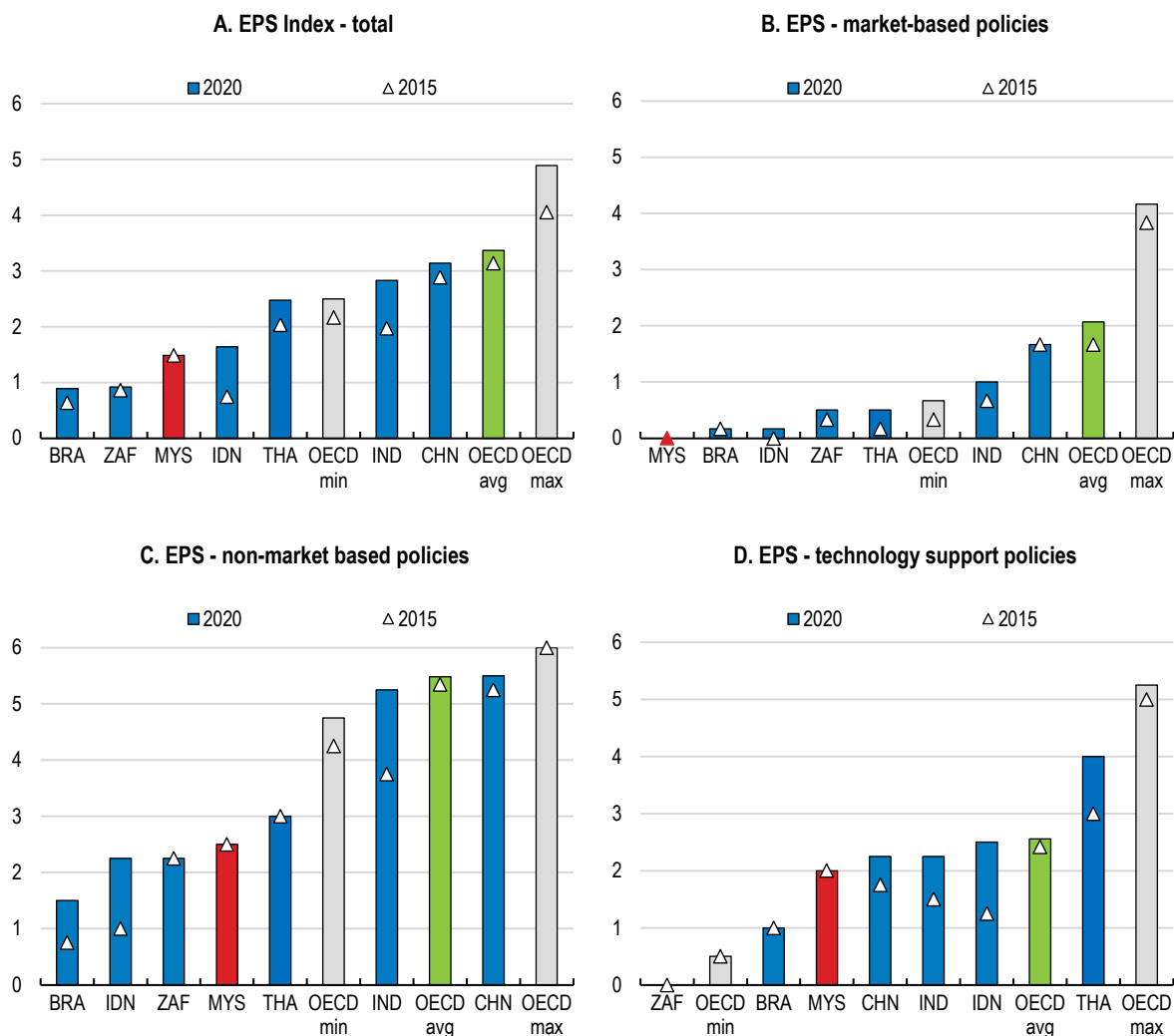
In this context, assessing Malaysia's current environmental regulations can be a useful starting point. The OECD has developed an Environmental Policy Stringency index that aims at capturing rigidity and intensity of a country's environmental policy from three dimensions: market-based policies such as carbon price measures through taxes or trading schemes, non-market based policies including regulatory measures and technology support policies including for the expansion of renewable energy sources (Box 3.2). In particular, the indicators compile information and allow comparisons on some major policy tools, including pollution standards and taxes.

Calculations prepared for this chapter suggest that Malaysia's environmental policies could be made more stringent across several dimensions. At present, Malaysia's policies are less stringent not only than OECD countries but when compared to China, India, Indonesia and Thailand (Figure 3.9). While the lack of

positive carbon rate makes Malaysia’s market-based EPS indicator the lowest in the sample, the non-market-based EPS indicator suggests that Malaysia also has room to do more on the regulatory dimension of environmental policies.

**Figure 3.9. Environmental policies are less stringent than in OECD countries, China and India**

Environmental Policy Stringency (EPS) Index, scale 0 (least stringent) to 6 (most stringent)



Source: (Ministry of Science, Technology and Innovation (MOSTI), 2022<sub>(15)</sub>), OECD, OECD Environmental Policy Stringency Index; OECD calculations.

StatLink  <https://stat.link/ztenph>

### Box 3.2. OECD Environmental Policy Stringency Index

There is a growing interest in cross-country comparisons of environmental policy instruments as many countries are setting environmental targets to tackle climate change. The cross-country comparison can help evaluate the impact of environmental policies on pollution as well as their economic and social effects, which is crucial for finding the effective policy tools and identifying relevant sectors. Given that quantifying diverse environmental policies with a single index is not simple, the OECD developed the Environmental Policy Stringency (EPS) indicators based on selected environmental policy measures with a focus on climate and air pollution. Introduced in 2014 and revised in 2021, the indicators serve as a comprehensive index and enable the comparison of environmental policies across 33 countries in the periods of 1990 and 2020.

The EPS indicators are widely used in empirical studies and policy recommendations as one of the key benchmark indices on the stringency of an environment policy. Stringency is defined as the degree to which environmental policies place explicit or implicit costs on pollution or environmentally harmful behaviour. For example, new taxes on pollutants will directly raise the costs of polluting firms, and would be counted as more stringent environmental policy. New subsidies to R&D or price support to renewable energy can also be interpreted as more stringent environmental policy in a sense that such subsidies will increase the opportunity cost of polluting. The index aggregates market-based policies, non-market-based policies, and technology support with simple weighting of scores from 0 (no policy) to 6 (most stringent).

The Index for market-based policies, accounting for one third of the overall index, consists of six sub-indices including, for example, taxation on CO<sub>2</sub> emissions. Based on the threshold, each sub-index has a score range from 0 to 6. The non-market-based policies index uses the emission limit value (ELV) of four kinds of pollutants as a benchmark to estimate stringency. The technology support index reflects the R&D expenditure to GDP ratio as well as adoption support proxied by the level of price support for solar and wind energy technologies.

Like any composite index, the EPS only covers a partial set of policies. The EPS focuses on policies aimed at curbing greenhouse gas emissions and local air pollution, and within this group of policies, it does not capture regulations for some specific sectors. For example, policies that regulate emissions from agricultural production are not included (Frohm et al., 2023<sup>[16]</sup>). The technology support index includes support for solar and wind energies, but Malaysia's public support for wind energy is zero due to the low wind speeds and the resulting limited potential of wind energy in Malaysia (Koons, 2023<sup>[17]</sup>).

Source: (Kruse et al., 2022<sup>[18]</sup>), (Bottai and Koźluk, 2014<sup>[19]</sup>)

## Changing the energy mix to transition toward a low carbon economy

The energy sector remains Malaysia's largest emitter of GHG emissions. Energy usage and transportation stand out as primary contributors to these emissions (Figure 3.5). The current energy matrix, characterized by its emissions profile, underscores the need for decisive actions to accelerate a just energy transition.

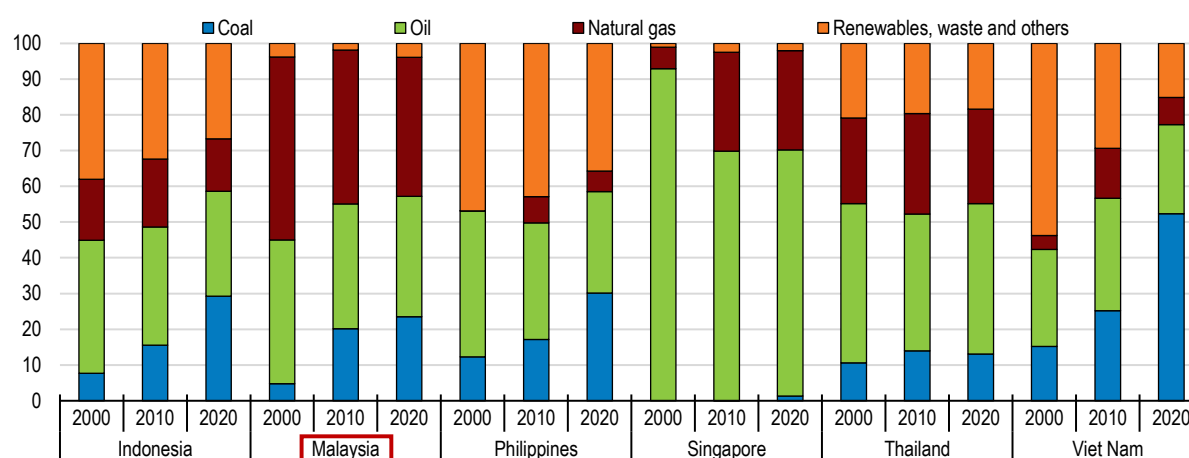
In 2020, four energy sources dominated the national total primary energy supply mix. Natural gas held the largest share at 42.4%, followed by crude oil and petroleum products at 27.3%, with coal close behind at 26.4% (Figure 3.10). Meanwhile, renewables, encompassing hydropower, solar, and bioenergy, accounted for a mere 3.9% (Ministry of Economy, 2023<sup>[20]</sup>). Notably, three-quarters of all oil supply was directed towards the transport sector, while industry, including non-energy uses, consumed 17% of the total oil supply (IRENA, 2023<sup>[21]</sup>). Furthermore, over half of the natural gas supply served industry needs, with electricity generation utilising another 40% of the total.

The heavy reliance on high carbon-emitting energy sources can be traced back to the historical abundance of fossil fuels, particularly oil and natural gas. As of 2019, Malaysia possessed significant reserves, including 4.7 billion barrels of crude oil and condensate, along with estimated natural gas reserves totalling 9.9 trillion standard cubic feet (tscf) of associated gas and 69.3 tscf of non-associated gas. Additionally, Malaysia's coal reserves amounted to 276 million tonnes across various types (IRENA, 2023<sup>[21]</sup>).

Transitioning to net-zero emissions by 2050 calls for increasing the use of electricity as an energy source and transitioning to greener electricity sources. Electrification plays a pivotal role in key sectors such as transportation and specific industrial sub-sectors. As of the end of 2021, Malaysia's total installed electricity generation capacity stood at 33 GW connected to the grid. Coal and natural gas remain the primary sources of electricity, accounting for approximately 70% of the total installed capacity. Renewable sources contribute around 22%, including a mix of large and small hydropower, biomass, and solar PV.

### Figure 3.10. Malaysia's fossil-fuel dependence is higher than in peer countries

Total energy supply by source, share %



Source: IEA, World Energy Balances.

StatLink  <https://stat.link/fdynjb>

The government has formulated a strategy to transition towards low-carbon systems and has developed several sectoral policies aimed at promoting the use of renewable energy as a first step in transitioning to a low-carbon economy. This strategy encompasses initiatives such as the Malaysia Renewable Energy Roadmap (MyRER), the National Energy Policy (NEP), and the National Energy Transition Roadmap (NETR), introduced in 2021, 2022, and 2023 respectively. The MyRER outlines strategies to increase the share of installed renewable energy capacity to 31% by 2025 and 40% by 2035. Furthermore, the National Energy Policy complements these efforts by targeting a total installed renewable energy capacity of 18.4 MW and aiming to reduce the capacity share of coal to 18.6%.

The government's identified transition path entails replacing coal and fuel by natural gas as a primary source of energy and electricity. Coal is slated for a nearly complete phase-out, while the share of renewable energy in total energy supply is projected to rise from 4% in 2023 to 22% by 2050 (Ministry of Economy, 2023<sup>[20]</sup>). The share of natural gas in total energy supply is expected to increase to 56% by 2050. Renewable energy will progressively scale up to constitute 70% of the installed capacity in the electricity mix by 2050. While natural gas is anticipated to play a pivotal role during the transition phase, its scale should be limited by 2050 to achieve a net-zero emission economy.

## **Boosting solar energy**

Malaysia possesses vast untapped renewable energy sources that offer affordable alternatives to fossil fuels. The country boasts substantial renewable energy resources, with an estimated 290 GW of technical potential nationwide. Currently, the installed capacity of renewable energy stands at 8 GW (Sustainable Energy Development Authority (SEDA) Malaysia, 2021<sup>[22]</sup>).

Accelerating the development of renewable energy and increasing electricity usage will be pivotal in transitioning to a low-carbon economy. As recommended by the OECD (OECD, 2021<sup>[23]</sup>), continuing the reform of the electricity market and further opening the grid to independent producers and renewable energy producers will be crucial for this transition. The power generation market in Malaysia has been gradually deregulated since the early 1990s. Electricity is generated by Tenaga Nasional Berhad (TNB), Malaysia's largest formerly state-owned electric utility company, and by independent power producers (IPPs). Independent power producers in Peninsular Malaysia are licensed by the government and sell power under the terms of power purchase agreements (PPAs). Currently, TNB is responsible for electricity transmission and distribution.

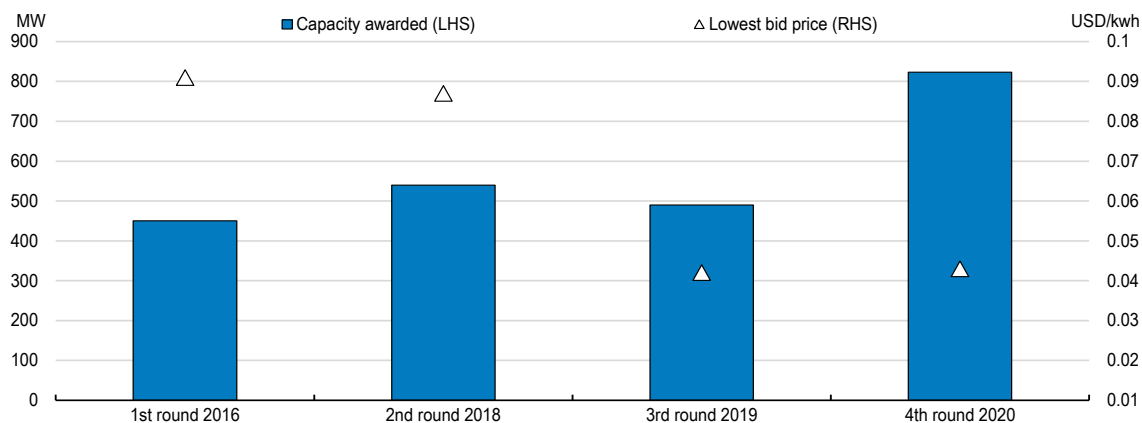
Experiences from OECD countries, such as Portugal, demonstrate that unbundling transmission, distribution, and generation can promote renewables (OECD, 2019<sup>[24]</sup>). In September 2019, the Malaysian government approved the 10-year Malaysia Electricity Supply Industry (MESI) 2.0 master plan to diversify the market, enhance competition, improve flexibility, and empower consumers. Implementing key measures of the MESI 2.0, such as allowing generators to source their own fuel, transitioning from power purchase agreements to capacity and energy markets, establishing a third-party access framework and network charges for the grid, and facilitating green energy producers and consumers, is essential. These reforms have the potential to create a more efficient electricity market, with prices reflecting costs and incentivising renewable electricity development.

Solar energy emerges as the most significant renewable energy source, with an estimated potential of 269 GW (Sustainable Energy Development Authority (SEDA) Malaysia, 2021<sup>[22]</sup>). Despite rapid growth in installed solar photovoltaic (PV) capacity, only 2.6 GW was installed by the end of 2020. Over the past decade, the government has implemented numerous policies to promote solar energy development. The feed-in-tariff (FiT) scheme, initiated in 2011 (excluding Sarawak), required large electricity consumers to pay an additional fee to finance renewable electricity development. Utility companies were mandated to purchase renewable electricity at a premium price, whereby the price difference is funded by this additional fee. As solar generation gained momentum, the provision of premium buy-back tariffs under the FiT scheme was discontinued. The Net Energy Metering (NEM) scheme, launched in 2016, allowed all electricity consumers to produce solar electricity for personal use and offset excess electricity for up to 24 months. The first phase's entire 500 MW quota was exhausted by the end of 2020, with an additional 500 MW quota allocated for the second phase (2021-2023), featuring an enhanced peer-to-peer energy offsetting system. Furthermore, a competitive bidding process for large-scale solar projects (above 30 MW capacity) commenced in 2016, known as Large Scale Solar, resulting in declining solar costs (Figure 3.11).

Taking the development of solar capacity to the next level requires a more streamlined and supportive framework. The current fragmented approach and lengthy permitting processes inflate fixed development costs, hindering the potential contribution of Large-Scale Solar projects to renewable energy efforts (Ministry of Economy, 2023<sup>[20]</sup>). Moreover, access to land remains challenging and time-consuming. Policy programmes aimed at boosting solar energy should address regulatory and licensing obstacles. Additionally, fostering a more flexible grid capable of accommodating solar energy, particularly small-scale supply, would support solar energy development.

**Figure 3.11. The cost of solar energy has decreased**

Large Scale Solar bid in Malaysia and lowest bid prices



Source: IRENA (2023)

StatLink  <https://stat.link/r5ksbl>

In contrast with the potential of solar energy, Malaysia's potential for wind energy is limited. Its average annual wind speed of 1.8 m/s is less than the recommended 4 m/s for small wind turbines to become economically viable using current technologies, and significantly below the 5.8 m/s wind speed for a utility-scale wind turbine. As a result, only niche uses for wind energies may be viable in select areas, in the absence of major technological progress.

### ***Further developing biomass and hydrogen as sources of energy***

Bioenergy already plays a significant role in Malaysia's energy mix and holds substantial potential for further development. Bioenergy encompasses biomass, biogas, and biofuels. Biomass, with an estimated potential of approximately 2.3 GW, constitutes the largest resource in Malaysia. Additionally, biogas and municipal solid waste show promising potential, with a total of 736 MW and 516 MW respectively (IRENA, 2023<sub>[21]</sub>). In 2019, bio-based products contributed 1% of the total primary energy supply, comprising 648 kilotonnes of oil equivalent (ktoe) of biodiesel, 204 ktoe of biomass, and 118 ktoe of biogas (Ministry of Economy, 2023<sub>[20]</sub>).

The production of biofuels has expanded over the years, primarily driven by oil palm plantations, which covered a total of 5.9 million hectares in 2021 (Ahmad Parveez et al., 2022<sub>[25]</sub>). Biofuel, primarily in the form of biodiesel, is widely used across the transport industry. However, further development of biofuels based on food crops like palm oil raises concerns regarding land competition and food security. Non-food biomass sources, such as agricultural waste residue, forest residue, livestock waste, fisheries waste, used cooking oil (UCO), as well as municipal solid waste (MSW), hold the most promising potential for bioenergy. Biogas, mainly derived from municipal solid waste, food waste, cattle manure, sewage, and palm oil mill effluent (POME), also offers significant potential.

The National Energy Transition Roadmap aims to leverage Malaysia's robust bioenergy potential, focusing on two key segments: agriculture-related bioenergy and non-agricultural waste, such as used cooking oil and municipal solid waste. Palm oil-related residue and municipal solid waste are significant and growing sources of bioenergy. The NETR sets the objective for increasing biorefinery capacity to 3.5 billion litres by 2050 and biomass and biogas power generation capacity to 1.4 GW by 2050. Improving the management of municipal solid waste, as recommended by the OECD (OECD, 2021<sub>[23]</sub>), would facilitate the collection, sorting, and utilization of these wastes for biogas production. Ensuring the regular functioning and collection of palm oil-related residue is crucial to attract investment and develop the sector.

Developing hydrogen presents a promising alternative to natural gas across various sectors, including industry, transportation, and power generation. The NETR proposes several targets for hydrogen development, including phasing out the use of grey hydrogen as a feedstock by 2050, producing up to 2.5 Mtpa of green hydrogen by 2050 from renewable sources like hydroelectric power and solar, and establishing one low-carbon hydrogen hub by 2030, with an additional two hubs by 2050.

Malaysia is advancing on two projects to produce green hydrogen in Sarawak, namely the H2ornbill and H2biscus projects, in collaboration with Japanese and South Korean partners, respectively. The H2ornbill project aims to generate up to 75MW or 10 000 tonnes per year capacity by 2025 (Malaysian Science and Technology Information Centre (MASTIC), 2023<sup>[26]</sup>).

Despite the potential of hydrogen, policy support has been weak, and there is a lack of defined standards and regulations governing hydrogen. To accelerate hydrogen production development, Malaysia needs to establish a comprehensive policy and regulatory framework, including defining standards and introducing hydrogen-specific regulations for transportation and storage. Streamlining permitting processes for hydrogen projects is also essential. Additionally, efforts are required to enhance local technical capacity and reduce the cost of electrolyzers using renewable energy sources such as solar and hydro.

### ***Other policies to reduce emissions***

Improving energy efficiency is crucial for reducing energy intensity and CO<sub>2</sub> emissions. Malaysia's 10-year strategy launched in 2015 aims to cut electricity demand by 8% by 2025, a target it is on track to achieve according to the NETR. The forthcoming Energy Efficiency and Conservation Act (EECA) will broaden energy-saving policies beyond electricity to include thermal energy, with goals of achieving 21% savings by 2040, including 15% in residential and 22% in industrial and commercial sectors. Increasing awareness and access to energy-efficient appliances, expanding Minimum Energy Performance Standards (MEPS), and implementing a national standard for building energy intensity will further reduce emissions.

Transportation emissions are the second-largest source of GHG emissions in Malaysia. Land transport, primarily private passenger vehicles, accounts for 85% of total transport emissions. To reduce these, Malaysia has set ambitious goals, aiming for a 60% public transport modal share and 80% electric vehicle penetration in the vehicle fleet by 2050 (Ministry of Economy, 2023<sup>[20]</sup>).

To reduce transport emissions, improvements in public transport infrastructure and support for electric vehicle adoption are imperative. Investing in public transport networks and discouraging private vehicle use can help to encourage public transit usage. Abolishing fuel subsidies and introducing carbon pricing on fuels could be instrumental in promoting greener choices. Developing the electric vehicle fleet will require tax incentives, continued funding for public charging stations, and streamlining regulations for private charging infrastructure. Additionally, enhancing the grid to accommodate renewables will facilitate electric vehicle charging. For example, Sarawak's grid modernisation plans will be essential for efficient and sustainable electric vehicle infrastructure.

Malaysia initiated a biodiesel blending program in 2006 under the National Biofuel Policy. By 2010, biodiesel blending for road transport began, reaching a 7% blending rate within five years. Malaysia's biodiesel serves both domestic and export markets, with a B10 (10% biodiesel) blending mandate for road transport and B7 for industrial use. Although a B20 blending target was planned for 2020, supply chain issues, compounded by the COVID-19 pandemic, delayed its implementation. Further incentivizing biofuel blending, such as through reduced taxation, can mitigate transport emissions.

Forests are vital carbon sinks, absorbing up to 75% of carbon emissions in Malaysia. Combating illegal deforestation remains crucial for forest preservation, as recommended by the 2021 OECD Economic Survey of Malaysia (OECD, 2021<sup>[23]</sup>). Malaysia has a target to keep 50% of its land mass forested and this includes efforts to regulate the sustainability of the palm oil sector through certification schemes (Tang, 2019<sup>[27]</sup>). Adequate financing for conservation efforts is essential to ensure the sustainability of domestic

sinks. Additionally, sufficient resources should be allocated to law enforcement to effectively protect forests.

## Accelerating climate change adaptation

Malaysia can do more to prepare against the risks and damages from natural disasters, particularly those exacerbated by climate change. The economic case for this is strong as reducing risks is typically less expensive than repairing the damages once they have occurred. Although Malaysia has numerous policies, frameworks, and entities tasked with disaster coordination, their focus predominantly lies on response and recovery, rather than disaster risk reduction and climate change adaptation.

A first step for better adaptation policies is to improve coordination and elaborate a comprehensive, publicly available National Adaptation Plan. Adaptation policies are currently fragmented across various sectors and ministries, hindering effective coordination and governance of climate change risk management. The mid-term review of the 12th Malaysia Plan identifies the formulation of such a plan as a top priority. This plan will concentrate on five key areas: public health, agriculture and food security, forestry and biodiversity, water resources and security, and infrastructure and cities. The National Adaptation Plan aims to streamline disaster response coordination, develop readiness policies, and address economic activities vulnerable to climate change impacts. This includes ensuring infrastructure, particularly transportation infrastructure, is resilient to climate change effects.

Malaysia relies heavily on surface water flows, which contribute 97% of its water supply, with reservoirs serving as the primary storage source (World Bank Group and Asian Development Bank, 2021<sup>[3]</sup>). However, changing precipitation patterns, prolonged dry spells, and rising temperatures are expected to significantly affect water availability. To address these challenges, the government is finalising a National Water Policy emphasising integrated water resource and basin management, alongside nature-based solutions. Degraded basin ecosystems can worsen drainage rates, leading to increased downstream flooding. Additionally, urban expansion into flood-prone areas heightens flood impacts and reduces natural flood buffers. Adaptation strategies in the water sector include expanding irrigation, dam construction, and sanitation infrastructure. Moreover, preservation policies, such as implementing water and land conservation measures within rural micro-basins, play a crucial role in mitigating these impacts.

Revising land occupation plans and authorisations along coastal zones is imperative considering the projected sea-level rise. The rapid urbanization has led to construction in vulnerable areas like floodplains and steep hillsides, making urban residences and public infrastructure particularly susceptible. Preparing for the displacement of agriculture land in vulnerable coastal areas may also be part of an adaptation strategy, but this may require financial support for affected subsistence farmers.

Integrating adaptation considerations into infrastructure planning and urban mobility systems will be another potential line of action. This requires comprehensive planning of land use, settlement patterns, and infrastructure projects that consider climate risks. For example, the construction of Kuala Lumpur's SMART tunnel included an additional tunnel for drainage, which can divert flood water away from the city (Sanghi, 2022<sup>[28]</sup>; Pugacheva and Mrkaic, 2018<sup>[29]</sup>). Investing in resilient mass-transit infrastructure can mitigate risks for commuters. Future public transport infrastructure expansion plans in Malaysia must incorporate climate change risk assessments and allocate responsibilities for climate-related risks. OECD guidelines for building climate-resilient infrastructure, covering design, institutional frameworks, and public-private partnerships, can inform these efforts (OECD, 2018<sup>[30]</sup>).

Improving the functioning of insurance markets is another way to prepare for climate risks. Flood risk insurance remains limited in Malaysia, primarily covering losses for commercial businesses, homeowners, and vehicles (Box 3.3). Comprehensive flood risk insurance faces obstacles due to significant gaps in flood-related information. Reporting on flood exposures and vulnerabilities from both businesses and public

sources is limited. Moreover, the complexity of quantifying flood risks due to uncertain climatic and natural processes poses challenges. Policy uncertainty, fragmented responsibilities, lack of coordination, and insufficient implementation capacity at the government level further hinder effective disaster risk management. Consequently, financial institutions in Malaysia struggle to accurately price, monitor, manage, and diversify flood risks. These challenges restrict the potential for risk transfers, such as to insurance and reinsurance companies.

### Box 3.3. Financial responses to the 2021 flood event

At the national level, the Department of Statistics Malaysia (DOSM) estimates that damages caused by the flood events in December 2021 and January 2022 alone at around USD 1.35 billion or 0.4% of GDP, with business premises, manufacturing, and the agriculture sector accounting for USD 330 million or 25% of total damages. In addition, the federal government allocated about USD 260 million in financial aid and other forms of relief associated with the flood events. In addition, Bank Negara Malaysia established the Disaster Relief Facility with USD 110 million to alleviate the financial burden on micro, small, and medium enterprises (MSMEs) affected by the floods. Additionally, several financial institutions offered loan moratoriums on housing or property financing, car financing, credit cards, and personal financing of up to six months to flood victims.

About a third of the losses, equivalent to USD 490 million, were covered by insurance. About 82% of the gross insured losses were from the commercial sector, mainly from large corporates with high insurance coverage for commercial premises. Residential homes accounted for another 11 percent of the insured losses. The 2021 flood events led to the largest claim payout in Malaysia's insurance and takaful industry for flood events in the past decade. Despite the large payout, the losses incurred by insurers and takaful operators (ITOs) did not pose risks for the industry because ITOs had sufficient liquidity and part of the risks had been transferred to re-insurance/re-takaful operators.

Source: (World Bank and Bank Negara Malaysia (BNM), 2024<sup>[2]</sup>)

Solutions may imply more active support by the public sector to further develop the flood insurance segment. The risk diversification capacity of the insurance industry can be strengthened by broadening the pool of insured assets through mandatory requirements for insurance uptake across all risk-levels of businesses and households. This may be essential to ensure the financial viability of a flooding insurance scheme. For instance, in France, compensation to cover the costs incurred by a natural disaster is paid out of a special fund, paid into by insurance companies and the government (Box 3.4). More specifically, a disaster risk fund financed through fees on all insurance contracts can provide the degree of pooling of risks and financial capacity needed to cover flood damages.

A comprehensive Disaster Risk Financing and Insurance (DRFI) strategy should prioritise frameworks for collecting and making flood-related data available to support flood risk assessments. Detailed flood risk mapping is an essential initial step in this process. Additional policy actions should include establishing standards for adaptation investments and enhancing flood risk monitoring by the financial sector to promote accountability and ensure effective risk management. Specific analyses and action plans are necessary to align the financial interests of institutions, including insurance companies, with those exposed to flood risk.

Developing a DRFI strategy would help to address Malaysia's high flood risk, considering the difficulties that private insurance markets can face in providing adequate insurance cover. DRFI aims to enhance the financial resilience of stakeholders by pre-arranging funding or transferring residual risk. Financial instruments like reserve funds, contingent budget lines, and market-based solutions such as insurance and catastrophe bonds are key components (Norris et al., 2023<sup>[31]</sup>). At the national level, public funds play a vital role in assisting those affected by floods. For instance, in 2021-2022, the federal government allocated MYR 1.2 billion (about USD 260 million) in financial aid and relief efforts. Additionally, Bank

Negara Malaysia established the Disaster Relief Facility, providing MYR 500 million (USD 110 million) to support micro, small, and medium enterprises affected by floods (World Bank and Bank Negara Malaysia (BNM), 2024<sup>[2]</sup>).

### Box 3.4. The French natural disaster fund

France operates a system where compensation for costs incurred due to a natural disaster is drawn from a dedicated fund, financed through contributions from insurance policies held with insurance companies and the government. The eligibility for natural disaster compensation arises only upon official declaration of a natural disaster by the government in the respective commune.

Natural disaster insurance, known as "assurance catastrophe naturelle," provides coverage for damages caused by natural disasters such as earthquakes, floods, droughts, landslides, etc., primarily pertaining to property damage. This insurance is typically included in all multi-risk home insurance policies, as well as all-risk vehicle and professional building insurances. Insurers are mandated to include natural disaster coverage in insurance plans, and refusal to do so can be contested through the Bureau Central de Tarification (BCT) within 15 days of refusal. However, subscribing to an all-risk insurance policy is not obligatory.

Therefore, to receive compensation under natural disaster insurance, inclusion of this coverage in the insurance plan is necessary, as mandated, along with the publication of a government decree declaring a natural disaster in the area.

A disaster is officially declared after the municipality affected by the disaster submits a request for recognition to the prefecture, which serves as the local representative body of the state. A national-level commission, led by the Ministry of the Interior, ultimately decides on the classification of natural disasters.

