



MALAYSIA ECONOMIC MONITOR

OCTOBER 2023

Raising the Tide, Lifting All Boats



WORLD BANK GROUP
Inclusive Growth & Sustainable Finance
Hub in Malaysia

CONNECT WITH US



wbg.org/Malaysia



[@WorldBankMalaysia](https://www.facebook.com/WorldBankMalaysia)



[@WB_AsiaPacific](https://twitter.com/WB_AsiaPacific)



http://bit.ly/WB_blogsMY

MALAYSIA ECONOMIC MONITOR



WORLD BANK GROUP
Inclusive Growth & Sustainable Finance
Hub in Malaysia

© 2023 International Bank for Reconstruction and Development / The World Bank

1818 H Street NW

Washington DC 20433

Telephone: 202-473-1000

Internet: www.worldbank.org

This work is a product of the staff of The World Bank with external contributions. The findings, interpretations, and conclusions expressed in this work do not necessarily reflect the views of The World Bank, its Board of Executive Directors, or the governments they represent.

The World Bank does not guarantee the accuracy, completeness, or currency of the data included in this work and does not assume responsibility for any errors, omissions, or discrepancies in the information, or liability with respect to the use of or failure to use the information, methods, processes, or conclusions set forth. The boundaries, colors, denominations, and other information shown on any map in this work do not imply any judgment on the part of The World Bank concerning the legal status of any territory or the endorsement or acceptance of such boundaries.

Nothing herein shall constitute or be construed or considered to be a limitation upon or waiver of the privileges and immunities of The World Bank, all of which are specifically reserved.

Rights and Permissions

The material in this work is subject to copyright. Because The World Bank encourages dissemination of its knowledge, this work may be reproduced, in whole or in part, for noncommercial purposes as long as full attribution to this work is given.

Attribution: Please cite the work as follows: World Bank (2023) "Raising the Tide, Lifting All Boats" Malaysia Economic Monitor (October), World Bank, Washington, DC.

Any queries on rights and licenses, including subsidiary rights, should be addressed to World Bank Publications, The World Bank Group, 1818 H Street NW, Washington, DC 20433, USA; fax: 202-522-2625; e-mail: pubrights@worldbank.org.

Cover image: © Samuel Goh/World Bank

Credit for non-WB images: unsplash.com

Cover design and layout: Kane Chong Sdn Bhd

MALAYSIA ECONOMIC MONITOR

OCTOBER 2023

Raising the Tide, Lifting All Boats



WORLD BANK GROUP
Inclusive Growth & Sustainable Finance
Hub in Malaysia

Acknowledgements

This edition of the Malaysia Economic Monitor (MEM) was co-led by Shakira Teh Sharifuddin and Yew Keat Chong, comprising a team of Apurva Sanghi, Mahama Samir Bandaogo, Yohendran Nadar Arulthevan, Fionne Lim Jing Wen, Ririn Salwa Purnamasari, Matthew Wai-Poi, Laura Rodriguez Takeuchi, Matthew Dornan, Alyssa Farha Jasmin, Ya Shin Wan, Agustin Samano Penaloza, Izzati Afiqah Abdul Razak, Yu Cao, Tatiana Didier, Philbert Tiki Yong, Soraya Azhar and Zainab Ali Ahmad.

The team is grateful to Wael Mansour, Sailesh Tiwari, Ergys Islamaj, Habib Rab, Sandor Karacsony, Gonzalo Varela and the Malaysian Institute of Economic Research for their constructive input on the document and to Ndiame Diop, Yasuhiko Matsuda, Lars Moller, Rinku Murgai and Yasser El-Gammal for their overall guidance.

The MEM consists of two parts. Part 1 presents a review of recent economic developments and a macroeconomic outlook. Part 2 focuses on a selected special topic that is key to Malaysia's medium-term development prospects and to the achievement of shared prosperity.

This report benefited from productive discussions with staff from the Ministry of Economy, the Ministry of Finance, Bank Negara Malaysia, and several other government ministries and agencies, all of whom provided valuable information and useful feedback.

In particular, the team would like to thank the International Cooperation Division of the Ministry of Economy, the International Division of the Ministry of Finance and the Economics Department of Bank Negara Malaysia for close ongoing collaboration with the World Bank and for the crucial support to the launch of this report.

Joshua Foong and Dina Murad led external communications and Kane Chong led the production and design of the report. Azlina Ahmad provided editing assistance, while Minisha Deepu provided administrative support.

The report is based on information current as of 25 September 2023.

Please contact Apurva Sanghi (World Bank Lead Economist for Malaysia) at asanghi@worldbank.org, Shakira Teh Sharifuddin (MEM task team leader and World Bank Senior Economist for Malaysia) at stehsharifuddin@worldbank.org or Yew Keat Chong (MEM co-task team leader and World Bank Senior Economist for Malaysia) at yehong@worldbank.org for questions, comments, or suggestions regarding the Malaysia Economic Monitor.

Abbreviations

1MDB	1Malaysia Development Berhad	LFPR	Labor Force Participation Rate
AE	Advanced Economies	LCR	Liquidity Coverage Ratio
ASEAN	Association of Southeast Asian Nations	LDR	Loan-to-Deposit Ratio
B10	Bottom 10 percent (of the population)	LMIC	Lower Middle-income Countries
B40	Bottom 40 percent (of the population)	LRT	Light Rail Transit
BKC	<i>Bantuan Khas COVID-19</i>	M40	Middle 40 percent (of the population)
BKM	<i>Bantuan Keluarga Malaysia</i>	M&E	Machinery and Equipment
BNM	Bank Negara Malaysia	MEM	Malaysia Economic Monitor
BPN	<i>Bantuan Prihatin Nasional</i>	MENA	Middle East and North Africa
BSH	<i>Bantuan Sara Hidup</i>	MGS	Malaysian Government Securities
CEQ	Commitment to Equity	MNC	Multinational Corporations
CCR	Common Capital Ratio	MOF	Ministry of Finance Malaysia
CIT	Corporate Income Tax	MPC	Monetary Policy Committee
COVID-19	Coronavirus Disease 2019	MRT	Mass Rapid Transit
CPI	Consumer Price Index	MTFF	Medium-Term Fiscal Framework
DOSM	Department of Statistics Malaysia	myBSHR	<i>Bantuan Sara Hidup Rakyat Malaysia</i>
eBR1M	<i>Bantuan Rakyat 1Malaysia</i>	MYR	Ringgit Malaysia
E&E	Electricals and Electronics	NCD	Non-communicable Disease
EAP	East Asia and Pacific	NPL	Non-performing Loans
ECRL	East Coast Rail Link	OE	Operating Expenditure
EIA	Energy Information Administration	OECD	Organization for Economic Co-operation and Development
EMDE	Emerging Market and Developing Economies	OPR	Overnight Policy Rate
EPF	Employees Provident Fund	PMI	Purchasing Manager's Index
FDI	Foreign Direct Investment	PIT	Personal Income Tax
GDP	Gross Domestic Product	PITA	Petroleum Income Tax
GFCF	Gross Fixed Capital Formation	PICS-3	3 rd Productivity and Investment Climate Survey
GST	Goods and Services Tax	PPI	Producer Price Index
HCI	Human Capital Index	PWM	Progressive Wage Model
HES	Household Expenditure Survey	Q/Q	Quarter-on-Quarter
HiFy	High-Frequency Phone Survey	REER	Real Effective Exchange Rate
HIC	High Income Countries	SMEs	Small and Medium Sized Enterprises
HIES/BA	Household Income, Expenditure and Basic Amenities Survey	SSB	Sugar-sweetened Beverages
HIS	Household Income Survey	SST	Sales and Services Tax
HQLA	High Quality Liquid Assets	SWRC	Social Wellbeing Research Center
IC	Integrated Circuits	SWS	Salaries and Wage Survey
IFS	International Financial Statistics	T20	Top 20 percent (of the population)
IIP	International Investment Position	TCR	Total Capital Ratio
IMF	International Monetary Fund	TFP	Total Factor Productivity
IT	Information Technology	UMIC	Upper Middle-income Countries
KWAP	Kumpulan Wang Amanah Persaraan	Y/Y	Year-on-Year



Table of Contents

Acknowledgements	4
Abbreviations	5
Executive Summary	8
Global and regional developments.....	8
Domestic developments.....	9
Economic outlook.....	17
Policy recommendations.....	18
PART ONE	22
Recent economic developments	24
Global growth is showing signs of deceleration, while regional growth is moderating.....	24
Developments in the Malaysian Economy	25
The momentum in Malaysia’s economic recovery moderated amid global economic slowdown.....	25
In line with weak global economic activity, exports growth slowed down.....	30
Labor market conditions are gradually returning to levels seen prior to the pandemic.....	34
Despite the economic recovery, poorer households remained vulnerable.....	42
Headline inflation has steadily declined in line with the moderation in global energy and food prices.....	44
The Malaysian banking sector maintained adequate capital buffers, ample liquidity and healthy funding conditions.....	45
Portfolio inflows into the bond market helped offset outflows from the equity market.....	48
Continuous decline in tax revenue has contributed to revenue inadequacy.....	53
Rigid expenditures and spending inefficiency remains a challenge.....	54
Malaysia’s fiscal space remains constrained.....	56
Economic Outlook	58
Global growth is expected to slow over the near term.....	58
Malaysia’s economy is expected to expand at a more moderate pace in 2023 and 2024.....	59
Malaysia’s growth outlook is subject to considerable uncertainty.....	61
Near-term policy measures should be anchored on supporting low-income households.....	61
PART TWO	62
Raising the Tide, Lifting All Boats	64
Malaysian income inequality remains high relative to peers and is beginning to rise while the remaining poor are hard to reach.....	64
Taxes, subsidies and social spending in Malaysia reduce income inequality and poverty.....	66
Malaysia leads many peers when it comes to poverty reduction through taxes and social spending, but trails in terms of inequality.....	74
International experience suggests that greater impacts on poverty and inequality can be achieved by taxing more and using well-targeted spending.....	78
Fiscal reforms in Malaysia can focus on increasing indirect taxes and broadening the PIT base while strengthening the delivery of social assistance and rethinking subsidies.....	84
References	101

Executive Summary

Global and regional developments

Global

Global economic activity registered resilient growth in early 2023 but is losing momentum. Advanced economies growth slowed less-than-anticipated in early 2023 as tight labor markets drove wages up, preventing a sharp decline in consumption. However, global growth slowed slightly in Q2 2023, with services growth cooling gradually and manufacturing remaining soft. Global inflation has moderated in recent months, largely reflecting favorable base effects from commodity prices falling below their 2022 peaks, along with abating supply chain pressures. Global trade in

services strengthened in 1H 2023 thanks to the easing of mobility restrictions but trade in goods slowed due to weakening global industrial production.

Regional

Most economies in developing East Asia and Pacific (EAP) have recovered from the succession of shocks since 2020 and are continuing to grow, albeit at a slower pace. Private consumption, rebounding from the pandemic and inflation-induced austerity, had sustained growth in the region but is losing momentum unexpectedly early, particularly in China. Foreign demand for manufactured goods and commodities in EAP is weakening as global growth slows down, while investment as a share of GDP has remained lower than pre-pandemic levels over the last few years.



Domestic developments

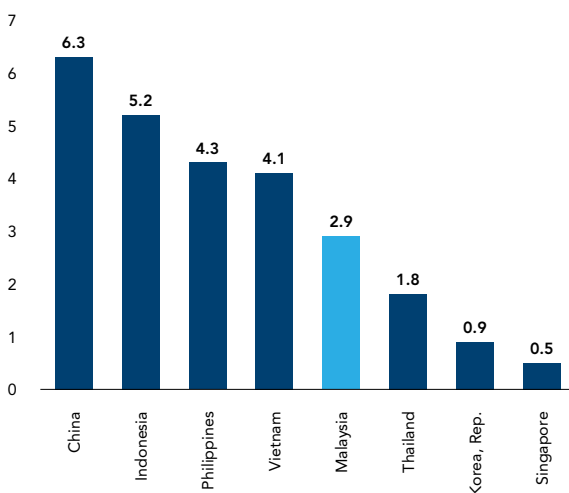
Momentum in economic recovery has moderated

Malaysia's economic growth moderated in Q2 2023 amid subdued external demand. Malaysia's GDP growth slowed to 2.9 percent in Q2 2023 (Q1 2023: 5.6 percent), consistent with those in the more trade-dependent EAP economies (Figure ES1). The external sector weighed down on economic activity through weaker external demand amid a global technology downcycle and moderating commodity prices. Nevertheless, continued growth in consumption and investment in both the private and public sectors supported growth in the quarter.

On the supply side, there was a broad deceleration across all economic sectors. The services sector expanded moderately by 4.7 percent (Q1 2023: 7.3 percent) on improved labor market conditions and continued recovery in consumer-related segments. The manufacturing sector grew marginally on weaker electrics and electronics (E&E) production as well as lower output of refined petroleum products. Meanwhile, the agriculture, and mining and quarrying sectors contracted on production-related issues.

FIGURE ES1
Trade-dependent countries like Singapore, Rep. of Korea, Thailand, Vietnam and Malaysia were more affected by slower external demand in Q2 2023

Real GDP growth, 2Q 2023, y/y, Percentage

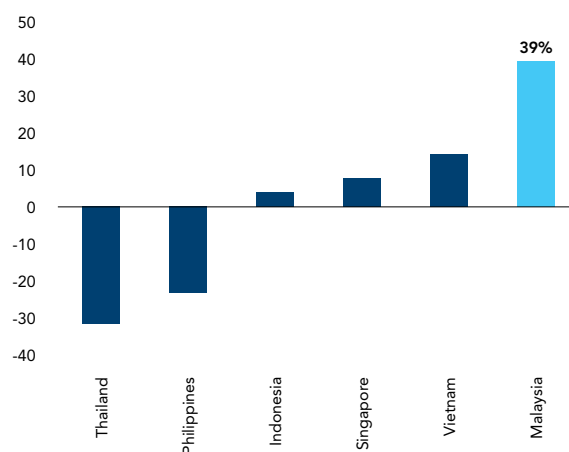


Source: Haver; DOSM

While output has surpassed its pre-pandemic level, it remains below the pre-pandemic projected level. Despite the strong economic recovery last year, aggregate GDP remains below its pre-pandemic projected level. Economic shocks, including the recent pandemic, have dented the growth momentum. A sustained increase in private investment, including foreign direct investment (FDI), will be necessary to maintain a sustainable economic growth trajectory. In 2022, Malaysia experienced the highest annual increase in net FDI inflows relative to its ASEAN peers (Figure ES2). However, Malaysia's net FDI inflows is still lagging behind some of its regional peers, particularly Indonesia and Vietnam (see Box 1 for the discussion on the latest FDI trends in Malaysia).

FIGURE ES2
Malaysia saw the highest increase in net FDI inflows compared to ASEAN peers in 2022

Change in net FDI inflows from 2021, Percentage



Source: World Bank Staff Calculations based on 2023 UNCTAD World Investment Report data

On the external front, against the backdrop of a weaker global economy, Malaysia's export contracted in Q2 2023. Gross exports contracted by 11.1 percent in Q2 2023 (Q1 2023: 3.0 percent), driven by a broad-based downturn in external demand across all products. Similarly, gross imports contracted by 11.5 percent in Q2 2023 (Q1 2023: 3.4 percent) due to weaker intermediate imports. The current account surplus increased to 2.1 percent of GDP (Q1 2023: 1.0 percent) on higher travel receipts and repatriation of profits from investments abroad, which helped offset a smaller goods surplus.

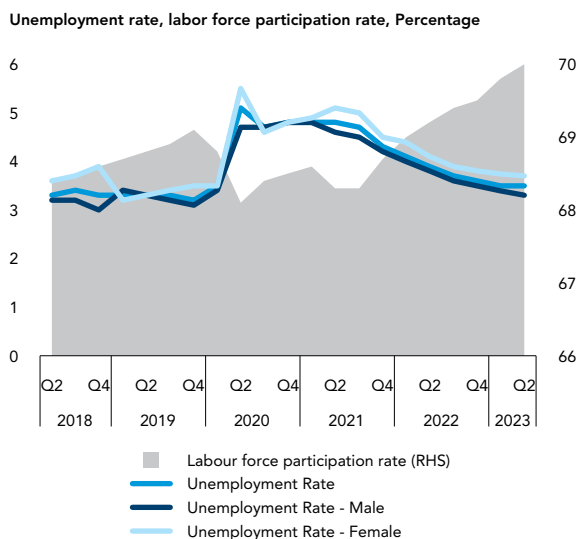
While exports of non-semiconductor E&E contracted by 9.5 percent in June 2023, exports of E&E remained resilient, expanding at 3.3 percent during the month. Between 2009 to 2022, Malaysia's

robust performance in the E&E semiconductor exports has been boosted by the global technology cycle, and the U.S.-China trade tensions. Nevertheless, maintaining its competitiveness in the semiconductor value chain remains a challenge (see Box 2 on the impact of US-China trade tensions on Malaysia’s semiconductor industry).