Source: <https://www.service-public.fr/particuliers/vosdroits/F3076> and <https://www.georisques.gouv.fr/minformer-sur-la-prevention-des-risques/la-garantie-cat-nat>

**Table 3.4. Policy recommendations from this chapter (Key recommendations in bold)**

MAIN FINDINGS	RECOMMENDATIONS
<b>Mitigation</b>	
Malaysia lacks a long-term strategy on how to attain mitigation targets.	<b>Develop a long-term low emissions development strategy.</b>
Carbon pricing can lead GHG emission reductions efficiently but may reduce the real purchasing power of low-income households.	<b>Phase out fossil fuel subsidies and introduce carbon pricing through a carbon tax or emission-trading scheme, protecting vulnerable households with targeted transfers.</b>
Many environmental policies are on a voluntary basis.	Make environmental regulations more stringent, including air pollution limits on power generation and combustion engine vehicles.
GHG emissions are highly concentrated in energy, particularly industry and transport.	Consider defining sectoral mitigation plans and targets, including public transport infrastructure.
<b>Energy transition</b>	
GHG emissions from energy are partly the result of a strong reliance on fossil-fuel energy.	<b>Further encourage the expansion of renewable energy sources. Streamline licensing procedures and expand the use of auctions.</b>
Bioenergy already plays a significant role in Malaysia's energy mix and holds substantial potential for further development.	Ensure the regular functioning and collection of palm oil-related residue.
Despite the potential of hydrogen, policy support has been weak, and there is a lack of defined standards and regulations governing hydrogen.	Establish a comprehensive policy and regulatory framework for hydrogen, including defining standards and introducing hydrogen-specific regulations for transportation and storage.
Generating electricity from natural gas generates less emissions than coal but is far from emission-free and can only help in the transition towards renewable energy sources.	Develop a long-term strategy to replace natural gas with low-carbon energy sources in electricity generation.
<b>Adaptation</b>	
Malaysia is exposed to significant climate risks. An economy-wide plan would allow reducing damage from these risks cost-efficiently.	Formulate and publish the National Adaptation Plan (MyNAP).
Sea-levels are set to rise, making some land unsuitable for its current use.	Revise land occupation plans along coastal zones.
Climate risks require enhancing financial resilience and risk sharing among stakeholders, including through insurance mechanisms.	<b>Develop a disaster risk financing and insurance strategy and create stable framework conditions for flood insurance.</b>

## References

- Ahmad Parveez, G. et al. (2022), "OIL PALM ECONOMIC PERFORMANCE IN MALAYSIA AND R&D PROGRESS IN 2021", *Journal of Oil Palm Research*, [25]  
<https://doi.org/10.21894/jopr.2022.0036>.
- Bottai, E. and T. Koźluk (2014), "Measuring Environmental Policy Stringency in OECD Countries: A Composite Index Approach", *OECD Economics Department Working Papers*, No. 1177, OECD Publishing, Paris, [19]  
[https://www.oecd-ilibrary.org/economics/measuring-environmental-policy-stringency-in-oecd-countries\\_5jxrjnc45gvg-en](https://www.oecd-ilibrary.org/economics/measuring-environmental-policy-stringency-in-oecd-countries_5jxrjnc45gvg-en).
- CREA (2022), *The Health and Economic Impacts of Ambient Air Quality in Malaysia*, [5]  
<https://energyandcleanair.org/publication/hia-ambient-aq-malaysia/>.
- D’Arcangelo, F. et al. (2022), "A framework to decarbonise the economy", *OECD Economic Policy Papers*, No. 31, OECD Publishing, Paris, [8]  
<https://doi.org/10.1787/4e4d973d-en>.
- Dorband, I. et al. (2019), "Poverty and Distributional Effects of Carbon Pricing in Low- and Middle-income Countries – A Global Comparative Analysis", *World Development*, Vol. 115, [9]  
 pp. 246-257, <https://doi.org/10.1016/J.WORLDDEV.2018.11.015>.
- Ercan, A., M. Bin Mohamad and M. Kavvas (2013), "The impact of climate change on sea level rise at Peninsular Malaysia and Sabah–Sarawak", *Hydrological Processes*, Vol. 27/3, [4]  
 pp. 367-377, <https://doi.org/10.1002/HYP.9232>.
- Frohm, E. et al. (2023), "Environmental policy stringency and CO2 emissions: Evidence from cross-country sector-level data", *OECD Economics Department Working Papers*, No. 1773, OECD Publishing, Paris, [16]  
<https://doi.org/10.1787/53ddcef7-en>.
- Government of Malaysia (2018), *Malaysia Third National Communication and Second Biennial Update Report to the UNFCCC*. [37]
- Hintermann, B. and M. Zarkovic (2020), "Carbon Pricing in Switzerland: A Fusion of Taxes, Command-and-Control, and Permit Markets", *ifo DICE Report*, Vol. 18/1, [11]  
<https://www.ifo.de/DocDL/ifo-dice-2020-1-Hintermann-Zarkovic-Carbon-Pricing-in-Switzerland-A-Fusion-of-Taxes,Command-and-Control,and-Permit-Markets-spring.pdf>.
- IEA (2021), *Air Quality and Climate Policy Integration in India: Frameworks to Deliver Co-benefits*, IEA, Paris, [14]  
<https://www.iea.org/reports/air-quality-and-climate-policy-integration-in-india>.
- IRENA (2023), *Renewables Are the Solution to Malaysia ’s Sustainable Future and Renewed Climate Ambition reduce*, IRENA. [21]
- Koons, E. (2023), *Wind Energy in Malaysia – Potential for Growth*, [17]  
<https://energytracker.asia/wind-energy-in-malaysia/> (accessed on 14 May 2024).
- Kruse, T. et al. (2022), "Measuring environmental policy stringency in OECD countries: An update of the OECD composite EPS indicator", *OECD Economics Department Working Papers*, No. 1703, OECD Publishing, Paris, [18]  
<https://www.oecd.org/economy/measuring-environmental-policy-stringency-in-oecd-countries-90ab82e8-en.htm>.

- Malaysia (2022), *Malaysia. Biennial update report (BUR). BUR 4.*, [38]  
<https://unfccc.int/documents/624776>.
- Malaysian Science and Technology Information Centre (MASTIC) (2023), *Hydrogen Economy & Technology Roadmap*. [26]
- Ministry of Economy (2023), *National Energy Transition Roadmap*. [20]
- Ministry of Natural Resources, Environment And Climate Change , Malaysia (2022), *FOURTH BIENNIAL UPDATE REPORT*, <https://unfccc.int/documents/624776>. [7]
- Ministry of Science, Technology and Innovation (MOSTI) (2022), *National Survey of Research and Development (R&D) in Malaysia 2021*. [15]
- Norris, A. et al. (2023), “Flood Risk Modeling to Support Risk Transfer”, in *Flood Risk Modeling to Support Risk Transfer : Challenges and Opportunities in Data-Scarce Contexts*, <https://documents.worldbank.org/en/publication/documents-reports/documentdetail/099255511072316127/IDU01dab70bb0f83b04d830b5460a05f6c3f5775>. [31]
- OECD (2023), *OECD Inventory of Support Measures for Fossil Fuels 2023*, OECD Publishing, Paris, <https://doi.org/10.1787/87dc4a55-en>. [33]
- OECD (2021), *Assessing the Economic Impacts of Environmental Policies: Evidence from a Decade of OECD Research*, OECD Publishing, Paris, <https://doi.org/10.1787/bf2fb156-en>. [12]
- OECD (2021), *OECD Economic Surveys: Malaysia 2021*, OECD Publishing, Paris, <https://doi.org/10.1787/cc9499dd-en>. [23]
- OECD (2019), *OECD Economic Surveys: Portugal 2019*, OECD Publishing, Paris, [https://doi.org/10.1787/eco\\_surveys-prt-2019-en](https://doi.org/10.1787/eco_surveys-prt-2019-en). [24]
- OECD (2018), “Climate-resilient infrastructure”, *OECD Environment Policy Papers*, No. 14, OECD Publishing, Paris, <https://doi.org/10.1787/4fdf9eaf-en>. [30]
- OECD (2011), *Demand-side Innovation Policies*, OECD Publishing, Paris, <https://doi.org/10.1787/9789264098886-en>. [13]
- Pugacheva, E. and M. Mrkaic (2018), *Adapting to Climate Change—Three Success Stories*, IMF Blog, <https://www.imf.org/en/Blogs/Articles/2018/03/20/adapting-to-climate-change-three-success-stories> (accessed on 11 April 2024). [29]
- Sanghi, A. (2022), *On climate change, Malaysia has three stories to tell*, The Star, <https://www.thestar.com.my/news/focus/2022/11/13/on-climate-change-malaysia-has-three-stories-to-tell> (accessed on 11 April 2024). [28]
- Steckel, J. et al. (2021), “Distributional Impacts of Carbon Pricing in Developing Asia”, *Nature Sustainability* 2021 4:11, Vol. 4/11, pp. 1005-1014, <https://doi.org/10.1038/s41893-021-00758-8>. [10]
- Stern, D. (2011), “The Role of Energy in Economic Growth”, *Annals of the New York Academy of Sciences*, Vol. 1219/1, pp. 26-51, <https://doi.org/10.1111/J.1749-6632.2010.05921.X>. [6]
- Sustainable Energy Development Authority (SEDA) Malaysia (2021), *Malaysia Renewable Energy Roadmap (MyRER)*. [22]

- Tang, K. (2019), "Climate change in Malaysia: Trends, contributors, impacts, mitigation and adaptations", *The Science of the total environment*, Vol. 650/Pt 2, pp. 1858-1871, <https://doi.org/10.1016/J.SCITOTENV.2018.09.316>. [27]
- UNFCCC (2023), *Nationally determined contributions under the Paris Agreement. Synthesis report by the secretariat*. [32]
- UNFCCC (2015), *Malaysia Biennial Update Report to the United Nations Framework Convention on Climate Change (UNFCCC)*. [1]
- United Nations Office for Disaster Risk Reduction (2020), "Disaster Risk Reduction in Malaysia: Status Report 2020", *United Nations Office for Disaster Risk Reduction (UNDRR)*. [36]
- World Bank (2023), "Malaysia Economic Monitor, October 2023: Raising the Tide, Lifting All Boats", *Malaysia Economic Monitor, October 2023: Raising the Tide, Lifting All Boats*, <https://doi.org/10.1596/40441>. [34]
- World Bank Group, W. and A. Asian Development Bank (2021), *Climate Risk country profile: Malaysia*. [3]
- World Bank/Bank Negara Malaysia (BNM) (2022), *An Exploration of Nature-Related Financial Risks in Malaysia*, World Bank, <https://doi.org/10.1596/37314>. [35]
- World Bank and Bank Negara Malaysia (BNM) (2024), *Managing Flood Risks: Leveraging Finance for Business Resilience in Malaysia*. [2]

# 4 Making micro, small and medium-sized enterprises an engine of growth

Randall Jones

---

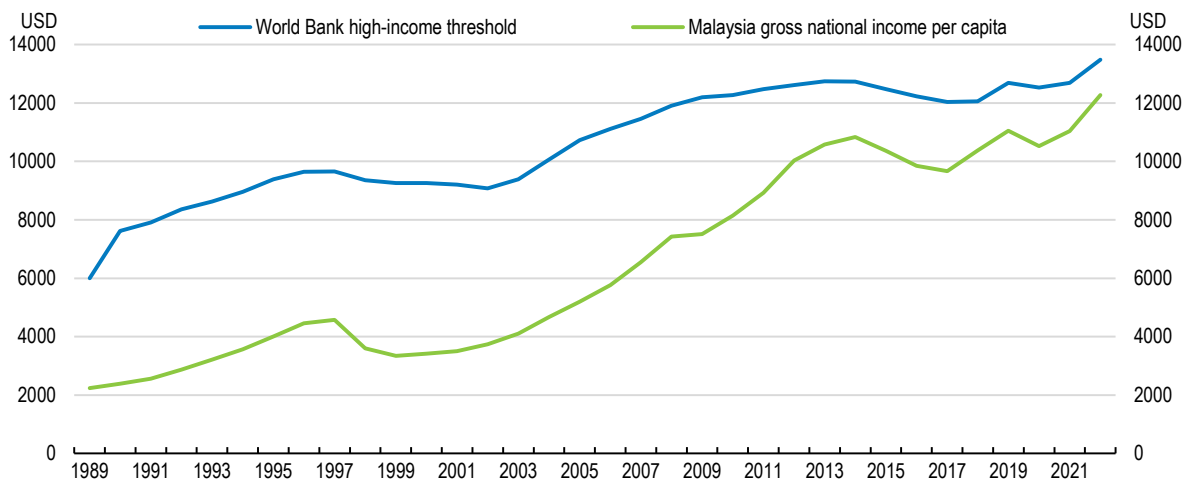
Low productivity in micro, small and medium-sized enterprises (MSMEs) is a headwind to Malaysia's march toward high-income status. Fulfilling the government's goal of making MSMEs a driver of growth is crucial to slow or reverse Malaysia's productivity slowdown in recent decades. Cross-country evidence demonstrates that the scaling up of MSMEs is a crucial element to achieve higher productivity. This is particularly true in Malaysia, where three-quarters of MSMEs have fewer than five workers. Malaysia has hundreds of programmes to support MSMEs, many targeted based on firms' sector, location or ownership. The priority should be to create framework conditions that enable a wide range of firms to prepare for high-growth episodes. Key characteristics of firms that are able to scale up include a focus on innovation and digital technologies, access to funding to make the necessary investment, and international linkages through trade and investment. Government policies should align in critical areas such as digitalisation, finance, international trade and regulation to enable potential high-growth firms to acquire the necessary attributes. In addition, it is crucial to address the strong presence of state-owned enterprises that can limit the scope for MSMEs to scale up.

---

## MSMEs can help lift Malaysia to high-income status


Sustained rapid and inclusive economic growth for half a century has brought Malaysia close to the threshold of high-income status. The shift from a focus on agriculture and commodity exports to a more diversified economy closely integrated into the global economy has driven the transformation. Per capita income rose from around one-third of the World Bank's threshold for high-income countries in 1989 to 91% in 2022 (Figure 3.2. ). The World Bank has projected that Malaysia will achieve high-income status by 2028 (World Bank, 2021<sup>[1]</sup>).

**Figure 4.1. Rapid economic development has boosted Malaysia close to high-income status**



Note: The World Bank defines high-income countries based on gross national income per capita converted into US dollars using the Atlas method.

Source: World Bank, [GNI, Atlas method \(current US\\$\) | Data \(worldbank.org\)](https://data.worldbank.org/ny/gny?locations=MY), accessed 4 March 2024.

StatLink  <https://stat.link/3kv7xd>

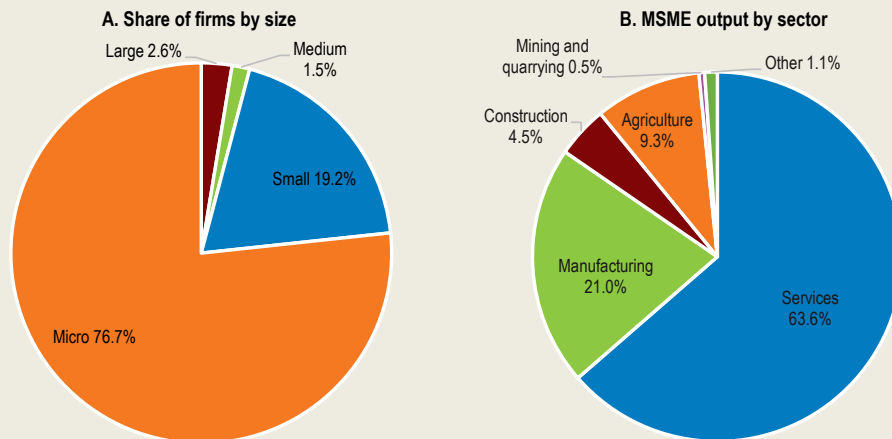
However, slowing productivity growth over the past three decades has raised concerns. The Twelfth Malaysia Plan (2021-25) states that the country's productivity growth is lagging behind its neighbours due to uncompetitive business practices, restricted market access, slow reaction to new trends, and uneven industrial development. Micro, small and medium-sized enterprises (MSMEs) (Box 4.1) have an essential role to play as engines of innovation, job creation, output growth and social cohesion. The Plan notes that "MSMEs continue to be uncompetitive" as they struggle with low-value activities, insufficient funding, and ineffective resource management. Their reliance on low-skilled labour and slow progress in digitalisation and innovation has resulted in low productivity growth (Ministry of Economy, 2021<sup>[2]</sup>).

MSME productivity remains low despite hundreds of government programmes and high levels of support. The Twelfth Malaysia Plan attributed ineffective policy implementation and governance to "regulations and programmes administered by multiple agencies, resulting in an overlapping of roles and functions as well as target groups". Looking ahead, the Plan sets an objective of making MSMEs "the new driver of growth" by: i) diffusing technology and digitalisation throughout this sector; ii) shifting MSMEs from domestic to global markets; and iii) enhancing the capabilities of Bumiputera (ethnic Malays and other indigenous peoples) entrepreneurs (Ministry of Economy, 2021<sup>[2]</sup>).


### Box 4.1. Overview of Malaysia's micro, small and medium-sized enterprise sector

MSMEs accounted for 97.4% of Malaysia's firms (Figure 4.2, Panel A), 38.4% of GDP and nearly half of employment in 2022. The MSME sector is somewhat smaller than the OECD average of 99% of firms, 60% of employment and 50-60% of GDP (Koirala, 2019<sup>[3]</sup>). However, there are no data on the number of workers by firm size in Malaysia. Nearly 85% of MSMEs were in the service sector, accounting for almost two-thirds of MSME output (Figure 4.2, Panel B) and employment. MSMEs account for around half of output in the agriculture and construction sectors, with smaller shares in services and manufacturing (Figure 4.3).

**Figure 4.2. Most firms in Malaysia are MSMEs and they are concentrated in the service sector**



Note: In 2022. Micro enterprises are defined as those that have less than 5 employees or annual sales of less than MYR 300 000. In services and other sectors: small enterprises have 5 to less than 30 workers or sales of MYR 300 000 to 3 million and medium enterprises have 30 to 75 workers or sales of MYR 3 million to 20 million. In manufacturing, small companies have 5 to 75 workers or sales of MYR 300 000 to 15 million and medium companies have 75 to 200 workers or sales of MYR 15 million to 50 million. Government-linked companies (GLCs) and subsidiaries of multinational companies cannot be classified as MSMEs no matter their size. Excludes import duties. Source: SME Corporation Malaysia, SME Corp Profile of MSMEs in 2016-2022.


StatLink  <https://stat.link/b9hpjo>

**Figure 4.3. MSMEs in agriculture and construction account for half of output in those sectors**

MSMEs' employment and value-added as a share of the total in each sector in 2022



Source: Department of Statistics Malaysia (2023), Micro, Small & Medium Enterprises Report 2022.

StatLink  <https://stat.link/9wv5dh>

## **Government policies for micro, small and medium-sized enterprises**

Government spending on programmes to assist MSMEs in Malaysia was relatively high at almost 1% of GDP in 2018 and 0.6% in 2019, compared to 0.15% in the Philippines and 0.4% in Czechia (Kuriakose and Tiew, 2022<sup>[4]</sup>). The government aims to increase the MSME share of GDP from 38.4% in 2022 to 50% in 2030 (Box 4.2). The outlays are disbursed through 275 different programmes that support MSMEs and entrepreneurship. The programmes are implemented by 80 different ministries and agencies, with the SME Corp. coordinating MSME and entrepreneurship policies and evaluating their impact at the national level through the SME Integrated Plan of Action.

Five major programmes account for 80% of spending. Many of the other 270 smaller programmes have similar, generic objectives. The large number of programmes and agencies administering them leads to a high degree of fragmentation and overlap, decreasing the efficacy of government efforts. The government has recognised the overlap of functions and roles in coordinating the development of the entrepreneur ecosystem and MSMEs and decided to create a permanent secretariat for the National Entrepreneur and SME Development Council (NESDC) to improve coordination. In addition, the government will create a comprehensive database containing information about MSMEs.

The Mid-Term Review of the Twelfth Malaysia Plan also noted a “lack of coordination and monitoring of initiatives and programmes” for MSMEs. Policies should not be designed in isolation but instead requires a holistic approach to policymaking. The interconnectedness of such policies that cut across ministries, departments, agencies and levels of government also requires more insights on effective whole-of-government approaches and vertical and horizontal coordination mechanisms (OECD, 2022<sup>[5]</sup>).

Programmes providing financial assistance accounted for 88.2% of government outlays for MSMEs over 2016-19. “Soft mechanisms”, such as business advice, education and training initiatives, play only a small role. Government loans and credit account for 58% of public financial support for MSMEs, followed at 36% for loans and credit guarantees, under which a government agency agrees to compensate the lender in case of a default. Grants (2%) and equity (less than 1%) provide the remainder of public financial assistance. The focus on financial support suggests that “Malaysia’s general intermediate objective for SME and entrepreneurship development is largely focused on the expansion of firms”, rather than targeting specific needs and deficiencies (Kuriakose and Tiew, 2022<sup>[4]</sup>). More than 190 of the government programmes focus on the growth and expansion phases of MSMEs, accounting for 87% of government spending on MSMEs. The remaining 80 programmes aim to help start-ups and facilitate the creation of new firms.

In many countries, MSME policies look through a narrow lens to identify and foster young firms in high-tech sectors. Unfortunately, such a “picking winners” approach aimed at identifying future unicorns has often been unsuccessful. This is even more likely in the absence of carefully designed evaluations of MSME policies that allow course corrections, when necessary, on the basis of evaluation findings. It is crucial to compare the performance of supported firms against a suitable control group that does not receive support. Ex ante monitoring and ex post evaluation should be performed regularly based on clearly defined, rigorous and measurable policy objectives and impacts (G20/OECD, 2015<sup>[6]</sup>).

### Box 4.2. Malaysia's targets for the micro, small and medium-sized enterprise sector

The SME Masterplan 2012-20 set ambitious targets for MSMEs' share of GDP, employment and exports (Table 4.1). Other objectives included: i) increasing firm creation at a 6% annual rate; ii) expanding the number of high growth and innovative firms by 10% annually; iii) doubling labour productivity; and iv) accelerating the formalisation of firms (National SME Development Council, 2012<sup>[7]</sup>). Despite the considerable investment in MSMEs, their share of employment and exports declined over 2010-20 and their share of GDP fell short of the target.

**Table 4.1. Targets set for MSMEs in the government's 2012-20 and 2023-30 plans**

Indicator	2010	2020 target	2020	2022	2025 target	2030 target
Share of GDP (%)	32.2	41.0	38.1	38.4	41.0	50.0
Share of employment (%) <sup>1</sup>	57.1	65.0	48.0	48.2	50.0	55.0
Share of exports (%)	16.4	25.0	13.5	10.5	15.0	30.0
Labour productivity (annual growth rate)					3.5% (2021-25)	3.8% (2025-30)
Ranking in the GCI <sup>2</sup>				27	Top 20	Top 15
Ranking in the GI <sup>3</sup>				36	Top 30	Top 20

1. MSMEs achieved their employment target for 2020 by 2016. However, the calculation of MSME employment for 2020 and beyond was changed by including the government, the informal sector (excluding agriculture), unregistered firms in agriculture, and outsourcing activities in computing total employment, which is the denominator in calculating MSMEs' share of employment. 2. The GCI refers to the Global Competitiveness Index. 3. The GI is the Global Innovation Index. The ranking of 36 was for 2019.

Source: National SME Development Council (2012), SME masterplan 2012- 2020; and Ministry of Entrepreneur and Cooperatives Development (2024), *Pelan Strategik Perusahaan Mikro, Kecil dan Sederhana 2030 (Micro, Small and Medium-sized Enterprises Strategic Plan 2030)*.

Current policies set ambitious targets for 2030, based on the 2019 National Entrepreneurship Policy 2030. In addition to significant increases in MSMEs' share of GDP, employment and exports, labour productivity is to increase by nearly one-third. The government also set a goal of having at least five home-grown or foreign unicorn start-ups in key digital industry clusters headquartered in Malaysia by 2030.

The MSME Strategic Plan 2030 lays out three main catalysts with eight focus areas (Table 4.2), 13 strategies and 56 initiatives. The Plan emphasises many of the priorities discussed in this chapter, including innovation, digitalisation, human capital, exports and regulatory reform, but it also has a specific the focus on entrepreneurs from certain groups, notably the Bumiputera.

**Table 4.2. The main catalysts for MSME growth included in the MSME Strategic Plan 2030**

<b>Mind and skills for entrepreneurship</b>
<ul style="list-style-type: none"> <li>Improve the business management skills of MSME owners, especially those in micro enterprises and special focus groups (Bumiputera, people under age 35, women, people with disabilities and Orang Asli).</li> <li>Encourage existing MSME owners to be more innovative and produce more, focusing on entrepreneurs who are in the special focus groups.</li> </ul>
<b>An ecosystem conducive to innovation</b>
<ul style="list-style-type: none"> <li>Improve MSMEs' access to digital knowledge through the implementation of long-term digitalisation initiatives and enable financing options.</li> <li>Provide MSME owners with the necessary resources to improve the digital and Fourth Industrial Revolution skills of their employees.</li> </ul>
<b>A business environment that is friendly to MSMEs</b>
<ul style="list-style-type: none"> <li>Provide the resources required by MSMEs to carry out export activities.</li> <li>Enable MSMEs to establish a stronger market network through a structured programme.</li> <li>Streamline the compliance process for MSMEs.</li> <li>Enable MSMEs to implement initiatives related to the sustainability of their business.</li> </ul>

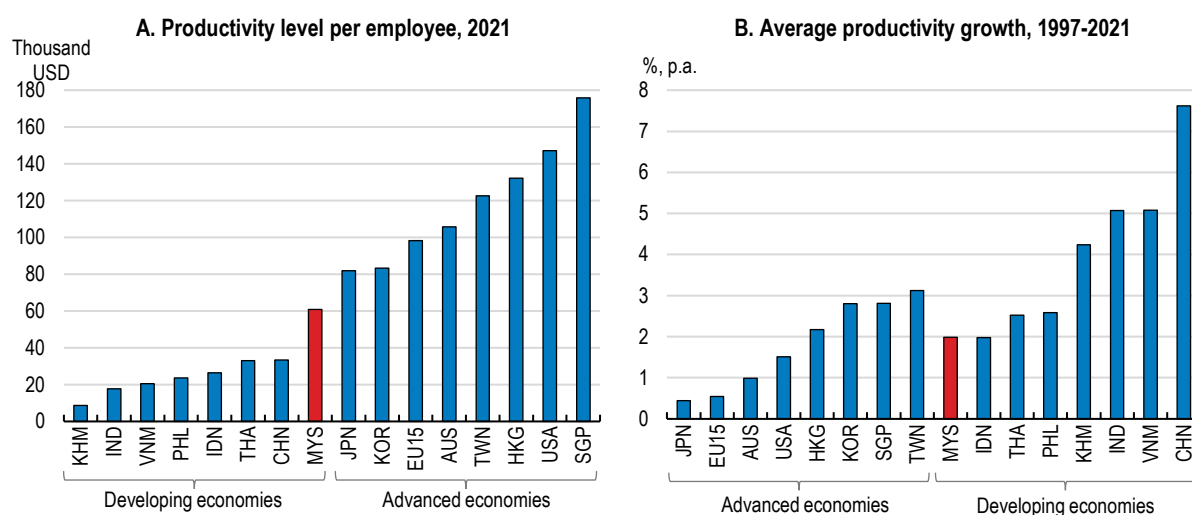
Source: Ministry of Entrepreneur and Cooperatives Development (2024), *Pelan Strategik Perusahaan Mikro, Kecil dan Sederhana 2030, (Micro, Small and Medium-sized Enterprises Strategic Plan 2030)*.

This chapter starts by examining the slowdown in productivity growth during the past few decades and its link to the MSME sector. The third section discusses the benefits of scaling up MSMEs to enhance productivity and economic growth and the factors that determine which firms are likely to grow. Expanding the scale of MSMEs is essential, given that more than three-quarters have less than five employees. This section also identifies characteristics of MSMEs that are able to scale up through high-growth episodes. One of the most important is the utilisation of digital tools and other new technology, which is discussed in the fourth section, along with the need for skilled workers to implement new technology. The fifth section discusses the problem of securing financing and other factors that limit scaling up. In Malaysia, MSMEs are nearly entirely dependent on their own resources and bank lending. New ways to provide equity financing, which is better suited to young firms, are a priority. This section also looks at the issues of regulation and MSME participation in international trade and global value chains. The final section looks at the large role of state-owned enterprises and government-linked investment companies, which can hinder the scaling up of small firms. The chapter concludes with recommendations to make MSMEs a key driver of growth.

## The challenge of boosting productivity

Boosting productivity is the key to avoiding the “middle-income trap”. Indeed, productivity accounts for half of the gap in income per capita between high-income and developing countries (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). Malaysia’s productivity level is significantly above that in most other ASEAN countries, as well as China and India (Figure 4.4, Panel A), though labour productivity growth has decelerated over the past 25 years as the level converged toward high-income countries (Figure 4.4, Panel B). Indeed, it slowed from an annual rate of 3.5% in the 1990s to 2.3% from 2010-21 (Figure 4.5). Malaysia’s source of economic growth will need to shift from factor accumulation, which has driven growth in recent decades, to productivity gains. Identifying policies to raise productivity is thus critical to alleviate poverty and fulfil rising aspirations. Korea, whose labour productivity level surpassed Malaysia’s in 1986, is an example of a country with sustained high productivity growth since the 1997 Asian Financial Crisis (Figure 4.4, Panel B) based on its successful post-crisis reforms.

**Figure 4.4. Malaysia’s labour productivity level is approaching that in advanced economies**

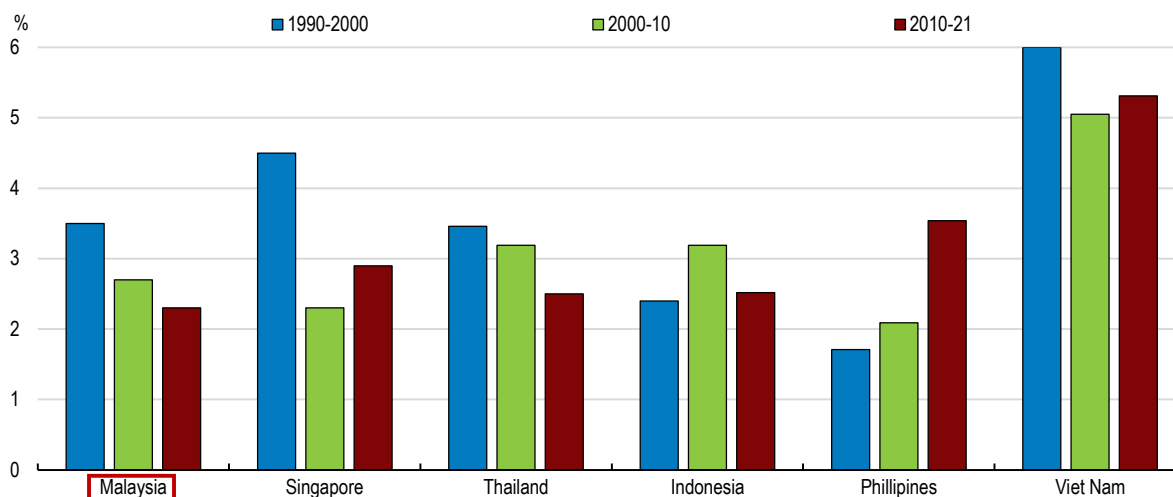


Note: Labour productivity is defined as GDP per worker.

Source: Asian Productivity Organisation, APO Productivity database 2023, accessed 18 January 2024.

StatLink  <https://stat.link/0ch8yi>

**Figure 4.5. Malaysia's labour productivity growth rate has slowed during the past few decades**



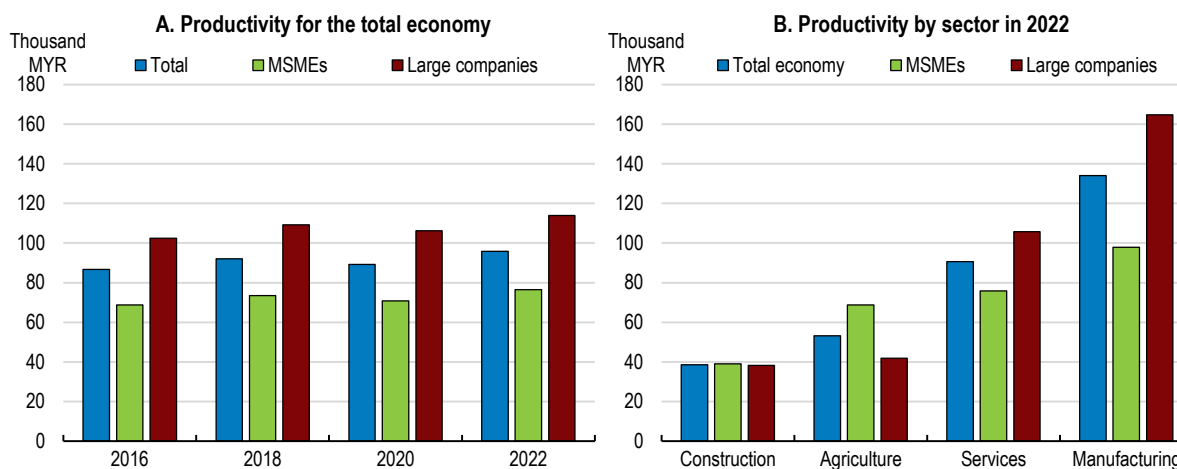
Note: Annual average growth rates. Labour productivity is defined as GDP per worker.

Source: Asian Productivity Organisation, APO Productivity database 2023, accessed 18 January 2024.

StatLink  <https://stat.link/hi5ayr>

The Twelfth Malaysia Plan set a 3.6% target for annual productivity growth during 2021-25. The target was revised upward to 3.8% for 2023-25 in the 2023 Mid-Term Review of the Plan, as productivity grew at a 3.7% annual pace during the rebound from the COVID-19 pandemic in 2021-22. However, Malaysia's trend GDP growth rate is expected to slow over the next 30 years, partly due to demographic headwinds (World Bank, 2021<sup>[1]</sup>). Achieving high productivity growth through 2025 and beyond will depend heavily on MSMEs, where productivity is around two-thirds of that in large firms (Figure 4.6, Panel A), indicating considerable scope for gains. Narrowing this gap would reduce the dual nature of the economy, with large and foreign-owned showing stronger performance and MSMEs lagging behind.

**Figure 4.6. Labour productivity in MSMEs in Malaysia is around two-thirds of that of large firms**



Note: Labour productivity in MSMEs in the mining & quarrying sector was slightly larger than in manufacturing in 2022 at MYR 137 000 per worker. However, labour productivity in large firms in that sector was 1 694 000, more than 12 times higher than for MSMEs.

Source: Department of Statistics Malaysia (2023), Micro, Small & Medium Enterprises Report 2022.

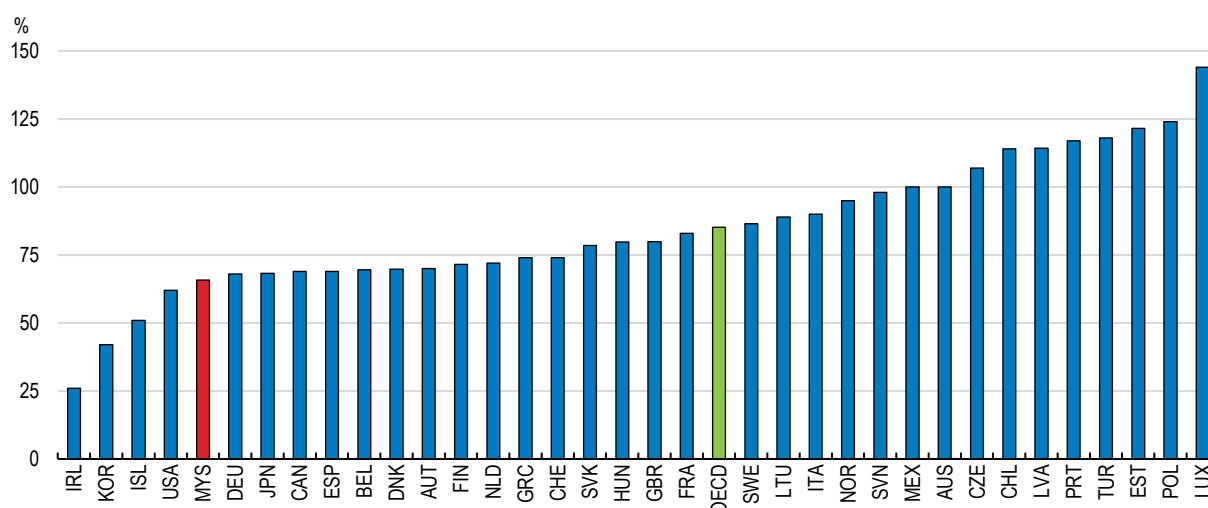
StatLink  <https://stat.link/nx3gvh>

With MSMEs accounting for nearly half of employment, an increase in their productivity would significantly impact nation-wide productivity. The Mid-Term Review states that the productivity gap will be narrowed by MSMEs' adoption of technology and digitalisation. However, MSMEs are highly dependent on low-skilled workers, making technological advances difficult (Ministry of Economy, 2023<sup>[9]</sup>). The large share of the labour force in low productivity MSMEs is also a driver of inequality. Although Malaysia's Gini coefficient for disposable income fell from 45 in 1990 to 43 in 2022, it is well above the OECD average of 32.


Low MSME productivity is linked to their concentration in services (Box 4.1). On an economy-wide basis, service-sector productivity in Malaysia is only 66% of that in manufacturing, well below the OECD average of 85% (Figure 4.7). Service sector productivity is typically below manufacturing productivity, reflecting in part the inherent characteristics of services that raise transaction costs and reduce competition; *i*) information asymmetries between suppliers and consumers are larger for services, as their quality tends to be more difficult to assess before purchase; *ii*) services such as banking and mobile phone services can involve more switching costs than goods, encouraging consumers to maintain long-term relationships with their service providers; and *iii*) some services have to be provided in person, limiting consumer choice (Sorbe, Gal and Millot, 2018<sup>[10]</sup>).

### Figure 4.7. Service sector productivity in Malaysia lags far behind that in manufacturing

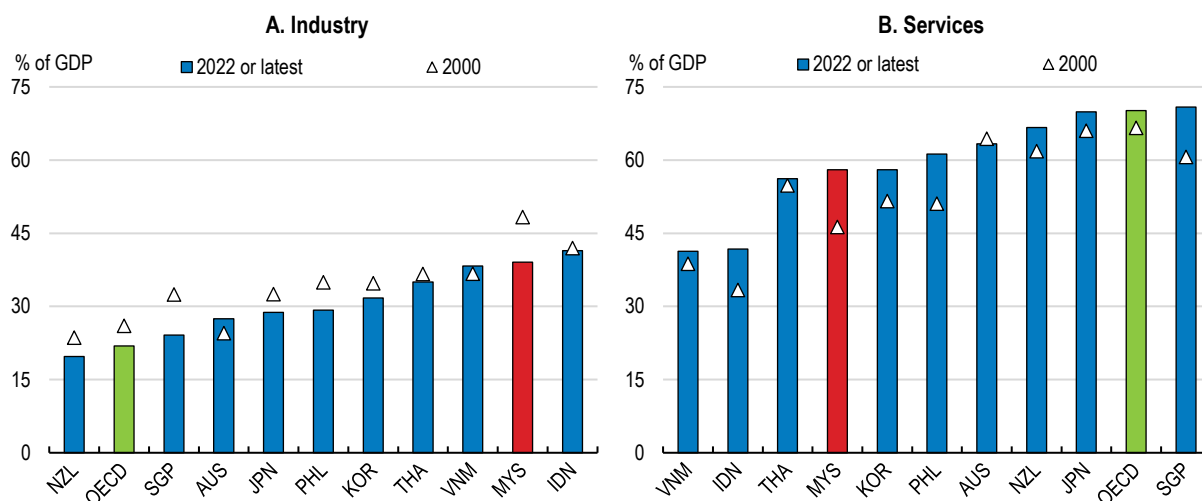
Labour productivity in services relative to manufacturing



Source: OECD (2021), Inclusive Growth Review of Korea: Creating Opportunities for All, OECD Publishing, Paris; and Department of Statistics Malaysia, Micro, Small & Medium Enterprises (MSMEs) Performance, 2021.

StatLink  <https://stat.link/3wdpaj>

The impact of low service sector productivity is currently limited by Malaysia's relatively low share of services at 58% of GDP in 2022 compared to 70% in the OECD area (Figure 4.8). However, the headwinds from low service productivity will intensify as continued economic growth and population ageing boost the share of services to the levels in the most advanced countries.

**Figure 4.8. Services' share of Malaysian GDP is low**

Source: World Bank, World Development Indicators database.

StatLink  <https://stat.link/jvqoy3>

## Scaling up MSMEs to boost productivity

The low productivity of Malaysia's MSMEs relative to large firms (Figure 4.6) partially reflects their small size and the resulting limited opportunities to exploit economies of scale. Medium-sized enterprises account for only 1.5% of establishments in Malaysia – less than the share of large firms – suggesting a “missing middle” as most micro and small firms fail to grow. The Mid-Term Review of the Twelfth Malaysia Plan identified the inability of MSMEs to scale up as a fundamental challenge. Expanding the size of MSMEs would result in economies of scale that allow them to reduce their average unit cost of production and reach an efficient output level, leading to higher productivity and profitability. A study of six million firms in eight European countries, the United States, Canada, and New Zealand reported that countries with large shares of both fast-growing and fast-contracting firms achieve higher productivity growth. In contrast, countries with a higher share of zero-growth firms have slower productivity growth (Bravo-Biosca, Criscuolo and Menon, 2016<sup>[11]</sup>).

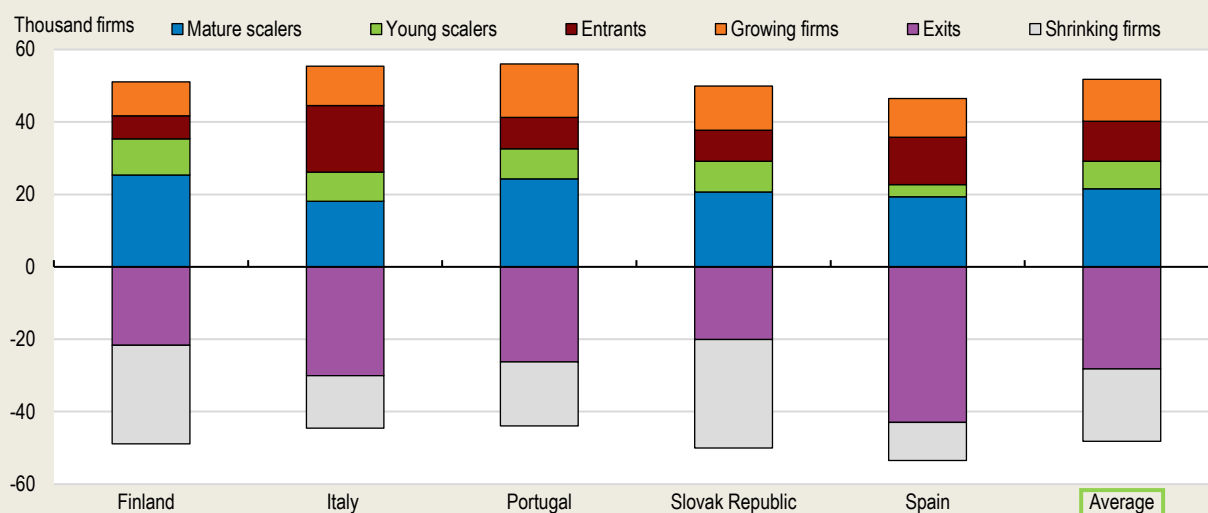
Among the small share of MSMEs that scale up, a few grow very quickly and account for most new jobs in OECD economies. “High-growth firms”, defined as those that grow at least 20% annually in employment or sales over three years (OECD/Eurostat, 2008<sup>[12]</sup>), accounted for only 6% of British firms but generated more than half of the jobs created over 2002-08. Newly created and slow-growing firms accounted for the remainder (Bravo-Biosca, 2010<sup>[13]</sup>). In many countries, firms that do not meet the high-growth definition destroy more jobs than they create and face declining sales. In practice, this pattern sometimes boils down to an 80/20 rule; dynamic firms that account for as much as 20% of enterprises create around 80% of new employment and sales. In addition, high-growth firms create positive spillovers in the firms that they trade with (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). An OECD study provides more evidence on the role of firms that “scale up” (Box 4.3).

### Box 4.3. Why is it crucial for SMEs to scale up?

A 2021 OECD study of firm-level data in Finland, Italy, Portugal, Slovak Republic and Spain provides detailed information on “scalers”, defined as firms with 10 to 249 employees that achieve growth of at least 10% per year in employment or sales over three years. The study examined firms’ behaviour over the two years before scaling begins, three years of rapid growth and the following two years. The results for scalers were broadly consistent across the five countries. The study found that 13%-15% of SMEs scaled up their employment during 2015-17, accounting for 54% to 72% of all jobs added by non-micro SMEs (Figure 4.9). At least half of the employment scalers also qualified as high-growth firms (at least 20% annual growth). The shares of turnover scalers in employment growth were slightly larger (OECD, 2021<sup>[14]</sup>). In sum, employment and sales growth is generated by a subset of SMEs that experience high-growth episodes.


### Figure 4.9. Firms that scale up are major drivers of employment

Gross job creation and destruction by young and mature scalers and other non-micro SMEs, 2015-17



Note: Firms with 10 to 249 employees that grow at least 10% per year in employment or sales over three years.

Source: OECD (2021), *Understanding Firm Growth: Helping SMEs Scale Up*, OECD Publishing, Paris, <https://doi.org/10.1787/60b04c-en>.

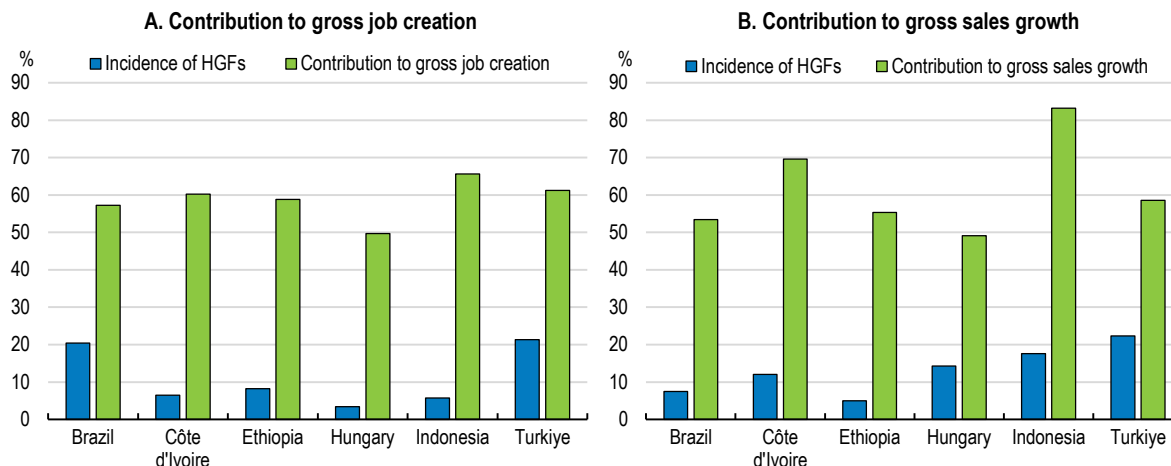
StatLink  <https://stat.link/nzogdx>

Micro firms (less than ten employees) are excluded because it would be misleading to compare their growth rates to small and medium-sized enterprises (SMEs). In OECD countries, only 3% of new firms entering the market with less than ten employees have more than ten after five years (Calvino, Criscuolo and Menon, 2015<sup>[15]</sup>). The lack of growth often reflects the entrepreneur’s objectives. Necessity-driven entrepreneurs, who are prevalent in Malaysia, usually lack other viable options for earning a living. In contrast, opportunity-driven entrepreneurs aim to create “transformative enterprises” that can achieve high growth rates. These different types of entrepreneurs have different needs and respond differently to government policies. Evidence suggests that only a negligible fraction of entrepreneurs transition from one type to the other (Ng and Stuart, 2016<sup>[16]</sup>).

In addition, a significant share of business owners have little desire to grow and innovate. For example, in over 50% of new businesses in the United States, the owners reported that non-pecuniary benefits such as “wanting flexibility over schedule” or “to be your own boss” were the primary reasons for starting a business (Hurst and Pugsley, 2011<sup>[17]</sup>).

High-growth firms are also powerful engines of employment and output growth in developing and emerging economies. A World Bank study of 11 countries found that 3.9% to 21.3% of SMEs achieved high-growth status in employment and/or sales. There is no clear relationship between the incidence of high-growth firms and a country's per capita income. High-growth firms accounted for at least half of gross job creation in the six countries where data are available (Figure 4.10, Panel A), and accounted for more than 100% of net job creation. In Indonesia, high-growth firms recorded rapid employment growth during their high-growth episodes (Figure 4.11). Similarly, firms classified as high growth based on sales generate at least half of the total increase in sales (Figure 4.10, Panel B).

**Figure 4.10. High-growth firms account for at least half of the growth in many economies**



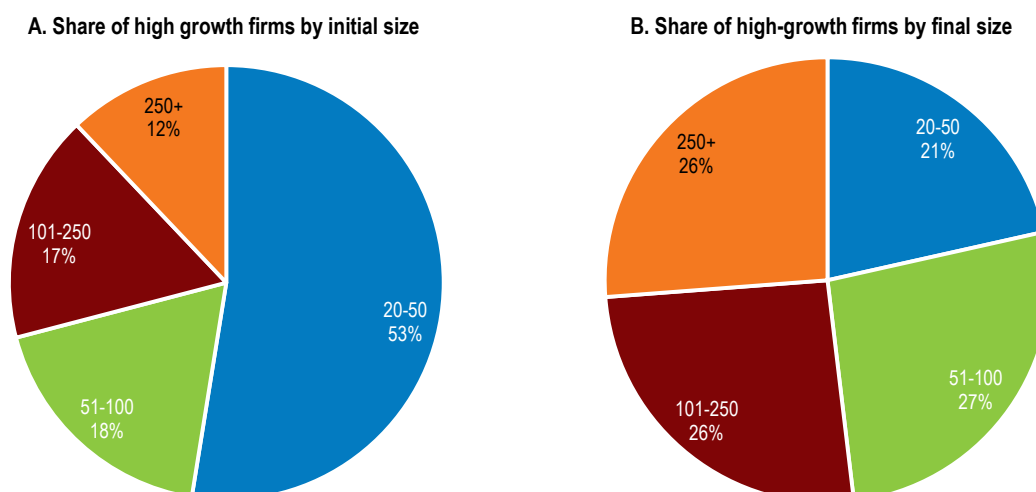
Note: High-growth firms are those that employ more than ten workers and whose employment (Panel A) or sales (Panel B) grow at an average annual rate of 20% or more over a period of three consecutive years and have positive employment or sales growth in each of the three years. Source: Grover Goswami, A., D. Medvedev and E. Olafsen (2019), *High-growth Firms: Facts, Fiction, and Policy Options for Emerging Economies*, World Bank, Washington, DC.

StatLink  <https://stat.link/m207ih>


Successfully identifying and nurturing potential high-growth firms has become a priority to boost employment, productivity and output. Indeed, the 2021 Malaysia Digital Economy Blueprint (2021-30) includes the explicit goal of having at least five home-grown or foreign unicorn start-ups in key digital industries headquartered in Malaysia by 2030.

Many countries tend to narrowly target support on firms deemed to be potential high-growth firms, typically young firms in high-tech sectors, as such support is expensive. This makes it essential to be able to identify potential high-growth firms. However, information on the characteristics of potential high-growth firms is limited. A World Bank study found that the success rate in identifying high-growth firms before or during their high-growth episodes is only 2% to 12%. It concludes that identifying potential high-growth firms and crafting policies to promote their scaling up “remains mostly art rather than science” (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). Many countries rely on *ad hoc* interventions instead of building an evidence-based foundation on which to develop effective policies to nurture potential high-growth firms (Nightingale and Coad, 2013<sup>[18]</sup>).

**Figure 4.11. High-growth firms in Indonesia scale up employment during high-growth episodes**



Note: Size is defined by the number of workers employed by high-growth firms at the beginning of their growth episode (initial size) or at the end (final size). High-growth firms are enterprises that employ more than ten workers and whose employment grows at an average annual rate of 20% or more over three consecutive years.

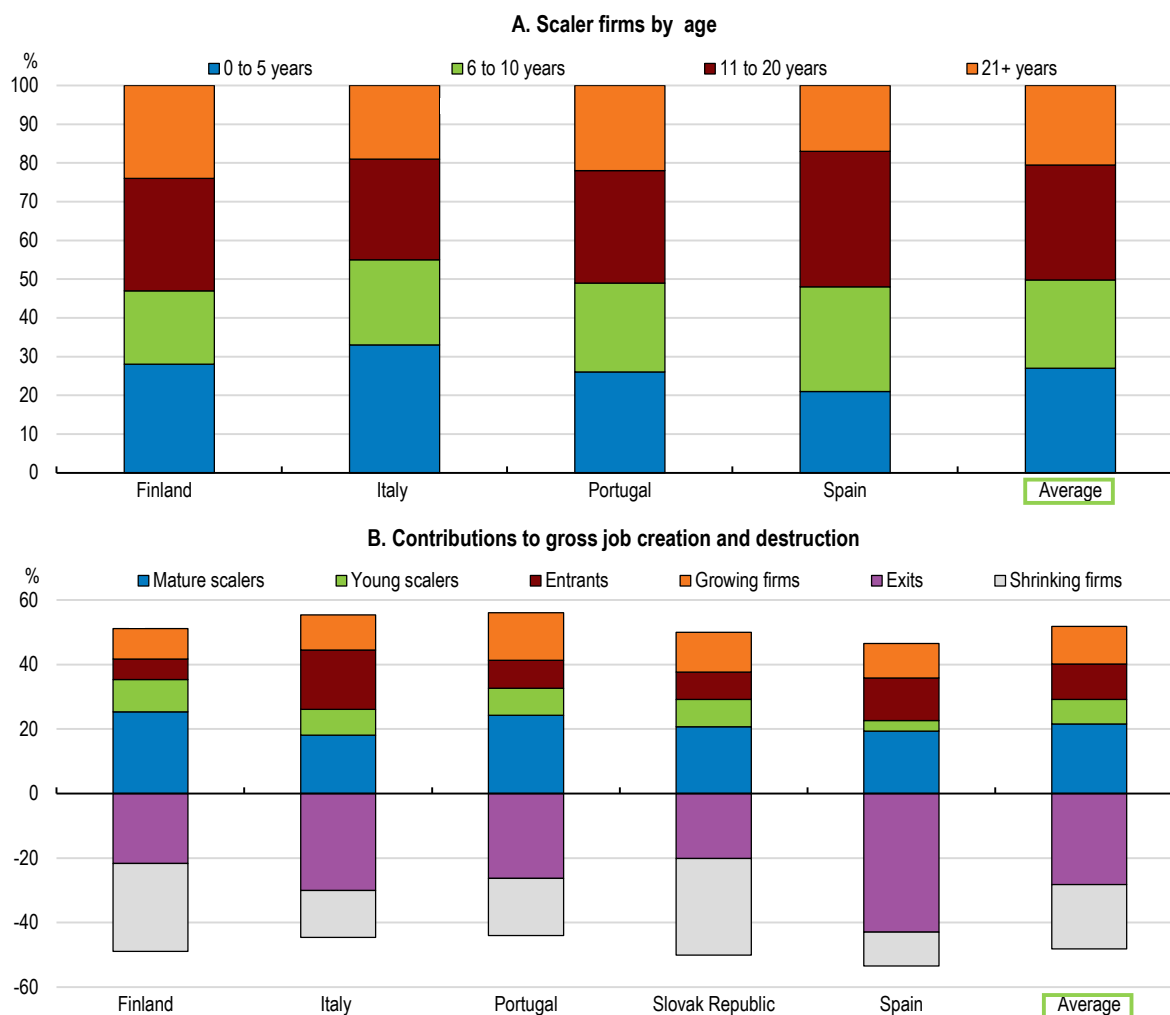
Source: Ferro and Kuriakose, 2018. "Indonesia: High-Growth Firms." Background paper for High-Growth Firms, World Bank, Washington, DC.  
 StatLink  <https://stat.link/0nxju7>

### **What types of firms are most likely to become scalars and high-growth firms?**

Recent OECD studies suggest four stylised facts about high-growth and scalar firms:

- *While young firms are more likely to achieve high growth, most high-growth firms are mature enterprises.* A higher share of young firms achieving high growth is found in many OECD countries (Criscuolo, Gal and Menon, 2014<sub>[19]</sub>) and emerging countries (Grover Goswami, Medvedev and Olafsen, 2019<sub>[8]</sub>). Firms less than six years old are three times more likely to scale up than those in business over 20 years. However, only around one-fifth of SMEs are young firms (less than six years old (OECD, 2021<sub>[14]</sub>), reflecting the high failure rate. Mature firms (at least six years old) account for nearly three-quarters of SMEs that scale up (Figure 4.12, Panel A) and almost four-fifths of gross job creation (Figure 4.12, Panel B).
- *Although firms in high-tech sectors are more likely to scale up, most scalars are in low and medium-low technology sectors* (Figure 4.13). Firms in knowledge-intensive services are 70% more likely to scale up in employment than firms in low and medium-low tech manufacturing. However, only around 15% of SMEs operate in knowledge-intensive services.
- *Firms that scale up are not necessarily small.* Firms of different sizes have similar propensities to scale up (OECD, 2021<sub>[14]</sub>). In Indonesia, nearly half of firms that scaled up employed more than 50 workers at the beginning of their high-growth episode (Grover Goswami, Medvedev and Olafsen, 2019<sub>[8]</sub>). US firm-level data shows no systematic relationship between firm size and relative growth (Haltiwanger, Jarmin and Miranda, 2010<sub>[20]</sub>).
- *Scalar firms are not limited to a country's most economically-developed regions.* The share of scalars in regions with a per capita income lower than the national average, such as Andalusia and Murcia in Spain and Basilicata, Campania and Puglia in Italy, are characterised by a higher incidence of scaling up than wealthier regions in the same country (OECD, 2021<sub>[14]</sub>). This is pertinent to Malaysia, given the priority on promoting development in Sabah and Sarawak.

**Figure 4.12. Mature firms account for the largest share of scaler firms and gross job creation**



Note: For employment scalers. Micro SMEs are excluded as comparing the relative growth of firms with less than ten workers with larger firms is misleading. Panel A shows the age of scaler firms that ended their first three-year scaling period between 2006 to 2015 in Spain, 2013 to 2014 in Portugal, 2011 and 2015 in Finland, and 2004 to 2015 in Italy. In Panel B, young scalers are less than six years old and mature scalers are six years old and above.

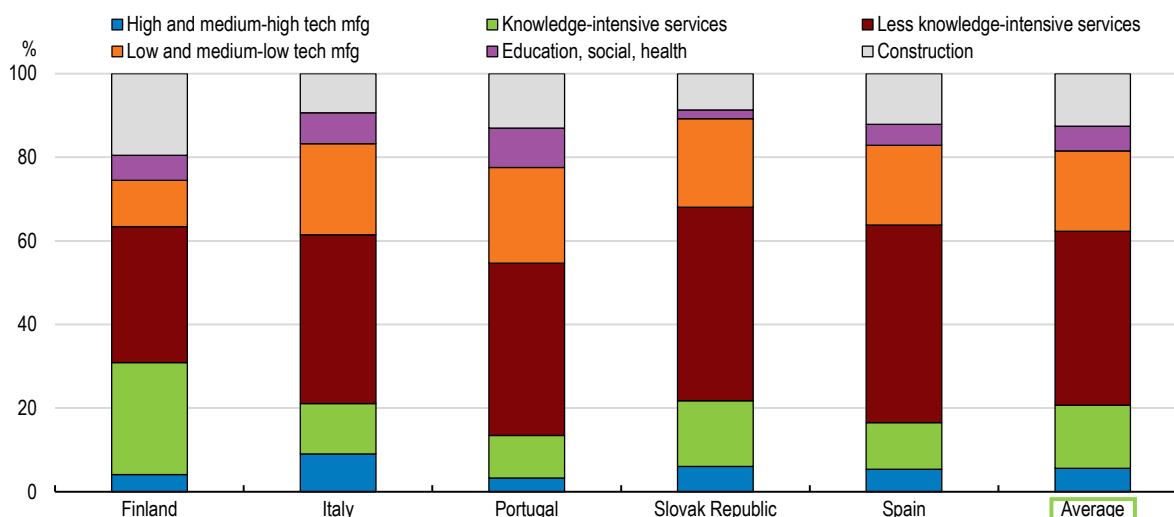
Source: OECD (2021), [Understanding Firm Growth : Helping SMEs Scale Up | OECD Studies on SMEs and Entrepreneurship | OECD iLibrary \(oecd-ilibrary.org\)](https://www.oecd-ilibrary.org/publications/understanding-firm-growth-helping-smes-scale-up).

StatLink  <https://stat.link/xei2f4>

High-growth phases tend to be temporary, one-time events, and consecutive scaling-up phases are rare (Coad et al., 2014<sup>[21]</sup>). In the United States, only 1.2% of high-growth firms repeated a high-growth episode during the following three years (NESTA, 2009<sup>[22]</sup>). In Indonesia, a high-growth firm that has just completed a high-growth episode has a 4.7% likelihood of following it with a second episode (Table 4.3). The majority are thus “one-hit wonders”. In sum, “high-growth firms do not appear to be a type of firm, but rather a phase that some firms go through during their life cycle” (Commonwealth of Australia, 2017<sup>[23]</sup>). Most high-growth firms maintain their larger scale after the high-growth episode. In the 2021 OECD study, between 40% and 70% of employment or turnover scalers remain at their newly achieved scale or continue to grow gradually during the three years after scaling up (OECD, 2021<sup>[14]</sup>).

**Figure 4.13. Most scaler firms are in less knowledge-intensive services**

Share of employment-based scaler firms by main sector of activity in 2018



Note: This excludes micro SMEs (less than ten employees) as it is misleading to compare their relative growth with larger firms.

Source: OECD (2022), [Financing Growth and Turning Data into Business: Helping SMEs Scale Up | en | OECD](#).

StatLink <https://stat.link/60xasv>

**Table 4.3. The likelihood of two consecutive high-growth periods for firms is small in Indonesia**

	3-year transition probability for firms observed in 1996, 1999, 2002, 2005, 2008, and 2011 (in percent)					6-year transition probability for firms observed in 1996, 1999, 2002, 2005 and 2008 (in percent)					
	Exit	Negative growth	Growth 0-5%	Growth 5 to 20%	High growth	Exit	Negative growth	Growth 0-5%	Growth 5 to 20%	High growth	
Birth	29.5	25.2	22.4	15.2	7.8	Birth	43.2	23.7	18.8	10.6	3.8
Negative growth	19.7	33.0	29.6	12.1	5.6	Negative growth	34.6	29.0	24.1	8.6	3.7
Growth 0-5%	18.6	31.3	36.5	9.0	4.8	Growth 0-5%	32.9	26.4	28.8	8.2	3.7
Growth 5-20%	21.0	34.8	25.4	12.7	6.0	Growth 5-20%	35.2	26.7	24.8	9.4	3.9
High growth	10.8	45.0	27.3	12.2	4.7	High growth	21.1	36.9	24.8	10.9	6.2

Note: High-growth firms have experienced at least 20% growth in employment for at least three years. The data are limited to firms with at least ten employees. Birth refers to the first year that a firm is observed.

Source: Grover Goswami, A., D. Medvedev and E. Olafsen (2019), [High-Growth Firms: Facts, Fiction, and Policy Options for Emerging Economies \(worldbank.org\)](#).

### What factors are most likely to trigger a high-growth episode?

Understanding the factors that enable some firms to scale up is crucial to create an environment that supports the process. Scaling up usually involves an inner transformation of the firm, which may be triggered by its characteristics, such as the entrepreneurs' skills and motivation. It can also result from external factors, such as increased demand and technological advances, and policy measures, such as regulatory reform. A 2021 OECD study finds a number of "anticipatory differences" during the two years before the high-growth period starts that are interconnected and mutually reinforcing (OECD, 2021<sup>[14]</sup>):

- *Innovation and digitalisation*: Firms that achieve high-growth episodes have a considerably higher rate of adopting digital technologies and use more IT resources (Benedetti Fasil et al., 2021<sup>[24]</sup>). A

larger skilled workforce and more R&D staff reinforces the investment in innovation (OECD, 2021<sup>[14]</sup>).

- *Finance*: Firms that plan to grow take on more debt than firms with no growth ambition.
- *Investment*: Studies of French and Italian firms show that investment intensity is higher in firms that will scale up in the following period (OECD, 2021<sup>[14]</sup>).
- *International links*: A significant share of scalers are involved in international trade prior to their high-growth episodes and the share rises with stronger growth (OECD, 2021<sup>[14]</sup>). In Hungary and Mexico, a firm's exporting status is strongly and positively correlated with a firm's likelihood of experiencing a high-growth event (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>).

As a result of these anticipatory differences, firms that will turn into scalers or high-growth firms begin with higher productivity than their peers (OECD, 2021<sup>[14]</sup>). Building on these anticipatory differences, the gap between scalers and high-growth firms and their peers widens during the high-growth period. Labour productivity in the United States is higher for high-growth firms, and the gap widens over time, (U.S. Small Business Administration (SBA), 2008<sup>[25]</sup>). The link between a firm's labour productivity and the likelihood of scaling up is also found in developing countries (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>).

### ***A strategy to promote the scaling up of MSMEs***

The universe of high-growth firms is more diverse than the stereotype of young start-ups in high-technology sectors. Instead, the typical scaler is a mature firm operating in less knowledge-intensive services that achieves rapid growth only once in its lifetime. Scalers can thus be found in all sectors, regions, firm sizes, and ages (OECD, 2023<sup>[26]</sup>; Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). Consequently, the focus of SME policies on high-tech sectors is misplaced.

The diversity of potential high-growth firms suggests avoiding “picking winners” or trying to identify future “gazelles” and “unicorns”. The results from venture capital show that even in the hands of professional investors, success is often random and most projects lose money (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). Such an approach is particularly hazardous for governments, as it leads to the waste of public funds. Moreover, it carries the risks of distortions based on political influence and a culture of rent-seeking and politically-connected firms. An OECD study found that efforts to target winners resulted in a multiplication of public support schemes and eligibility criteria, leading to the waste of government funds. This makes it difficult for potential scaler firms to identify the most suitable government programmes for their growth (OECD, 2022<sup>[5]</sup>).

The government made “breaking the barriers for MSMEs to scale up” a priority in the Mid-Term Review of the Twelfth Malaysia Plan (Ministry of Economy, 2021<sup>[2]</sup>). The Review attributed the “inability of MSMEs to scale up and stay competitive” to “inadequate policies and initiatives in scaling up MSMEs”. When trying to identify potential high-growth firms, it is crucial to avoid looking through a lens that is too narrow. Policymakers should not focus support on young, high-technology firms in manufacturing, as that would exclude more mature firms operating in low-technology services, which account for most high-growth firms, as noted above. Policies should be based on the evidence that successful scaling up is achieved by a diverse group of firms during a unique phase of their lifetime rather than by a small group of exceptional firms that consistently achieve high growth. Rather than targeting potential high-growth firms, policymakers should instead focus on creating the right framework conditions and support that enable a wide range of firms seeking to grow to acquire the “anticipatory differences” found in future high-growth firms. In other words, policies should be firm-neutral but growth-episode friendly (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>).