Overall labor market conditions are returning to pre-pandemic levels

Conditions in the labor market continued to improve. The national unemployment rate declined to 3.5 percent in August (Q4 2019: 3.2 percent). At the same time, labor force participation rose to 70.0 percent in Q2 2023 (Q4 2019: 69.1 percent) (Figure ES3). The decline in the unemployment rate was partly driven by the declining unemployment amongst the younger workforce.

FIGURE ES3
The unemployment rate shows a steady decline towards pre-pandemic levels



Source: DOSM

Skills-related underemployment among workers with tertiary education but working in semi- or low-skilled occupations remains high. In particular, skills-related underemployment for women has been increasing. This could reflect the fact that women are more likely to shoulder the burden of childcare and elderly care, and thus may opt to have less-demanding jobs. In addition, skills-related underemployment rate has generally been on the rise amongst youth. The overall increasing trend in skills-related underemployment may imply that structural factors are

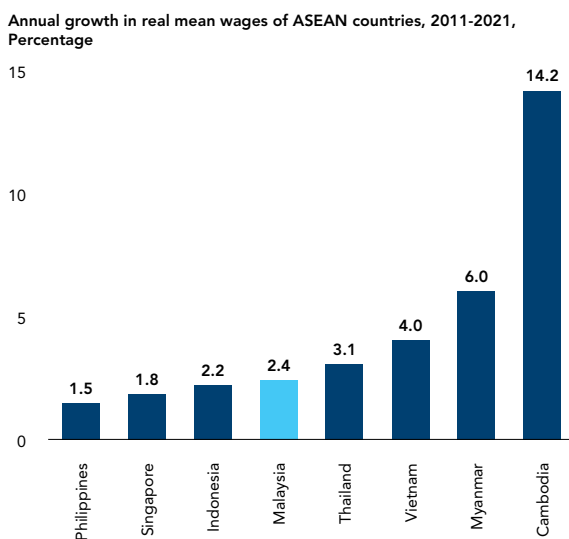
at play, with skills in supply not well matched to demand in the labor market.

Over the last decade, the wage gap has increased

The wage gap between low-skilled and high-skilled workers in Malaysia has increased in the last decade. Relative growth in real median wages for low-skilled workers has been the highest compared to other workers in recent years. However, low-skilled workers have not been able to ‘catch up’ to high-skilled workers. The absolute difference in real median wages between low-skilled and high-skilled workers has widened over time. In 2010, the gap between the two groups was RM1,800, and by 2021 this gap increased to RM2,474. When compared to ASEAN countries, real wage growth in Malaysia has been low (Figure ES4).

Around half of all workers in Malaysia earned less than RM2,000 per month in 2021, only slightly above the current statutory minimum wage of RM1,500 nationwide. This suggests that many workers earn well below the suggested “living wage”, an adequate amount to provide beyond affording basic necessities, such as social participation and financial security. The cabinet has recently approved the progressive wage system policy with hopes that it would result in a more stable and inclusive salary growth in Malaysia (see Box 3 on wage growth in Malaysia over the years).

FIGURE ES4
When compared to ASEAN neighbors, annual real wage growth in Malaysia has been low



Source: World Bank Staff Calculations based on DOSM and ILO Global Wage Report 2022-23 data

Lower income households remain vulnerable despite the recovery

Malaysia's absolute poverty rate stood at 6.2 percent in 2022, higher than the pre-pandemic level of 5.6 percent in 2019. Nearly 490,000 Malaysian households still live below the average national poverty line of monthly household income of RM2,589. While rural poverty declined to 12 percent (2019: 12.4 percent), the urban poverty rate rose significantly to 4.5 percent in 2022 (2019: 3.8 percent) as urban areas were generally hit harder by COVID-19 than rural areas.

High inflation observed last year affected real incomes in selected households, including those in poorer states. The 2022 Household Income Survey reported an increase in Malaysia's mean household gross income from RM7,901 in 2019 to RM8,479 in 2022. However, after considering high inflation in 2022, several states including Federal Territories Kuala Lumpur and Putrajaya have suffered a negative growth in household real income. The high inflation also affected real incomes in poorer states, for example, in Kedah and Kelantan.

Since peaking in 2022, headline inflation has continuously declined and was estimated at 2.0 percent in July 2023

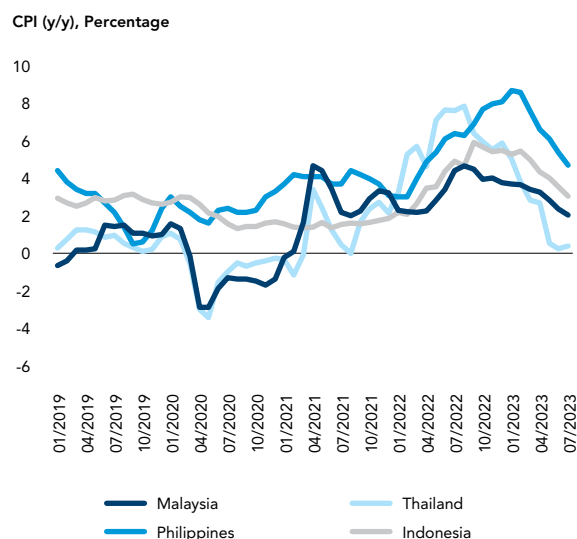
As inflationary pressures eased, the central bank kept the overnight policy rate at 3.00 percent

Headline inflation in Malaysia has steadily declined in line with other regional countries (Figure ES5). Since peaking in 2022, headline inflation has continuously declined and was estimated at 2.0 percent in July 2023. Easing commodity prices and lower inflation for transportation, food and non-alcoholic beverages have contributed to the decline in headline inflation. Meanwhile, the producer price index (PPI) declined moderately, mainly driven by decreases in production prices in the mining and manufacturing sectors.

Amidst easing inflation and moderating growth outlook, the overnight policy rate (OPR) was maintained at 3.00 percent in July and September. At this current rate, the Monetary Policy Committee

(MPC) deems monetary policy remains supportive of the economy and it expects both headline and core inflation to trend lower in 2H 2023, broadly within its expectations.

FIGURE ES5
Headline inflation in Malaysia has steadily declined in line with other regional countries



Source: World Bank Staff Calculations based on DOSM data

The banking sector remains well-capitalized and has ample liquidity

The Malaysian banking sector has maintained adequate capital buffers. The total capital ratio (TCR) remained stable at 18.5 percent as of end-June 2023, well above the regulatory minimum capital level. In addition, the liquidity coverage ratios (LCR) remained above the regulatory minimum, climbing to 154.4 percent as of June 2023. Banks have also increased holdings of high-quality liquid assets since last year.

Loans to household and firms continue to grow at 4.5 percent annually to RM2.1 trillion in June 2023. Gross non-performing loans (NPLs) ratios remain relatively low compared to the levels experienced in the previous crises. While the latest figure showed that total NPLs has continued to inch higher since December 2022 to 1.76 percent, Malaysia's gross NPL ratio remains among the lowest among the ASEAN countries, where ratios have ranged between 1.8 percent and 3.5 percent. Banks have also reduced provisions for NPLs since the expiry of forbearance measures and stress test results published by the central bank indicate that financial institutions have adequate capacity to absorb increases in NPLs. The share of loans under repayment assistance has further declined to 4.2 percent of total

loans outstanding respectively as of December 2022 (December 2021: 26.1 percent).

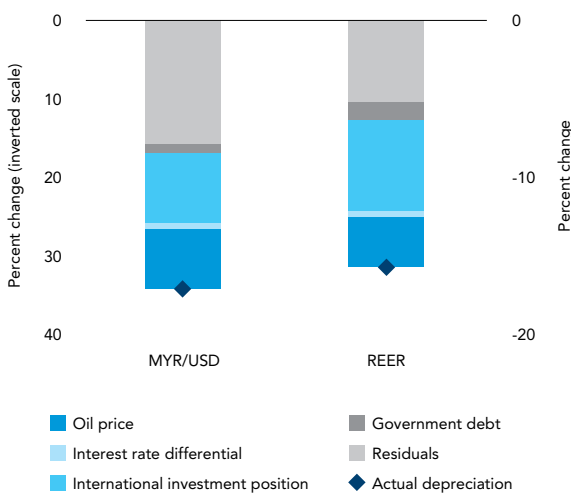
In the domestic financial markets, net portfolio inflows into the bond market helped to offset outflows from the domestic equity markets. Amid inflows into the bond market, foreign holdings of debt securities and *sukuk* in Malaysia increased to 13.7 percent of the total value outstanding as of June 2023 (December 2022: 13.2 percent). In tandem, portfolio inflows into the bond market also coincided with declines in government bond yields. The 10-year yields on the Malaysian Government Securities (MGS) declined 22 basis points between end-December 2022 and end-June 2023. The decline in MGS yields also reflected BNM's pause in monetary policy tightening.

Concerns about weak global growth partly contributed to the ringgit depreciation

Concerns about weak global growth partly contributed to the weakening of the ringgit. From 1 January to 24 August 2023, the ringgit depreciated by 5.2 percent against the U.S. dollar, one of the largest among regional countries. Similarly, the real effective exchange rate (REER) was on a downward trend, and unlike other countries in the region Malaysia's REER has been declining since 2018.

FIGURE ES6
The oil price shock accounted for 22.6 percent of the depreciation observed between July 2014 and January 2016

Oil Drivers of Ringgit Depreciation, (Quarter 3, 2014-Quarter 4, 2015)



Source: International Financial Statistics, IMF; World Bank Commodity Price Data (The Pink Sheet), World Bank; Monthly Highlights & Statistics, BNM; Board of Governors of the Federal Reserve System (US); Morgan Markets.

Analysis on the two largest episodes of ringgit depreciation over the last decade, 2014-2016 and 2021-2023, show several factors driving exchange rate movements. In the former period, ringgit depreciation was largely driven by lower oil prices and capital outflows (Figure ES6). In the latter period, ringgit depreciation was mainly due to U.S. monetary policy tightening as well as movements in oil prices (see Box 4 on What Drives Ringgit Depreciation?).

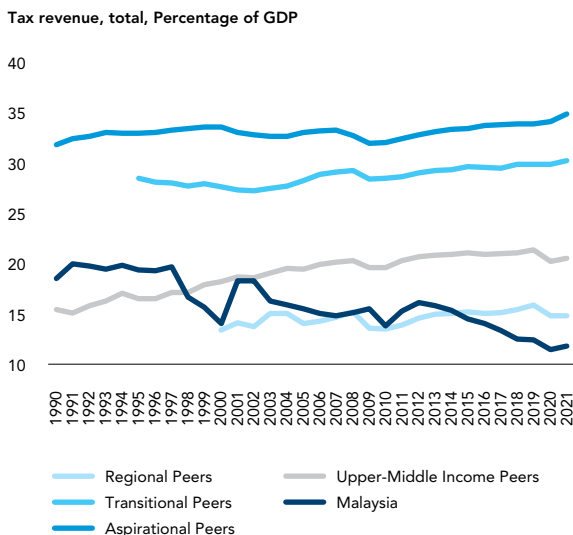


Fiscal space is expected to remain narrow in the near term

Persistent decline in tax revenue as a percentage to GDP continues to contribute to revenue inadequacy. After a higher revenue collection in 2022 driven by higher petroleum revenues, the government's revenue collection is expected to resume its downward trend this year. Analyses of revenue adequacy shows that Malaysia's tax revenue collection is well below its estimated potential tax revenue. Its tax-to-GDP ratio has been declining over the years, trailing increasingly behind comparator countries (Figure ES7).

Malaysia's limited fiscal space is further exacerbated by the marked rigidity and inefficiency in government spending. In 2022, almost 55 percent

FIGURE ES7
Malaysia's tax-to-GDP ratio has been declining over the years, trailing increasingly behind comparator countries



Source: World Bank Staff Calculations based on OECD data

of the government's operating expenditures (OE) was channeled to rigid expenditures, namely, obligations related to salaries, pensions, and debt service payments. Government investment averaged at 4.0 percent of GDP, above the OECD average of 3.1 percent. While Malaysia's public investment is comparable to OECD levels, implementation challenges and high levels of public debt make it more difficult to achieve development goals.

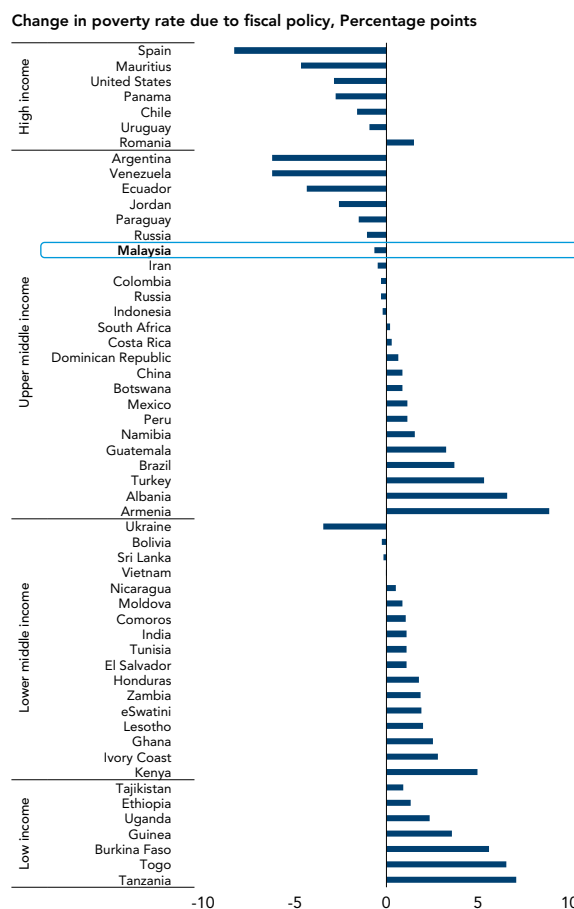
In addition, inefficiency in government spending exists, particularly in subsidies expenditures. It is estimated that the total expenditure on blanket fuel subsidies in 2022 amounted to RM52 billion or 2.9 percent of GDP, making up 56 percent of total subsidy spending. The government has indicated that it will present further details about subsidy reform plans in the upcoming Budget 2024 (see Part 2: Raising the Tide, Lifting All Boats).

The government has reiterated its commitment towards consolidating the fiscal position for more sustainable public finance. Under the recently announced *Madani* Economy framework, the government announced that one of its medium-term economic targets is to achieve fiscal sustainability, with the fiscal deficit narrowing to 3 percent of GDP or lower over the medium-term. For 2022 the government's fiscal deficit decreased to 5.6 percent of GDP (2021: 6.4 percent).

Special Topic: Raising the Tide, Lifting All Boats

Malaysia's taxes, transfers and subsidies do better than the upper-middle income country (UMIC) average at reducing poverty (Figure ES8). The combination of taxes, spending on subsidies (imputed as cash) and cash transfers reduce poverty in Malaysia by 0.9 percentage points (excluding the non-cash benefits of health and education as well as infrastructure spending). Although the tax burden on poorer households is low, with many goods and services tax-exempt, as of 2019, transfer benefits are also relatively low, as are the average benefits from fuel and other subsidies. In most non-OECD (Organization for Economic Co-operation and Development) countries, poverty is actually increased by fiscal policy as taxes outweigh cash benefits for the poor.