A strategy to facilitate the scaling up of MSMEs requires a broad approach that addresses the obstacles facing firms. First, “overcoming low awareness and limited investment in digitalisation” (Ministry of Economy, 2021<sup>[2]</sup>). Second, implementing new technology requires addressing the shortages of skilled

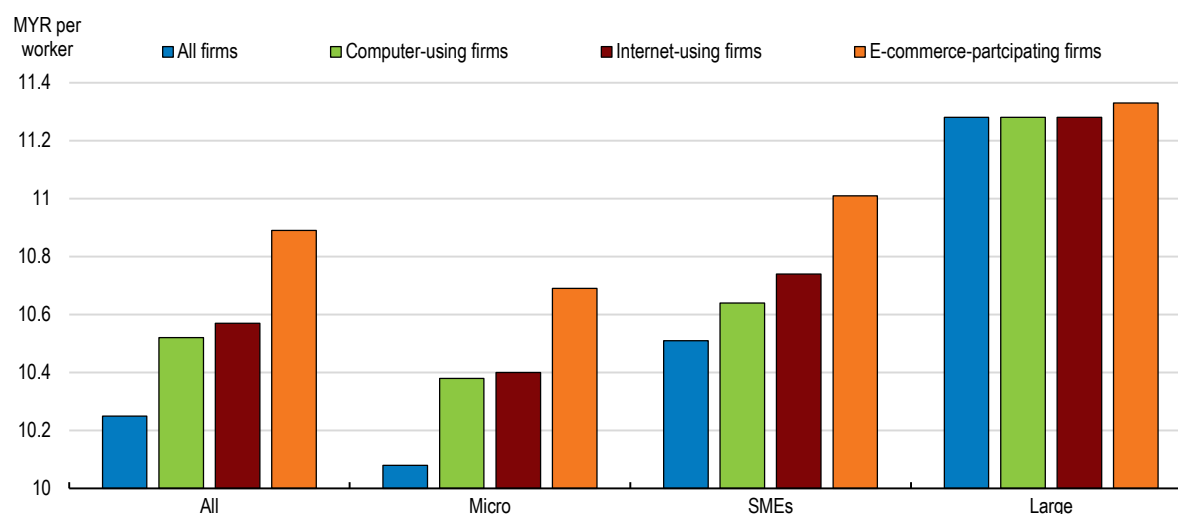
labour. Third, expanding the availability of financing is a prerequisite for scaling up. Fourth, enhancing the role of MSMEs in international trade would be a driver of growth. Fifth, regulatory reform, particularly in sectors where MSMEs are prevalent, would offer new growth opportunities. Sixth, scaling back the role of government-linked companies and government-linked investment companies would create more opportunities for MSMEs to scale up. Another concern is the availability of labour necessary to scale up, making it important to bring informal workers into the formal sector (Chapter 2).

## Supporting MSMEs in taking advantage of digitalisation and technology

Digitalisation is a distinctive feature of firms that scale up. This feature extends before, during and after the high-growth episode. For MSMEs, digitalisation is a game-changer by allowing them to compete on a more even footing with larger firms. It facilitates MSME scaling up by enhancing their access to markets without the need for large-scale investments in marketing and distribution. Digital platforms leverage network externalities, data, and disruptive technologies, leading to greater efficiency, higher productivity and increased consumer welfare (OECD, 2022<sup>[5]</sup>). Moreover, digitalisation helps overcome labour shortages. Digital gaps at the firm level are strongly associated with differences in scaling up, productivity, innovation and growth. In Malaysia, increased use of computers and the Internet and greater participation in e-commerce are correlated with the growth and level of service-sector productivity for all firm sizes (Figure 4.14).


### Figure 4.14. Firms adopting digital tools in Malaysia achieve higher labour productivity

Labour productivity in the service sector, in log of MYR per worker in 2015



Note: Micro firms in the service sector are defined as having less than five workers and SMEs as having between five and 75 workers. The three groups of digital uptake are not mutually exclusive. For example, computer-using firms could include firms using the Internet or participating in e-commerce.

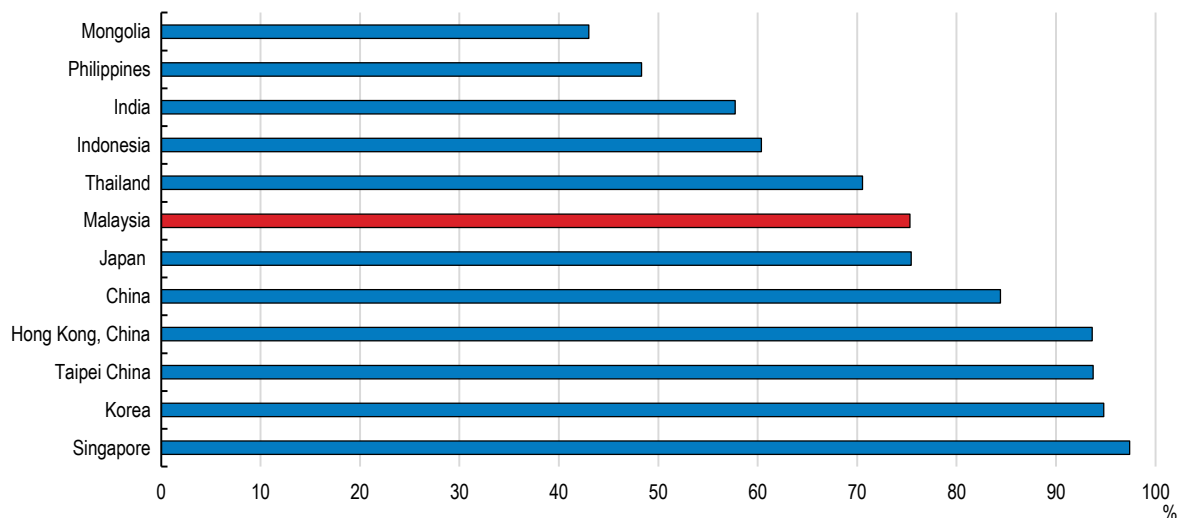
Source: OECD (2021), [OECD Economic Surveys: Malaysia 2021 | OECD Economic Surveys: Malaysia | OECD iLibrary \(oecd-ilibrary.org\)](#).

StatLink  <https://stat.link/9aem0n>

Malaysia performs well in global indices measuring digital competitiveness. For example, the 2023 IMD World Digital Competitiveness Ranking measures the capacity and readiness of 64 economies to adopt and explore digital technologies as a critical driver for economic transformation. Malaysia was ranked 33<sup>rd</sup>, above its ASEAN peers, India and 12 OECD member countries, and was on par with Japan (Figure 4.15). However, Malaysia lags significantly behind high-income economies in the East Asia Pacific region, where it ranks sixth in the number of digital businesses relative to GDP. Nearly one-third of digital businesses operating in Malaysia are headquartered overseas in 39 countries, with the largest shares in Singapore,


the United States, the United Kingdom and India. Foreign enterprises are better funded: the average total funding received by foreign e-commerce firms in Malaysia is more than five times higher than domestic firms (Kuriakose et al., 2022<sup>[27]</sup>).

**Figure 4.15. Malaysia performs well in digital competitiveness**



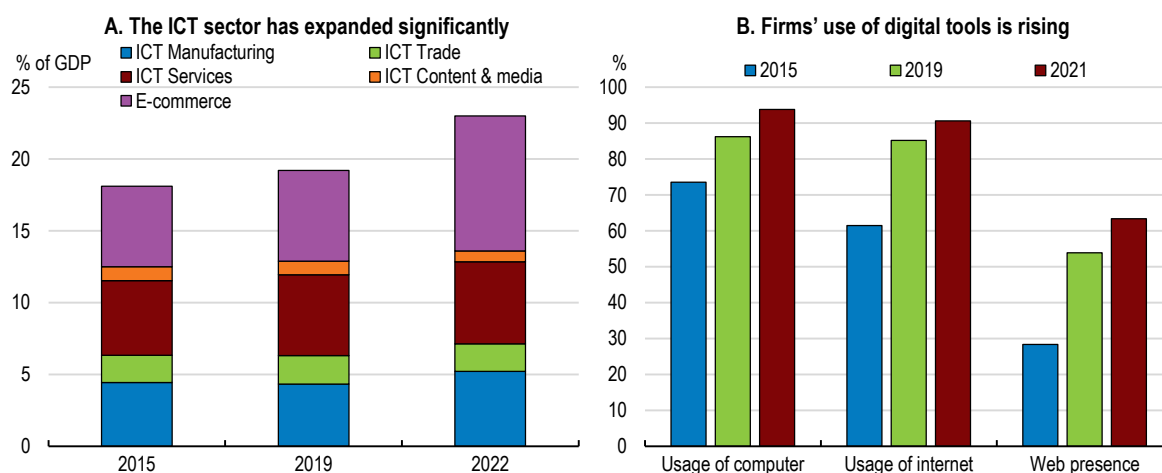
Note: The rankings are based on a mixture of hard data and survey replies from business and government executives on a country's knowledge, technology and future readiness for digitalisation.

Source: IMD, [World Digital Competitiveness Ranking 2023 - IMD business school for management and leadership courses](https://www.imd.org/insights/world-digital-competitiveness-ranking-2023).

StatLink  <https://stat.link/4m0pbh>

The upward trend in the share of the information and communication technology (ICT) sector in Malaysia's GDP increased during the pandemic (Figure 4.16, Panel A). E-commerce made the largest contribution to the upward trend, rising at a double-digit pace during 2021-22 due to new users of digital tools during the pandemic before slowing to only 1% during the first three quarters of 2023 (Department of Statistics Malaysia (DOSM), 2023<sup>[28]</sup>). The Twelfth Malaysia Plan set a target of 25.5% of GDP in 2025 for the ICT sector, driven by the adoption of digitalisation in healthcare, oil and gas, and tourism. ICT industry accounted for about 8% of the labour force and Malaysia's net exports of ICT goods amounted to 8.6% of GDP in 2021. Progress in digitalisation is also visible in the rising share of firms using computers and the Internet and having a web presence (Figure 4.16, Panel B). By 2021, more than 90% of firms used both computers and the Internet. The share with a web presence remained relatively low and varied from 49% in agriculture to 72% in manufacturing.

**Figure 4.16. The ICT sector and firms' use of digital solutions has greatly increased in Malaysia**



Note: The ICT sector includes ICT industry (manufacturing, trade and services) and ICT content and media. E-commerce is a medium or platform for buying or selling goods and services online.

Source: Department of Statistics Malaysia (2023), [digitaleconomy\\_2022.pdf \(dosm.gov.my\)](https://dosm.gov.my/digitaleconomy_2022.pdf).

StatLink  <https://stat.link/lqvtao>

### **Small firms lag behind in digitalisation**

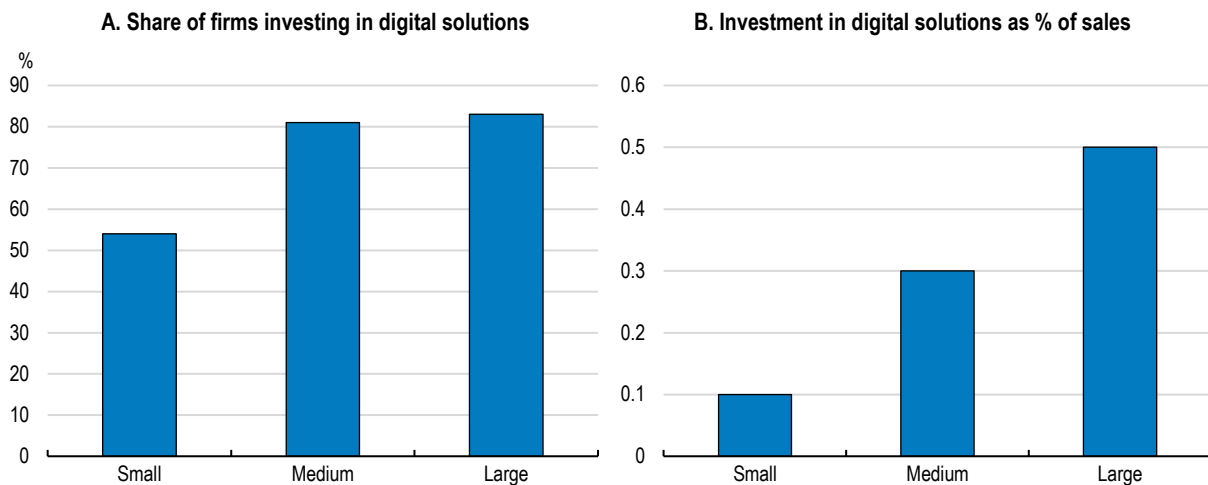
To make digitalisation a major driver of the Malaysian economy, it is crucial to narrow the gap between the companies that have implemented digital technologies, which tend to be large firms, and MSMEs, most of which have yet to fully embrace digital opportunities (World Bank, 2018<sup>[29]</sup>). In particular, the cost of digitalisation is a burden to MSMEs. MSME use of digital tools in 2017 was lowest in the service sector, reflecting low take-up in food and beverages, transport and storage (Kuriakose et al., 2022<sup>[27]</sup>). As noted in the 2021 *OECD Economic Survey of Malaysia*, “A number of SMEs, especially micro-sized firms, do not use computers and the Internet. Most SMEs do not make their transactions through e-commerce” (OECD, 2021<sup>[30]</sup>).

The COVID-19 pandemic has accelerated digitalisation worldwide, making it a silver lining of the crisis. Increased demand for online services and goods during the crisis opened up opportunities for existing firms to scale up and new entrepreneurs to enter the market. Firms mitigated the impact of the pandemic by turning to digital technologies, notably by reaching customers and selling on digital platforms. Business surveys suggest that up to 70% of MSMEs worldwide have intensified their use of digital technologies due to the pandemic. As in other countries, Malaysian firms' use of digitalisation to cope with the crisis was correlated with their size – the smaller the firm, the less likely it was to adopt new digital tools (OECD, 2021<sup>[31]</sup>). Around 83% of large firms responded to the COVID-19 crisis by investing in digital solutions compared to 54% of small firms, reflecting their limited capacity for investment in new technology (Figure 4.17, Panel A). Moreover, the value of firms' digital investment relative to their sales also increased with the size of firms; large firms invested on average five times more relative to their sales revenues than small ones during the pandemic (Figure 4.17, Panel B). Firms that invested in new digital solutions to cope with the pandemic had only a 10% decline in sales compared to 22% for firms that did not invest (controlling for size, sector, and region) (World Bank, 2023<sup>[32]</sup>).

MSME digitalisation has remained limited, focusing on basic services and customer-facing business (“front end”) functions, such as marketing and social media presence. In contrast, large firms invest more in digital solutions covering broader business activities, including more advanced “back end” functions, such as administration, accounting, production and supply chain management (Kuriakose and Tiew, 2022<sup>[4]</sup>). Only 54% of MSMEs use back-end processes, which would allow them to rethink their business strategies. This

situation is sometimes called a “computerisation trap” (SME Corp. and Huawei, 2018<sup>[33]</sup>). Consequently, digitalisation was more likely to fundamentally change the operations of large firms.

**Figure 4.17. Larger firms are more likely to invest in digital solutions, leading to better outcomes**



Note: During 2020-22. The change in sales is controlled for the size, sector and region of firms.

Source: World Bank (2023) [Malaysia Economic Monitor February 2023: Expanding Malaysia's Digital Frontier \(worldbank.org\)](https://www.worldbank.org).

StatLink  <https://stat.link/iuxqw8>

The Twelfth Malaysia Plan stated that MSMEs’ “reliance on low-skilled labour and their slow progress toward automation and mechanisation resulted in low productivity growth”. To make MSMEs the new driver of growth, the Plan set an objective of accelerating their development through technology and digital adoption (Ministry of Economy, 2021<sup>[2]</sup>) with a focus on back-end operations to transform the conventional way of doing business (Minister of Investment, Trade and Industry, 2023<sup>[34]</sup>). The Plan set a target of digitalising 90% of SME business operations. The government will also introduce “a prerequisite digital adoption requirement for businesses” to strengthen existing campaigns for society to go cashless (Ministry of Economy, 2021<sup>[2]</sup>). To achieve this goal, the central bank has been promoting the use of e-Payment by small merchants. In other countries, including Korea, such measures improved tax compliance by small companies (OECD, 2003<sup>[35]</sup>). Digitalisation is also a priority in the public sector. In 2022, the government launched a digital literacy programme for civil servants to improve the delivery of public services (Ministry of Economy, 2021<sup>[2]</sup>).

### **Creating a more favourable digital economy ecosystem**

The Mid-Term Review of the Twelfth Malaysia Plan identified the country’s unfavourable digital economy ecosystem as a key obstacle to promoting digitalisation. It suggested areas for improvement, which are crucial to digitalisation:

- Enhancing digital governance
- Building a conducive digital infrastructure
- Bridging the digital divide

#### *Improving government policies for digitalisation*

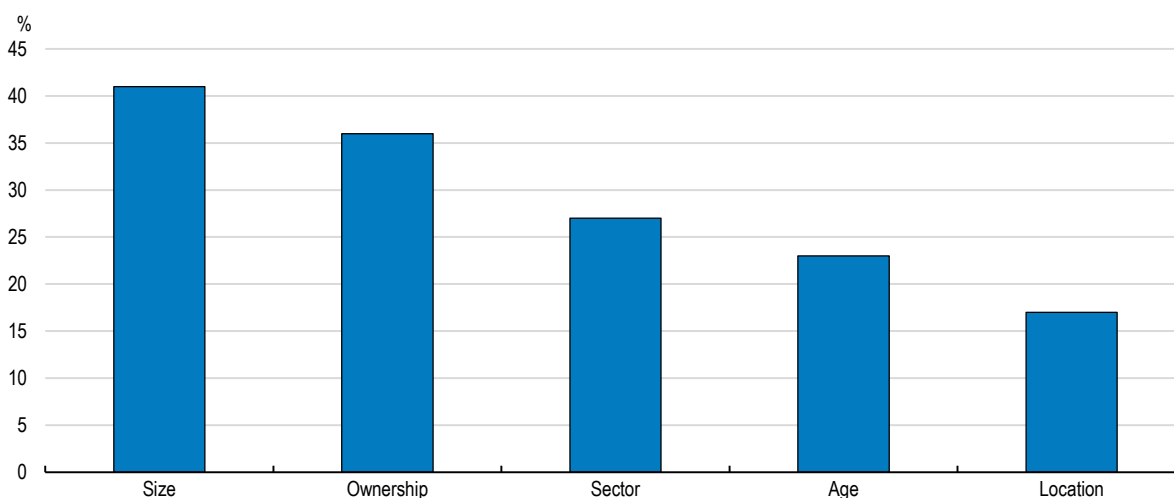
The priority is to streamline the roles and functions of ministries and agencies. The Malaysian government is among the most active in Asia in supporting the digitalisation of MSMEs. Over a dozen public strategies have focused on this area during the past decade, of which the 2021 Malaysia Digital Economy Blueprint (2021-30) is the most important (Prime Minister’s Department, 2021<sup>[36]</sup>). Around 25 central government

ministries and agencies and at least ten state and municipal agencies offer more than 100 programmes to promote the digitalisation of MSMEs. The government's response to the pandemic increased the number of programmes. More than 40% of programmes provide some form of financial support; grants (33%), soft loans (7%), equity (2%) and guarantees (1%), with a maximum benefit of MYR 20 million (USD 4.8 million). In addition, 80% of the programmes deliver non-financial support, notably training on digital technologies and managerial training.


When multiple programmes and agencies perform similar functions and target the same beneficiaries, it can result in wasted resources and confusion, with resources spread too thin across the programmes. For example, one study identified 29 recent initiatives in Malaysia intended to educate MSMEs regarding e-commerce opportunities, 32 providing financial support to invest in digital solutions and 40 offering training on digital technologies (Kuriakose and Tiew, 2022<sup>[41]</sup>). One reason is that many programmes are targeted at specific groups based on size (typically micro-enterprises or SMEs), ownership (Bumiputera, youth, women, or at least 50% Malaysian-owned), sector (such as manufacturing or retail), age of the firm (number of years in operation), and location (a particular state or area) (Figure 4.18). The large number of programmes could also create confusion for SMEs seeking support to adopt digital technologies. Most digitalisation programmes reach only “a very small fraction of the total number” of the 1.2 million MSMEs. One survey of MSMEs found that only about half were aware of these government programmes. Some of the MSMEs that did participate found the application process for government programmes to be overly complex, lengthy and opaque. Weaknesses include cumbersome application processes and poor user experience; long processing times, especially for the disbursement of grants; and a lack of clarity regarding grant approval/rejection and grant and programme continuity, as assistance may end when funds are exhausted (Kuriakose and Tiew, 2022<sup>[41]</sup>).

**Figure 4.18. MSME programmes in Malaysia are targeted at firms meeting certain eligibility criteria**

Share of programmes



Source: Kuriakose, S. et al. (2022), *Digitalizing SMEs to Boost Competitiveness*, World Bank Group, Washington, D.C.

StatLink  <https://stat.link/adgx7v>

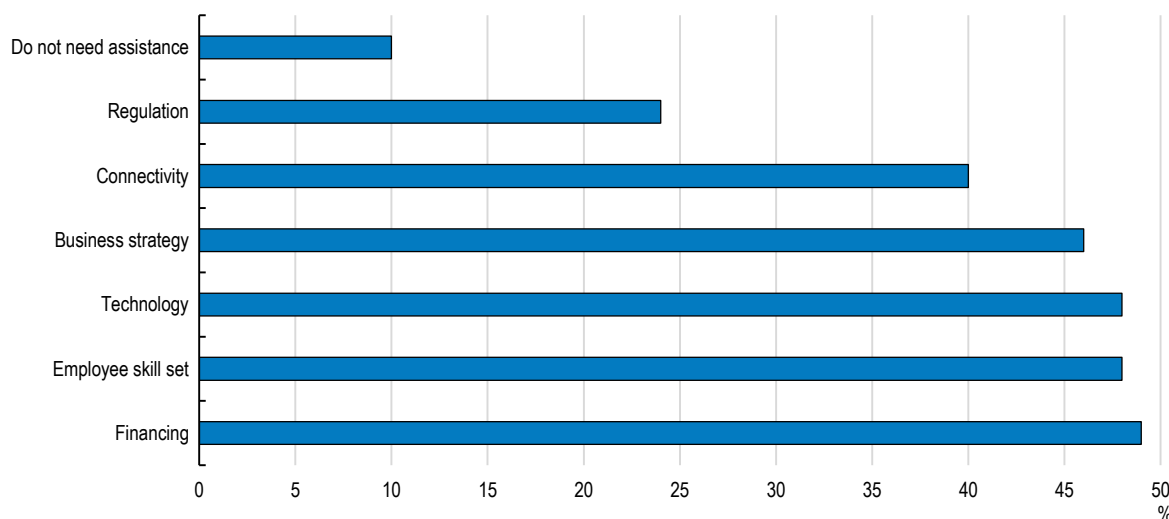
A more integrated and coordinated approach within the federal government and between it and the states is needed to identify the overlaps, synergies and gaps in programmes. This would allow a better alignment of the roles and functions of ministries and agencies across the federal and state governments and promote inter-agency coordination to optimise the use of resources (Ministry of Economy, 2023<sup>[9]</sup>). A more integrated and coordinated approach depends in part on rigorous cost-benefit analysis to identify what approaches are most successful. Effectively using the MyAssist MSME Portal, an online one-stop shop with detailed information on all programmes, would improve coordination and allow MSMEs to identify the

programmes that best meet their needs. Another priority is to improve the application process. Public agencies supporting MSME digitalisation should conduct and publish monitoring and evaluation of their programmes to ensure that the public resources used have significant and durable positive impacts on many firms. This requires a rigorous comparison of productivity and profitability of firms receiving assistance with a control group that does not receive support, as is done in some countries (Chang, 2016<sup>[37]</sup>).

### *Building a conducive digital infrastructure*

In a survey of Malaysian MSMEs, 40% cited connectivity as an obstacle to digitalisation (Figure 4.19). The problem is most serious in less developed regions. The operability of cloud computing and the Internet of Things, and usage of big data technologies depend on reliable service capable of sustaining high volumes of information. Access to the Internet depends, in turn, on basic infrastructure elements, such as a reliable power supply and cable infrastructure. In Malaysia, the pandemic crisis triggered a rapid expansion in access and usage of the Internet. Although Malaysia lags in the number of fixed broadband connections per capita compared to OECD countries (Figure 4.20, Panel A), it exceeds the number of mobile subscriptions (Figure 4.20, Panel B).

**Figure 4.19. The key obstacles to digitalisation cited by MSMEs**



Note: Based on a 2018 study of 2 033 MSMEs representing all sectors (services, manufacturing, construction and agriculture) and regions of Malaysia.

Source: SME Corp. and Huawei (2018), *Accelerating Malaysian Digital SMEs: Escaping the Computerisation Trap*.

StatLink  <https://stat.link/j4gchf>

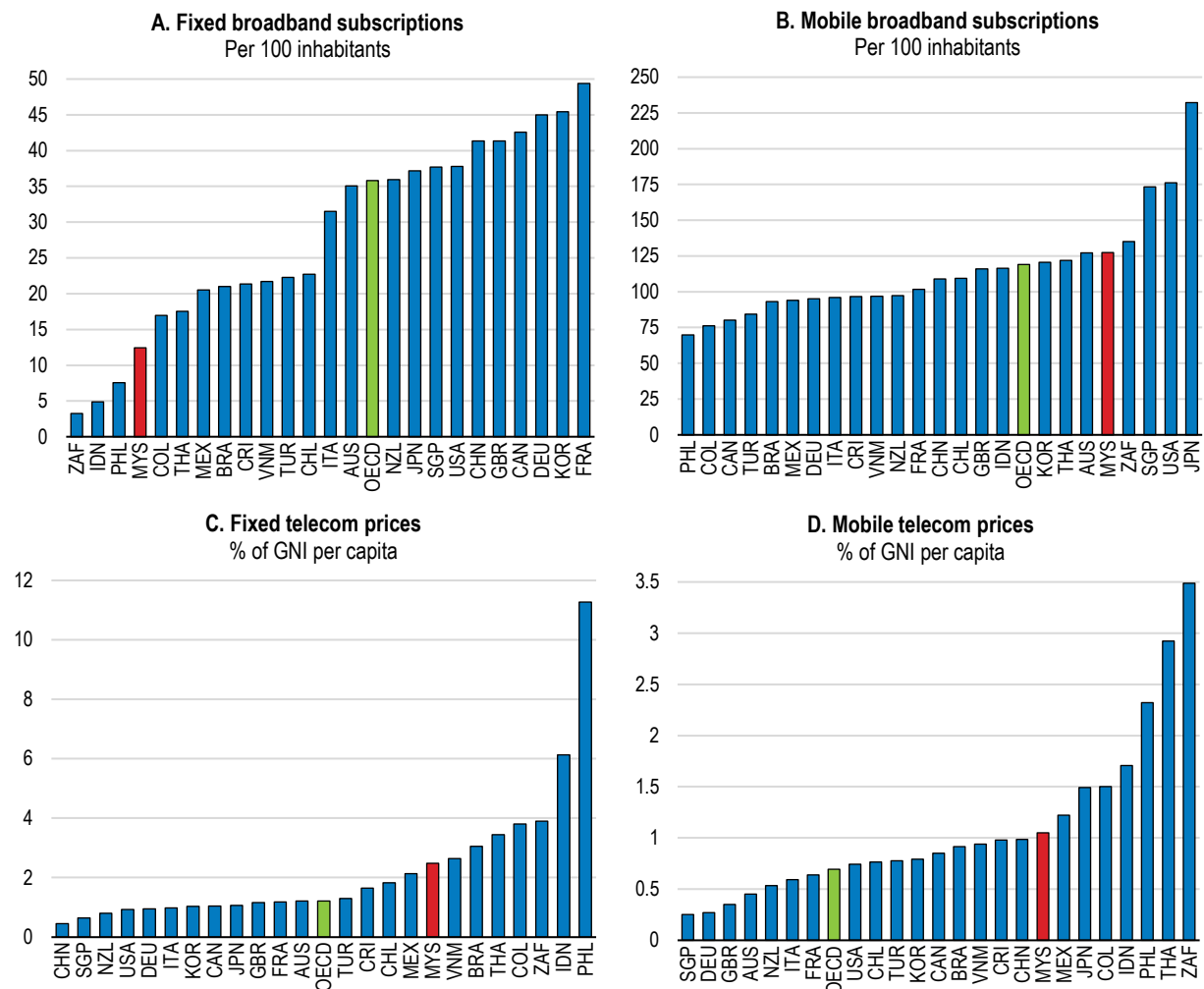
While Internet usage increased sharply during the pandemic, concerns remain about the affordability and quality of Internet access. Indeed, in a 2018 survey of more than 2 000 MSMEs, the major issues regarding Internet connectivity were affordability (52%) and speed (47%). Fixed and mobile telecom prices relative to income per capita in 2022 exceeded the OECD average (Figure 4.20, Panels C and D). In the Economist Impact Index, Malaysia ranked 53<sup>rd</sup> out of 100 countries in the cost of Internet access relative to income levels, reflecting an insufficiently competitive digital environment (Economist Impact Index, n.d.<sup>[38]</sup>). The regulatory framework for prices for fixed and mobile connectivity are guided by the Mandatory Standard on Access Process. In terms of quality, the speed of Malaysia's fixed and mobile broadband infrastructure is behind that of neighbouring countries, such as Thailand, Singapore and China (World Bank, 2023<sup>[32]</sup>). At the end of 2022, 47.1% of populated areas were covered by 5G mobile networks, which are more than twice as fast as 4G, and 96.9% were covered by 4G (JENDALA (Jalanan Digital Negara), 2023<sup>[39]</sup>). In the

Economist Impact Index, Malaysia ranked 41<sup>st</sup> in the quality and breadth of available infrastructure for Internet access (Economist Impact Index, n.d.<sup>[38]</sup>).

Increased access to digital infrastructure can lead to job creation while improving consumer welfare. The Mid-Term Review of the Twelfth Malaysia Plan stated that the government will utilise government-owned land and buildings to accelerate the development of telecommunication infrastructure (Ministry of Economy, 2023<sup>[9]</sup>). To improve affordability and availability, it is essential to develop digital infrastructure by promoting competition (World Bank, 2023<sup>[32]</sup>). Competition can be enhanced by ensuring appropriate licensing and regulatory rules, constraining anti-competitive behaviour and reducing costs for operators. In particular, Malaysia should amend the Competition Act 2010 to enable authorities to identify and address potential threats before a merger, rather than trying to correct anti-competitive outcomes afterwards. In addition, the authorities will have to cope with the emergence of digital platforms that allow the exploitation of network effects (World Bank, 2023<sup>[32]</sup>).

**Figure 4.20. Mobile broadband subscriptions are widely available but the price is high**

In 2022



Note: The fixed telecom price refers to a fixed-broadband basket with 5 GB and the mobile telecom price refers to a high-usage voice and data plan allowing up to 140 minutes of phone calls, 70 SMS and 2 GB data using at least 3G technology.

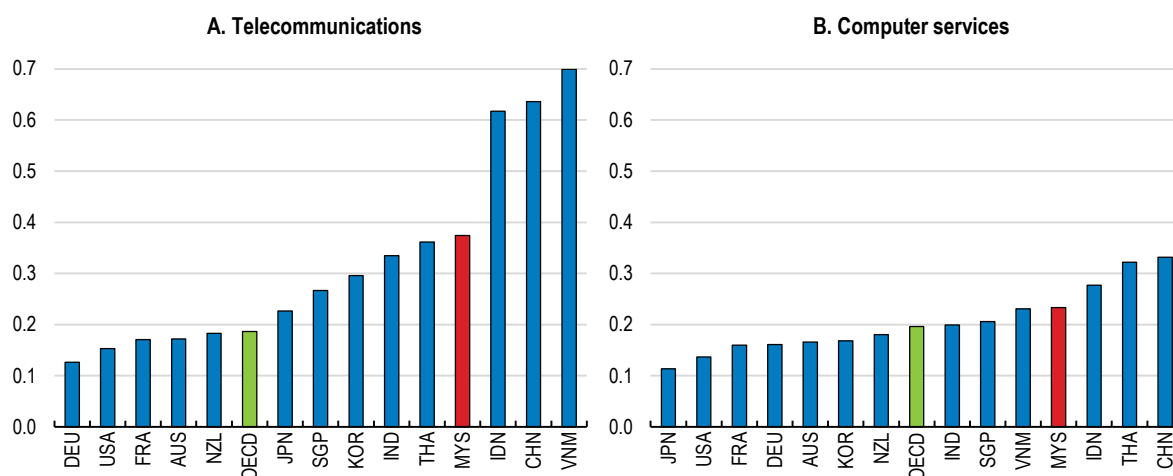
Source: International Telecommunication Union; and OECD calculations.

StatLink <https://stat.link/i5nlom>

In addition, trade restrictions on two areas crucial to the digital economy – telecommunications and computer services – are relatively high in Malaysia (Figure 4.21). Easing foreign entry restrictions in telecommunications would help boost investment in modern, high-quality, and affordable telecommunication services, closing significant gaps in Malaysia’s digital infrastructure. In particular, it would improve the speed and quality of telecommunications services, primarily through fixed fibre broadband and in next generation communication networks to keep pace with advancements in digital technology (World Bank, 2023<sup>[32]</sup>). Such progress would help Malaysia’s MSMEs expand their business across international borders (OECD, 2021<sup>[30]</sup>). The high restrictions on computer services (Figure 4.21, Panel B) limit cross-border data flows. Foreign firms must incorporate or register a branch in Malaysia to provide computer and other digitally-enabled services. The 12-month limit on the period of stay for foreign specialists has restricted the movement of skilled labour. Given the shortage of skilled workers in Malaysian MSMEs, further reducing these barriers would foster their digitalisation.

**Figure 4.21. Malaysia’s restrictions on telecommunications and computer services trade are high**

0 (open) to 1 (closed)



Source: OECD Stat., Services Trade Restrictiveness Index, accessed 23 February 2024.

StatLink  <https://stat.link/avkfr3>

### *Bridging the digital divide*

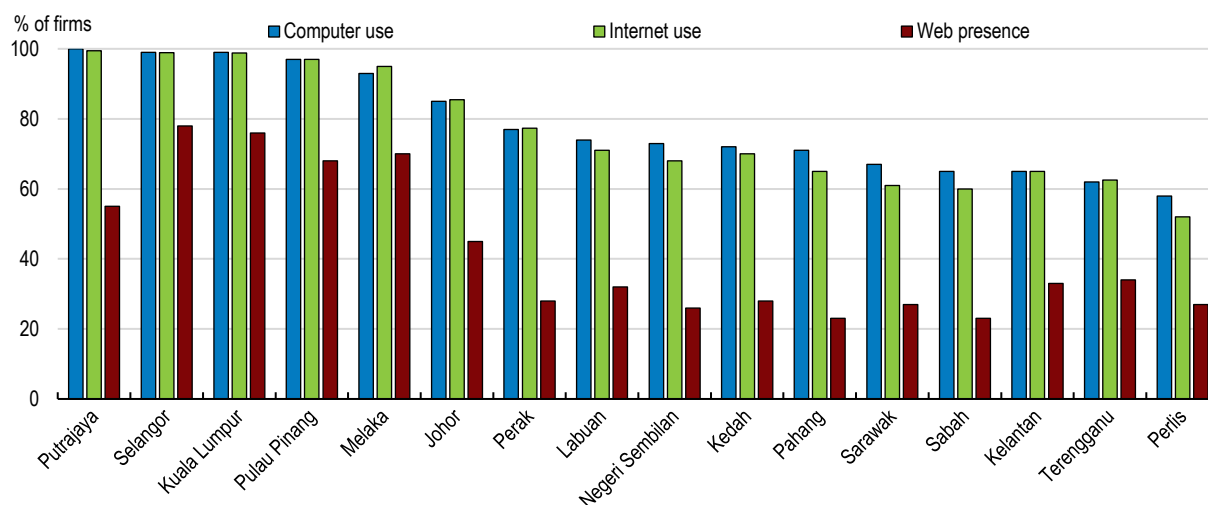
The slower pace and depth of digitalisation in the MSME sector are widening the digital divide in Malaysia. In addition to the negative impact on productivity and growth, the digital divide aggravates income inequality (OECD, 2021<sup>[31]</sup>). First-mover advantages in digital markets and strong network effects can exacerbate the digital divide. Moreover, there are complementarities in digital diffusion: the adoption of technology A rises with the adoption of technology B. The digital divide in Malaysia is reflected in significant regional differences in the use of digital tools. The share of firms without a web presence was over half in seven of the 16 states and territories (Figure 4.22). In particular, MSMEs operating in rural areas and in East Malaysia (Sabah and Sarawak) face inadequate digital infrastructure and connectivity (Kuriakose et al., 2022<sup>[27]</sup>).

The government’s goal is “affordable, quality, safe and secure access to digital technologies and services, including connectivity, for everyone to better lives” (Ministry of Economy, 2023<sup>[9]</sup>). It is implementing a national digital infrastructure plan (Jalinan Digital Negara (JENDALA)) and developing the Malaysia Digital Inclusiveness Index to measure the digital divide and enable targeted policies, including resource allocation and talent development. Earmarked programmes, such as the National Information Dissemination Centre (Nadi), are essential to boost digital literacy and enhance trust to achieve wider

digital adoption, particularly among vulnerable groups. Such programmes should address the digital divide and prepare MSME employees for the changing work environment brought about by the digital transformation.

**Figure 4.22. ICT use by firms varies widely between regions in Malaysia**

Share of firms in each state



Source: Department of Statistics Malaysia (2023), Malaysia Digital Economy 2023.

StatLink  <https://stat.link/w1eg9c>

### Upgrading technology and human skills

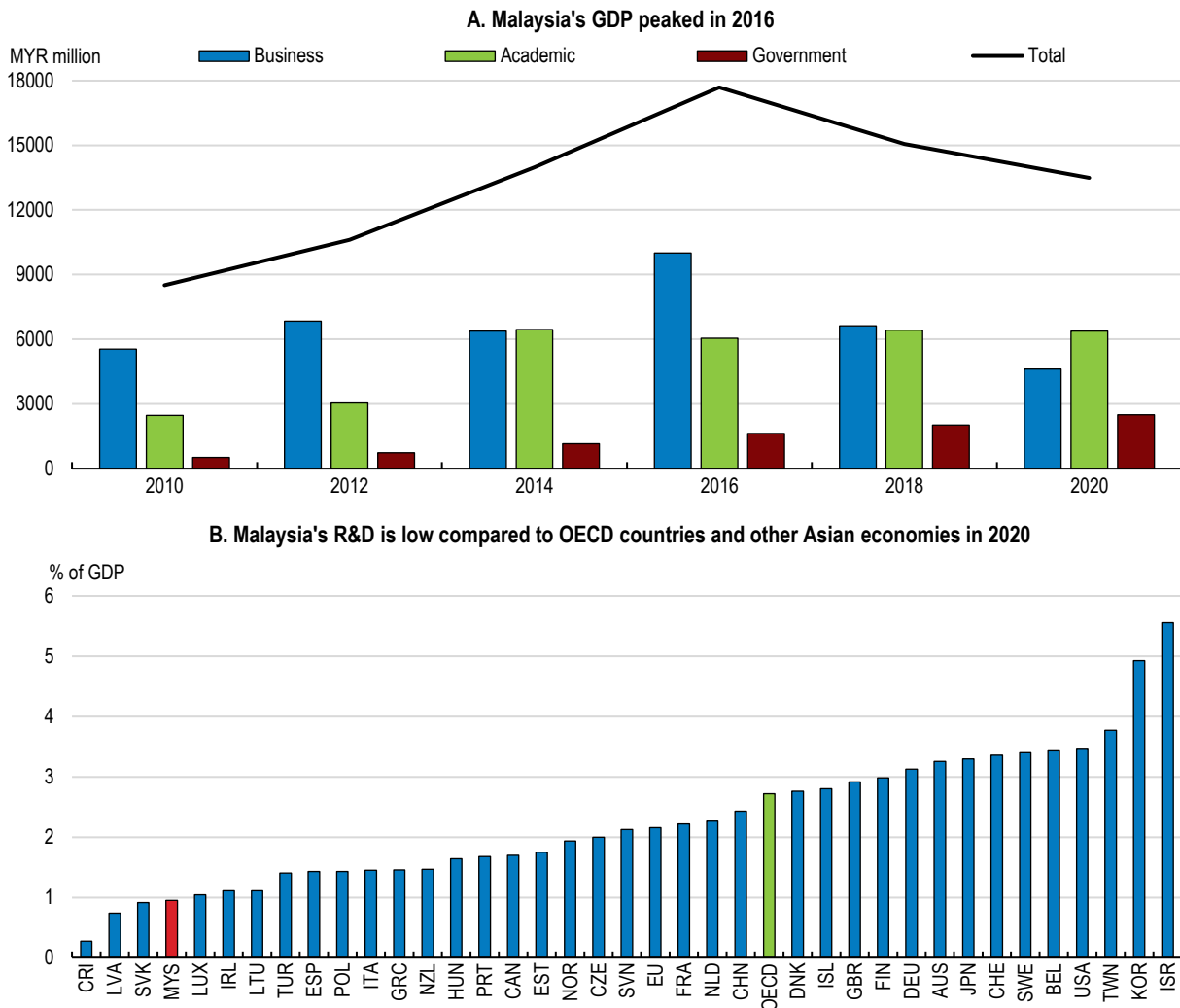
The second and third most serious obstacles to the uptake of digitalisation by Malaysia's MSMEs are weaknesses in the employee skill set and a lack of the necessary technology (Figure 4.19). Compared to their ASEAN peers, Malaysian MSMEs are less likely to adopt complex innovations and technologies in their business operations and management practices due to a lack of technical capabilities (Kuriakose and Tiew, 2022<sup>[41]</sup>). The 2023 Productivity Report identifies "sluggish technology adoption, especially among small and medium enterprises" as the key obstacle to improving productivity (Malaysia Productivity Corporation, 2023<sup>[40]</sup>). Progress in digitalisation would be an effective catalyst for further innovation, as it reduces transaction costs through better and quicker access to information and communication between staff, networks and suppliers. Moreover, it facilitates access to resources, training, finance and recruitment channels and enables firms to generate data and analyse their operations in new ways (OECD, 2021<sup>[31]</sup>).

Malaysia's total R&D expenditure grew from 0.2% of GDP in 1996 to a peak of 1.4% in 2016. However, it gradually declined to around 1% of GDP in 2020, as R&D expenditure by the business sector fell by more than half, and remained around 1% in 2021 (Figure 4.23, Panel A). Malaysia ranks low relative to OECD countries in R&D spending (Figure 4.23, Panel B). In addition, the number of researchers (per 10 000 in the labour force) fell from 74 in 2016 to 33 in 2020 (Ministry of Science, Technology and Innovation, 2023<sup>[41]</sup>).

Low levels of R&D spending, research staff and patenting contribute to Malaysia's score behind China and the average of five neighbouring countries in the World Intellectual Property Organization's (WIPO) 2023 Innovation Index scores for creative outputs and knowledge and technical outputs (Figure 4.24). Malaysia does rank above ASEAN peers, except Singapore, in its overall ranking, suggesting large potential for innovation.

The Twelfth Malaysia Plan set target for total R&D expenditure of 2.5% of GDP by 2025. To help achieve the target, the government will encourage increased access to alternative financing, including through venture capital and international funding. In addition, an endowment fund will be established to source funds from industry, matching grants, crowdfunding and charitable contributions for R&D activities related to science and technology (Ministry of Economy, 2021<sup>[2]</sup>). It is essential that the newly formed Research Management Unit (RMU), under the Economic Planning Unit, ensure that public R&D funds are used effectively.

**Figure 4.23. R&D expenditures have fallen since 2016 and are low compared to OECD countries**



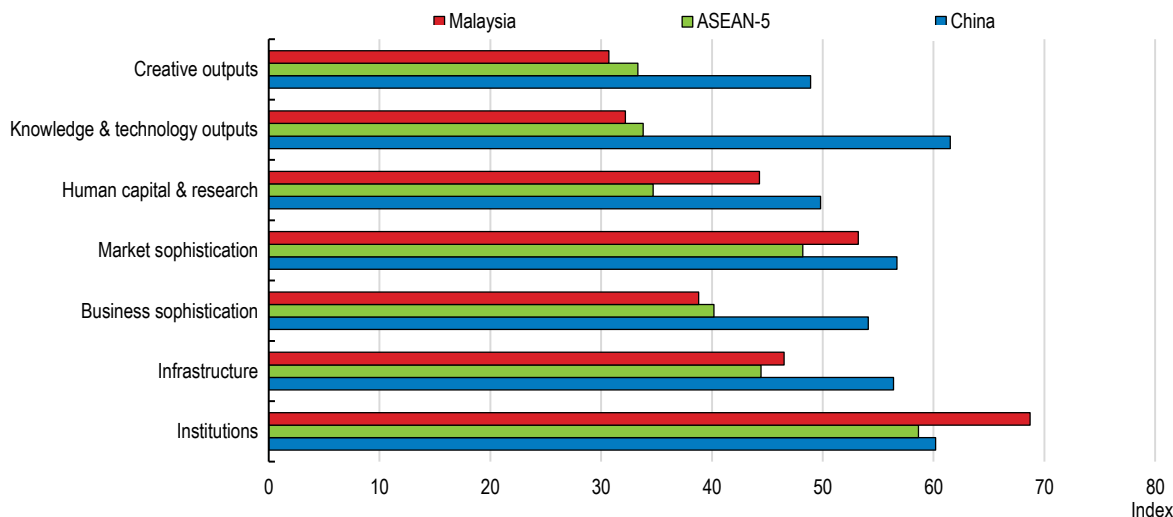
Source: Ministry of Science, Technology and Innovation (2023), Summary Report National Survey of Research and Development (R&D) in Malaysia 2021 | Malaysian Science and Technology Information Centre (mosti.gov.my).

StatLink  <https://stat.link/l8jx3m>

Only 6% of small firms and 20% of medium-sized firms invest in R&D, which is low compared to Viet Nam, the Philippines and China (Figure 4.25). MSMEs' R&D activities are limited by insufficient skills and funding, making it difficult to expand their in-house innovation capabilities. Given these weaknesses, it is essential to increase MSMEs' uptake of R&D by strengthening their collaboration with experts in academia and the business sector to benefit from knowledge spillovers from other firms and universities. However, programmes and instruments targeting R&D by MSMEs account for a relatively small proportion of government support for MSMEs (Kuriakose and Tiew, 2022<sup>[4]</sup>). Companies that engage in research can

apply for “R&D status”, which allows them a double tax deduction for R&D expenditures. Such incentives are less effective for young MSMEs, as they are typically not profitable in their early years. Making R&D tax incentives more advantageous for small firms and increasing their access to new technology by focusing government research institutes’ R&D on issues pertinent to MSMEs would promote greater innovation in MSMEs. Some OECD countries use refundable R&D tax credits to promote innovation by MSMEs (Box 4.4).

**Figure 4.24. Malaysia’s scores in the World Innovation Index show room for improvement**

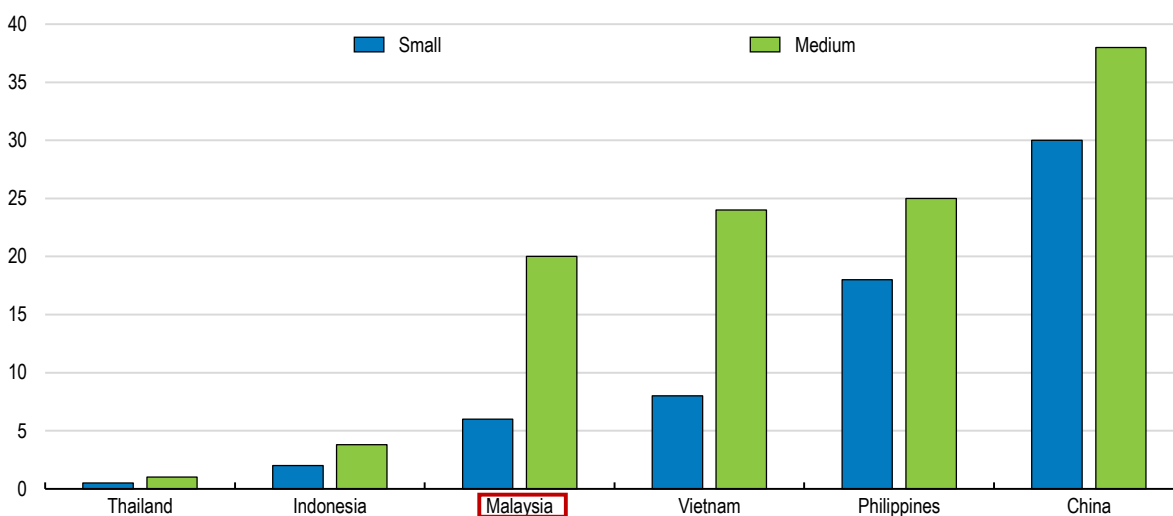


Note: The ASEAN-5 consists of Indonesia, Philippines, Singapore, Thailand and Viet Nam.

Source: WIPO (2023), [Global Innovation Index 2023: Innovation in the face of uncertainty](https://www.wipo.int/global_innovation_index/en/2020/) (wipo.int)[https://www.wipo.int/global\\_innovation\\_index/en/2020/](https://www.wipo.int/global_innovation_index/en/2020/).

StatLink <https://stat.link/mj3tsv>

**Figure 4.25. The share of small and medium-sized firms participating in R&D in Malaysia is low**



Source: Kuriakose, S. and H. Tiew (2022), *Malaysia: SME Program Efficiency Review*.

StatLink <https://stat.link/1io9uj>

#### Box 4.4. Tax measures by OECD countries to support R&D spending by SMEs

In 2022, 33 OECD countries offered tax incentives to firms that invest in R&D. Of these countries, 21 offered refundable (payable) tax credits or equivalent incentives. Tax credits directly reduce the amount of tax a firm owes, in contrast to tax deductions, which reduce a firm's taxable income. A refundable tax credit provides a refund even if the tax owed is zero. Three of the OECD countries offering refundable tax credits – Australia, Canada and France – explicitly target SMEs and young firms with preferential treatment relative to large enterprises (OECD, 2023<sup>[42]</sup>).

France introduced the Credit d'Impôt Innovation (CII) or Research Tax Credit in 2013. It allows SMEs to receive tax credits on expenses related to developing prototypes or pilot trials of new products. The tax credit rate is 20% and expenses subject to the tax credit are capped at EUR 400 000 per year, with any unused amount of credit allowed to be carried over for up to three years. Eligible expenses include staff costs, intellectual property acquisition, and research contracts with third parties. Thanks to this generous scheme, 86% of R&D tax relief recipients in 2019 were SMEs.

The CII is particularly suited to encouraging research commercialisation by supporting prototype development. It also has less distortive effects on the market, as it covers only the development phase and not the production phase. One limitation is that innovations in the service sector and non-technological innovations, such as those in marketing and business processes, are not eligible for the tax credit (OECD, 2018<sup>[43]</sup>).

MSMEs' shortage of skilled workers is recognised as a serious obstacle in the Mid-Term Review of the Twelfth Malaysia Plan. While the COVID-19 pandemic forced many MSMEs to introduce digital tools, they often lack the human capital to effectively use those tools. Around 58% of small firms (5-19 employees) report difficulties finding workers with computer or general IT skills. In addition, less than a quarter of small and medium-sized firms (less than 100 workers) provide formal training compared to more than 70% of large firms (Kuriakose and Tiew, 2022<sup>[4]</sup>). Firms that pay higher wages and attract better workers are more likely to become high-growth firms (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). However, MSMEs face challenges in retaining top talent due to limited ability to pay competitive salaries and provide career development opportunities. MSMEs are thus caught in a vicious circle: low wages and productivity prevent them from attracting the skilled labour that would allow them to become high-growth firms. The government classifies 72% of workers as low-skilled or semi-skilled, leaving only 28% qualifying as skilled, and the share has increased only slightly since 2015 from 25.5%. The mean years of schooling in Malaysia is 10.6 compared to as many as 14 years in some OECD countries (United Nations Development Programme, 2022<sup>[44]</sup>). Malaysia aims to boost its mean years of schooling to 11.6 by 2026.

Malaysia's Critical Occupations List, which identifies mid and high-skilled occupations that are experiencing labour shortages, reported that the demand for advanced digital skills has been increasing more rapidly than its supply, despite the government providing training and up-skilling programmes for basic digital skills (OECD, 2021<sup>[30]</sup>). Five of the six occupations requiring digital skills that appeared in the 2018/2019 List have remained on it for the past six years, indicating a persistent shortage of those skills. In addition, the education requirements for these job vacancies also fell, which may adversely affect productivity (World Bank, 2023). The need for greater digital education is underlined by a poll of MSMEs during the COVID-19 pandemic asking why they had not introduced digital technology. More than a quarter responded that they did not see the need, the benefits were uncertain or they lacked information (Kuriakose et al., 2022<sup>[27]</sup>).

Digital education is thus a key to unlocking the benefits of digitalisation. In Malaysia, digital education has prioritised front-end (i.e., customer-facing) business functions, such as sales and marketing, and e-commerce through participation in digital platforms. While this is in line with the needs expressed by the

businesses themselves, going forward, it is necessary to increase the emphasis on back-end skills (World Bank, 2023<sup>[32]</sup>). The digital and technology “Big Bold” initiative in the Mid-Term Review of the Twelfth Malaysia Plan stated that measures to improve digital skills should be done in collaboration with the business sector (Ministry of Economy, 2023<sup>[9]</sup>). Another major obstacle to digitalisation is a lack of management skills. In a 2022 survey asking SMEs why they did not invest in digital solutions, around 30% of SMEs said that they saw “no need” and a similar share responded that the benefits were uncertain. Around a quarter said that they did not invest in digital solutions because they lacked information (World Bank, 2023<sup>[32]</sup>). Innovative approaches in Mexico and Canada offer ideas on how to overcome such obstacles (Box 4.5).

#### **Box 4.5. Upgrading digital and managerial skills: the cases of Mexico and Canada**

Mexico launched a so-called “tablet programme” in 2015 to assist micro-enterprises primarily in traditional sectors, such as retail trade (60% of the firms) and low value-added manufacturing. This innovative approach combines basic training in key management principles with the provision of new ICT solutions. Management training focuses on areas crucial for the survival and growth of small firms: the use of management software, inventory management, accounting, customer relationships, micro-market analysis and repayment capability. Moreover, participants receive a tablet that includes the management software, another software programme that enables customers to pay utility bills and phone charges, and a swipe-card extension to the tablet that allows customers to pay by credit/debit card. As many of these firms operate in the informal economy, another objective is to bring them into the formal economy.

The training programme had 70 000 participants during its first two years. One concern is that the training provided by organisations can lead to the exit of organisations that do not receive such support. In sum, this approach could have a positive impact in Malaysia, where enterprises with fewer than five employees account for three-quarters of firms.

The Canadian government created in 2004 the Canada Business Network (CBN), a “click, call, and visit” nationwide business service to provide information (free of charge) on starting, growing and closing a business. The website has become the major point of contact for business-related information, including on SME support programmes and services. In Fiscal Year 2012-13, the national web portal recorded 2.25 million visits. In addition, the CBN links visitors to information on government programmes and services, both at the federal and provincial levels, as well as to BizPaL, an online service for information on business permit and licensing requirements at the federal, provincial and municipal levels. For Malaysia, a partnership between central and state governments would help provided help to SMEs throughout the country.

### **Addressing other obstacles to MSME growth**

In addition to the challenges of acquiring the necessary technology and the lack of employees with the appropriate IT skills, as discussed above, MSMEs face other obstacles to making a significant step towards upscaling and digitalisation. According to the results of the survey of MSMEs presented in Figure 4.19, these include *i)* financing to meet the costs of digitalisation; *ii)* sufficient networks, including overseas; and *iii)* regulations that inhibit the transformation of an enterprise. Only 10% of MSMEs said they did not need assistance to digitalise. This section will focus on the issues of financing, international trade and regulation.

## **Providing financing for MSMEs**

The Mid-Term Review of the Twelfth Malaysia Plan stated that improving the accessibility of financing is a key to the scaling up of MSMEs (Ministry of Economy, 2023<sup>[9]</sup>). The relationship between financial development and the performance of high-growth firms in upper-middle-income countries (such as Malaysia) is significantly positive (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). Obtaining access to financing is particularly difficult for smaller enterprises.

### *The rationale of public support for financing for MSMEs and the risks*

Market failures justify financial support to MSMEs. Small firms' absence of collateral, short credit history and lack of expertise needed to produce financial statements limits their access to credit. For lenders, the small scale of lending may not compensate for the cost of screening and monitoring, resulting in an information asymmetry. As a result, financial institutions attribute a high risk of default to borrowers, providing some justification for government intervention to overcome this market failure. In principle, the level of public financing support for MSMEs should depend on the financing gap, i.e., the difference between the amount of SME financing that would occur in the absence of market failures and the actual amount of financing, although this is difficult to calculate in practice (Jones and Kim, 2014<sup>[45]</sup>). In particular, closing the financing gap should enable MSMEs to build up intangible assets, such as patents, software, databases, managerial skills and distribution skills, which are key drivers of innovation and productivity growth. Financing MSMEs' acquisition or development of intangible assets is more difficult than for tangible assets (Demmou and Franco, 2021<sup>[46]</sup>).

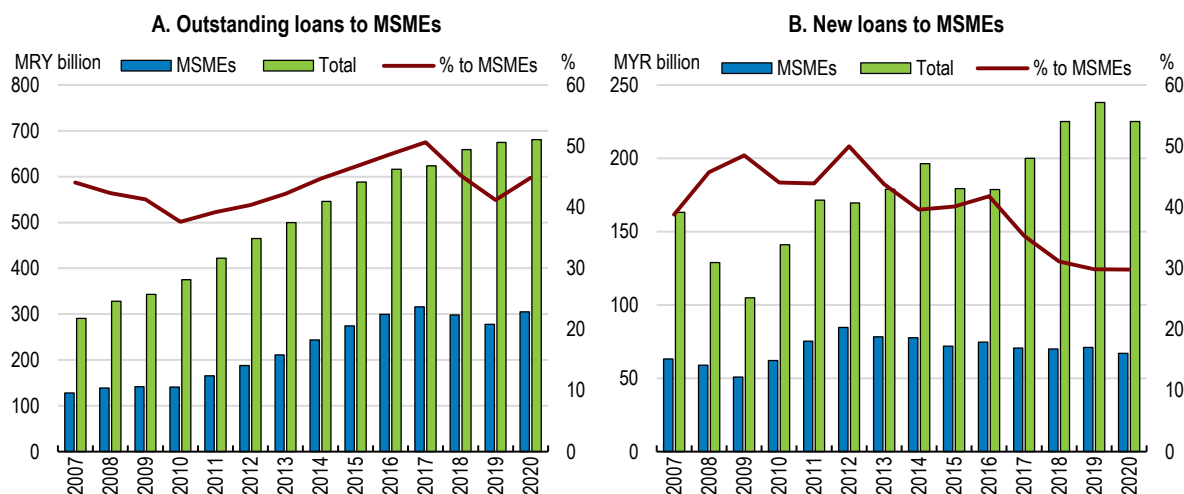
While government policies are needed to help overcome market failures that limit MSME financing, generous government support for SMEs has negative side effects. First, it crowds out private funding and hinders financial market development by reducing financial institutions' incentives to develop credit evaluation and risk management skills. Instead, it encourages them to rely on government credit guarantees. MSMEs also have an incentive to rely on government loans, which tend to carry lower interest rates than loans from financial institutions. Second, government financing can delay the necessary restructuring and possible exit of MSMEs. This distorts resource allocation by limiting the scope for the entry of new firms and the expansion of innovative firms. Studies in Korea show that public programmes to support SME financing actually lowered the productivity of recipient firms and increased the survival probability of incompetent ones (Chang, 2016<sup>[37]</sup>). Third, the higher leverage of MSMEs resulting from government support can raise financial-sector risks. Fourth, public support can discourage some MSMEs from scaling up in order to continue receiving long-lasting public support and avoid the abrupt end to such support once they graduate from MSME status. Such firms thus fail to experience the productivity gains from scaling up (see above). In Japan, for example, the thresholds on capital in the definition of SMEs significantly discouraged investment by firms just below the limit. When the threshold was raised, the share of firms that increased their capital was significantly higher for those just below the threshold than for those already above the threshold or well below it (Tsuruta, 2017<sup>[47]</sup>).

### *Government policies to promote the financing of MSMEs*

MSMEs received 97% of their financing in 2023 through loans from commercial banks. Another 2% was provided by development financial institutions (DFIs), which the government established to develop and promote strategically important sectors. In 2016, DFIs' had 94 loan schemes. Direct government lending through DFIs offers advantages such as targeted allocation, flexibility, customised financial products, and risk mitigation. According to a 2019 SME Corp. survey, 36.1% of MSMEs seeking new or additional financing applied to banks and 11.5% to DFIs. Outstanding bank loans to MSMEs rose steadily over 2010-17, accounting for about half of total business lending, before edging down before the pandemic (Figure 4.26, Panel A). New lending to MSMEs has trended down since 2012, reducing its share to below 30% (Figure 4.26, Panel B). Impaired loans to MSMEs in 2020 were 3.2% of their total loans, slightly below

the 3.4% of total business lending. In 2023, 50% of outstanding borrowing by MSMEs was used for working capital, 17% for construction, 9% for purchase of land and 6% for fixed assets other than land and buildings (Bank Negara Malaysia, 2024<sup>[48]</sup>).

**Figure 4.26. MSMEs' share of outstanding and new bank loans has edged down**

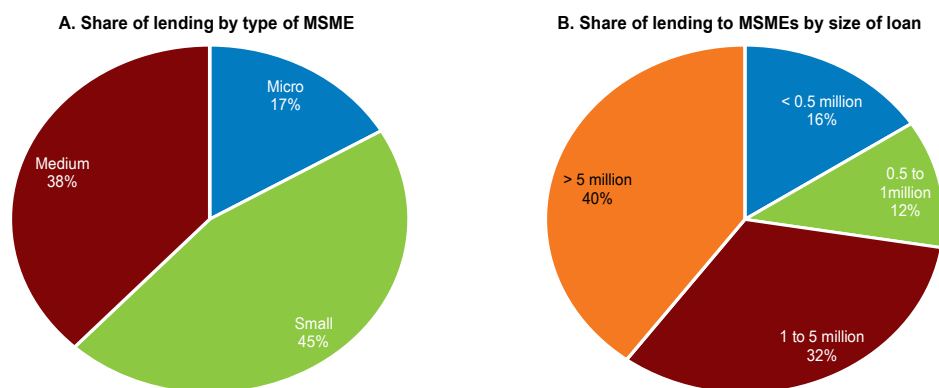


Source: OECD (2022), [Financing SMEs and Entrepreneurs 2024: An OECD Scoreboard | en | OECD](#).

StatLink <https://stat.link/h4wvkz>

The financing gap seems to be a problem particularly for micro firms, which received only 17% of new loans to MSMEs in 2023 (Figure 4.27, Panel A), although they account for around three-quarters of MSMEs. Moreover, loans over MYR 1 million (USD 209 thousand) accounted for almost three quarters of lending, suggesting that banks focused on larger firms in the MSME category (Figure 4.27, Panel B).

**Figure 4.27. MSME loans are primarily to small and medium firms and most exceed MYR 1 million**



Note: Includes loans from commercial and development financial institutions. The size of the loans in Panel B are in MYR.

Source: Bank Negara Malaysia (2024), Financial Inclusion Data for Malaysia - Bank Negara Malaysia ([bnm.gov.my](http://bnm.gov.my)).

StatLink <https://stat.link/ezbriv>

In 2017, 88.3% of government support for MSMEs was used to provide funding, focusing on innovative new sectors, social inclusion and Bumiputera firms, i.e., firms owned by ethnic Malays and other indigenous peoples (Box 4.6). This indicates that financing is the key stumbling block for MSMEs. Financing programmes aimed to reach nearly 400 000 MSMEs, almost half of the total in 2017 (OECD/ERIA, 2018<sup>[49]</sup>). In addition to direct lending and guarantees, the government provides grants (eight schemes as of 2016) and equity (14 schemes) to MSMEs in all sectors and stages of development (SME Corp., n.d.<sup>[50]</sup>). For example, the provides grants to firms to help them introduce automation technology.

### Box 4.6. Malaysia's policies to improve the economic status of Bumiputera

In 1971, Malaysia launched the New Economic Policy (NEP) to promote national unity and foster nation-building by eradicating poverty. It also aimed to restructure society by improving the well-being of Bumiputera (literally “sons of the land”), which refers to the Malays and indigenous people. Bumiputera accounted for 63% of Malaysia's population in 2023, with smaller population shares accounted for by ethnic Chinese (20%), ethnic Indians (6%) and foreigners (10%). The Bumiputera agenda continues to be a national agenda to improve the economic status of the Bumiputera population for attaining fair, equitable and inclusive growth. The NEP included a target that by 1990, Bumiputera should own at least 30% of corporate equity. The 2015-2019 Eleventh Malaysia Plan added that Bumiputera should have 30% ownership with “effective control”.

The NEP has transformed Malaysia by promoting Bumiputera's participation in higher education, high-level occupations, enterprise management and wealth ownership (Lee, 2021<sup>[51]</sup>). In addition to subsidies, the Bumiputera were granted other advantages including quotas in university enrolment, government contracts and procurement, business licences and loans, and employment in the civil service and government-related entities. While the NEP presented a broad vision of a greater economic role for Bumiputra, the 30% equity target has received disproportionate attention. Bumiputera's share of equity ownership increased from 2.4% in 1970 to 16.9% in 2018 (Table 4.4). The failure to achieve the target reflects the liberalisation of a number of economic sectors, including the relaxation of the condition of 30% Bumiputera equity ownership in the manufacturing sector, which led to divestment to non-Bumiputera and foreigners.

**Table 4.4. Bumiputera's share of equity ownership remains below the 30% target**

Category	NEP target	1970	1980	1990	1999	2004	2008	2011	2015	2018
<b>Malaysian</b>	70.0	36.6	57.0	74.9	67.3	67.5	62.1	62.8	54.7	55.1
Bumiputera	30.0	2.4	12.5	19.3	19.1	18.9	21.9	23.4	16.2	16.9
Non-Bumiputera	40.0	34.3	44.5	46.8	40.3	40.6	36.7	34.8	30.7	26.3
Nominee companies <sup>1</sup>	..	..	..	8.5	7.9	8.0	3.5	4.5	7.8	11.9
<b>Foreign</b>	30.0	63.4	43.0	25.4	32.7	32.5	37.9	37.2	45.3	44.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. “Nominee companies” are firms that join joint ventures with foreign companies to meet ownership requirements for foreign direct investment. Local shareholders waive their economic interest and voting rights.

Source: Economic Planning Unit.

The Twelfth Malaysia Plan stated, “the key issues faced by Bumiputera are the inequitable distribution of income, the high incidence of poverty and unemployment rate as well as the high concentration in low-skilled occupational categories”. The incidence of absolute poverty among the Bumiputera in 2022 was 7.9%, compared to the national average of 6.2% and 1.9% among the Chinese. The median income of Bumiputera households has risen from 67% of the national average in 1974, shortly after the launch of the NEP, to 91% in 2022.

Bumiputera are primarily involved in micro, low value-added businesses. Bumiputera entrepreneurs have a “high dependency on government assistance”, which provides financial assistance to support start-ups and the expansion of existing firms through a range of targeted programmes (Ministry of Economy, 2021<sup>[2]</sup>). The Twelfth Malaysia Plan reaffirmed the target of boosting Bumiputera's share of corporate equity ownership to at least 30% by 2025, although there are difficult measurement issues involved in calculating Bumiputera's equity ownership, such as the exclusion of government ownership.

While the NEP has significantly narrowed inequality between the Bumiputera and other ethnicities, it has also been criticised for negative side effects. Some have argued that this has encouraged rent-seeking behaviour and government patronage and hindered the development of the Bumiputera communities' capability and competitiveness, with adverse effects for the Malaysian economy (Lee, 2021<sup>[51]</sup>). The NEP also has negative implications for trade, as it mandates the allocation of a portion of government procurement to firms with Bumiputera ownership.