FIGURE ES8
Malaysia's taxes, transfers and subsidies reduce poverty by more than most other UMICs

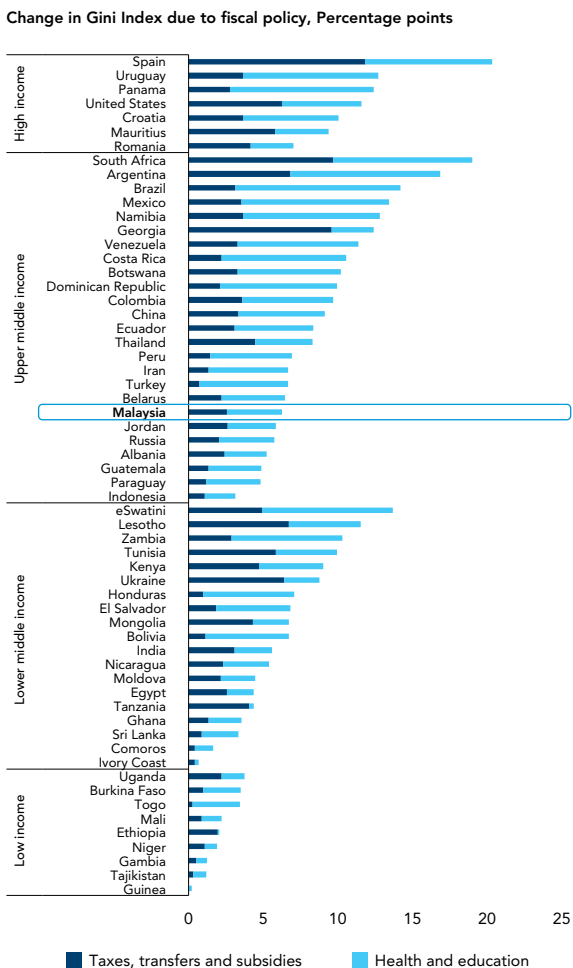


Source: World Bank Staff Estimates based on CEQ Data Center on Fiscal Redistribution, OECD and World Bank data. See World Bank. 2022. Correcting Course.

Note: Impact on taxes, subsidies and transfers on the poverty headcount rate at the international poverty line for a country's income category. Excludes non-cash benefits of health and education as well as infrastructure spending.

Malaysia's taxes, subsidies, transfers and in-kind spending on health and education also cause income inequality to fall by 6.4 points. While this is a significant impact, it is nonetheless only 18th out of 25 UMICs (Figure ES9). Moreover, majority of the inequality reduction comes from health and education services. While important, these are non-cash and do not help meet daily living expenses (and thus are not included in the poverty impact estimates). With the focus of the analysis on current distributional outcomes, only short-term health and education benefits are included, valued at their cost of delivery. They have important longer-term benefits as well which are not included here.

FIGURE ES9
Malaysia's impact on inequality through taxes, transfers and subsidies is relatively small compared to other UMICs

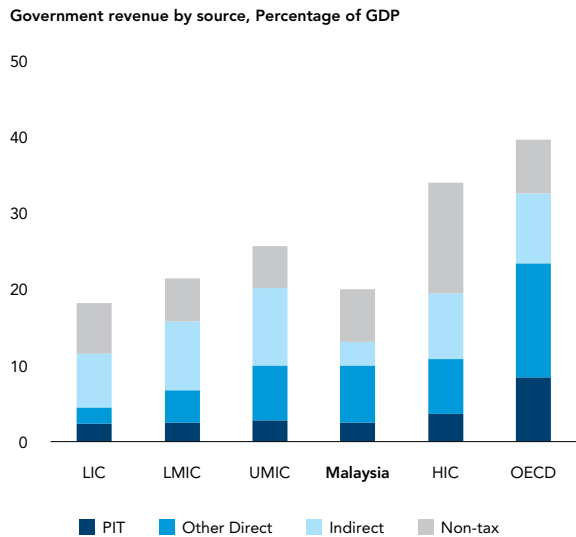


Source: World Bank Staff Estimates based on CEQ Data Center on Fiscal Redistribution, OECD and World Bank data. See World Bank. 2022. Correcting Course.
 Note: Impact on taxes, subsidies, transfers and health and education spending on the Gini Index of income inequality.

Despite a long-term declining trend, income inequality in Malaysia remains high compared to regional and transitional peers. This emphasizes the importance of a more progressive fiscal policy. Income inequality, as measured by the Gini Index, fell from a high of 56 points in 1976 to 39 by 2016, a sustained and sizeable decline. Since then, however, the decline has stalled and even begun to reverse even before the COVID-19 pandemic to 41 by 2019, while inequality remains high relative to regional and aspirational peers. Malaysia's Gini Index of income inequality is higher than in most other Association of Southeast Asian Nations (ASEAN) countries, recently transitioned high income countries and OECD countries.

Malaysia's revenue collection is closer to a low-income than a high-income country. Prior to COVID-19, Malaysia collected only around 12 percent of GDP in tax revenues. This is not much more than in low-income countries and considerably below the UMIC average. This is also far from the high income and OECD level Malaysia aspires to (Figure ES10).

FIGURE ES10
Malaysia collects much less revenue than other middle income countries, driven by very low rates of indirect taxation



Source: World Bank. 2022. Poverty and Shared Prosperity Report: Correcting Course and MOF.
 Note: Malaysia data point is for 2019.

The very low tax collection is mainly due to relatively little collection in consumption and personal income taxes. Indirect taxes e.g., taxes on consumption such as goods and services tax (GST), sales and services tax (SST) and excises are easier to collect than direct taxes e.g., such as personal and corporate income

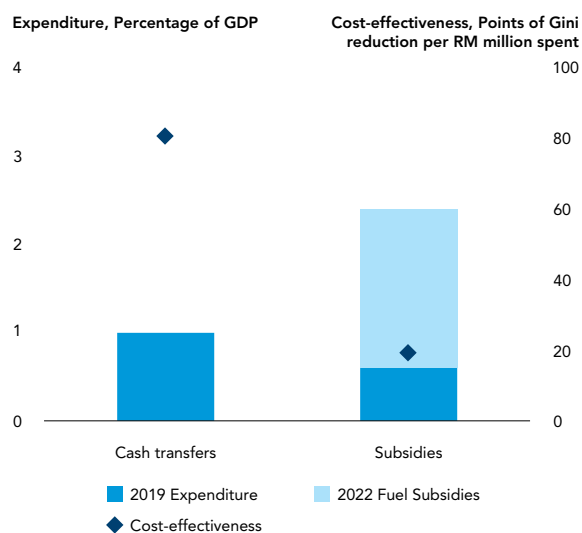


tax. However, Malaysia collects just 3 percent of GDP through this channel, less than half of the low-income country average. In addition, personal income tax (PIT) collection is also relatively low and has declined in recent years. Since COVID-19, it has fallen to 1.9 percent of GDP.

Low revenues mean low social spending, which is the main reason Malaysia's fiscal policy does not reduce inequality as much as in most other UMICs. Countries of all income levels spend a relatively fixed percentage of GDP on non-social spending such as administration and security. Consequently, once sufficient revenue has been generated to cover these fixed costs of running the country, greater revenues mean more fiscal space for pro-poor spending, which generally expands rapidly as countries move from low to middle to high income; there is also more fiscal space for growth-enhancing public investments such as infrastructure. Malaysia's low revenues mean its spending on education, health and social assistance (excluding fuel subsidies) are all lower than UMIC averages. Low spending levels partly contribute to education and some health outcomes which are below those predicted by Malaysia's income, as well as when compared to aspirational high-income countries.

Moreover, fuel and other subsidy spending further consumes the limited social spending budgets. In 2019, Malaysia spent 0.6 percent of GDP on fuel and other subsidies. As international fuel prices soared with the Russian invasion of Ukraine, fuel subsidy spending rose to 2.9 percent of GDP in 2022, more than the 2019 total health budget, over double that of social assistance, and four-fifths of that for education. Total social assistance cash and non-cash transfers are four times more cost effective at reducing inequality than subsidies (Figure ES11).

FIGURE ES11
Direct transfers are four times more cost effective at reducing inequality than subsidies



Source: MOF, 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations. Note: Cost-effectiveness is points of Gini Index reduction per RM million spent. Direct transfers include all cash and non-cash social assistance benefits.

There is global evidence that well-designed social assistance programs that involve cash transfers do not create dependency or reduce labor market incentives when benefit levels are set accordingly. Policymakers and the wider public often express concerns that cash transfers will increase dependency on the state and discourage work. However, global reviews of the evidence find little grounds for concern in developing countries. One reason for this is that the benefit levels are often not enough for beneficiaries to be able to afford to stop working; in Indonesia, the temporary cash transfers used to offset the impact of fuel subsidy reforms actually increased employment rates of beneficiaries.



標條湯
KOAY TEOW SOUP
RM 4.50 RM 4.00

燒臘雞鴨飯
ROASTED CHICKEN RICE

港式燒臘飯
CHICKEN RICE

標條湯

CUGUR
UDANG
TAUKUA
PENDANG
PASSEMBUR

BAHAR CAPE CORNER

紅豆冰
Red Bean Ice

加哩麵
CURRY MEE
RM 5.00 RM 6.00

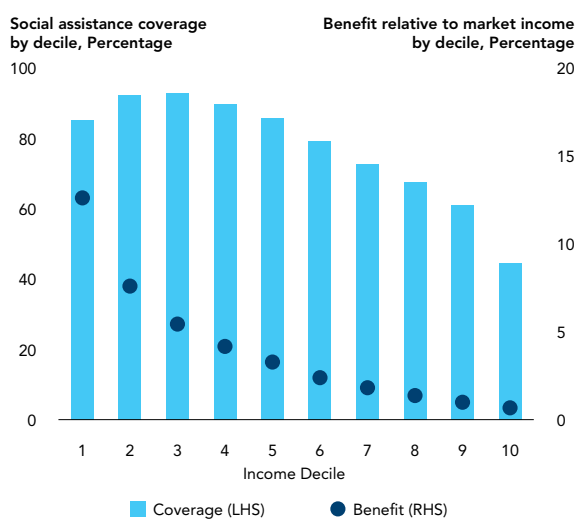
經濟食
ECONOMY R

叻沙
LAKSA

In Malaysia, however, the current challenge is the opposite. Instead of the risk of creating dependency because of the generosity of the cash transfer benefits, the amount that reaches the poor and vulnerable remains insufficient to help them meet their basic needs. This is mainly because too many richer households who do not need the social assistance receive the assistance, diluting the benefits for those who do need it. Malaysia does well at ensuring most poor and vulnerable households receive some sort of social assistance; only around 10 percent of the B40 are excluded (Figure ES12). However, many non-poor Malaysians also receive assistance. 76 percent of the M40 receive assistance and even 61 percent of second-highest and 45 percent of the highest income deciles do as well. Consequently, only 49 percent of transfers goes to the B40. Spreading out the social assistance budget over so many – 78 percent of the total population – means that the benefits are diluted for the poor. For beneficiaries in the poorest decile, average transfers are equivalent to only 13 percent of their pre-fiscal income, and 8 percent for 2nd poorest decile income (Figure ES12), compared to an average of 25 percent pre-fiscal income for the poorest two deciles of households in UMICs. Better targeting of transfers away from richer households would mean the current budget could be spent on more generous benefits for the poor, achieving a greater impact on poverty and inequality at no extra cost, although even if the current budget was perfectly targeted to B40 households, the average benefit levels would still be under the UMIC average.

FIGURE ES12

Most poor receive transfers but so do many non-poor, with the M40 and T20 receiving half of all benefits



Source: MOF, 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.
Note: Cost-effectiveness is points of Gini Index reduction per RM million spent.

Economic outlook

Global growth is expected to slow over the near term

Global growth is projected to moderate to 2.1 percent in 2023 before edging up to 2.4 percent in 2024 (2022e: 3.1 percent). While the aggregate global forecast has been revised up, projections for most economies have been revised down, with larger downgrades among countries that have had a greater degree of monetary tightening. Global inflation is expected to gradually ease but will remain above its pre-pandemic level.

Growth in the EAP region is projected to strengthen to 5.0 percent in 2023 before slowing to 4.5 percent in 2024. China's growth is expected to slow in 2024 as the rebound from the re-opening of the economy fades, while elevated debt, weakness in the property sector, and longer-term structural factors weigh on growth. Growth in the rest of the region is projected to edge up to 4.7 percent in 2024, as likely recovery of global growth and the expected easing of global financial conditions are expected to offset the impact of China slowing down.

Malaysia's economic growth is expected to moderate in 2023

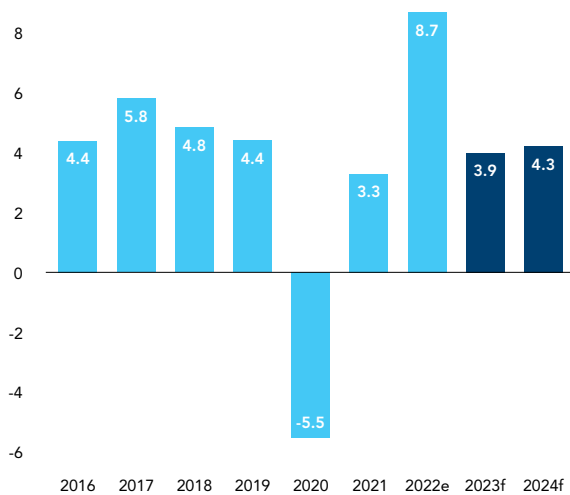
In the face of slowing external demand, Malaysia's GDP growth is forecast to moderate to 3.9 percent this year before picking up modestly to 4.3 percent next year (Figure ES13). Domestic demand will continue to be the main driver of growth throughout the forecast period. Private consumption is forecast to expand at a more moderate rate of 5.2 percent this year and 6.1 percent next year, supported by further improvement in labor market conditions as well as continuous household income support from the government. Public consumption is projected to grow at 0.9 percent this year (2024f: 0.8 percent) on account of higher emolument outlays by the government.

Gross fixed capital formation (GFCF) growth is expected to be sustained at 5.1 percent in 2023 (2024f: 3.6 percent). Private investment will continue to be supported by ongoing and new multi-year investments in the technology-intensive manufacturing and services sectors. Meanwhile, capital spending by the general government will continue to be directed mainly towards upgrading public infrastructure in the transportation, health and education sectors.

FIGURE ES13

Malaysia's economy is projected to expand at a more moderate pace in 2023

GDP, y/y, Percentage



Source: World Bank Staff Calculations based on DOSM data

Investment activity by public corporations will be largely supported by the ongoing and new infrastructure projects, including the East Coast Rail Link (ECRL), Light Rail Transit Line 3 (LRT3) and the Pan-Borneo Highway.

The weakness in the external sector is likely to persist in the second half of the year. Malaysia's export is projected to contract by 5.8 percent this year (2024f: 3.7 percent). This reflects the weaker-than-expected performance in Malaysia's goods trade in recent months amid weakening global demand, and the ongoing shift in global consumption toward less trade-intensive goods. Similarly, import growth is forecast to contract by 6.3 percent this year (2024f: 4.3 percent), in line with the expected fall in export activity and more moderate growth in consumption spending and investment activity.

Headline consumer price inflation is expected to moderate to between 2.5 and 3.0 percent this year (2022: 3.3 percent). The lower inflation forecast is expected to be driven by base effects, easing global supply constraints and lower commodity prices. The forecast is also premised on the assumption that the ceiling on retail fuel prices and price control measures on selected food items remains in place throughout the year, limiting cost pressures from the prevailing global oil and food prices. Core inflation will also likely trend lower in 2H 2023 but is expected to remain relatively elevated at around 3 percent this year.

The baseline growth projections for Malaysia are subject to several external and domestic downside risks. On the external front, global growth could be weaker than projected in the event of tighter-than-expected global financial conditions or a greater-than-expected monetary tightening. A faster-than-anticipated fading of the post-pandemic rebound in China and an intensification of geopolitical tensions could also result in slower-than-expected expansion in global economic activity. The materialization of these risks could have considerable adverse spillovers to Malaysia given its high level of integration with the global economy and financial markets.

Domestically, the key downside risk relate to the uncertainty around domestic inflation and the strength of household consumption. Higher or more persistent domestic inflation and weaker real disposable income growth could weigh on the strength of consumption spending, especially for low-income households. An upside shock to inflation may also prompt further monetary tightening, compounding the dampening effect on growth from existing policy normalization.

Policy recommendations

Near-term focus should be on supporting the vulnerable and rebuilding fiscal buffers

Both financial and non-financial support and assistance measures particularly to vulnerable, low-income households should continue. While government support to households was pro-poor, the level of assistance remain insufficient and efforts to move towards a more targeted subsidy framework that would benefit lower income households would be relevant and timely. In parallel, access to good jobs and secure employment are fundamental to alleviate poverty and reduce income inequality. As such, more comprehensive labor market policies are essential to address labor demand and supply constraints.