The significant progress in narrowing the income gap raises the question of whether the negative side effects of current policies now outweigh their benefits. Given the decline in income inequality between Malaysia's different ethnicities, a gradual phasing out of the NEP, accompanied by expanding social assistance for all low-income households (Chapter 2) and greater emphasis on policies promoting the scaling up all MSMEs may be beneficial for Malaysia.

Around half of MSMEs that received loans in 2022 pledged collateral, which on average was about 55% of the loan amount (OECD/ERIA, 2018<sup>[49]</sup>). Many firms with no or inadequate collateral and an insufficient financial track record cannot obtain financing, or if they do, the amount is insufficient. Moreover, some firms do not even apply due to their lack of financial literacy, negative perception of financial markets or preference to avoid debt. To help such firms, Malaysia uses credit guarantees to enable MSMEs to increase their access to financing and/or reduce its cost. Guarantees reduce the risk to lenders, prompting them to offer better rates, terms and conditions. According to a 2019 government survey, two-thirds of MSME loan applications were approved with collateral and/or guarantees. The 2024 federal budget earmarked MYR 20 billion (1.0% of GDP) to provide additional guarantees to MSMEs, with particular attention to those involved in the green economy, technology and halal sectors. Malaysia has two major guarantee providers:

- The Credit Guarantee Corporation Malaysia Berhad (CGC), established in 1972, had provided 442 000 financing packages valued at MYR 63.7 billion (USD 13.3 billion) by 2017 (OECD/ERIA, 2018<sup>[49]</sup>). The CGC and the partner financial institutions share the risks. The CGC guarantees loans up to MYR 500 000 (USD 105 000). At the end of 2022, the CGC's outstanding stock of guarantees was MYR 21.9 billion (1.1% of GDP).
- The Syarikat Jaminan Pembiayaan Perniagaan Berhad (SJPP) was created in 2009 as a wholly-owned company of the Minister of Finance, Incorporated to provide guarantees for loans to MSMEs. The government determines the terms for each of the nine SJPP guarantee schemes provided by the 22 participating banks. Thus far, the SJPP has assisted more than 100 000 SMEs, with a total value of guarantees exceeding MYR 80 billion. Taking account of repayments and settlements, the outstanding stock of guarantees is MYR 37.3 billion (1.9% of GDP).

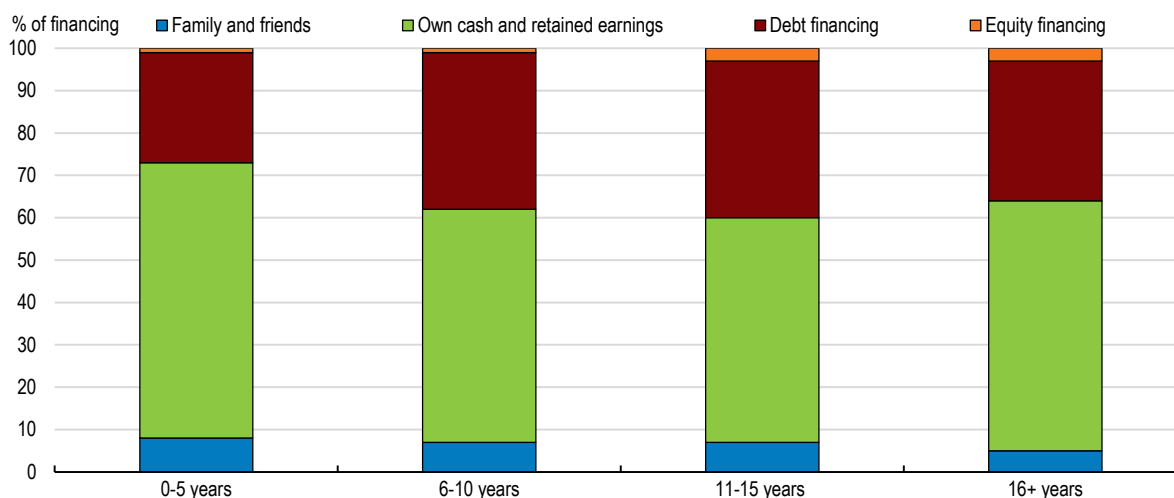
Malaysia's credit guarantee schemes for MSMEs follow best practices by setting guarantees below 100% of the loan so that the lending institution has "skin in the game". Completely guaranteeing loans would weaken market forces as banks have less incentive to monitor such loans, as they do not face a loss in case of default. Moreover, in Malaysia, before the credit guarantor approves the claims, it needs to be satisfied that the banks have fulfilled their responsibility in collecting the debt. Still, lowering the ratio to the 75-80% range typical in OECD countries would further strengthen incentives for banks. Once loans are given to a firm, financial institutions and credit guarantee providers share a common interest in its survival, as a default would result in losses for both of them. To delay or prevent such a loss, they may continue to support the firm, a phenomenon referred to as "evergreening", which facilitates the survival of "zombie firms", and slows economic growth. In addition, it is essential to ensure that loans support new firms rather than artificially extend the life of non-viable firms, allowing them to continue to compete with unsupported firms. In Malaysia, 47% of the firms receiving guarantees were at least ten years old. Limiting the length of guarantees would increase the share of young firms among beneficiary firms, thereby ensuring that support for older firms does not crowd out young enterprises (Jones and Lee, 2016<sup>[52]</sup>).

*Greater MSME access to alternative financing models would be beneficial*

Given MSMEs' reliance on bank loans for 97% of their external financing, measures to improve their access to lending is crucial. At the same time, it is essential to expand other financing sources. While Malaysia's entrepreneurial ecosystem as a whole compares favourably with neighbouring countries, the lack of risk capital is an obstacle (Global Entrepreneurship and Development Institute, 2019<sup>[53]</sup>). In 2023, own cash – retained earnings and family and friends – accounted for nearly three-quarters of financing for firms less than six years old (Figure 4.28). Such sources of financing stifle firm creation as entrepreneurs risk “losing it all” (Kuriakose et al., 2022<sup>[54]</sup>). Moreover, many MSMEs are risk-averse and prefer to avoid debt or at least limit it. Equity financing plays a minor role, even for firms more than 15 years old. In 2023, equity accounted for only 2% of MSMEs' funding. The government aims to transform Malaysia into a top 20 global start-up ecosystem by 2030.

**Figure 4.28. Young firms rely primarily on internal funds for financing**

In 2023



Source: Bank Negara Malaysia (2024), [Financial Inclusion Data for Malaysia - Bank Negara Malaysia \(bnm.gov.my\)](https://www.bnm.gov.my/en/financial-inclusion).

StatLink  <https://stat.link/s2tilm>

Bank loans, which account for 98% of MSME external financing, are better suited to more established businesses with proven track records. However, they are less suitable for high-risk, high-growth start-ups and early-stage firms, which tend to have limited collateral and uncertain revenues in the short run. Meeting MSMEs' financing needs instead requires greater reliance on alternative funding sources, as “the traditional forms of financing are found increasingly to be inadequate” (OECD, 2024<sup>[55]</sup>). The Twelfth Malaysia Plan aims to develop “a vibrant alternative financing to complement the banking system” (Ministry of Economy, 2021<sup>[2]</sup>). Equity financing would be a more suitable instrument for MSMEs, but it is difficult for them to access the Bursa Malaysia, one of the largest stock markets in ASEAN countries. The government has created two additional markets tailored toward smaller firms:

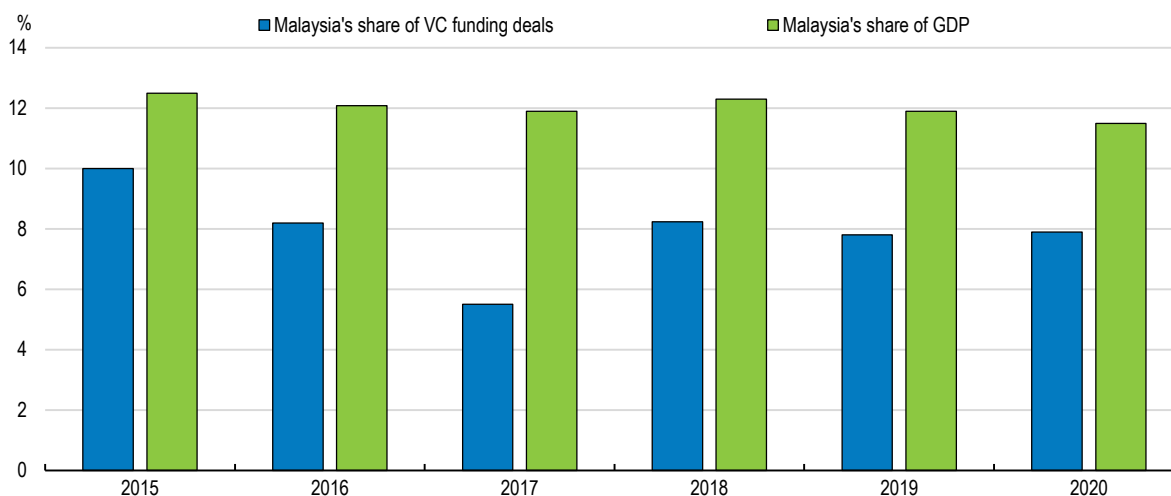
- The ACE Market, established in 2009 with lower listing requirements, provides a platform for small and growing companies to raise capital. Currently, 176 firms are listed on the ACE Market. However, its market capitalisation is less than 1% of GDP compared to 12% for KOSDAQ, which plays a similar role in Korea.
- The Bursa Malaysia launched the Leading Entrepreneur Accelerator Platform (LEAP Market) in 2017. Given the higher risk involved, only experienced investors and high net-worth individuals or entities can invest in LEAP companies. The LEAP market is aimed in part at Bumiputera firms. A company must have a Bumiputera ownership share of at least 12.5% to be eligible for the LEAP

market. In 2018, the government announced an initiative to reduce the cost of listing in order to encourage at least 100 Bumiputera companies to join the LEAP Market and will reimburse the cost for Bumiputera firms that have already joined (OECD/ERIA, 2018<sup>[49]</sup>). By 2023, 48 companies had listed on the Leap Market, with total market capitalisation amounting to MYR 5.5 billion (USD 1.15 billion).

New ways of accessing equity, including venture capital, private equity, equity crowdfunding and peer-to-peer financing, can help overcome market failures. Venture capital in Malaysia is relatively small relative to its GDP compared to other countries in the region (Figure 4.29), suggesting significant scope for growth. Moreover, the average deal size for seed funding is also low compared to its regional peers, suggesting a lack of high-quality investment opportunities. Indeed, the modest levels of R&D and knowledge creation in Malaysia may limit the number of deals below that required to facilitate the emergence of a vibrant venture capital industry. Increasing R&D in line with the government’s target, as noted above, would help spark an increase in venture capital. The number of registered venture capital corporations stood at 106 at the end of 2021, with total committed funds of MYR 5.2 billion (USD 1.2 billion). In 2020, 108 venture capital deals were recorded, focusing on early stage firms (50.5%) and growth (38.9%) (OECD, 2022<sup>[56]</sup>). Venture capital investment is skewed toward more established, later-stage firms (Kuriakose et al., 2022<sup>[54]</sup>).

### Figure 4.29. Malaysia’s share of venture capital deals is low relative to the size of its economy

Malaysia’s share of venture capital deals and GDP among five other Southeast Asian peers



Source: Kuriakose, S. et al. (2022), Malaysia - Assessment of the Start-Up Financing Ecosystem.

StatLink  <https://stat.link/elv4x5>

A large share of venture capital-backed deals are funded by public-sector entities such as government agencies and government-linked investment companies (45.0%) and sovereign wealth funds (27.9%), suggesting a need to crowd-in greater private-sector funding. Given significant untapped liquidity in the corporate sector, its share of venture capital funding could be raised above its current level of 19.7%. The Angel Tax Incentive Office was established in 2013 to encourage early-stage investments by private-sector angels. However, Malaysia’s major weakness in venture capital, according to the Venture Capital and Private Equity Country Attractiveness Index, are administrative burdens and the slow implementation of a range of tax incentives to encourage additional investment (Groh et al., 2023<sup>[57]</sup>). A World Bank study stated that “improving the clarity of the legal and regulatory framework for the VC industry is essential to enhance investor confidence and to crowd-in a higher degree of private venture capital funds” (Kuriakose et al., 2022<sup>[54]</sup>).

Private equity (capital invested in an entity not publicly listed or traded) is another investment channel. In 2020, Malaysia had 21 private equity firms and a total of MYR 9.65 billion (USD 2.3 billion) in committed funds. Primary sources of funds are corporate investors (31.5%), individuals and families (17.1%) and fund-of-funds and other asset managers (13.1%). In 2020, 29 private equity deals were recorded. Private equity in Malaysia is still skewed toward leveraged buyout exits rather than growth-stage investments in terms of the relative number of deals. In contrast to venture capital, government entities and sovereign wealth funds account for less than 2% of the investment (Kuriakose et al., 2022<sup>[54]</sup>).

The Securities Commission Malaysia (SC) has facilitated the development of alternative financing platforms that connect firms with traditionally untapped pools of investors through cheaper, faster and more convenient non-banking channels. These include equity crowdfunding and peer-to-peer (P2P) (OECD, 2024<sup>[55]</sup>). The Malaysia Co-Investment Fund (MCIF) was established in 2019 to co-invest in MSMEs with private investors through equity crowdfunding and P2P platforms. Thus far, the MCIF has co-invested over MYR 357 million (USD 75 million) in 16 000 campaigns involving 2 280 firms (0.2% of MSMEs).

- *Equity crowdfunding*: In 2015, Malaysia became the first ASEAN country to establish a framework for equity crowdfunding (which differs from rewards and donation crowdfunding). It now has ten operators registered with the Securities Commission. In 2020, total capital raised grew by more than five-fold to MYR 127.7 million (USD 37 million) via 80 campaigns, with about half the amount concentrated in firms in the pre-seed and seed funding stages. Online crowdfunding platforms allow entrepreneurs and firms to showcase their projects to more potential investors than conventional forms of raising capital. The process is less burdensome than the more traditional Initial Public Offerings (IPOs) approach. Most of the fundraising was by technology-focused issuers based primarily in Kuala Lumpur and Selangor aiming to expand their businesses. Around 45% of the campaigns raised more than MYR 0.5 million (USD 105 000) in 2020 (Kuriakose et al., 2022<sup>[54]</sup>).
- *Peer-to-peer financing (P2P)*: Malaysia has 11 P2P lending platforms registered with the Securities Commission. This approach, which usually occurs on third-party platforms that function as matchmakers connecting lenders with borrowers, raised total capital of MYR 503.3 million (USD 105 million) in 2020. A total of 1 325 issuers successfully participated in 7 760 campaigns. Compared to equity crowdfunding, P2P generally raised smaller amounts: 74% of the campaigns generated less than MYR 50 000. Another difference is that three-quarters involved terms of three months or less, usually for working capital. P2P is similar to equity crowdfunding in its concentration in Kuala Lumpur and Selangor (63% of issuers) and its focus on technology (36%).

New financing methods, such as equity crowdfunding and P2P, have proven successful in some countries helping firms raise capital without incurring new debt. In Malaysia, however, they are still in a nascent stage, reflecting MSMEs' lack of awareness and financial literacy. Moreover, MSMEs may find alternative financing methods unattractive due to the loss of ownership, costly administrative procedures and increased scrutiny.

Creating an appropriate regulatory framework for new forms of attracting equity is crucial to ensure its success and protect all parties involved. Unlike conventional capital-raising methods for early-stage companies, which primarily rely on investments from a small group of professional investors, equity crowdfunding targets a broader range of investors. With numerous small shareholders participating, protecting investors by ensuring transparency and preventing fraudulent activities is crucial. To address the concerns of numerous small shareholders, companies seeking crowdfunding should be required to disclose relevant information to investors and regulatory authorities. For example, in the United States, transactions must take place online through a Securities and Exchange Commission intermediary. Restrictions on the amount individual investors can invest and the participation of non-accredited investors are also needed. A balanced regulatory framework can enhance market confidence, encouraging more

investors to participate in crowdfunding while avoiding excessively stringent regulation could stifle creativity and hinder its growth.

Greater access to funding, both direct and indirect, for MSMEs also depends on enhancing their financial literacy. The G20/OECD High-Level Principles on SME Financing (2015) stated that “public policies should champion SMEs’ enhanced financial literacy and their awareness and understanding of the broad range of available financial instruments” (G20/OECD, 2015<sup>[6]</sup>). Numerous studies in Malaysia have found a positive relationship between MSMEs’ performance and the financial literacy skills of their owners and managers. This includes their understanding of such topics as debt, savings, insurance and investment (Yakob et al., 2021<sup>[58]</sup>). The government has taken steps to improve financial literacy through the combined efforts of 60 Entrepreneurship Development Organisations, DFIs and commercial banks. It also launched the five-year National Strategy for Financial Literacy in 2019 to foster financial awareness and increase access to financial management tools and resources. The Financial Education Network monitors the implementation of the Strategy, focusing on MSMEs and low-income groups (Financial Education Network, 2023<sup>[59]</sup>). Policies implemented in Mexico and Canada (Box 4.5) have useful measures that contribute to management capabilities and financial literacy.

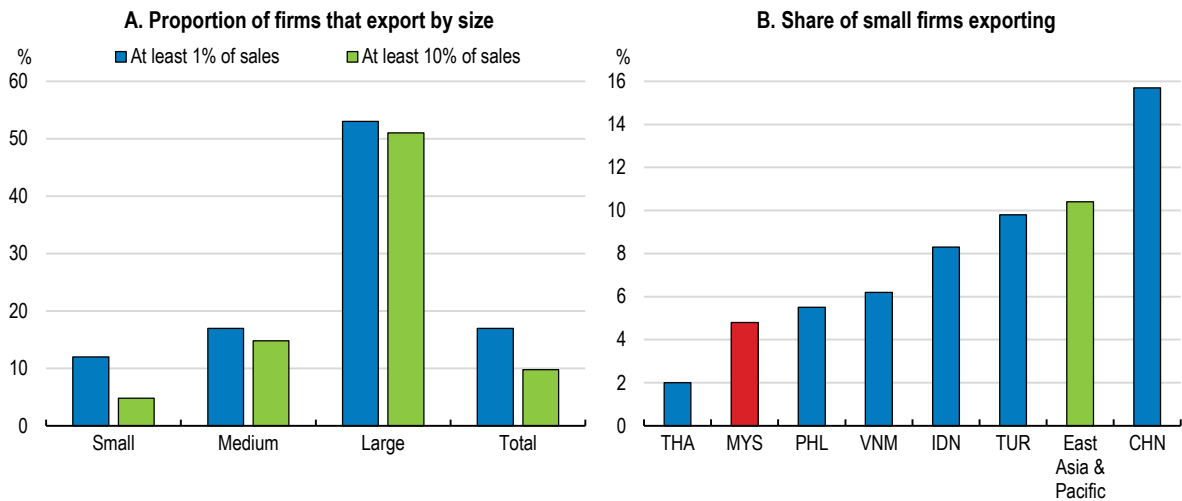
### ***Enhancing MSMEs role in international trade***

The Mid-Term Review of the Twelfth Malaysia Plan stated that integrating MSMEs into global value chains is a key to their scaling up (Ministry of Economy, 2023<sup>[9]</sup>). Selling products and services in foreign markets increases the probability that an MSME will scale up and achieve a high-growth episode. This could result from self-selection; better-performing firms are more likely to choose to become exporters or seek foreign partnerships (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). However, the OECD study of European MSMEs found that future high-growth firms began exporting before they started scaling up. Indeed, their propensity to trade was similar to the larger firms to which they eventually caught up. In other words, the increased trade of future scaler firms was not a random episode resulting from greater foreign demand, but rather a strategic decision to experiment with more products and destinations (OECD, 2021<sup>[14]</sup>). This suggests that policies to increase MSME integration in global markets should be part of government policies to support the scaling up of small firms.

Firms with global linkages tend to be larger, more productive and profitable, pay higher wages and have higher rates of technology adoption. Global exposure can improve MSMEs’ performance as they “learn from exporting” how to improve product quality. It also allows MSMEs to optimise their sourcing strategies by giving them access to less expensive and more advanced imported products and services and to obtain foreign technology (OECD, 2021<sup>[14]</sup>). In Malaysia, firms’ investment in digital assets and solutions is positively correlated with exporting (Kuriakose et al., 2022<sup>[27]</sup>).

Large firms dominate Malaysia’s exports. Exports account for at least 10% of revenues for 50% of large firms and 12% of medium firms, but less than 5% of small firms (Figure 4.30, Panel A). The proportion of Malaysian small firms that meet the 10% threshold is low compared to other countries (Figure 4.30, Panel B). MSMEs’ share of Malaysia’s exports dropped significantly with the outbreak of COVID-19, reducing the share from 17.7% in 2015 to 10.5% in 2022, even as MSMEs’ share of GDP and employment remained level (Figure 4.31, Panel A). A 70% drop in services exports, reflecting the sharp drop in tourism during the pandemic, was primarily responsible for the decline (Figure 4.31, Panel B). However, MSMEs’ service exports failed to rebound in 2022, even as Malaysia’s total exports increased by 25% in value terms.

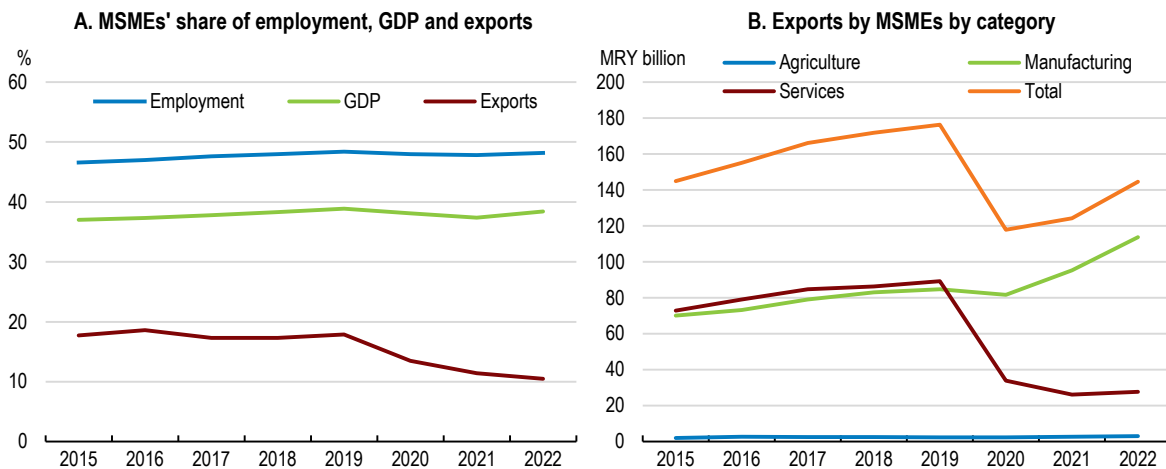
**Figure 4.30. Only a few small firms are exporters**



Note: Panel B shows the share of small firms for which exports (direct or indirect) account for at least 10% of sales.  
 Source: Kuriakose, S. and H. Tiew (2022), Malaysia: SME Program Efficiency Review.

StatLink <https://stat.link/8ljcvb>

**Figure 4.31. MSMEs' exports account for a small share of Malaysia's exports and the share has fallen**



Source: Department of Statistics Malaysia (2023), *Micro, Small & Medium Enterprises Report 2022*.

StatLink <https://stat.link/1thdqj>

One of the “game-changers” in the Twelfth Malaysia Plan is to shift MSMEs from domestic to global markets and raise their share of total exports to 25%. The low share of exports reflects the fact that only a fifth of MSMEs supply goods and services to large firms, which instead source inputs primarily from other large firms and from overseas (Ministry of Economy, 2023<sup>[9]</sup>). The government’s Inclusive Business model aims to strengthen MSME participation in the value chains of government-linked companies and multi-national corporations in high-impact industries. Foreign investors can claim tax deductions for costs involved in providing support to local suppliers, including training, product development and testing, and factory auditing to ensure the quality of local suppliers.

Moreover, government procurement will be fully leveraged to support MSMEs in the domestic market (Ministry of Economy, 2021<sup>[2]</sup>). Government procurement has long given preferential treatment to MSMEs and to firms owned by Bumiputera (Lee, 2021<sup>[51]</sup>). In 2018, 29 OECD countries had policies to enhance

SMEs' access to public procurement through various means, such as promoting joint bidding of SMEs with large companies, breaking large contracts into lots to enable SMEs to bid, and e-procurement to facilitate the bidding process (Jones and Lee, 2018<sup>[60]</sup>). Such policies helped to create a more level playing field for SMEs, while maintaining efficiency-enhancing competition. However, reserving a certain amount of procurement for SMEs can have the unintended side effect of increasing dependency on public support and slowing productivity gains. In Korea, for example, SMEs chosen for public procurement in 2009 had significantly lower productivity in 2011 (Jones and Lee, 2018<sup>[60]</sup>).

Malaysia's membership in key multilateral and bilateral trade agreements offers significant export opportunities, including to MSMEs. In 2022, Malaysia joined two of the world's largest trade agreements; *i*) the Regional Comprehensive Economic Partnership (RCEP), which includes the ten ASEAN members and China, Korea, Australia, Japan and New Zealand; and *ii*) the Comprehensive and Progressive Agreement for the Trans-Pacific Partnership (CPTPP), which allows Malaysia preferential access to Canada, Mexico, and Peru, which had not been part of Malaysia's previous free trade agreements (FTAs). CPTPP goes beyond traditional FTAs by addressing the development of the digital economy and the role of MSMEs in the global economy. RCEP and the CPTPP allow MSMEs to access a broader market of about 2.3 billion. In addition, as a member of ASEAN, Malaysia has regional FTAs with China, Japan, Korea, India, Australia, New Zealand and Hong Kong, China. Moreover, Malaysia has bilateral FTAs with seven countries (Australia, Chile, India, Japan, New Zealand, Pakistan and Turkey). These agreements reduce tariffs and trade barriers, simplify export procedures, reduce administrative burdens and costs, and harmonise trade rules and regulations among member countries. The Twelfth Malaysia Plan stated that the government will "leverage the benefits of FTAs in widening market access and accelerating the internationalisation of MSMEs". It also pledged that "the 'Buy Malaysia Campaign' will be intensified to support local MSMEs", though this could run counter to international trade agreements (Ministry of Economy, 2021<sup>[2]</sup>).

However, many MSMEs lack the expertise to utilise these agreements effectively, thus limiting their entry into new markets and global supply chains. The Ministry of Investment, Trade and Industry (MITI) is encouraging MSMEs to explore overseas markets through its trade promotion agency, MATRADE. Its Export Readiness Assessment Tool (ERAT) is a free online service to assess firms' export capability. MATRADE also uses its network of 49 overseas offices to help match foreign buyers with local companies. In some countries, MSMEs have created export consortia to increase their role in international trade (Box 4.7).

Malaysia would benefit from laying the foundations for reaching FTAs with other major economies. This includes removing barriers to foreign participation in government procurement and considering adhering to the WTO Government Procurement Agreement, which would likely help to reach new trade agreements as it has been a stumbling stone in earlier FTA negotiations. This could be part of efforts to de-emphasise ethnic ownership targets in favour of promoting the scaling-up of all MSMEs, which would greatly benefit Bumiputera (Box 4.6).

Trade agreements also address e-commerce and digital trade regulations, providing a framework for MSMEs to expand their business operations beyond national borders. The National E-Commerce Strategic Roadmap 2.0 aims to triple the number of MSMEs using e-commerce to export from 27 000 in 2020 to 84 000 in 2025. In the digital era, trade involves complex regulatory frameworks related to electronic transactions, secured payment systems, intellectual property rights and cross-border digital services. The impact of digital trade barriers fall disproportionately on MSMEs, reflecting the higher compliance costs of diverging regulations across countries. Service trade barriers may result in an additional tariff equivalent that is as high as 7% on small firms' cross-border exports compared to large firm (Rouzet, Benz and Spinelli, 2017<sup>[61]</sup>). Smaller firms in Malaysia and other ASEAN countries are more likely to export if they have a web presence (López González, 2019<sup>[62]</sup>), making digitalisation a key to increasing their role in global trade. The OECD Digital Services Trade Restrictiveness Index, which measures the openness of

the regulatory environments in these areas, shows that Malaysia is more open than the OECD average and other ASEAN countries (Figure 4.32). Malaysia has actively contributed to regional and international regulatory harmonisation in forums such as APEC and ASEAN (OECD, 2021<sup>[30]</sup>).

#### Box 4.7. Export consortia: the case of Italy

An MSME can significantly enhance its export potential and lower the costs and risks involved in entering foreign markets by forming an export consortium with other companies. An export consortium is a voluntary alliance of firms aimed at promoting the export of goods and services of its members through joint actions. This approach can help MSMEs overcome weaknesses that limit their participation in international trade, such as the lack of the necessary knowledge and financing, difficulty in meeting foreign regulatory requirements, and limited production quantities that are insufficient for foreign buyers. Participating firms retain their financial, legal, managerial, and commercial autonomy (UNIDO, 2024<sup>[63]</sup>).

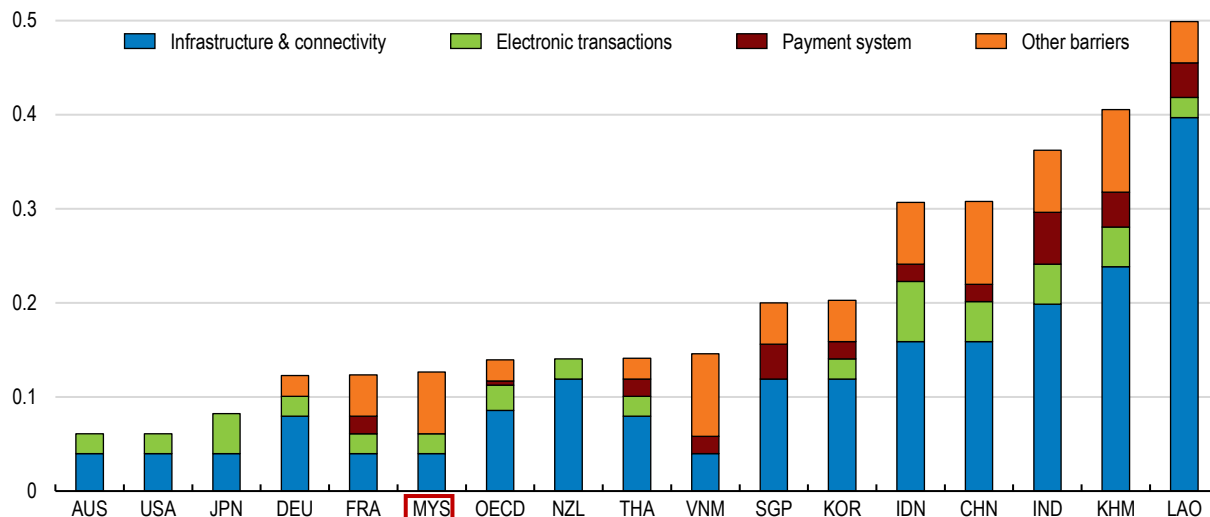
Italy has a long tradition of export consortia. Each consortium must have at least eight SMEs (five in southern Italy). Government grants, which average EUR 2-3 million annually, are provided to finance visits abroad, workshops and advertising. In 2014, the government funded 110 consortia, which included over 1 600 companies. The Italian Federation of Export Consortia (Feder-export) assists the consortia by providing tax and legal advice, organising conferences and market surveys, and negotiating credit lines with banks to finance the consortia's export activities (OECD, 2018<sup>[43]</sup>).

The export consortia has succeeded by helping SMEs attain the scale needed to internationalise. Moreover, the policy leverages government funds by channelling resources to a group of SMEs, rather than individual firms, spreading the financial benefits across a larger number of beneficiaries. The implementation costs are reduced because the government only interfaces with the leaders of the consortia. The collaboration and knowledge exchange can extend beyond the initial objective of increased export activity. However, one drawback is that turnover in government-supported consortia has been limited, as some have become overly dependent on government support (OECD, 2018<sup>[43]</sup>). Still, the export consortia approach could be successful in Malaysia, which has a long history of co-operatives. Other countries, such as Argentina, Brazil, India, Morocco and Tunisia, have created export consortia and the OECD has recommended this approach to Indonesia (OECD, 2018<sup>[43]</sup>).

Malaysian companies must be prepared to meet Environment, Social and Governance (ESG) standards to participate in global supply chains. Key global ESG regulatory standards include the EU's Carbon Border Adjustment Mechanism and Sustainable Finance Disclosure Regulation, the UK Sustainability Disclosure Requirements, and the German Supply Chain Due Diligence Act. Already in 2022, almost 9 600 companies with a total market capitalisation of USD 98 trillion (87% of the world total) disclosed sustainability-related information (OECD, 2024<sup>[64]</sup>). In 2023, Malaysia became the first country in the world to provide MSMEs operating in global supply chains with a streamlined and standardised set of guidelines in relation to ESG. The guidelines were prepared by Capital Markets Malaysia, an affiliate of the Securities Commission Malaysia (SC). In addition, the New Industrial Master Plan 2030, launched in 2023, aims to "build SMEs' ESG capacity to help secure their continued participation in ESG-compliant MNC vendor ecosystems" (Minister of Investment, Trade and Industry, 2023<sup>[34]</sup>). Such measures will also help MSMEs join international value chains.

**Figure 4.32. Malaysia is relatively open to digital trade**

0 (open) to 1 (closed)



Note: Other refers to intellectual property rights and other barriers affecting trade in digitally enabled services.