Increasing the fiscal space remains a priority in the government's near-term current fiscal management. It is imperative to continue with efforts to enhance revenue mobilization in line with the

growing spending and investment needs. Concurrently, spending efficiency could be achieved by enhancing the targeted social safety net programs. Improved targeting and consolidation of support instruments is needed to provide better coverage and protection to low-income and vulnerable households (see Part 2: Raising the Tide, Lifting All Boats).

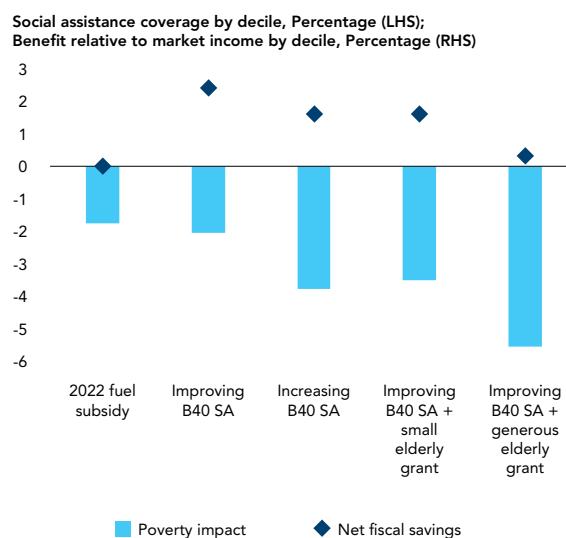
A combination of stronger tax collection, reduced blanket subsidies and more adequate targeted support for those who need it would further reduce poverty and inequality. Increasing taxes or reducing fuel subsidies will increase the cost of living for all, including poorer households. However, improving targeting of existing social assistance could more than offset any increase. Moreover, a portion of the new revenues or saved expenditures could be used to increase the social assistance budget, further reducing poverty and inequality while still making fiscal gains.

It is imperative to continue with efforts to enhance revenue mobilization in line with the growing spending and investment needs

Redirecting the 2022 fuel subsidy budget into expanded and refocused social assistance could double poverty reduction while generating 1.6 percent of GDP in fiscal savings. Figure ES14 compares the fiscal cost and impact on poverty of more focused social assistance initiatives to the 2022 fuel subsidy baseline; analysis is based on an earlier estimate of 2.4 percent of GDP, so the results here underestimate potential budget savings by 0.5 percentage points of GDP. The four options examined all eliminate fuel subsidies and redirect the spending: i) save the entire fuel subsidy budget while improving the targeting and delivery of the 2019 social assistance budget of 1.0 percent of GDP to cover just B40 households; (ii) improve targeting of B40 households while also increasing the budget to 1.8 percent of GDP with higher benefit levels; (iii) improved targeting of B40 households with 1.0 percent of GDP budget and introduce a RM 125 per month transfer for each elderly member in a B40 household and a RM 85 transfer for each elderly member in a M40 household; and (iv) the

same as (iii) but changing the elderly benefit levels and coverage to RM 400 for B40 elderly and RM 265 for elderly in Quintile 3 of the income distribution (M41-60). The first scenario – improving social assistance targeting at current budget levels – is sufficient to not only offset the poverty impact of removing the fuel subsidy but also achieve slight improvements in poverty reduction (2.0 points) while banking the entire fuel subsidy budget as fiscal savings. The second and third scenarios – not only improving targeting but either expanding B40-focused support or adding a modest but very broad elderly grant – around double poverty reduction to 3.8 and 3.5 points respectively while saving 1.6 percent of GDP. The final – introducing a more generous elderly grant – reduces poverty the most, by a considerable 5.6 points, albeit while spending most of the fuel subsidy budget, with only 0.3 percent of GDP saved.

FIGURE ES14
Redirecting fuel subsidy spending into expanded and refocused social assistance could double poverty reduction while also generating 1.6 percent of GDP in fiscal savings



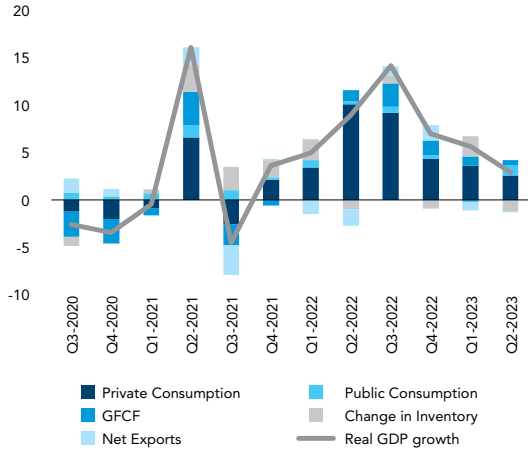
Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.

Note: 2022 fuel subsidy uses the 2019 CEQ baseline and increases international oil prices to 2022 average prices and increases government subsidy spending to maintain fixed domestic prices (costing 2.4 percent of GDP). Scenarios: (i) Improving B40 SA retains the 2019 1.0 percent of GDP for social assistance transfers but restricts coverage to B40 households only using PMT targeting; (ii) Increasing B40 SA is the same as (i) but increases the budget to 1.8 percent of GDP with higher benefit levels; (iii) Improving B40 SA + small elderly grant is the same as (ii) but adds a RM 125 per month transfer for all elderly in a B40 household and RM 85 transfer for all elderly in a M40 household; (iv) Improving B40 SA + generous elderly grant is the same as (iii) but increases the benefit to RM 400 for B40 elderly and RM 265 for elderly in Quintile 3 of the income distribution (M41-60).

Recent trends in Malaysia's economy

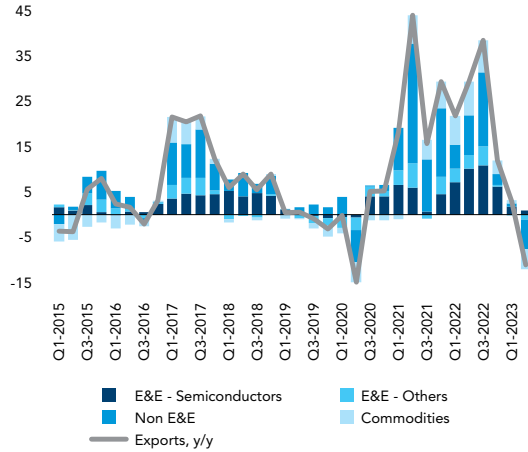
Malaysia's economy recorded a moderate growth in Q2 2023

Contribution to Real GDP growth and Real GDP growth, y/y, Percentage



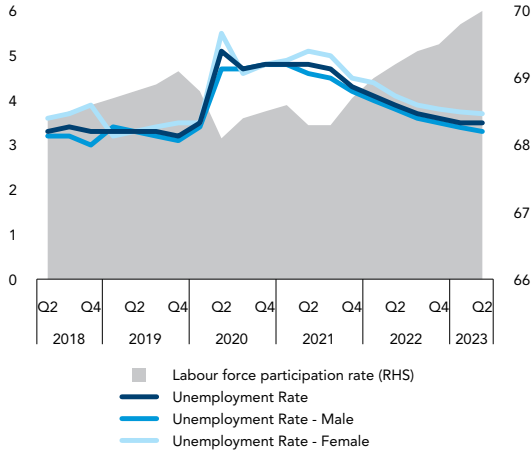
Exports growth contracted on broad-based decline in external demand

Contribution to Export Growth, y/y, Percentage (4-quarter moving average)



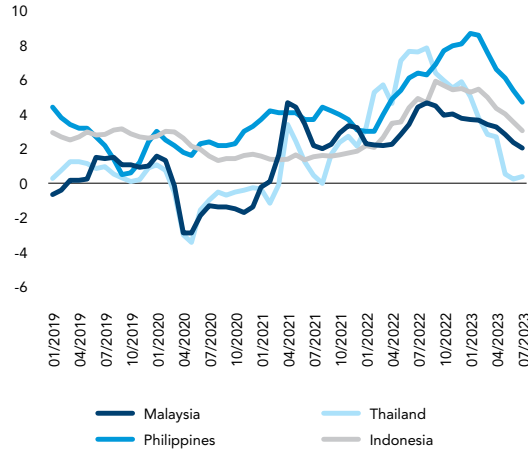
Unemployment rate has declined towards pre-pandemic levels

Unemployment rate, Percentage and Labor force participation rate, Percentage



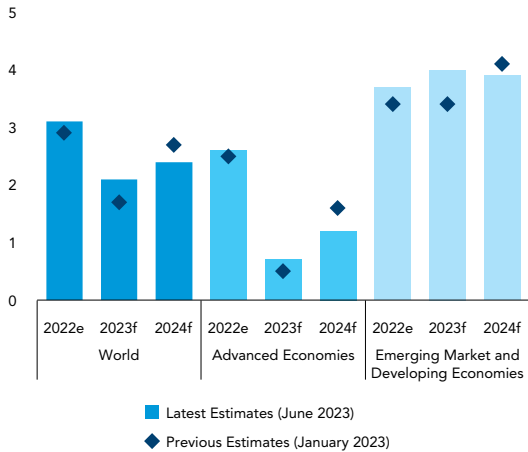
Headline inflation in Malaysia has steadily declined in line with other regional countries

CPI (y/y), Percentage



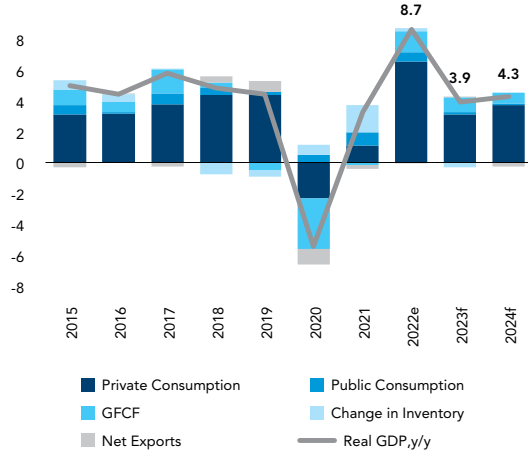
Global growth is projected to slow to 2.1 percent in 2023

Real GDP, y/y, Percentage



Malaysia's economy is projected to expand at a more moderate pace in 2023 and 2024

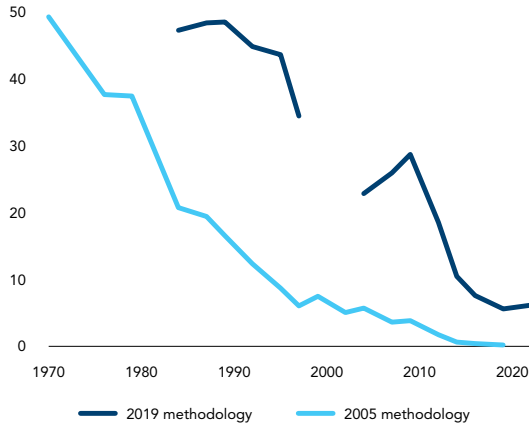
Real GDP, y/y, Percentage



Raising the Tide, Lifting All Boats

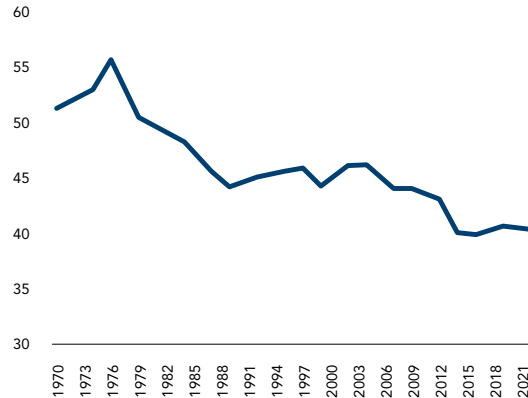
Poverty has fallen considerably over the last 50 years, but the pace of reduction has slowed in recent years

Poverty Rate, Percentage



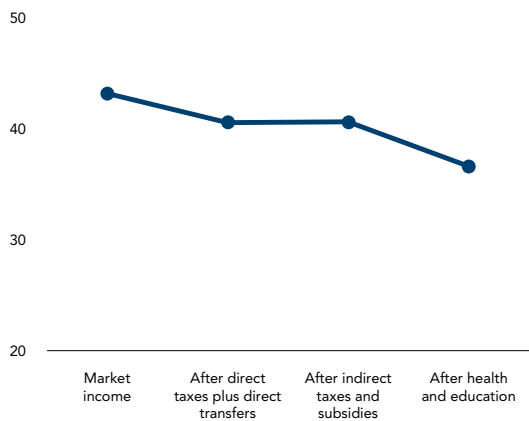
Inequality fell dramatically since 1976, but the decline began flattening and then reversing

Gini Index (total household income), Points



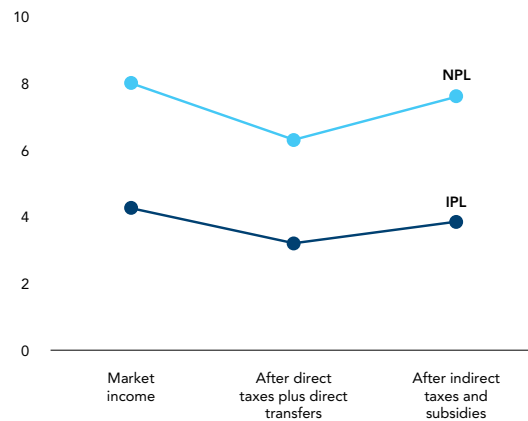
Pre-COVID-19 fiscal policy reduced inequality in Malaysia...

Gini Index before and after fiscal policy, 2019, Percentage



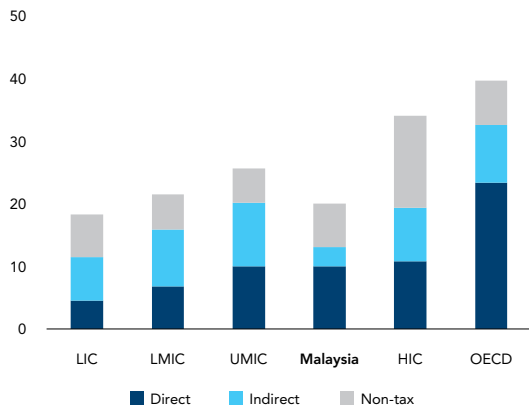
...but largely leaves poverty unchanged

Poverty headcount rate at national poverty line (NPL) and UMIC international poverty line (IPL) before and after fiscal policy, 2019, Percentage



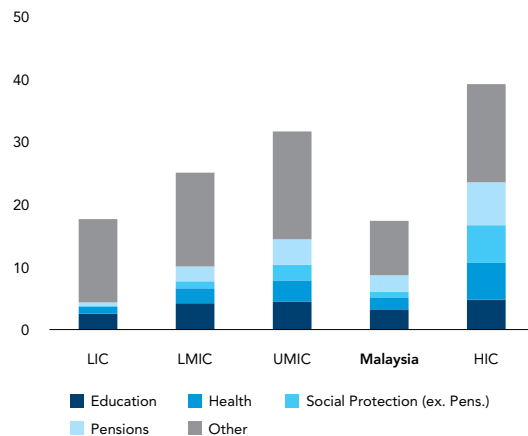
Generally, richer countries collect more total taxes and rely more on progressive direct taxation

Government revenue by source, Percentage of GDP



The greater fiscal space of richer countries means they spend more on health, education and social protection

Government expenditure by type, Percentage of GDP





- ← Masjid Kampung Hulu
- ← Jambatan Jalan Pasar
- Medan Kampung Pantai
- Padang Nyiru



PART ONE

Recent Economic Developments and Outlook

Recent economic developments

Global growth is showing signs of deceleration, while regional growth is moderating

Global economic activity registered resilient growth in early 2023 but is losing momentum.

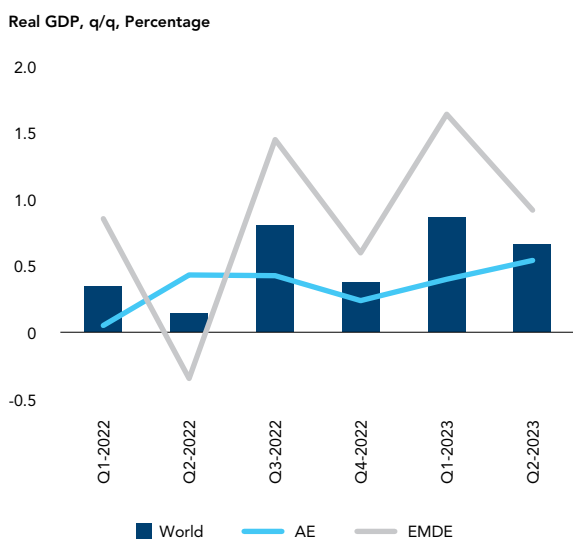
Global growth picked up to 0.9 percent (q/q) in Q1 2023, mainly reflecting the reopening of China’s economy and resilient consumption in the United States (Figure 1). In advanced economies (AE), growth slowed less-than-anticipated as tight labor markets drove wages up, preventing a sharp decline in consumption. However, global growth slowed slightly to 0.7 percent (q/q) in Q2 2023. The Purchasing Managers Indexes (PMIs) for June 2023 are indicating signs of deceleration for global activity, with services growth cooling gradually and manufacturing remaining soft. Global inflation has moderated in recent months, largely reflecting favorable base effects from commodity prices falling below their 2022 peaks, along with abating supply chain pressures.