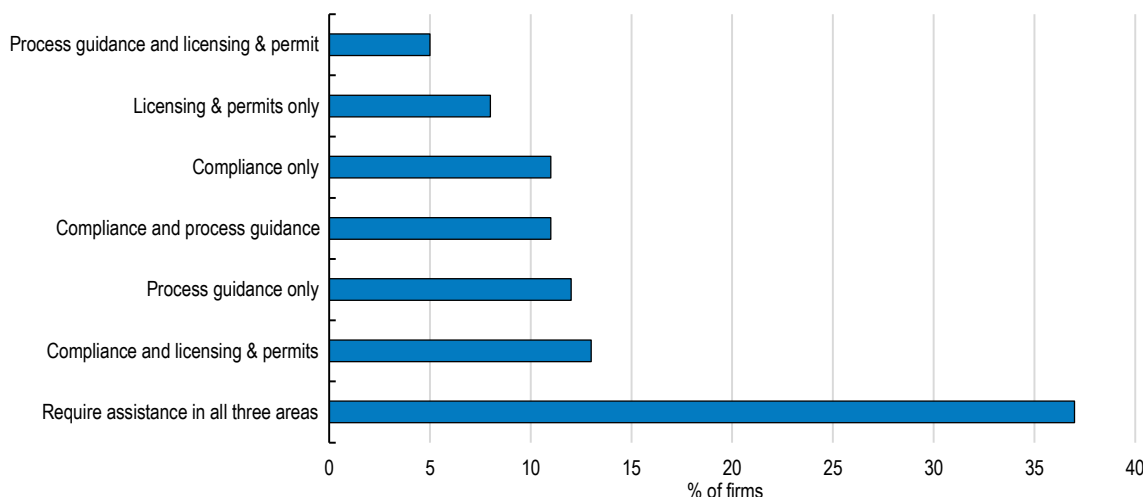
Source: OECD, Services Trade Restrictiveness Index database.

StatLink  <https://stat.link/7hy0oz>

### Regulatory reform to facilitate the scaling up of MSMEs

A regulatory environment that fosters competition and encourages business dynamism can be instrumental to boost MSME productivity, while burdensome regulations can limit MSMEs' ability to scale up (Andrews, Criscuolo and Gal, 2015<sup>[65]</sup>). Productivity-limiting regulations not only reduce the number of firms able to attain high growth but are also likely to misallocate resources in a way that allows less efficient firms to achieve high growth (Grover Goswami, Medvedev and Olafsen, 2019<sup>[8]</sup>). Malaysia launched the Modernising Business Regulation programme in 2007 to boost the country's productivity by reforming the regulatory structure (OECD, 2018<sup>[66]</sup>). The Twelfth Malaysia Plan identified "restricted market access" as a key factor responsible for MSME weakness (Ministry of Economy, 2021<sup>[2]</sup>). The Malaysia Productivity Corporation (MPC) is responsible for regulatory reviews to reduce red tape and bureaucratic hurdles to doing business. It estimates that there are 3 295 regulations comprising acts, regulations, permits and licences at the federal government level, covering the company life cycle from creating, operating and closing a business. Together, these regulations impose an estimated MYR 45 billion (2.3% of GDP) in compliance costs annually (Malaysia Productivity Corporation, 2023<sup>[40]</sup>).

Regulations require firms to monitor their suppliers, staff and operations, to report their compliance performance and show proof of licensing and permit applications. Many regulatory requirements are imposed by multiple agencies, increasing the time and resources needed for MSMEs to comply. Among informal entrepreneurs, around 40% reported that fees and the required documents and legal procedures discouraged them from formalising their operations (Ministry of Entrepreneur and Cooperatives Development, 2024<sup>[67]</sup>). In a 2018 survey of more than 2 000 MSMEs by the SME Corp. and Huawei, 37% said that they needed help with three tasks: *i*) regulatory compliance related to their business field; *ii*) process guidance for operating; and *iii*) meeting licensing and permit regulations (Figure 4.33). Another 29% required assistance for two of these tasks.

**Figure 4.33. MSMEs need assistance to comply with regulations**

Note: Based on a survey of 2 033 MSEMAs asking if they need assistance in three tasks; i) compliance; ii) process guidance; and iii) licensing & permits.

Source: SME Corp. and Huawei. (2018), *Accelerating Malaysian Digital SMEs: Escaping the Computerisation Trap*.

StatLink  <https://stat.link/an2fvr>

The MPC cited eight specific issues related to bureaucracy and red tape in Malaysia in their 2023 report that are key to reducing the regulatory burden (Malaysia Productivity Corporation, 2023<sup>[40]</sup>):

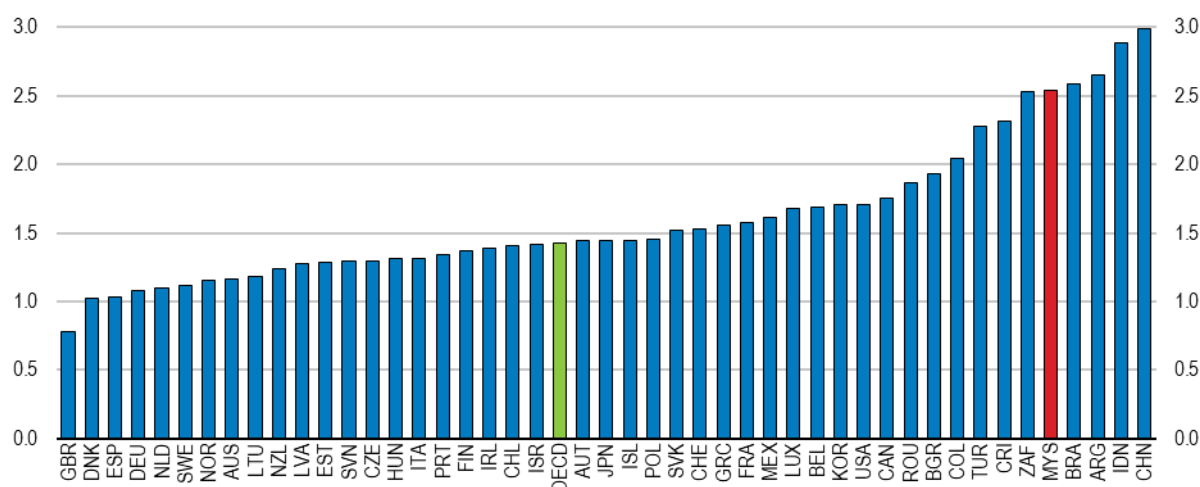
- **Lengthy processing time:** Permission for land conversion, for example, may take more than one year in some localities, reflecting a multiple-stage decision-making process. Risk-averse regulators may prioritise low-risk applications from businesses for fast processing.
- **Complex, numerous and overlapping procedures:** Applicants must often submit similar information to different agencies and regulators using forms and formats particular to each agency. A standardised application in a format acceptable to multiple agencies and creating “one-stop shops” would save time and money. In addition, digitalising the processes would simplify applications.
- **Sequential work process:** Many applications for licenses and permits require step-by-step approval from various agencies and regulators. Rather than waiting for the completion of one approval before advancing to the next step, allowing steps to be accomplished simultaneously would save time.
- **Lack of transparency and clarity:** Difficulty understanding regulations creates confusion and unpredictability for firms and may result in a misinterpretation of regulations. Making clear and precise guidelines for regulatory compliance available online would help resolve this issue.
- **Obsolete and outdated regulations:** In today’s fast-changing economic landscape, regulations can quickly become outdated, making them unclear and ineffective. To keep regulations up to date, frequent regulatory reviews are needed using the “guillotine” approach to identify and eliminate unnecessary and burdensome regulatory requirements.
- **Corruption and abuse of power:** Corruption increases the cost of doing business and creates an uneven playing field for businesses, thereby reducing trust and confidence in the government. Digitalising regulatory procedures decreases the risk of corruption by minimising in-person dealings.
- **Inconsistent enforcement of regulations:** Inconsistency leads to a lack of predictability, which is particularly harmful for investors, given their need for precise and accurate information. Centralising the regulatory procedures necessary for a specific project through a digital end-to-end, one-stop centre platform would standardise regulatory requirements.

- *Manual processing of regulatory processes and procedures:* Manual processing of documents to comply with regulatory requirements is still widely practised even though digital platforms are available. Shifting to digital platforms by educating regulators and the public would reduce time and costs.

The burdens imposed by Malaysia's regulatory policies on product market competition are high compared to OECD countries (Figure 4.34). Moreover, Malaysia ranks worse than all but four OECD countries in the complexity of its regulations (OECD-WBG, 2023<sup>[68]</sup>). The OECD Product Market Regulation (PMR) indicator assesses the extent to which regulations support or restrict competition in key sectors of the economy. This ranking is confirmed by the IMD's World Competitiveness Ranking, which places Malaysia 45<sup>th</sup> in business legislation (IMD, 2023<sup>[69]</sup>). While Malaysia ranks well behind OECD countries, its regulations are less restrictive than in large non-OECD countries covered by the indicators, including Indonesia and China.

**Figure 4.34. Product market regulation in Malaysia is more stringent than in most OECD countries**

Overall Product Market Regulation indicator, index scale of 0-6 from least to most restrictive



Note: Information used to calculate the OECD's 2018 PMR indicators is based on laws and regulations in place on 1 January 2018 or a later year (1 January 2020 for Malaysia).

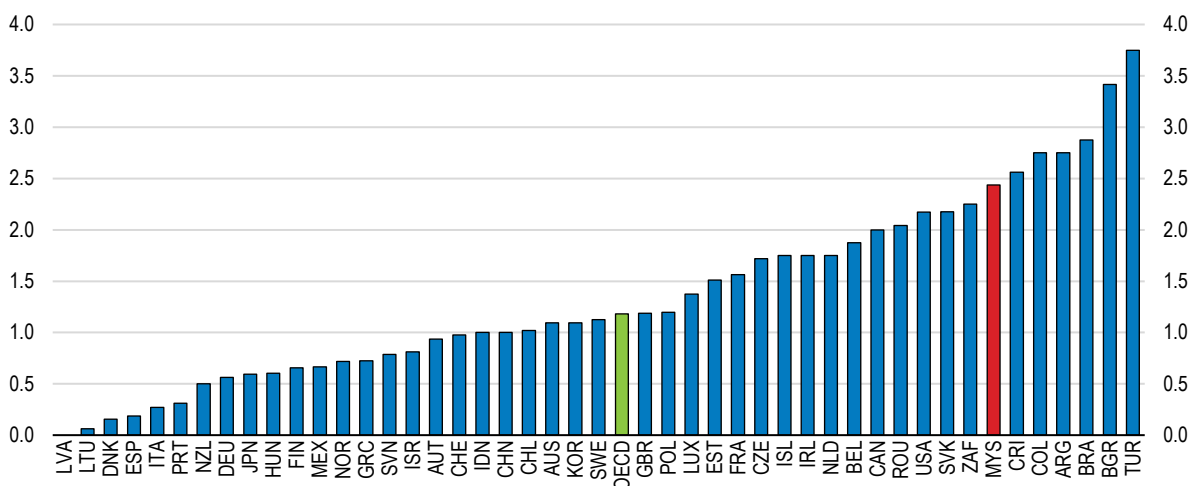
Source: OECD, *Product Market Regulation database*; and OECD-WBG, *Product Market Regulation database*.

StatLink  <https://stat.link/1lkndo>

The ease of starting a new business is a critical determinant of firm creation. Malaysia, which has a lower firm creation rate than the OECD average, has a relatively high administrative burden on new start-ups according to the OECD's PMR index, which is based on 2020 for Malaysia (Figure 4.35). The PMR index also shows that the burden of licenses and permits is higher than all but two OECD countries. The PMR result is consistent with the World Bank's 2020 *Doing Business Index*, which ranked Malaysia 126<sup>th</sup> in its indicator of starting a business.

### Figure 4.35. Malaysia has high administrative burdens on start-ups

Product Market Regulation indicator: Administrative burdens on start-ups, Index scale of 0-6 from least to most restrictive



Note: Information used to calculate the OECD's 2018 PMR indicators is based on laws and regulations in place on 1 January 2018 or a later year (1 January 2020 for Malaysia).

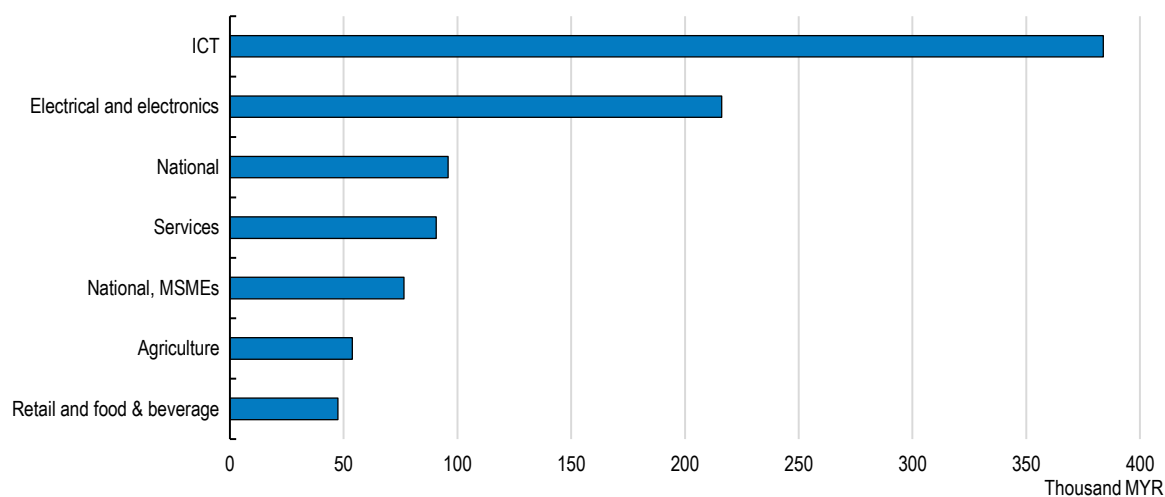
Source: OECD, *Product Market Regulation database*; and OECD-WBG, *Product Market Regulation database*.

StatLink  <https://stat.link/z4jio7>


The government has taken measures to address some of the key issues noted above that were cited by the MPC. In 2020, the government launched the MalaysiaBiz portal as a one-stop centre to manage business registration and licensing. This has helped make business registration more affordable and efficient, with registration fees ranging from MYR 30-60 and a registration time of four to five working days. In comparison to business registration, the process for obtaining the necessary licenses and permits to operate in Malaysia is significantly more burdensome. According to the 2023 Global Business Complexity Index (GBCI), Malaysia is the 21<sup>st</sup> most complex country in the world to do business. The Index compares differences in the rules and requirements for doing business in 78 jurisdictions around the world. Malaysia has improved from its ranking as ninth in 2020, suggesting that reform efforts have had an impact. Moreover, Malaysia is viewed more favourably than Indonesia (11<sup>th</sup>) and China (15<sup>th</sup>). Still, Malaysia has room for further improvement towards the Philippines (31<sup>st</sup>), India (33<sup>rd</sup>), Viet Nam (46<sup>th</sup>), Thailand (52<sup>nd</sup>) and Singapore (59<sup>th</sup>) (TMF Group, 2023<sup>[70]</sup>).

As noted above, 85% of MSMEs are in services, of which nearly half are in the retail sector, according to the 2016 census. Labour productivity in the retail and food and beverage sectors fell slightly below half of the national average after being hit hard by the pandemic (Figure 4.36). A more efficient retail sector may emerge, driven by the investments made to cope with COVID-19.

**Figure 4.36. Labour productivity in retail in Malaysia is less than half of the national average**



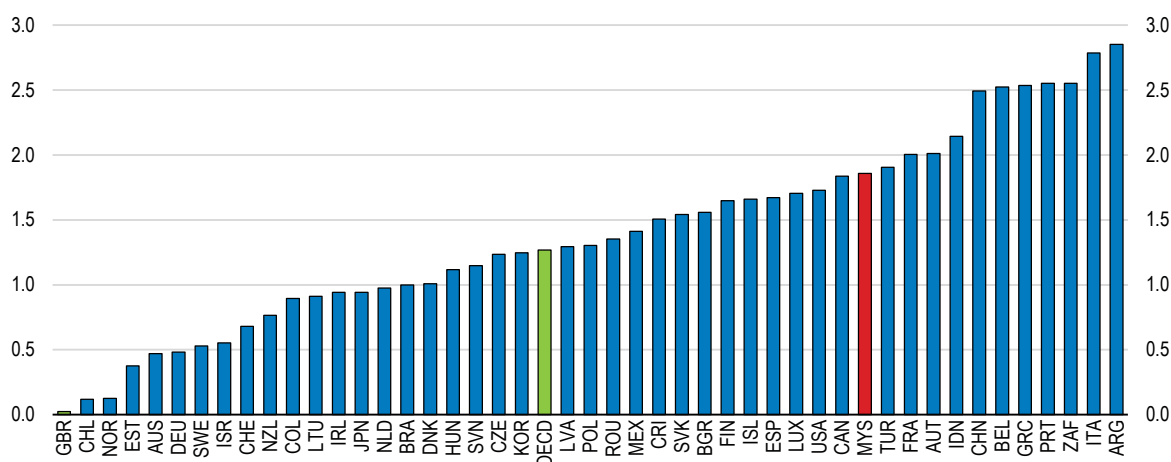
Source: Department of Statistics Malaysia (2023), *Micro, Small & Medium Enterprises Report 2022*; and Malaysia Productivity Corporation (2023), [MPC Productivity Report 2023.pdf \(cdn-website.com\)](https://cdn-website.com/MPC_Productivity_Report_2023.pdf).

StatLink  <https://stat.link/1otlmk>

However, Malaysia's retail sector faces stricter regulations than the OECD average (Figure 4.37). Foreign-owned retailers are subject to a separate regulatory regime in Malaysia, which imposes restrictions on their floor size and opening hours, thus limiting competition (OECD, 2021<sup>[30]</sup>). A small retail store may require as many as ten different licenses, permits and approvals to operate (Malaysia Productivity Corporation, 2023<sup>[40]</sup>).


**Figure 4.37. Retail sector regulations in Malaysia are more restrictive than the OECD average**

Product Market Regulation indicator: Retail sector regulations, Index scale of 0-6 from least to most restrictive



Note: Information used to calculate the OECD's 2018 PMR indicators is based on laws and regulations in place on 1 January 2018 or a later year (1 January 2020 for Malaysia).

Source: OECD, *Product Market Regulation database*; and OECD-WBG, *Product Market Regulation database*.

StatLink  <https://stat.link/ueo4fp>

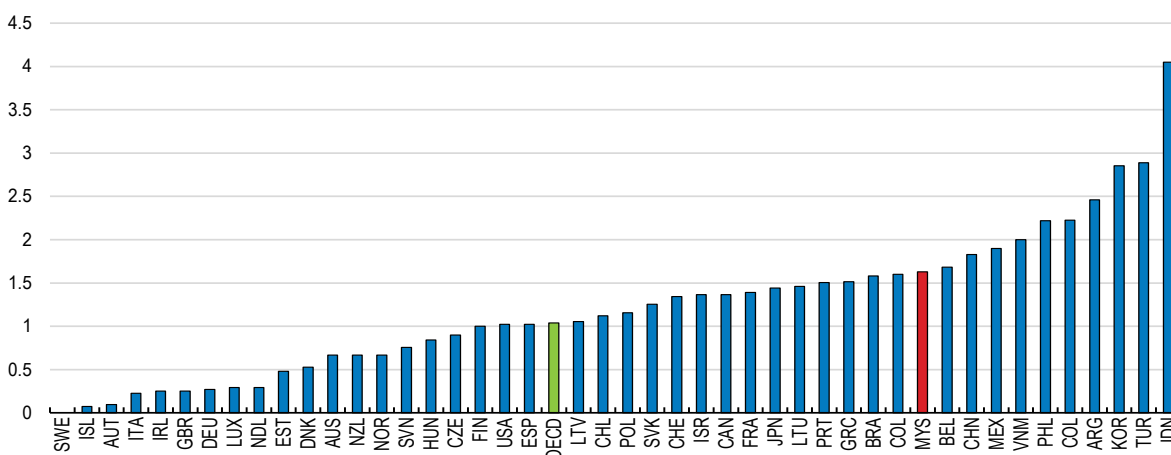
One key issue is price controls; the government sets the maximum price of around a dozen essential goods, including sugar, petrol and diesel. The government implemented a broad anti-profiteering framework to protect consumers from excessive price rises following the introduction of the Goods and Services Tax. It allows the government to take action against retailers whose profits exceed “reasonable”

levels as determined by the government. Although the tax has been abolished, the price regulation remains in place.

Compared to OECD countries, price controls are prevalent in Malaysia (Figure 4.38). A World Bank survey found that half of firms in Malaysia are affected by price controls (World Bank, 2023<sup>[32]</sup>). Price controls tend to inhibit business dynamism by limiting business strategies and limiting product market competition, which is key to productivity gains. Price controls also reduce incentives for firms to increase supply and scale up. The World Bank survey found that of the firms affected by price controls, 37% reported that they reduced production by an average of 24%, which leads to shortages that put upward pressure on prices. Moreover, the survey found that “the burden of price controls falls disproportionately on smaller firms as compared to medium and large-sized firms that could pivot away from price-controlled products” (World Bank, 2023<sup>[32]</sup>). In addition, reporting requirements under the anti-profiteering framework create an administrative burden for firms, particularly MSMEs. The removal of price controls should be accompanied by strong competition policy to limit monopoly pricing power and by appropriate pricing policies for natural monopolies.

**Figure 4.38. Price controls are prevalent in Malaysia compared to OECD countries**

Product Market Regulation indicator: Price controls, Index scale of 0-6 from least to most restrictive



Source: OECD, Product Market Regulation database; and OECD-WBG, Product Market Regulation database.

StatLink  <https://stat.link/u32okx>

### ***Improving the insolvency framework can promote the scaling up of firms***

Inefficient insolvency regimes can delay or prevent the failure of non-viable firms, thereby slowing the reallocation of workers and capital to successful enterprises. The survival of so-called “zombie” companies thus tends to slow the scaling up of successful firms (OECD, 2021<sup>[14]</sup>). In addition to the timely exit of non-viable enterprises, an effective insolvency framework can promote the successful restructuring of viable companies (André and Demmou, 2022<sup>[71]</sup>). The positive relationship between the ease of resolving insolvencies and business density suggests that a more efficient insolvency regime favours new business creation, in part by allowing second chances to “honest failed entrepreneurs” (OECD, 2021<sup>[30]</sup>).

Malaysia has reformed its insolvency and bankruptcy regimes. In 2016, amendments to the Companies Act introduced two new corporate rescue mechanisms. They were accompanied by additional controls on court-sanctioned schemes to make the process more effective in promoting effective corporate debt restructuring. According to the World Bank’s Doing Business Assessment by the World Bank, it takes one year on average to resolve insolvencies in Malaysia compared to the OECD average of about 1.7 years. Moreover, the recovery rate for secured creditors is 81 compared to an OECD average of 70 (OECD, 2021<sup>[30]</sup>).

Still, additional reforms could further improve Malaysia's insolvency and bankruptcy regimes. In the 2019 Global Entrepreneurship Monitor (GEM) Survey, nearly 45% of adults in Malaysia who have identified attractive business opportunities would not start a business for fear of failure. Moreover, the cost of insolvency is relatively high in Malaysia at around 10% of the estate compared to Japan (4.2%) and Korea (3.5%), suggesting that there is scope for further streamlining of the process (OECD, 2021<sup>[30]</sup>). A disproportionately large penalty on failed entrepreneurs can discourage firm creation and encourage owners of non-viable enterprises to remain in business.

The government should pursue other reforms proposed in the 2021 *OECD Economic Survey of Malaysia*. First, Malaysia's insolvency framework should distinguish between blameless and blameworthy bankruptcies, as in other common law jurisdictions, such as the United Kingdom. Second, Malaysia's insolvency regime could also ease the penalty attached to failure by supporting debtors through more generous asset exemptions and access to credit after the commencement of insolvency proceedings. Third, creditor participation in insolvency proceedings should be strengthened. Under the current system, the sale of substantial assets of the debtor does not require approval by the creditors. Moreover, the creditor does not have the right to request information from the insolvency representative (OECD, 2021<sup>[30]</sup>).

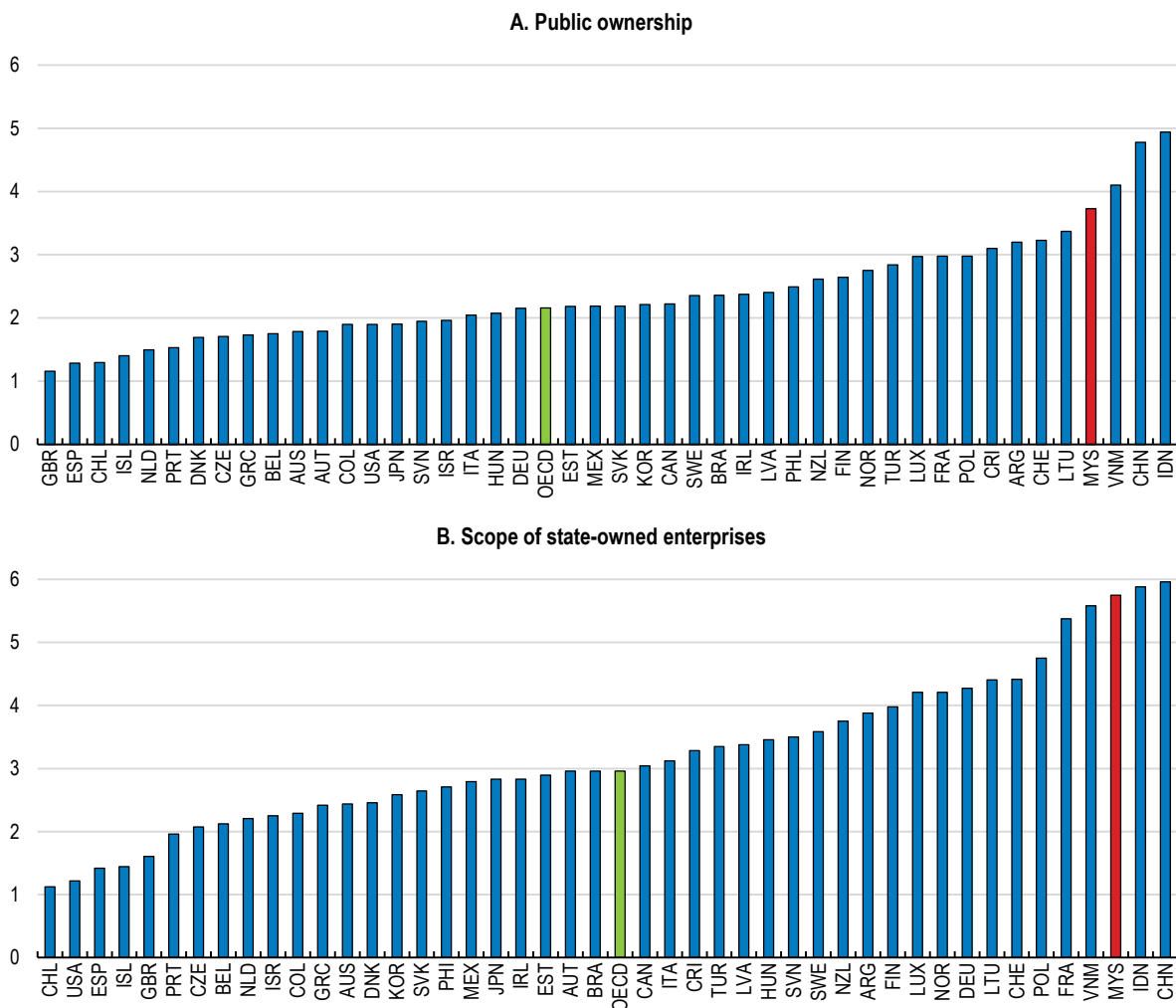
## Reducing the role of state-owned enterprises to facilitate the scaling up of MSMEs

The significant role of state-owned enterprises (SOEs), often referred to as government-linked companies or GLCs in the Malaysian context, poses obstacles to scaling up MSMEs. According to the OECD Product Market Regulation index, the scale of public ownership in Malaysia exceeds all OECD countries and approaches that in Viet Nam and China (Figure 4.39). This is partly related to Malaysia's New Economic Policy (NEP), introduced in the 1971 to pursue economic development and increase the economic role and wealth of the Bumiputera (Gomez et al., 2018<sup>[72]</sup>) (Box 4.6).


SOEs in Malaysia are defined as "companies that have a primary commercial objective and in which the government has a direct controlling stake, i.e., the ability to appoint board members and senior management, make major decisions (e.g., contract awards, strategy, restructuring and financing acquisitions and divestments) either directly or through the seven government-linked investment companies" (OECD, 2013<sup>[73]</sup>). The share of SOEs among Malaysia's top ten firms, as measured by the equally-weighted average of their shares of sales, assets and market value of the country's top ten firms, is the fifth highest globally. Eight of the ten listed companies with the highest market value are SOEs and 35 SOEs were ranked among the top 100 listed firms in 2013. Together, they make up 42% of Bursa Malaysia's market capitalisation. The number of GLCs and their subsidiaries increased from an estimated 1 158 in the 1990s (Adam and Cavendish, 1995<sup>[74]</sup>) to more than 68 000 at the federal level (Gomez et al., 2018<sup>[72]</sup>) and hundreds at the state government level (Gomez et al., 2018<sup>[75]</sup>). Measured by operating revenue or income, SOEs' share exceeds 50% in utilities, transport, warehousing, agriculture, banking, information communications, construction and retail trade (Menon, 2017<sup>[76]</sup>).

**Figure 4.39. The scale of public ownership and the scope of SOEs is high in Malaysia**

Product Market Regulations: Distortions from state involvement,  
Index scale from 0 to 6, from most to least competition-friendly regulations



Source: OECD, Product Market Regulation database; and OECD-WBG, Product Market Regulation database.

StatLink  <https://stat.link/k60wnt>

The dominance of SOEs has been perceived as an obstacle to the growth of private companies by crowding out private investment and making it harder for privately owned firms to compete (Williams, 2023<sup>[77]</sup>). An empirical study found that when SOEs are dominant in a business sector, investment by private firms is significantly negatively affected. Conversely, when SOEs do not dominate an industry, the negative impact on private investment is not seen (Menon and Ng, 2017<sup>[78]</sup>). This affects MSMEs, as SOEs play a significant role in sectors where MSMEs are prevalent, such as retail and transport. Consequently, many SOEs compete directly with MSMEs, which limits their ability to scale up. This has been recognised by the National Economic Advisory Council which stated that “the government’s role as both a business owner and regulator of industries creates conflicts of interest that can give SOEs an unfair advantage over private firms” (National Economic Advisory Council, 2010<sup>[79]</sup>). For example, SOEs have preferential access to government procurement contracts and enjoy other benefits, including direct subsidies, concessionary financing, state-backed guarantees, and exemptions from antitrust enforcement and bankruptcy rules (Menon, 2017<sup>[76]</sup>).

Moreover, SOEs have had a negative impact on the fiscal situation. The 2016 OECD Economic Survey of Malaysia noted that although the federal government's fiscal deficit had declined, the public sector's overall deficit increased partly due to rising SOE-related expenditures (OECD, 2016<sup>[80]</sup>).

The strong role of SOEs has also been associated with governance challenges (Menon, 2017<sup>[76]</sup>). Along with their significant market power, the "lack of governance and transparency of SOEs hinder accountability and control of corruption" (World Bank, 2021<sup>[11]</sup>). SOEs' special access to government and regulatory agencies can easily create a perception of cronyism and corruption, and appointments to key SOE positions have lacked transparency (World Bank, 2021<sup>[11]</sup>).

### ***Reforming state-owned enterprises***

Reforming SOEs has been on the policy agenda for some time. In 2010, the government proposed a shift away from Malaysia's traditional approach of "large direct public investment (including through SOEs) in selected economic sectors", given that "the size of SOEs and their mere presence may inhibit expansion of new firms" (National Economic Advisory Council, 2010<sup>[79]</sup>). At that time, the government had planned to divest SOEs in industries where the private sector is operating effectively and ensure SOEs operate on a strict commercial basis free of government interference (National Economic Advisory Council, 2010<sup>[79]</sup>). Nonetheless, the government's share in the stock market rose further over 2011-15. At the same time, privatisations have posed governance challenges as well (Williams, 2019<sup>[81]</sup>).

The Twelfth Malaysia Plan stated that "the role of SOEs will be enhanced while a fairer and healthier competitive environment will be encouraged to improve market efficiency for the private sector to expand into domestic and international markets", recognising the importance of a more level playing field for competition between SOEs and private firms. This is planned through prioritising investment in SOEs in strategic sectors while gradually reducing the role of SOEs in non-strategic sectors. The transfer of SOE assets in non-strategic sectors is meant to give preference to qualified Bumiputera entrepreneurs (Ministry of Economy, 2021<sup>[21]</sup>). In 2024, the government reaffirmed that SOEs remain committed to supporting the Bumiputera agenda (Malay Mail, 2024<sup>[82]</sup>).

The New Economic Policy has helped increase the median income of Bumiputera households from 67% of the national average in 1974 to 91% in 2022. The success in narrowing the income gap between Malaysia's ethnic groups raises the question of whether the negative side effects of the NEP exceed its benefits. A gradual phasing out of current policies should include re-evaluating the costs and benefits of operating SOEs in sectors where the private sector is operating efficiently. This should be accompanied by increasing social assistance of all low-income households (Chapter 2) and effective policies to promote the scaling up of MSMEs.

In addition, it is essential to level the playing field between private firms and those that remain government-owned. International organisations including the World Bank (World Bank, 2021<sup>[11]</sup>) and the IMF, in its 2023 IMF Article IV on Malaysia, have called for "increased transparency of SOE operations" (IMF, 2023<sup>[83]</sup>). This requires improving SOE management structures and corporate governance. The independence of SOE boards should be respected and protected from political influence, in line with the OECD State-Owned Enterprise Guidelines (OECD, 2015<sup>[84]</sup>). This would protect the minority shareholder rights of private entities (Gomez et al., 2018<sup>[72]</sup>). The Twelfth Malaysia Plan stated that "more stringent processes will be put in place in appointing board members, based on merit, integrity, technical, financial and corporate governance skills" (Ministry of Economy, 2021<sup>[21]</sup>). Not allowing politicians to serve on SOE boards would be an important step in reducing political influence (World Bank, 2021<sup>[11]</sup>). Despite efforts to limit the role of politicians in SOEs, politicians continue to be appointed to board and chairman positions, thereby threatening the autonomy of SOEs. Malaysia may wish to consider the experience of Brazil where the 2016 SOE Statute has helped reduce political interference in the management of SOEs and advance the professionalisation of its boards by establishing clear rules for the appointment of directors, including

minimum experience, academic background, and morality requirements, as well as a minimum “cooling off” period if coming from political office (Vitale et al., 2022<sup>[85]</sup>).

### ***The role of government-linked investment companies***

SOEs are closely connected to Malaysia’s government-linked investment companies (GLICs) (Table 4.5). These are defined as “investment companies in which the federal government has influence over the management by appointing and approving board members and senior management, who in turn report directly to the government” (OECD, 2013<sup>[73]</sup>). The government oversees GLICs and participates in their board through the Ministry of Finance or the Prime Minister’s office. The Minister of Finance is ultimately responsible for appointing directors (IMF, 2013<sup>[86]</sup>). The Prime Minister has stated that “GLICs play an important role in Malaysia’s economic development and nation building” and have been “a key pillar of the national economy since the 1970s” (Ministry of Finance, 2021<sup>[87]</sup>).

**Table 4.5. Malaysia’s government-linked investment companies**

GLIC	Type	Agenda	Source of funds
Ministry of Finance Incorporated (MoF Inc.)	Government Investment Special Purpose Vehicle	To increase value and returns of federal government assets	Government tax revenue and borrowing. Funds can be directly obtained from debt and equity markets (especially Khazanah National)
Khazanah National	Sovereign Wealth Fund	To initiate and implement strategic industries and national objectives	
Employees Provident Fund (EPF)	Retirement savings	Private-sector employees	Funds directly collected from the investing public
Kumpulan Wang Persaraan (KWAP)		Civil servants	
Lembaga Tabung Angkatan Tentera (LTAT)		Military personnel and veterans	
Lembaga Tabung Haji (LTH)	Special Purpose Savings	Saving for hajj pilgrimage	
Permodalan Nasional Bhd (PNB)	Unit Trust Management	Raise equity ownership held by Bumiputera	

Source: Gomez, E. et al. (2018), Minister of Finance Incorporated: Ownership and Control of Corporate Malaysia (repec.org).

Among the seven GLICs, there are a number of institutional types – a special purpose fund, a sovereign wealth fund, retirement funds, and a trust fund manager. With the exception of the Ministry of Finance, Incorporated (MoF Inc.), the GLICs are major business groups with majority ownership of Malaysia’s leading publicly-listed companies, including the 35 SOEs in the top 100 listed firms. The GLICs directly hold about a quarter of Bursa Malaysia’s total market capitalisation. The total assets under the control of the seven GLICs amounted to RM 1.7 trillion (120% of GDP) in 2021 (Prime Minister’s Office, 2021<sup>[88]</sup>). The International Monetary Fund stated that, “the government has substantial de facto ownership in the financial sector: the seven GLICs have large interests in the main Malaysian financial and banking groups” (IMF, 2013<sup>[86]</sup>). In addition, “the GLICs are by far the most influential players in the Malaysian capital market” (IMF, 2013<sup>[86]</sup>). This situation is largely a reflection of the government agenda to encourage household savings and investment in the domestic economy and drive specific developmental agendas by the development financial institutions (DFIs).

The significant role of GLICs may discourage small firms from scaling up, as they may be acquired if they become large firms. GLICs have shown an appetite for taking over entrepreneurial companies, which may discourage private firms from working with SOEs. In 2021, the government announced principles to strengthen and optimise the overall structure and governance of GLICs. The 20 initiatives aim to achieve five key outcomes: i) sharpen clarity on the mandate of each GLIC; ii) spur new growth and enhanced socio-economic impact through developmental investments; iii) crowd-in the private sector while streamlining the role of the government and its agencies in business; iv) future-proof GLICs with best-in-class governance, capabilities, and strategies; and v) strengthen social protection safeguards and fiscal

resilience (Ministry of Finance, 2021<sup>[87]</sup>). The selection process for the management and members of statutory boards should be based on performance indicators to assess qualifications (Chapter 1).

The largest GLIC is MoF Inc., which was established in 1957 to: i) stimulate economic growth by investing in strategic sectors; ii) attract local and foreign investors in specific areas such as biotechnology, information technology and communication; iii) fill in gaps where the private sector gives less investment priority, mainly due to substantial initial investment costs and high market barriers; and iv) provide services, such as public transport and utility services, to the public (Malaysian Institute of Chartered Secretaries and Administrators, 2021<sup>[89]</sup>).

**Table 4.6. Past recommendations on creating a more dynamic business sector**

Recommendations	Actions taken since August 2021
Enhance the coordination among ministries and agencies by integrating and streamlining the business registration system.	The MalaysiaBiz portal launched as a one-stop centre to manage business registration and licensing has made business registration more affordable and efficient, with registration fees ranging from MYR 30-60 and a registration time of four to five working days.
Improve the usability of existing one-stop-shop mechanisms for business authorisations, by widening the number of participating agencies.	No action taken.
Strengthen the insolvency scheme further, by improving debtors' access to credit and widening creditors' participation in the restructuring process.	In 2021, Bank Negara Malaysia implemented the Financial Management and Resilience Programme (URUS) and the Financial Resilience Support Programme (FIRST) to provide repayment assistance to eligible borrowers that continue to struggle to resume their original loan/financing repayments.
Ensure adequate and inclusive consultation which fully involves non-business stakeholders, with more systematic adoption of public consultation guidelines.	No action taken.
Provide support programmes to promote the uptake of digital tools, including basic ones, such as computer and the Internet, particularly targeting older SMEs.	In 2022, Malaysia had 29 initiatives intended to educate MSMEs on e-commerce opportunities, 32 providing financial support to invest in digital solutions and 40 offering training on digital technologies.
Strengthen training programmes of basic digital skills for employers and employees of firms, in particular micro- and small-sized enterprises with less than ten workers.	Training programme for employers and employees to improve digital skills have been started by various government agencies and made available on a centralised web portal.
Implement the Malaysia Digital Economy Blueprint as planned, by reviewing, improving and streamlining all relevant and state legislations and regulations related to digital infrastructure development.	In June 2022, the Special Committee for Standardising Charges and Fees for Communication Infrastructure Development was established to standardise charges and fees in the telecommunication industry.
Revise the Competition Act and the Competition Commission Act to provide the competition authorities with oversight of mergers and acquisitions.	The Malaysia Competition Commission has announced plans to table legislation on merger control in Parliament in June 2024.
Enhance the financial support to firms and workers to help them acquire necessary equipment and investment in case they wish to telework but do not have adequate resources to conduct it.	Tax exemptions have been provided to firms who support workers' purchases of personal IT equipment, internet subscriptions and reading materials.
Provide more ICT training opportunities to workers to help them acquire necessary skills to practice teleworking	A public agency has been offering ICT-related training, creating 17 278 training places by end-2023.
Accelerate investment to upgrade digital infrastructure, such as in 5G and fixed broadband.	Infrastructure investments for mobile and fixed broadband have been increased, aiming for 100% coverage in populated areas by 2025.

**Table 4.7. Recommendations from this chapter (Key recommendations in bold)**

Main findings	Recommendations
<b>Improving the effectiveness of programmes to assist MSMEs</b>	
Around 80 central government ministries and agencies administer about 275 programmes to support MSMEs, leading to considerable overlap and redundancy, as well as confusion among MSMEs seeking support.	Streamline and consolidate MSME programmes to reduce duplication, increase efficiency and reduce confusion among the beneficiaries.
The impact of Malaysia's MSME programmes on the beneficiaries' productivity and profitability is uncertain.	Use carefully designed evaluations to compare the performance of supported firms against a control group of firms not receiving support to evaluate the effectiveness of MSME programmes.
Growth-friendly framework conditions can help MSMEs to scale up.	<b>Create firm-neutral, growth-episode friendly framework conditions that enable the creation and expansion of MSMEs.</b>
Cross-country data suggest that access to finance, investment, innovation and R&D, and international links are key factors that enable firms to scale up.	Identify the characteristics that contribute to the scaling up of Malaysian MSMEs' and use them to guide MSME policy.
<b>Promoting the scaling up of MSMEs through digitalisation and new technologies</b>	
Fixed and mobile telecom prices, relative to income per capita, exceed the OECD average. Malaysia ranks low in terms of the quality and breadth of available infrastructure for internet access.	Ensure an adequate digital infrastructure through stronger competition by preventing anti-competitive M&As and relaxing foreign entry restrictions.
The share of firms without a web presence is over half in seven of Malaysia's 16 states and territories. MSMEs operating in rural areas and in East Malaysia face inadequate digital infrastructure and connectivity.	<b>Increase access to digital services for vulnerable and rural populations to narrow the digital divide.</b>
Only 6% of small firms and 20% of medium-sized firms invest in R&D. The government grants a double tax deduction for firms' R&D expenditures, but this has less impact on young MSMEs, which often are not profitable.	Increase MSMEs' access to new technology by focusing government research institutes' R&D on issues pertinent to MSMEs and making R&D tax incentives more advantageous for small firms.
The government classifies 72% of workers as low- or semi-skilled. The "Critical Occupations List" shows a persistent shortage of workers with digital skills. Weak managerial skills pose an obstacle to digitalisation.	Focus efforts to promote digital and managerial skills on micro enterprises.
<b>Expand financing channels to enable firms to scale up</b>	
Firms at least ten years old receive nearly half of government loan guarantees, which risks crowding out younger firms, which tend to have greater needs and face more serious market failures in obtaining financing.	Increase the share of young firms that benefit from guarantees and limit the time period over which firms can receive guarantees.
Young start-ups rely primarily on internal funding sources, including family and friends, given the difficulty of obtaining bank loans and the paucity of equity investments in small firms. Venture capital markets are small and the public sector provides most venture capital funding.	<b>Boost investment in MSMEs through new channels, such as equity crowdfunding and peer-to-peer financing, and crowd-in more private venture capital funds by improving tax incentives and the legal and regulatory framework.</b>
<b>Removing obstacles to the growth of MSMEs</b>	
The share of small firms that export is low compared to neighbouring countries. Malaysia's participation in two important trade agreements – RCEP and CPTPP – offers potentially significant opportunities to MSMEs.	Create export consortia of MSMEs, with government support, to enable them to reach the scale necessary to export and help MSMEs comply with ESG reporting guidelines.
Trade restrictions on two areas crucial to the digital economy – telecommunications and computer services – are relatively high in Malaysia. Restrictions on computer services limit cross-border data flows.	End the requirement that foreign firms register a branch in Malaysia in order to provide computer and other digitally-enabled services and lengthen the permitted period of stay for foreign specialists.
Labour productivity in the retail and food and beverage sectors is below half of the national average. The PMR shows that retail sector regulation is very stringent. Operating a retail store requires as many as ten permits.	<b>Reduce the regulatory requirements on retail stores, including the price ceilings set on essential goods.</b>
Complex and overlapping regulatory procedures administered by different agencies and manual processing of paperwork increase the regulatory burden.	Introduce a standard application in a format that can be accepted by multiple agencies, establish "one-stop shops" and put paperwork on digital platforms.
<b>Reducing the role of state-owned enterprises</b>	
Eight of the 10 listed companies with the highest market value are SOEs and 35 SOEs are among the top 100 listed firms. Together, they comprise 42% of stock market capitalisation and have 68 000 subsidiaries.	<b>Re-evaluate the costs and benefits of SOEs in sectors where the private sector is operating efficiently and create a more level playing field for MSMEs by improving SOE governance.</b>
The seven GLICs hold MYR 1.2 trillion (120% of GDP) of assets, including substantial ownership of banks and financial groups.	Increase transparency about the investments of the GLICs and gradually reduce their holdings.

## References

- Adam, C. and W. Cavendish (1995), “Early Privatisations”, in Jomo, K. (ed.), *Privatizing Malaysia: Rents, Rhetoric and Reality*, Westview Press, Inc. [74]
- André, C. and L. Demmou (2022), “Enhancing insolvency frameworks to support economic renewal”, *OECD Economics Department Working Papers*, No. 1738, OECD Publishing, Paris, <https://doi.org/10.1787/8ef45b50-en>. [71]
- Andrews, D., C. Criscuolo and P. Gal (2015), “Frontier Firms, Technology Diffusion and Public Policy: Micro Evidence from OECD Countries”, *OECD Productivity Working Papers*, No. 2, OECD Publishing, Paris, <https://doi.org/10.1787/5jrql2q2jj7b-en>. [65]
- Andrews, D., C. Criscuolo and C. Menon (2014), “Do Resources Flow to Patenting Firms?: Cross-Country Evidence from Firm Level Data”, *OECD Economics Department Working Papers*, No. 1127, OECD Publishing, Paris, <https://doi.org/10.1787/5jz2lpmk0gs6-en>. [91]
- Bank Negara Malaysia (2024), *Financial Inclusion Statistics*, <https://www.bnm.gov.my/financial-inclusion-data-for-malaysia>. [48]
- Benedetti Fasil, C. et al. (2021), *High growth enterprises in the COVID-19 crisis context – Demographics, environmental innovations, digitalization, finance and policy measures*, Publications Office of the European Union, <https://doi.org/10.2760/63402>. [24]
- Bravo-Biosca, A. (2010), “Growth Dynamics: Exploring business growth and contraction in Europe and the US”, *Research Report*, NESTA. [13]
- Bravo-Biosca, A., C. Criscuolo and C. Menon (2016), “What drives the dynamics of business growth?”, *Economic Policy*, Vol. 31/88, pp. 703-742, <https://doi.org/10.1093/epolic/eiw013>. [11]
- Calvino, F., C. Criscuolo and C. Menon (2015), “Cross-country evidence on start-up dynamics”, *OECD Science, Technology and Industry Working Papers*, No. 2015/6, OECD Publishing, Paris, <https://doi.org/10.1787/5jrxtkb9mxtb-en>. [15]
- Chang, W. (2016), “Is Korea’s Public Funding for SMEs Achieving Its Intended Goals?”, *KDI FOCUS Series No. 63*, [https://www.kdi.re.kr/eng/research/focusView?pub\\_no=14595](https://www.kdi.re.kr/eng/research/focusView?pub_no=14595). [37]
- Coad, A. et al. (2014), “High-growth firms: introduction to the special section”, *Industrial and Corporate Change*, Vol. 23/1, pp. 91-112, <https://doi.org/10.1093/icc/dtt052>. [21]
- Commonwealth of Australia (2017), *Australian innovation system report 2017*. [23]
- Criscuolo, C., P. Gal and C. Menon (2014), “The Dynamics of Employment Growth: New Evidence from 18 Countries”, *OECD Science, Technology and Industry Policy Papers*, No. 14, OECD Publishing, Paris, <https://doi.org/10.1787/5jz417hj6hg6-en>. [19]
- Demmou, L. and G. Franco (2021), “Mind the financing gap: Enhancing the contribution of intangible assets to productivity”, *OECD Economics Department Working Papers*, No. 1681, OECD Publishing, Paris, <https://doi.org/10.1787/7aefd0d9-en>. [46]
- Department of Statistics Malaysia (DOSM) (2023), *Malaysia Digital Economy 2023*, [https://storage.dosm.gov.my/gdp/digitaleconomy\\_2022.pdf](https://storage.dosm.gov.my/gdp/digitaleconomy_2022.pdf). [28]

- Economist Impact Index (n.d.), *Inclusive Internet Index, supported by META*. [38]
- Financial Education Network (2023), *FEN National Strategy Progress Report 2019-2022*, <https://www.fenetwork.my/wp-content/uploads/2023/05/FEN-National-Strategy-Progress-Report-THE-COMPLETE-REPORT-FINAL.pdf>. [59]
- G20/OECD (2015), *High-Level Principles on SME Financing*, <https://www.oecd.org/finance/G20-OECD-High-Level-Principles-on-SME-Financing.pdf>. [6]
- Global Entrepreneurship and Development Institute (2019), *International Entrepreneurship Development Data*, <http://thegedi.org/tool/>. [53]
- Gomez, E. et al. (2018), *Government in Business: Diverse Forms of Intervention*, Institute for Democracy and Economic Affairs (IDEAS), <https://www.ideas.org.my/publications-item/malaysia-glc-monitor-2018-government-in-business-diverse-forms-of-intervention/>. [75]
- Gomez, E. et al. (2018), “Minister of finance incorporated: Ownership and control of corporate Malaysia”, <https://doi.org/10.1007/978-981-10-4897-5>. [72]
- Groh, A. et al. (2023), *The Venture Capital and Private Equity Country Attractiveness Index 2023*, <https://blog.iese.edu/vcpeindex/files/2023/11/report2023.pdf>. [57]
- Grover Goswami, A., D. Medvedev and E. Olafsen (2019), *High-Growth Firms: Facts, Fiction, and Policy Options for Emerging Economies*, Washington, DC: World Bank, <https://doi.org/10.1596/978-1-4648-1368-9>. [8]
- Haltiwanger, J., R. Jarmin and J. Miranda (2010), “Who Creates Jobs? Small vs. Large vs. Young”, *NBER Working Paper Series*, Vol. 16300, <https://doi.org/10.3386/w16300>. [20]
- Hurst, E. and B. Pugsley (2011), “What Do Small Businesses Do?”, *Brookings Papers on Economic Activity* No. 2, <https://www.brookings.edu/articles/what-do-small-businesses-do/>. [17]
- IMD (2023), *World Competitiveness Ranking 2023*, <https://www.imd.org/centers/wcc/world-competitiveness-center/rankings/world-competitiveness-ranking/>. [69]
- IMF (2023), *Malaysia: 2023 Article IV Consultation-Press Release and Staff Report*, <https://www.imf.org/en/Publications/CR/Issues/2023/05/31/Malaysia-2023-Article-IV-Consultation-Press-Release-and-Staff-Report-533968>. [83]
- IMF (2013), *Malaysia: Financial Sector Stability Assessment*, <https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Malaysia-Financial-Sector-Stability-Assessment-40359>. [86]
- JENDALA (Jalinan Digital Negara) (2023), *Phase 1 (September 2020 - 31 December 2022) Concluding Report*, <https://myjendela.my/Sitejendela/media/Doc/JENDELA-Phase-1-Concluding-Report.pdf>. [39]
- Jones, R. and M. Kim (2014), “Fostering a Creative Economy to Drive Korean Growth”, *OECD Economics Department Working Papers*, No. 1152, OECD Publishing, Paris, <https://doi.org/10.1787/5jz0wh8xkrf6-en>. [45]
- Jones, R. and J. Lee (2018), “Enhancing dynamism in SMEs and entrepreneurship in Korea”, *OECD Economics Department Working Papers*, No. 1510, OECD Publishing, Paris, <https://doi.org/10.1787/ced4b0e9-en>. [60]

- Jones, R. and J. Lee (2016), "Raising Korea's productivity through innovation and structural reform", *OECD Economics Department Working Papers*, No. 1324, OECD Publishing, Paris, <https://doi.org/10.1787/5jlr3tl19gkd-en>. [52]
- Koirala, S. (2019), "SMEs: Key drivers of green and inclusive growth", *OECD Green Growth Papers*, No. 2019/03, OECD Publishing, Paris, <https://doi.org/10.1787/8a51fc0c-en>. [3]
- Kuriakose, S. et al. (2022), *Digitalizing SMEs to Boost Competitiveness*, World Bank Group, Washington, D.C. [27]
- Kuriakose, S. et al. (2022), *Malaysia - Assessment of the Start-Up Financing Ecosystem*, World Bank, <https://doi.org/10.1596/37136>. [54]
- Kuriakose, S. and H. Tiew (2022), *Malaysia: SME Program Efficiency Review*, World Bank Group, <https://documents.worldbank.org/en/publication/documents-reports/documentdetail/099255003152238688/p17014606709a70f50856d0799328fb7040>. [4]
- Lee, H. (2021), "Fifty Years of Malaysia's New Economic Policy: Three Chapters with No Conclusion", *Economics working paper* No. 2021 - 07, [https://www.iseas.edu.sg/wp-content/uploads/2021/07/ISEAS\\_EWP\\_2021-7\\_Lee.pdf](https://www.iseas.edu.sg/wp-content/uploads/2021/07/ISEAS_EWP_2021-7_Lee.pdf). [51]
- López González, J. (2019), "Fostering participation in digital trade for ASEAN MSMEs", *OECD Trade Policy Papers*, No. 230, OECD Publishing, Paris, <https://doi.org/10.1787/63561b11-en>. [62]
- Malay Mail (2024), *PM Anwar urges GLCs to remain committed to supporting Bumiputera agenda*, <https://www.malaymail.com/news/malaysia/2024/01/22/pm-anwar-urges-glcs-to-remain-committed-to-supporting-bumiputera-agenda/113910>. [82]
- Malaysia Productivity Corporation (2023), *Productivity Report 2023*, [https://irp.cdn-website.com/9c99ef26/files/uploaded/MPC\\_Productivity%20Report%202023.pdf](https://irp.cdn-website.com/9c99ef26/files/uploaded/MPC_Productivity%20Report%202023.pdf). [40]
- Malaysian Institute of Chartered Secretaries and Administrators (2021), *FAQ*, [https://www.maicsa.org.my/media/8296/technical\\_announcements\\_230721\\_1\\_3.pdf](https://www.maicsa.org.my/media/8296/technical_announcements_230721_1_3.pdf). [89]
- Menon, J. (2017), "Government-Linked Companies: Impacts on the Malaysian Economy", *Policy IDEAS* No. 45, <https://www.ideas.org.my/wp-content/uploads/2021/04/PI45-Government-Linked-comapnies-and-its-Impacts-on-the-Malaysian-Economy-V5.pdf>. [76]
- Menon, J. and T. Ng (2017), "Do state-owned enterprises crowd out private investment? Firm level evidence from Malaysia", *Journal of Southeast Asian Economies*, Vol. 34/3, pp. 507-522, <https://doi.org/10.1355/AE34-3E>. [78]
- Minister of Investment, Trade and Industry (2023), *MITI Report 2022*, [https://www.miti.gov.my/miti/resources/MITI%20Report/MITI\\_REPORT\\_2022.pdf](https://www.miti.gov.my/miti/resources/MITI%20Report/MITI_REPORT_2022.pdf). [34]
- Ministry of Economy (2023), *The Mid-Term Review of the Twelfth Malaysia Plan*. [9]
- Ministry of Economy (2021), *Twelfth Malaysia Plan, 2021-2025*. [2]
- Ministry of Entrepreneur and Cooperatives Development (2024), *Pelan Strategik Perusahaan Mikro, Kecil dan Sederhana 2030 (Micro, Small and Medium-sized Enterprises Strategic Plan 2030)*. [67]

- Ministry of Finance (2021), *PERKUKUH Strategic Transformation of GLICs for enhanced resilience and socioeconomic impact*, PERKUKUH Program Management Office, [https://www.bursamalaysia.com/sites/5d809dcf39fba22790cad230/assets/616934ee5b711a10db1ec06c/PERKUKUH\\_Booklet\\_Final-2\\_Oct\\_2021.pdf](https://www.bursamalaysia.com/sites/5d809dcf39fba22790cad230/assets/616934ee5b711a10db1ec06c/PERKUKUH_Booklet_Final-2_Oct_2021.pdf). [87]
- Ministry of Science, Technology and Innovation (2023), *Summary Report National Survey of Research and Development (R&D) in Malaysia 2021*. [41]
- National Economic Advisory Council (2010), *New Economic Model for Malaysia*, <https://www.ekonomi.gov.my/sites/default/files/2020-02/nem.pdf>. [79]
- National SME Development Council (2012), *SME Master Plan 2012–2020: Catalysing Growth and Income*. [7]
- NESTA (2009), “The vital 6 per cent: How high-growth innovative businesses generate prosperity and jobs”, *Research Summary*. [22]
- Ng, W. and T. Stuart (2016), “Of Hobos and Highfliers: Disentangling the Classes and Careers of Technology-Based Entrepreneurs”. [16]
- Nightingale, P. and A. Coad (2013), “Muppets and gazelles: political and methodological biases in entrepreneurship research”, *Industrial and Corporate Change*, Vol. 23/1, pp. 113-143, <https://doi.org/10.1093/icc/dtt057>. [18]
- OECD (2024), *Financing SMEs and Entrepreneurs 2024: An OECD Scoreboard*, OECD Publishing, Paris, <https://doi.org/10.1787/fa521246-en>. [55]
- OECD (2024), *Global Corporate Sustainability Report 2024*, OECD Publishing, Paris, <https://doi.org/10.1787/8416b635-en>. [64]
- OECD (2023), *Corporate Tax Statistics 2023*, OECD Publishing, Paris, <https://doi.org/10.1787/f1f07219-en>. [42]
- OECD (2023), “Grow and Go? Retaining Scale-ups in the Nordic Countries”, *OECD Regional Development Papers*, No. 51, OECD Publishing, Paris, <https://doi.org/10.1787/9be5339d-en>. [26]
- OECD (2022), *Financing Growth and Turning Data into Business: Helping SMEs Scale Up*, OECD Studies on SMEs and Entrepreneurship, OECD Publishing, Paris, <https://doi.org/10.1787/81c738f0-en>. [5]
- OECD (2022), “Malaysia”, in *Financing SMEs and Entrepreneurs 2022: An OECD Scoreboard*, OECD Publishing, Paris, <https://doi.org/10.1787/3bc2915c-en>. [56]
- OECD (2021), *Inclusive Growth Review of Korea: Creating Opportunities for All*, OECD Publishing, Paris, <https://doi.org/10.1787/4f713390-en>. [90]
- OECD (2021), *OECD Economic Surveys: Malaysia 2021*, OECD Publishing, Paris, <https://doi.org/10.1787/cc9499dd-en>. [30]
- OECD (2021), *The Digital Transformation of SMEs*, OECD Studies on SMEs and Entrepreneurship, OECD Publishing, Paris, <https://doi.org/10.1787/bdb9256a-en>. [31]
- OECD (2021), *Understanding Firm Growth: Helping SMEs Scale Up*, OECD Studies on SMEs and Entrepreneurship, OECD Publishing, Paris, <https://doi.org/10.1787/fc60b04c-en>. [14]

- OECD (2018), *Good Regulatory Practices to Support Small and Medium Enterprises in Southeast Asia*, OECD Publishing, Paris, <https://doi.org/10.1787/9789264305434-en>. [66]
- OECD (2018), *SME and Entrepreneurship Policy in Indonesia 2018*, OECD Studies on SMEs and Entrepreneurship, OECD Publishing, Paris, <https://doi.org/10.1787/9789264306264-en>. [43]
- OECD (2016), *OECD Economic Surveys: Malaysia 2016: Economic Assessment*, OECD Publishing, Paris, [https://doi.org/10.1787/eco\\_surveys-mys-2016-en](https://doi.org/10.1787/eco_surveys-mys-2016-en). [80]
- OECD (2015), *OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015 Edition*, OECD Publishing, Paris, <https://doi.org/10.1787/9789264244160-en>. [84]
- OECD (2013), *OECD Investment Policy Reviews: Malaysia 2013*, OECD Investment Policy Reviews, OECD Publishing, Paris, <https://doi.org/10.1787/9789264194588-en>. [73]
- OECD (2003), *OECD Economic Surveys: Korea 2003*, OECD Publishing, Paris, [https://doi.org/10.1787/eco\\_surveys-kor-2003-en](https://doi.org/10.1787/eco_surveys-kor-2003-en). [35]
- OECD/ERIA (2018), *SME Policy Index: ASEAN 2018: Boosting Competitiveness and Inclusive Growth*, OECD Publishing, Paris/ERIA, Jakarta, <https://www.oecd-ilibrary.org/content/publication/9789264305328-en>. [49]
- OECD/Eurostat (2008), *Eurostat-OECD Manual on Business Demography Statistics*, OECD Publishing, Paris, <https://doi.org/10.1787/9789264041882-en>. [12]
- OECD-WBG (2023), *OECD WBG Indicators*, <https://web-archive.oecd.org/2023-11-24/536786-OECD-WBG-PMR-Economy-Wide-Indicator%20values-2018.xlsx>. [68]
- Prime Minister's Department (2021), *Malaysia Digital Economy Blueprint*, <https://www.ekonomi.gov.my/sites/default/files/2021-02/malaysia-digital-economy-blueprint.pdf>. [36]
- Prime Minister's Office (2021), *GLICs Mandate Recharge : Launch of Perkukuh Pelaburan Rakyat ("Perkukuh")*, [https://www.pmo.gov.my/wp-content/uploads/2021/08/120821\\_PERKUKUH- -YABPM-Speech- -Finale.pdf](https://www.pmo.gov.my/wp-content/uploads/2021/08/120821_PERKUKUH- -YABPM-Speech- -Finale.pdf). [88]
- Rouzet, D., S. Benz and F. Spinelli (2017), "Trading firms and trading costs in services: Firm-level analysis", *OECD Trade Policy Papers*, No. 210, OECD Publishing, Paris, <https://doi.org/10.1787/b1c1a0e9-en>. [61]
- SME Corp. (n.d.), *Financing Schemes for SMEs in Malaysia*. [50]
- SME Corp. and Huawei (2018), *Accelerating Malaysian Digital SMEs: Escaping the Computerisation Trap*. [33]
- Sorbe, S., P. Gal and V. Millot (2018), "Can productivity still grow in service-based economies?: Literature overview and preliminary evidence from OECD countries", *OECD Economics Department Working Papers*, No. 1531, OECD Publishing, Paris, <https://doi.org/10.1787/4458ec7b-en>. [10]
- TMF Group (2023), *Global Complexity Index 2023*, <https://www.tmf-group.com/globalassets/pdfs/publications/qbci-2023-eng.pdf>. [70]
- Tsuruta, D. (2017), "SME Policies as a Barrier to Growth of SMEs", *RIETI Discussion Paper Series 17-E-046*, <https://www.rieti.go.jp/jp/publications/dp/17e046.pdf>. [47]

- U.S. Small Business Administration (SBA) (2008), "High-Impact Firms: Gazelles Revisited", *Small Business Research Summary* No. 328, <https://www.govinfo.gov/content/pkg/GOVPUB-SBA-PURL-LPS97248/pdf/GOVPUB-SBA-PURL-LPS97248.pdf>. [25]
- UNIDO (2024), *What are SME consortia?*, <https://www.unido.org/our-focus-advancing-economic-competitiveness-setting-and-supporting-export-consortia/what-are-sme-consortia>. [63]
- United Nations Development Programme (2022), *Human Development Index and its components*. [44]
- Vitale, C. et al. (2022), "Product Market Regulation in Brazil", *OECD Economics Department Working Papers*, No. 1735, OECD Publishing, Paris, <https://doi.org/10.1787/ea3dd09e-en>. [85]
- Williams, G. (2023), *Deregulate and 'superfund' domestic investment*, Free Malaysia Today, <https://www.freemalaysiatoday.com/category/opinion/2023/08/30/deregulate-and-superfund-domestic-investment/>. [77]
- Williams, G. (2019), "Responsible Privatisation: A New Malaysian Model of the role of government in the economy", *Brief IDEAS* No. 15, <https://www.ideas.org.my/publications-item/brief-ideas-no-15-responsible-privatisation-a-new-malaysian-model-of-the-role-of-government-in-the-economy-2/>. [81]
- World Bank (2023), *Malaysia Economic Monitor February 2023: Expanding Malaysia's Digital Frontier*, <https://www.worldbank.org/en/country/malaysia/publication/malaysia-economic-monitor-february-2023-expanding-malaysia-s-digital-frontier>. [32]
- World Bank (2021), *Aiming High: Navigating the Next Stage of Malaysia's Development*, <https://openknowledge.worldbank.org/handle/10986/37834>. [1]
- World Bank (2018), *Malaysia's Digital Economy: A New Driver of Development*, <https://openknowledge.worldbank.org/server/api/core/bitstreams/45fdcf5b-0e7f-595c-9815-6e03331c2822/content>. [29]
- Yakob, S. et al. (2021), "Financial Literacy and Financial Performance of Small and Medium-sized Enterprises", *The South East Asian Journal of Management*, Vol. 15/1, pp. 72-96, <https://doi.org/10.21002/SEAM.V15i1.13117>. [58]

## OECD Economic Surveys

# MALAYSIA

Sustained rapid and inclusive economic growth for half a century has brought Malaysia close to the threshold of high-income status. Growth is now accelerating, driven mostly by domestic demand. Exports are also set to rebound amid stronger external demand. The economy has been resilient to recent shocks, and inflation has remained contained. A new fiscal framework provides a good basis for the needed fiscal consolidation, but rising spending needs will require mobilising additional tax revenues. Improving the targeting of social protection while raising social assistance coverage and benefit levels would allow stronger reductions of poverty and inequality. Better access to childcare and a better alignment of tertiary education curriculums with labour market needs would allow more workers, especially women, to participate in the labour market and find jobs that match their skills. Addressing climate change requires phasing out fossil fuel subsidies and a stronger role for carbon pricing, complemented by stricter regulations. Better disaster risk financing and insurance could bolster adaptation efforts.

**SPECIAL FEATURES: SMALL AND MEDIUM-SIZED ENTERPRISES; BOOSTING PRODUCTIVITY; SOCIAL PROTECTION; GREEN GROWTH**

**Volume 2024/19  
August 2024**



**PRINT ISBN 978-92-64-65098-5  
PDF ISBN 978-92-64-40707-7**

**ISSN 0376-6438  
2024 SUBSCRIPTION  
(18 ISSUES)**



9 789264 650985