Global trade in services strengthened in 1H 2023 thanks to easing of mobility restrictions but trade in goods has slowed amid weakening global industrial production.

Most economies in developing East Asia and Pacific (EAP) have recovered from the succession of shocks since 2020 and are continuing to grow, albeit at a slower pace (Figure 2).

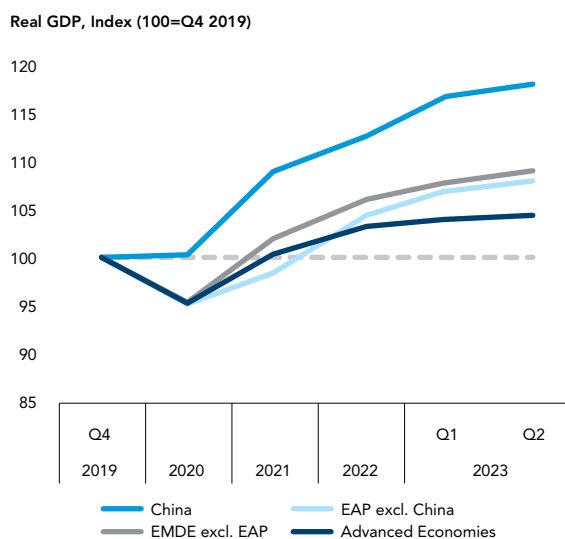
Private consumption, rebounding from the pandemic and inflation-induced austerity, had sustained growth in the region but is losing momentum unexpectedly early, particularly in China. Foreign demand for manufactured goods and commodities in EAP is weakening as global growth slows down, while investment as a share of GDP has remained lower than pre-pandemic levels over the last few years.

FIGURE 1
Global growth picked up in the first quarter of 2023 but is showing signs of moderation



Source: World Bank Global Economic Monitor

FIGURE 2
Growth in EAP economies have recovered from the succession of shocks since 2020 and are continuing to grow, but at a slower pace



Source: World Bank East Asia Pacific Economic Update October 2023

Developments in the Malaysian Economy

The momentum in Malaysia's economic recovery moderated amid global economic slowdown

The Malaysian economy grew at a more moderate rate of 2.9 percent in Q2 2023 (Q1 2023: 5.6 percent) (Figure 3). Malaysia's weaker growth in the second quarter was consistent with those in the more trade-dependent EAP economies as the external sector weighed down on economic activity through weaker external demand amid a global technology downcycle and moderating commodity prices (Figure 4). Consequently, gross exports and gross imports fell sharply by 11.1 percent (Q1 2023: 3.0 percent) and 11.5 percent (Q1 2023: 3.4 percent) during the quarter.

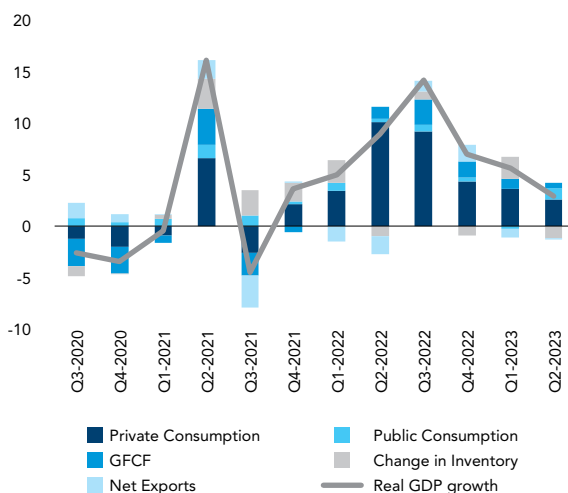
However, continued growth in consumption and investment in both the private and public sectors supported growth in the quarter. Private consumption continued to expand, albeit at a moderate rate of

4.3 percent (Q1 2023: 5.9 percent), as labor market conditions improved further while public consumption grew at 3.8 percent (Q1 2023: -2.2 percent) as emolument spending rose. Higher private and public capital spending on infrastructure, machinery & equipment (M&E), and government's fixed assets contributed to further improvements in investment activity. Gross fixed capital formation (GFCF) increased by 5.5 percent (Q1 2023: 4.9 percent). Meanwhile, on a quarter-on-quarter seasonally adjusted basis, the economy grew by 1.5 percent (Q1 2023: 0.9 percent).

On the supply side, there was broad deceleration across all economic sectors with contractions in the agriculture, and mining and quarrying sectors. The services sector expanded moderately by 4.7

FIGURE 3
Malaysia's economy recorded a moderate growth in Q2 2023

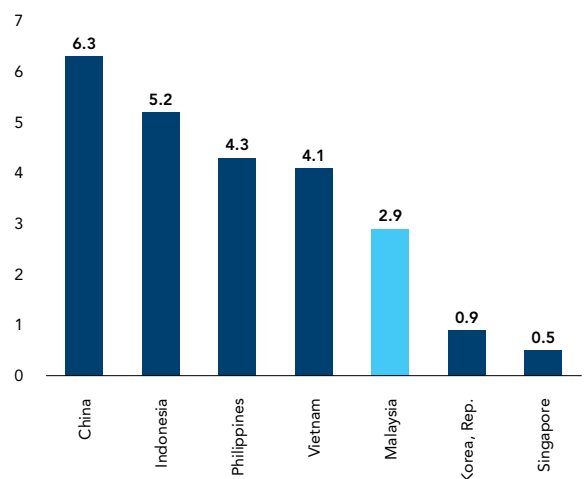
Contribution to Real GDP growth and Real GDP growth, y/y, Percentage



Source: DOSM

FIGURE 4
Countries that are more trade-dependent were more affected by weaker external demand

Real GDP growth, Q2-2023, y/y, Percentage

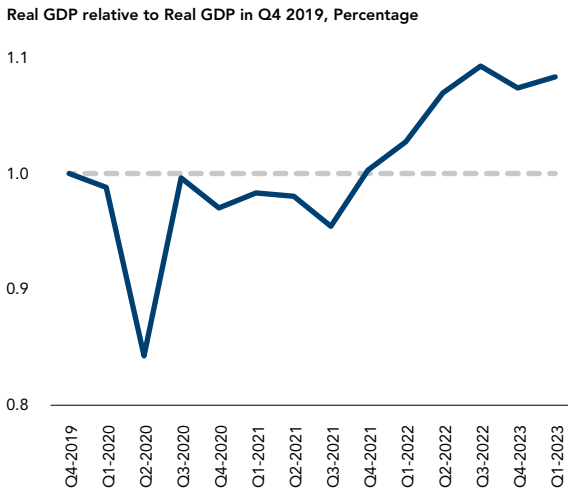


Source: DOSM, Haver

percent (Q1 2023: 7.3 percent) on improved labor market conditions and continued recovery in consumer-related segments such as retail and leisure-related services. Meanwhile, the manufacturing sector grew marginally by 0.1 percent (Q1 2023: 3.2 percent) due to weaker E&E production as well as lower output of refined petroleum products. The construction sector expanded by 6.2 percent (Q1 2023: 7.4 percent), led by continued progress of large infrastructure projects. On the other hand, the mining sector recorded a contraction of 2.3 percent (Q1 2023: 2.4 percent) on lower oil and gas output due to maintenance shutdowns. In the agriculture sector, output shrunk by 1.1 percent (Q1 2023: 1.0 percent), driven mainly by lower oil palm output and fisheries output due to unfavorable weather conditions.

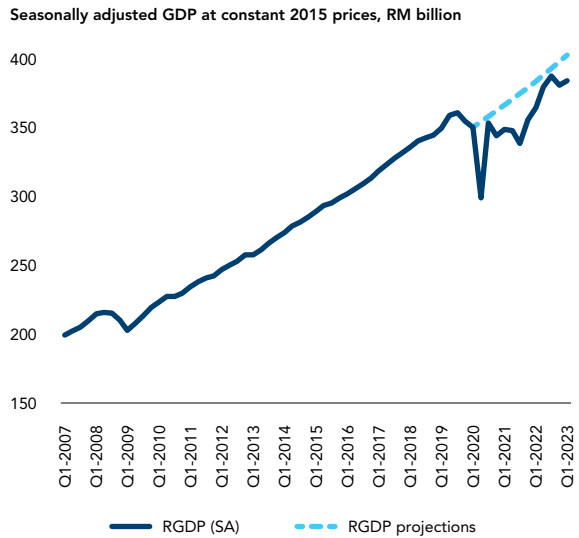
While output has surpassed its pre-pandemic level, it remains below the pre-pandemic projected level (Figure 5 and Figure 6). Thus far, the economic recovery in Malaysia has been strong, with the average growth rate in 2021-2022 estimated at 6 percent, compared to the 5-year pre-pandemic average of 4.9 percent. However, despite this strong economic performance, aggregate GDP remains below its pre-pandemic projected level. Economic shocks, including the recent pandemic, have dented the growth momentum. A sustained increase in private investment, including in foreign direct investment (FDI), coupled with improvements in productivity will be necessary to maintain a sustainable economic growth trajectory that enables Malaysia to reach high-income status¹ (see Box 1 on the latest FDI trends in Malaysia).

FIGURE 5
GDP has surpassed its pre-pandemic level...



Source: Haver Analytics and World Bank Staff Calculations

FIGURE 6
...however, it remains below its pre-pandemic projected level



Source: Haver Analytics and World Bank Staff Calculations
 Note: The RGDP projections are based on the forecast in the Malaysian Economic Monitor of December 2019. For 2022, the projected growth rate is the 5-year average, as of December 2019. Since GDP growth forecasts are annual, it is assumed equal growth rate in all quarters.

¹ See World Bank (2021) 'Aiming High – Navigating the Next Stage of Malaysia’s Development,' Country Economic Memorandum, Washington, DC: The World Bank.



BOX 1

FDI Trends in Malaysia

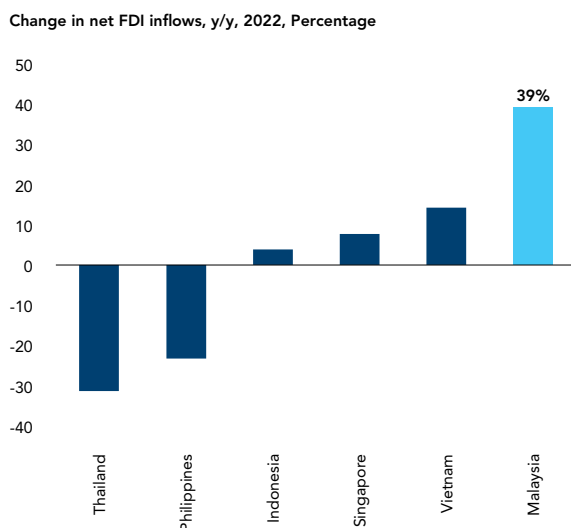
Malaysia experienced the highest annual increase in net FDI inflows relative to its ASEAN peers in 2022 (Figure 7). Net FDI inflows² to Malaysia increased by 39 percent to its highest record of US\$17 billion (RM74.6 billion) in 2022, positioning it 23rd globally ahead of regional peers like Thailand and the Philippines (Figure 8). This increase of inflows was in part due to increases in greenfield projects and project finance deals, by 24 percent and 129 percent respectively.³ Within developing countries, Malaysia has successfully attracted the top project for telecommunications (*The YTL Green Data Center Park Project*) and the second top project in agrifood systems (*The FGV Chuping Agro Valley Integrated Dairy Farming Project*).

The top contributing countries of Malaysia's net FDI inflows were the United States, Singapore, and Japan, with investments from these countries

flowing predominantly into the manufacturing sector followed by the services sector (Figure 9). Investments in manufacturing were largely in electrical, transport equipment, and other sub-sectors. In recent years, Malaysia has also been one of the top destinations for solar energy components manufacturing projects. Between 2016-2022, Malaysia was among the top 3 developing countries that attracted projects in battery manufacturing, right after Brazil and India. Meanwhile, Malaysia FDI inward stock increased by US\$3.3 billion (RM14.4 billion) for Q1 2023 and US\$1.5 billion (RM6.8 billion) for Q2 2023. The main sector contributing to this increase is the services sector, followed by manufacturing (Figure 10).

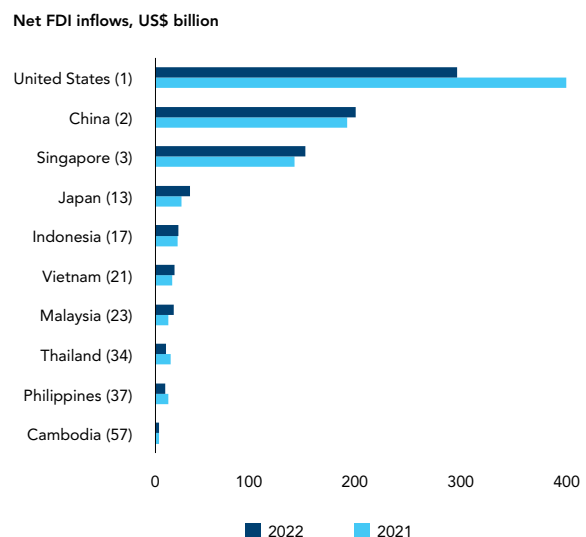
However, Malaysia's overall FDI performance is still lagging some of its regional peers. Despite experiencing the highest increase in net FDI inflows

FIGURE 7
Malaysia saw the highest increase in net FDI inflows compared to ASEAN peers in 2022



Source: World Bank Staff Calculations based on 2023 UNCTAD World Investment Report data

FIGURE 8
Malaysia ranks 23rd in the world for net FDI inflows in 2022



Source: World Bank Staff Calculations based on 2023 UNCTAD World Investment Report data

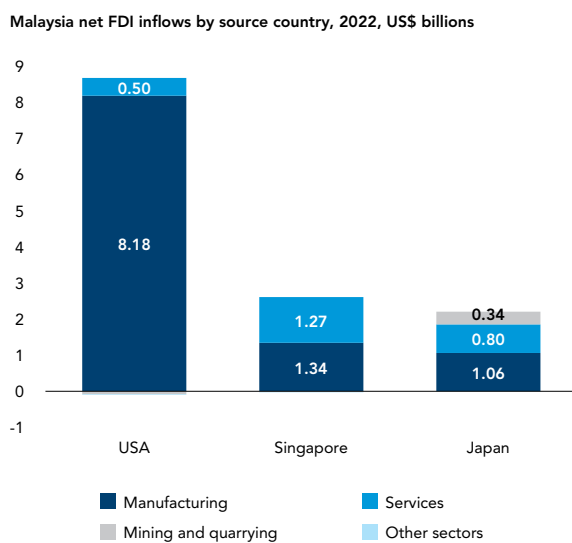
² Value of inward direct investment into Malaysia made by foreign enterprises – including equity capital, reinvested earnings, loan transactions, trade credits – net of repatriation of capital and repayment of loans.

³ The number of greenfield projects increased from 123 in 2021 to 153 in 2022, whereas the number of international finance projects increased from 16 in 2021 to 43 in 2022.

among ASEAN economies in 2022, this amount achieved by Malaysia still falls behind that of Indonesia and Vietnam, at US\$22 billion and US\$18 billion respectively. Malaysia's FDI inward stock as a percentage of GDP has also trailed Thailand over the last decade. Meanwhile, Vietnam's FDI inward stock as

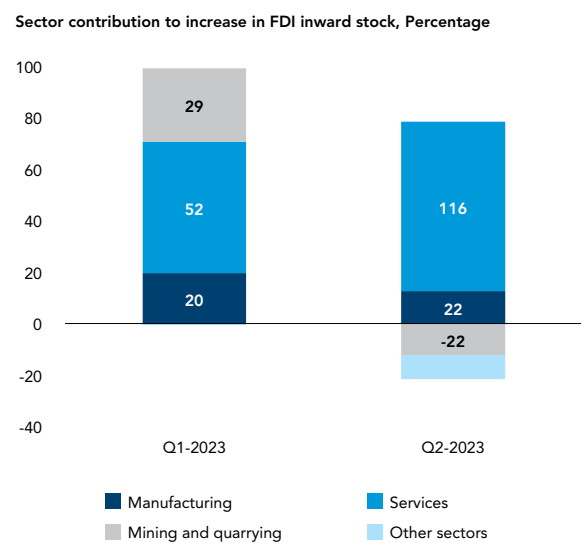
percentage of GDP has caught up and remained above Malaysia's since 2015 (Figure 11). Since 2017, Malaysia has not been performing as well as it did across the decade in attracting FDI that are channeled into the ASEAN region (Figure 12).

FIGURE 9
Manufacturing is the main contributing sector for Malaysia's net FDI inflows in 2022



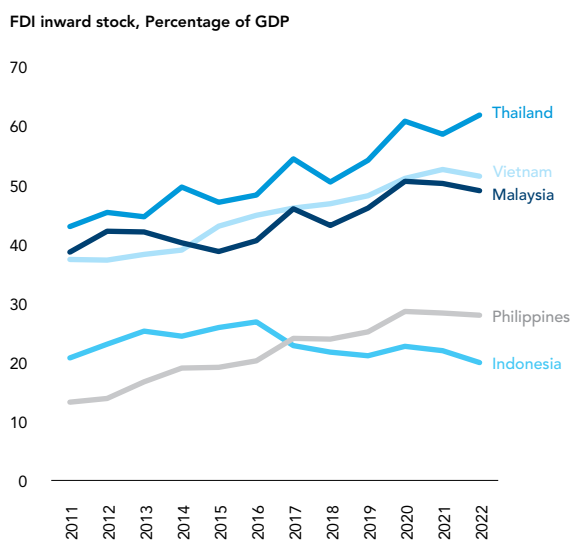
Source: DOSM

FIGURE 10
Services is the main sector driving up Malaysia's FDI inward stock for Q1 and Q2 2023



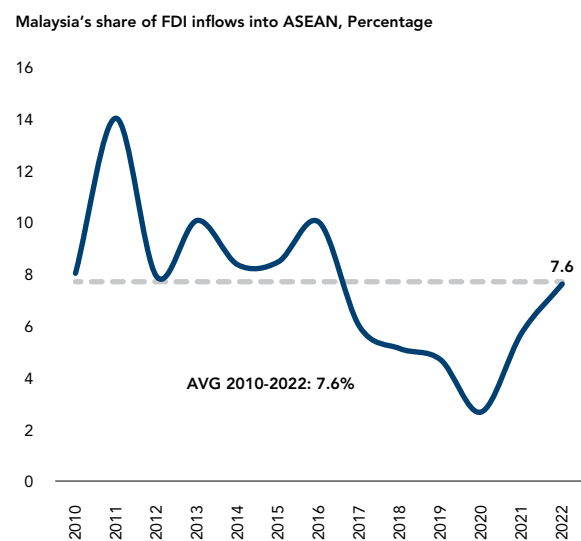
Source: DOSM

FIGURE 11
Vietnam caught up with Malaysia in FDI position



Source: 2023 UNCTAD World Investment Report and World Development Indicators

FIGURE 12
Malaysia lagged in attracting FDI channeled into the ASEAN region in recent years



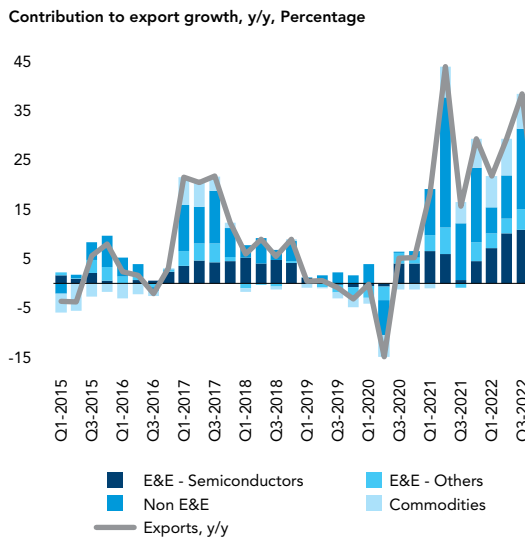
Source: World Bank Staff Calculations based on UNCTAD data

In line with weak global economic activity, exports growth slowed down

Against the backdrop of a weak global economy, Malaysia's exports contracted further in Q2 2023 (Figure 13). Gross exports contracted by 11.1 percent in Q2 2023 (Q1 2023: 3.0 percent) amid a broad-based downturn in external demand across all products, with exports of non-semiconductor E&E contracting by 9.5 percent in June 2023. Meanwhile, exports of E&E remained resilient, growing at 3.3 percent in June 2023 (see Box 2 on the impact of U.S.-China trade tensions

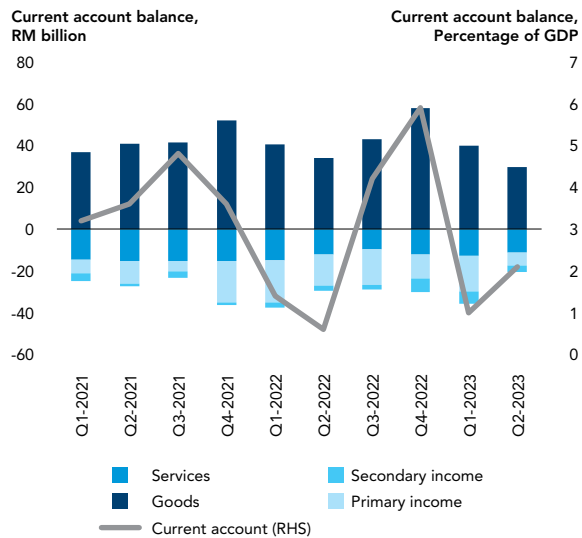
on Malaysia's semiconductor industry). Similarly, gross imports contracted by 11.5 percent in Q2 2023 (Q1 2023: -6.5 percent) due to weaker intermediate imports. On balance, the current account surplus increased to 2.1 percent of GDP (Q1 2023: 1.0 percent) on higher travel receipts and repatriation of profits from investments abroad, which helped offset a smaller goods surplus (Figure 14).

FIGURE 13
Exports contracted on broad-based decline in external demand



Source: World Bank Staff Calculations based on BNM and DOSM data

FIGURE 14
The current account surplus increased to 2.1 percent of GDP



Source: World Bank Staff Calculations based on BNM and DOSM data

TABLE 2
Exports contracted, while the current account surplus increased

	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022	Q1 2023	Q2 2023
Balance of Goods & Services (% of GDP)	5.5	3.7	8.1	7.6	6.0	6.8	7.1	8.8	6.1	5.0	7.9	9.7	6.1	4.1
Current Account Balance (% of GDP)	2.2	1.8	7.2	5.0	3.2	3.3	5.2	3.8	1.4	0.6	4.2	5.9	1.0	2.1
Total Exports (% of GDP)	61.0	60.7	61.4	62.8	66.3	70.7	72.7	72.5	72.3	77.3	80.7	77.2	68.1	68.9
Total Imports (% of GDP)	55.5	57.0	53.4	55.2	60.3	64.0	65.5	63.7	66.1	72.3	72.8	67.5	62.0	64.8
Net Portfolio Investment (RM billion)	-41.6	20.6	-20.7	-7.8	-0.1	20.2	-3.9	2.6	-8.9	-15.4	0.5	-26.7	-33.3	8.1
Gross Official Reserves (RM billion)	440.1	443.1	436.5	432.4	451.0	461.6	482.6	486.9	485.9	480.1	492.0	503.4	509.9	522.1
Gross Official Reserves (US\$ billion)	101.7	103.4	105.0	107.6	108.6	111.1	115.2	116.9	115.6	109.0	106.1	114.7	115.5	111.4

Source: World Bank Staff Calculations based on DOSM data

BOX 2

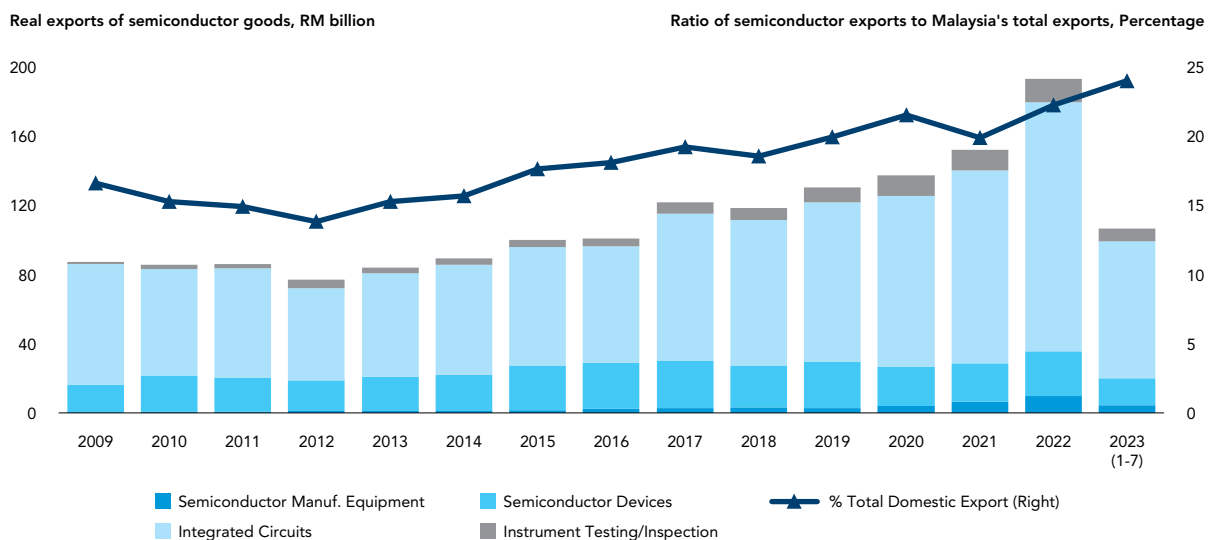
Impact of U.S.-China Trade Tensions on Malaysia's Semiconductor Industry

Malaysia's semiconductor exports grew from RM87 billion in 2009 to over RM193 billion⁴ in 2022 (Figure 15). Malaysia is critical in the global semiconductor manufacturing landscape and ranks among the top five exporters of semiconductor devices, integrated circuits, and testing and inspection instruments. In 2022, Malaysia's semiconductor exports accounted for approximately 56 percent of total E&E exports and contributed 22 percent of total exports. Semiconductor exports rival the combined totals of other major developing ASEAN countries such as Thailand, Vietnam, Philippines, and Indonesia.

The global technology cycle and the U.S.-China trade war has further boosted Malaysia's semiconductor exports. Specifically, in the 2021 – 2022 period, exports of ICs recorded a robust growth rate of 29 percent, fueled by the demand from China, U.S., and Singapore customers (Figure 16).

Interestingly, trade tensions between China and the U.S. increased Malaysia's semiconductor exports both to the U.S. and China (and other countries as well). Import tariff hikes between U.S. and China have had a positive trade diversion effect on Malaysia

FIGURE 15
Malaysia's semiconductor exports surged in 2022

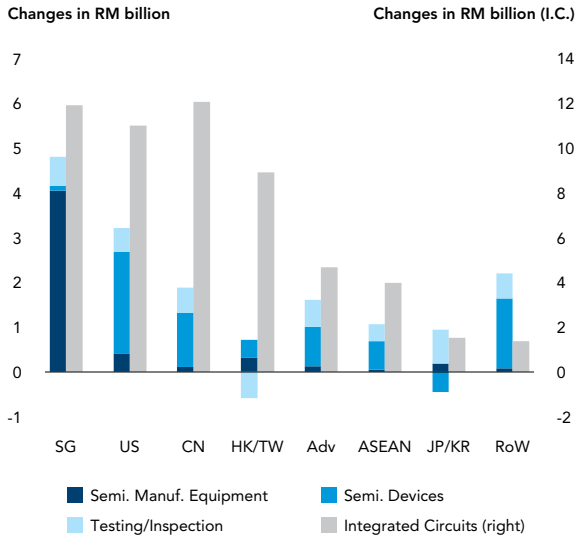


Source: World Bank Staff Calculations based on Malaysia's METS Database

Notes: The identification of semiconductor goods is based on the HS07 code (i.e., 8486 for semiconductor manufacturing equipment, 8541 for semiconductor devices, 8542 for integrated circuits, 903082, 903090, and 903141 for instrument of testing and inspections).

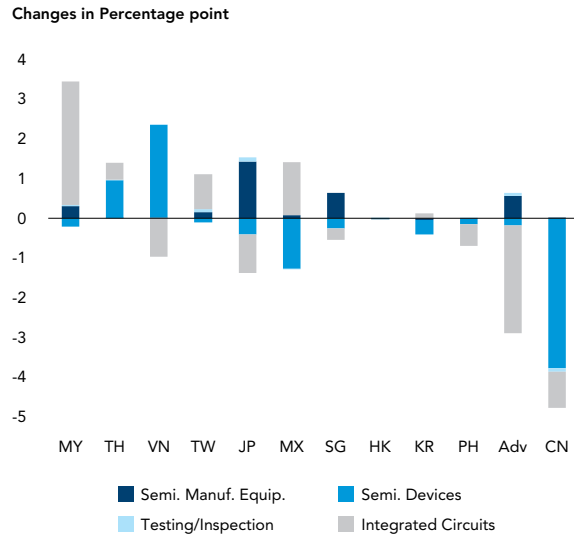
⁴ Adjusted using the GDP deflator.

FIGURE 16
The surge in Malaysia’s semiconductor exports was driven by increased demand from Singapore, China and the U.S.



Source: World Bank Staff Calculations based on METS Database
Note: The chart shows the destination of Malaysia’s semiconductor exports in 2021 and 2022.

FIGURE 17
Exports of some EAP economies to the U.S. increased after the U.S. imposing tariffs on China imports



Source: World Bank Staff Calculations based on US Census data
Notes: The chart shows the product decomposition of changes in the economy’s share of respective imports between 2022-2012.

(Fajgelbaum et al., 2023). For every single percentage point increase in U.S. tariffs on Chinese semiconductor goods, Malaysia’s exports to the U.S., China, and other ASEAN countries rose by 1.6 percent, 1.8 percent, and 2.5 percent, respectively (Figure 18). U.S.-China trade tensions have also led to a rise in Malaysia’s

semiconductor imports from China, indicating deeper ties with China’s supply chain. This could expose Malaysia to risks, especially if U.S. sanctions disrupts China’s supply and consequently impact Malaysia’s ability to produce downstream products.

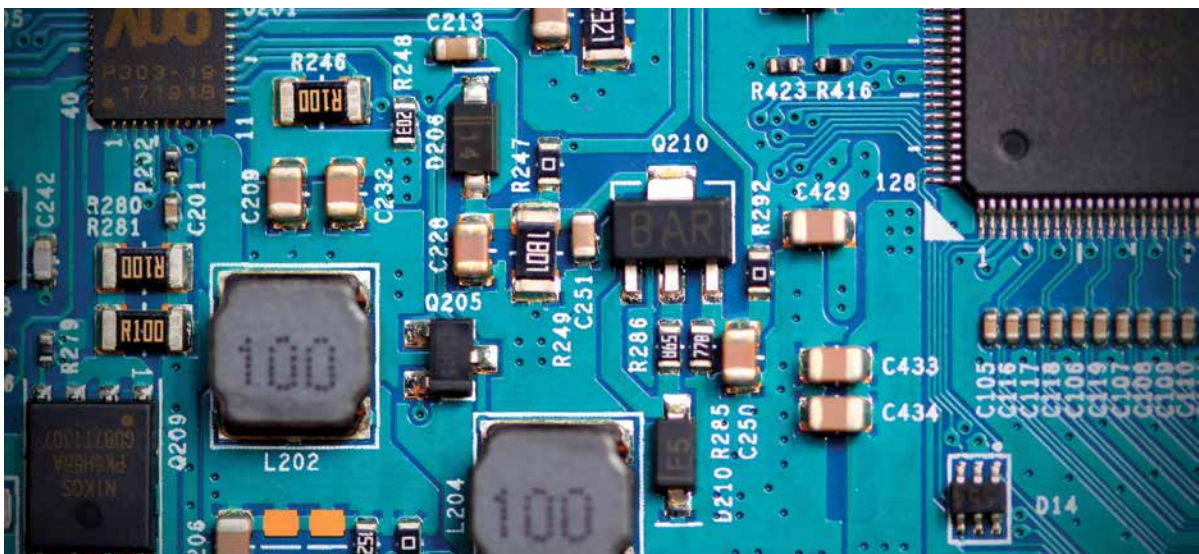
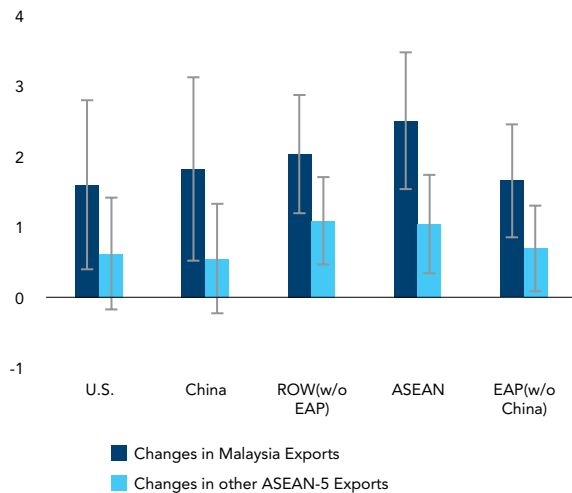


FIGURE 18

Amid US tariff hikes on China, Malaysia shows the strongest semiconductor export growth among ASEAN-5 countries

Estimated marginal growth in semiconductor exports in 2018-2019 from 2016-2017, Percentage



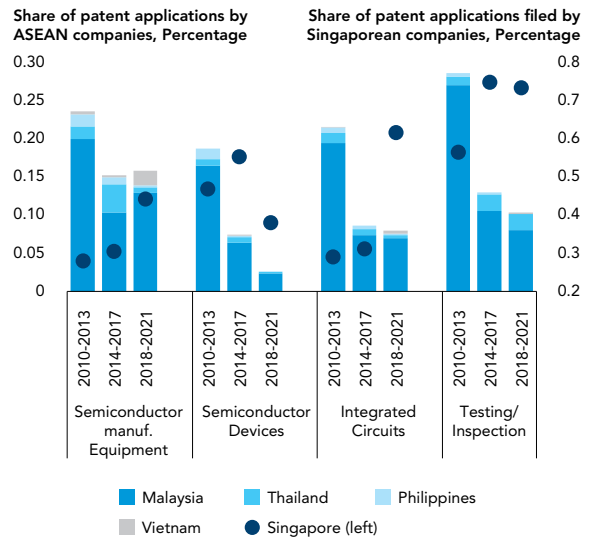
Source: World Bank Staff Calculations based on BACI-CEPII database
Note: The bar is the estimated coefficients of the U.S. import tariff on China's semiconductor goods. The whisker indicates a 95% confidence interval.

However, maintaining its competitiveness in the semiconductor value chain remains a challenge for Malaysia. Escalating trade tensions and geopolitical risks are causing MNCs to reassess their supply chains and diversify production facilities to mitigate risks. Countries like Vietnam and Thailand are looking to attract these MNCs, thereby intensifying the market competition for Malaysia companies, specially in the production of labor-intensive semiconductor parts. Malaysia also faces obstacles in moving up the semiconductor value chain. Even though Malaysia holds an 8 percent share of the global IC market, its contribution to the most advanced patents is notably low, representing only 0.2 percent of the world's total. This share has declined to 0.07 percent in recent years (Figure 19). Most of Malaysia's ICs exports cater to the consumer-grade market, indicating its position on the lower end of the value chain, underscoring the need to focus on advancing technological innovation and climbing the global value chain.

At least two factors constrain Malaysia's climbing the global value chain: (a) lack of indigenous innovation and (b) low R&D investments. Over 70 percent of semiconductor-related patents filed within

FIGURE 19

Malaysia's contribution to the most advanced patents in the global IC market has declined in recent years



Source: World Bank Staff Calculations based on PATSTAT database
Notes: The bar decomposes the patent application share based on the companies' location. The dot is the share of patent applications filed by companies in Singapore.

the Malaysia patent office already received approval in other jurisdictions before being published in Malaysia. Patents listed in Malaysia were primarily to use or license the technology to domestic firms for manufacturing. Although this allows Malaysia access to cutting-edge technology, it also reflects the country's lag in indigenous innovation. Moreover, most patents filed in the Malaysia patent office remain foreign owned (above 80 percent), mostly from the U.S., Japan, and other advanced economies. Malaysia's R&D investment is also noticeably lower compared to other major semiconductor exporting countries. In 2018, Malaysia's R&D expenditure-to-GDP ratio was only 1.08 percent versus China's (2.15 percent) and Taiwan's (3.35 percent). Fostering indigenous innovation and increasing R&D investments, for example, through increasing absorptive capacity of domestic firms, and improving local – foreign linkages would help Malaysia's quest to climb the highest segments of the semi-conductor global value chain.

Labor market conditions are gradually returning to levels seen prior to the pandemic

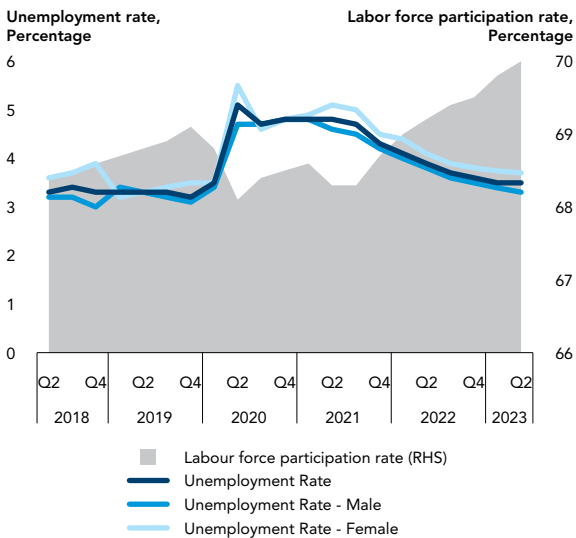
The unemployment rate is showing a steady decline towards pre-pandemic levels (Figure 20). The national unemployment rate has declined to 3.5 percent in August (Q4 2019: 3.2 percent), while the labor force participation rate rose to 70.0 percent in Q2 2023 (Q4 2019: 69.1 percent). The declining trend in unemployment rates of the younger workforce (15–24-year-olds and 25–34-year-olds) who made up 51 percent of the labor force in Q2 2023 have contributed to the downward trend of the national unemployment rate (Figure 21). Meanwhile, the unemployment rate of workers between 55-64 years old has increased by 0.5 percentage points in the last quarter.

The gender gap in labor force participation rate is relatively high in Malaysia. The unemployment rate for women was slightly higher than men, registering a level of 3.7 percent in Q2 2023, while for men it was 3.3 percent (Figure 20). On the other hand, the gender gap in labor force participation rate (LFPR) has widened to 26.6 percent in Q2 2023 (Q4 2019: 25 percent), driven by the fact that the LFPR for men has

increased faster than women (Figure 22). Nevertheless, the LFPR for women in Malaysia is relatively low among its regional and aspirational peers (Figure 23), with the gender gap in 2022 recording 26.1 percent – a level that is markedly higher than its comparators, and is only lower than the gender gap in Indonesia. The low female LFPR represents an underutilized source of labor supply in Malaysia, and could be attributed to a multitude of factors, such as lack of affordable and quality childcare centres and gender norms (World Bank 2019b).

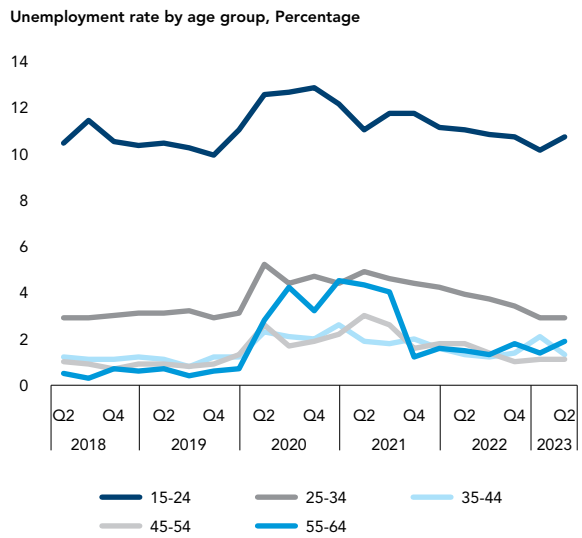
While time-related underemployment has improved to pre-pandemic levels, skills-related underemployment remains high. Time-related underemployment has moderated to 1.2 percent by Q2 2023 (Q4 2019: 1.1 percent), in tandem with overall recovery of the labor market (Figure 24). However, skills-related underemployment has increased further to 37.4 percent in Q2 2023 (Q4 2020: 34.8 percent). In particular, skills-related underemployment for women increased significantly over the last two quarters,

FIGURE 20
The unemployment rate shows a steady decline towards pre-pandemic levels



Source: DOSM

FIGURE 21
Declining unemployment rates of the younger workforce contributed to the downward trend of the national unemployment rate

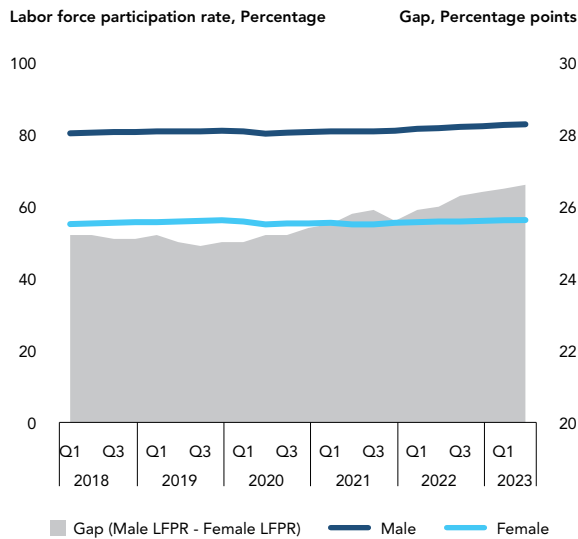


Source: DOSM
Note: The youth unemployment rate refers to the unemployment rate among workers aged 15 to 24.

moving from 35.3 percent in Q4 2022 to 42.5 percent in Q2 2023 (Figure 25). This trend partly reflects the notion that women are more likely to shoulder the burden of

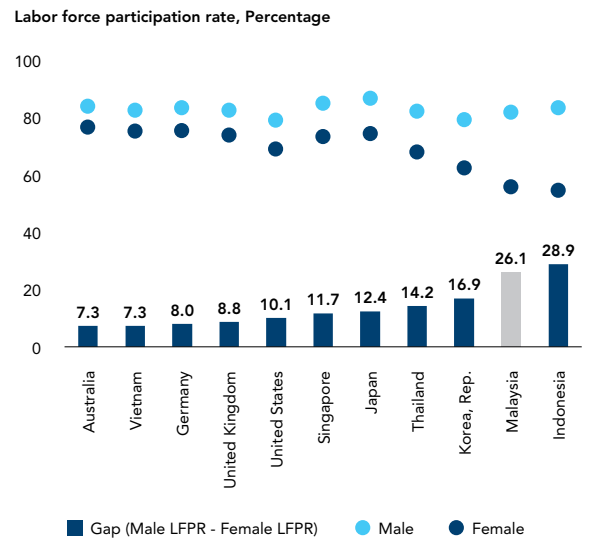
childcare and elderly care, and thus may opt to have less demanding jobs despite having tertiary education (see World Bank 2019).⁵

FIGURE 22
The gender gap in labor force participation rate has been widening in recent years...



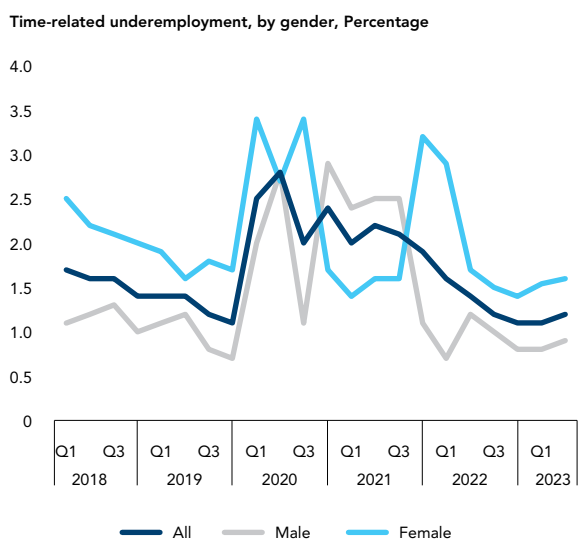
Source: DOSM

FIGURE 23
...and the gender gap in Malaysia is one of the highest among comparator countries



Source: ILOSTAT and DOSM for latest available year

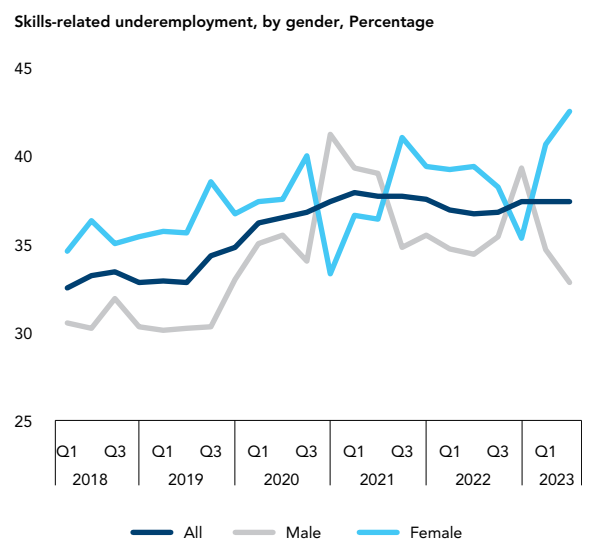
FIGURE 24
Time-related underemployment has returned to its pre-pandemic level...



Source: DOSM

Note: The time-related underemployment rate reflects the share of workers employed for less than 30 hours per week due to the nature of their work or to the insufficient availability of work.

FIGURE 25
...while skills-related underemployment remains relatively high



Source: DOSM

Note: The skills-related underemployment rate is the share of workers with tertiary qualification who are employed in semi-skilled or low-skilled jobs.

⁵ Unlike the measure of time-related underemployment, which considers the willingness and ability to work more hours, the measure of skills-related underemployment does not take into account the preference for high-skilled versus mid- or low-skilled jobs.

By age-group, in the last six years the skills-related underemployment rate has generally been on the rise for youth in particular (15-24 year olds) (Figure 26). There has, however, been a drop in the skills-related underemployment rate for youth in the latest quarter, from 73.4 percent in Q1 2023 to 69.9 percent in Q2 2023. Nonetheless, the overall increasing trend may imply that structural factors are at play, with skills in supply not well matched to demand in the labor market.

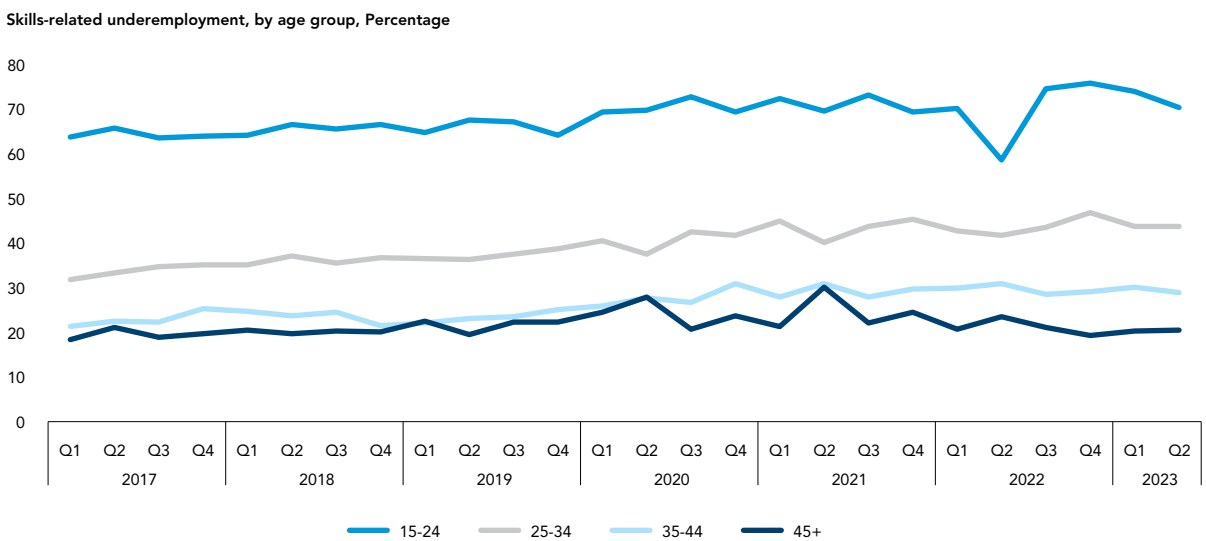
Skills-related underemployment has been on the rise since 2017, before the pandemic, and there are various factors that could be driving this. Tertiary educated workers may not be able to obtain high-skilled jobs due to a mismatch in the area of study, or a lack of skills that do not relate to formal education qualifications, or due to an insufficient number of high-skilled jobs offered by firms. Tertiary educated workers could also be choosing not to apply for or hold high-skilled jobs, due to a mismatch in the preferred characteristics of employment, such as wages offered, the hours of work required and the location of work, and that being offered by such jobs. Studies on *skills mismatches* – which can refer to having either a lower level of skills or higher level of skills required than needed for one’s job – in Malaysia generally conclude that employers value skills that go beyond technical skills emphasized by education institutions, such as communication, problem-solving, and critical thinking skills, commonly referred to as soft skills (see KRI 2018; Penang Institute 2022; World Bank 2023). Such studies

suggest that a lack of soft skills is one of the likely reasons that tertiary educated workers are not able to obtain high-skilled jobs, thus contributing to skills-related underemployment.

Tertiary educated workers may not be able to obtain high-skilled jobs due to a mismatch in the area of study, or a lack of skills that do not relate to formal education qualifications, or due to an insufficient number of high-skilled jobs offered by firms

It is worth noting that skills mismatches are a global phenomenon. Mismatches are evident in many OECD countries, ranging from 22.2 percent of all workers in Poland to 50.5 percent in Mexico. Using the same indicator, 32.2 percent of Malaysian workers are either over-qualified or under-qualified in their jobs (Figure 27). As such, a better understanding of the nature of the skills mismatch would be needed to address the high level of skills-related underemployment.

FIGURE 26
In the last six years the skills-related underemployment rate has generally been on the rise for the youth in particular (15–24-year-olds)

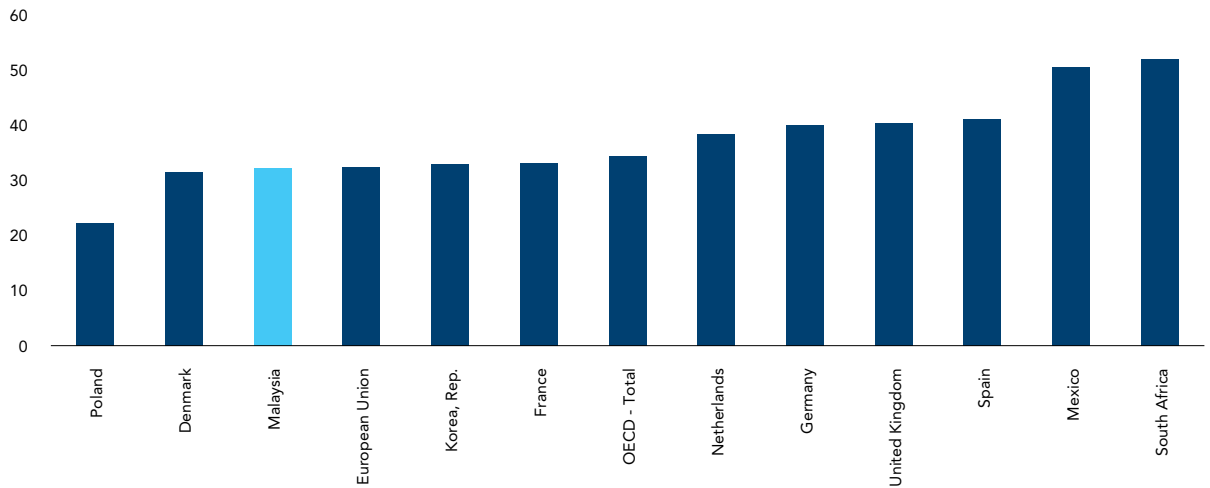


Source: DOSM

Note: The skills-related underemployment rate is the share of workers with tertiary qualification who are employed in semi-skilled or low-skilled jobs.

FIGURE 27
Skills mismatches is a global phenomenon

Skills-mismatches by selected countries, 2019, Percentage

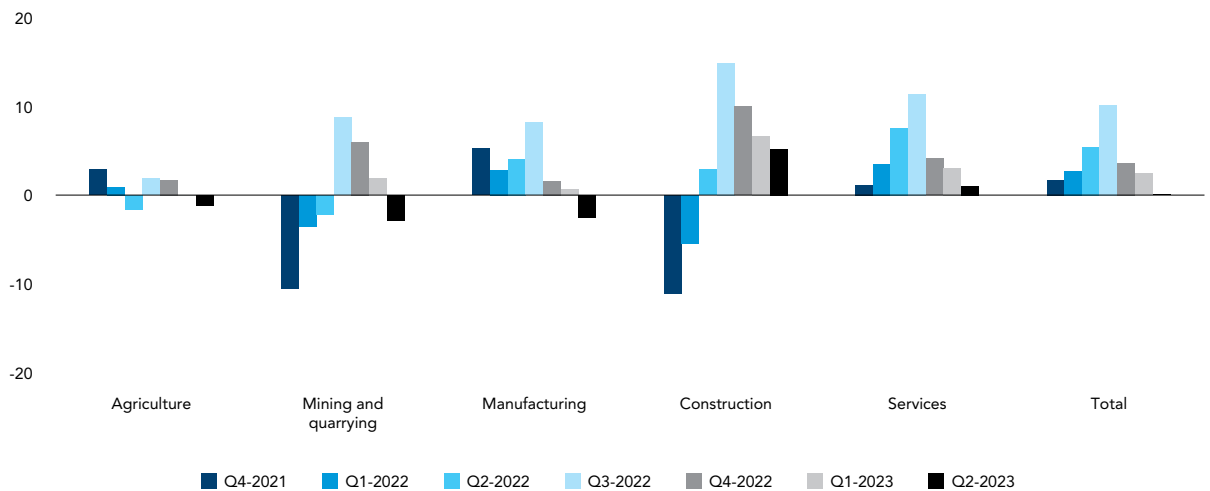


Source: OECD

Note: The data measures the average percentage of workers that have a qualification that does not match the requirements of their jobs. As such, the data combines both over-qualification and under-qualification. The full methodology can be accessed through the OECD's Skills for Jobs Indicators website.

FIGURE 28
Malaysia experienced broad-based slowdown in labor productivity growth since Q3 2022

Labor productivity by sector, y/y, Percentage



Source: DOSM

Malaysia experienced broad-based slowdown in labor productivity growth since Q3 2022 (Figure 28). One of the likely reasons for the slowdown is the fact that 2022 saw a relatively large rise in labor productivity growth, given its low level in 2021 when

the economy was at the beginning of its recovery process from the pandemic⁶. Since then, labor productivity growth has moderated. In particular, total labor productivity growth has declined to 0.02 percent in Q2 2023 (Q3 2022: 10.1 percent). The mining and

⁶ Mobility and economic restrictions in Malaysia were only fully lifted in November 2021.



quarrying sector experienced the biggest slowdown in labor productivity growth during this period, where productivity declined to -3.0 percent in Q2 2023 (Q3 2022: 8.7 percent). This is followed by the manufacturing sector which declined from 8.2 percent to -2.6 percent during the same period.

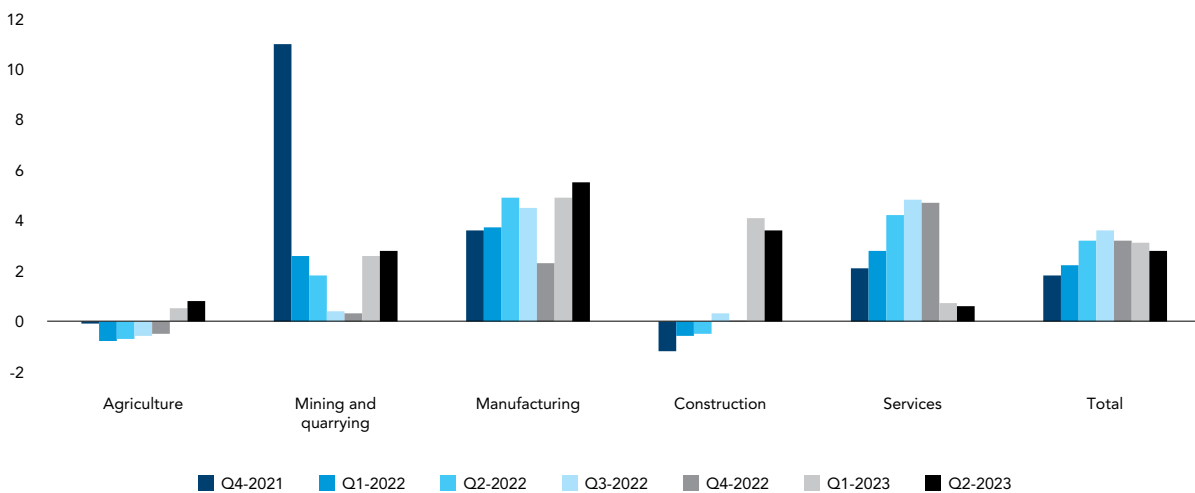
Employment growth in the agriculture and construction sectors expanded, in part due to higher entry of foreign workers. The construction sector has seen the largest increase in employment growth, moving from 0.3 percent in Q3 2022 to 3.6 percent in Q2 2023. This is followed by the employment growth in the mining sector, which grew from 0.4 percent to 2.8 percent, and the agriculture sector which saw employment growth rise from -0.6 percent to 0.8

percent during the same period. The increases in the agriculture and construction sectors may in part be due to the approval of the entry of foreign workers in critical sectors to fill in labor shortages, which also include farming and agriculture, manufacturing, construction and services.⁷ At an aggregate level, employment growth moderated to 2.8 percent in Q2 2023 (Figure 29).

The cabinet has recently approved the implementation of the progressive wage system policy. The government added that its details will be tabled soon. The government hopes that the system would result in a more stable and inclusive salary growth in Malaysia (see Box 3 on wage growth in Malaysia over the years).

FIGURE 29
Employment growth has also moderated since Q3 2022

Employment by sector, y/y, Percentage



Source: DOSM

⁷ New Strait Times (2023). "Government approves entry of 500,000 foreign workers". Retrieved from <https://www.nst.com.my/news/nation/2023/01/871302/government-approves-entry-500000-foreign-workers>

BOX 3

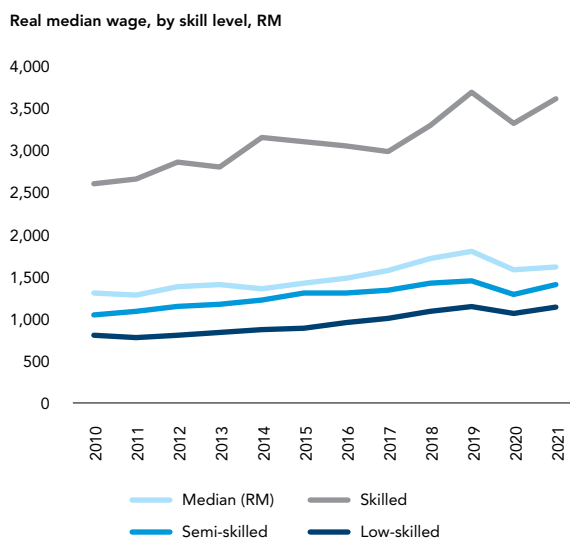
Wage Growth in Malaysia Over the Years

While overall wages have increased in the last decade, so has the wage gap between low-skilled and high-skilled workers. Median wages have grown in the last decade, with real median wage increasing from RM1,300 in 2010 to RM1,612 in 2021 (Figure 30).⁸ Different groups of workers have experienced wage growth differently in the same period. By gender, real median wages have generally experienced similar growth rates, with slightly higher wage growth for men. However, there remains gender wage gaps in the level of wages – in 2021, mean and median wages were higher for men by 3.9 percent and 7.9 percent respectively. Growth in real median wages for low-skilled workers have been high when compared to other workers in recent years when measured in percentage terms (Figure 31). However, the difference has not been sufficient for low-skilled workers to ‘catch up’ to high-skilled workers, with the wages of high-skilled

workers increasing more in absolute (or ringgit) terms. The absolute difference in real median wages between low-skilled and high-skilled workers has therefore widened over time. In 2010, the gap between the two groups was RM1,800, and by 2021 this gap increased to RM2,474. Semi-skilled workers, who comprise of around 57.7 percent of total employed in 2021 have faced the slowest wage growth. This is consistent with the findings of Muthusamy et al. (2023), who show that the wage growth for the median to the eighth decile of wage workers has been the slowest over the past decade, reinforcing the notion of a “squeezed middle”.

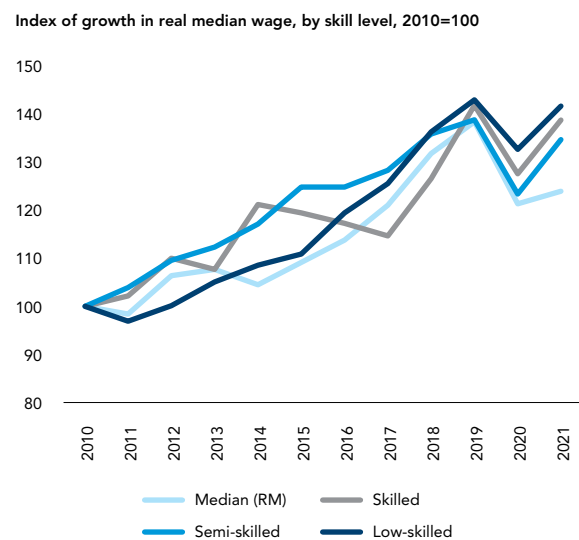
Malaysia’s real wage growth has grown as fast as upper middle-income countries on aggregate, and faster than that in high income countries in the past decade (Figure 32). However, when compared to ASEAN neighbors such as Thailand, Vietnam, Myanmar

FIGURE 30
Median wages have grown in the last decade



Source: World Bank Staff Calculations based on DOSM data
Note: Data includes citizens and non-citizens

FIGURE 31
Growth in real median wages for low-skilled workers has been the highest when measured in percentage terms



Source: World Bank Staff Calculations based on DOSM data
Note: Data includes citizens and non-citizens

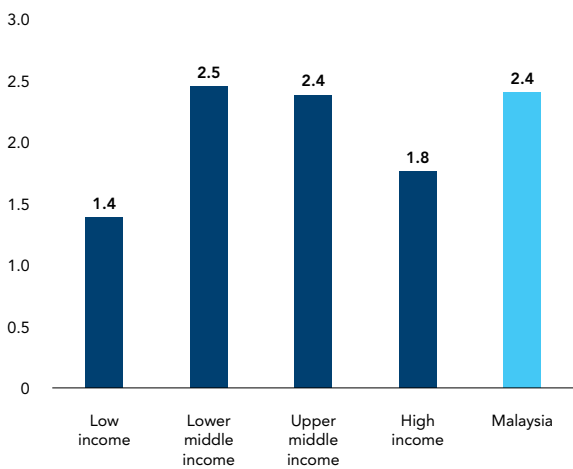
⁸ Data sourced from the Salaries and Wages Survey (SWS) by the Department of Statistics Malaysia for various years. However, the SWS only covers employees, thereby excluding employers, own-account workers and unpaid family workers. Having said that, employees are a large share of the workforce, comprising of 78.5 percent of all workers in Malaysia in 2021.

and Cambodia, real wage growth in Malaysia has been low (Figure 33). It is worth noting that wage growth is expected to be slower in high income countries due to a number of factors, including slower economic growth,

consistent with the trends seen here. Additionally, real wage growth has generally outpaced labor productivity growth since 2010 (Figure 34), with the former growing faster than the latter for all sectors.

FIGURE 32
Real wage growth has grown as fast as upper middle-income countries, and faster than that in high income countries in the past decade

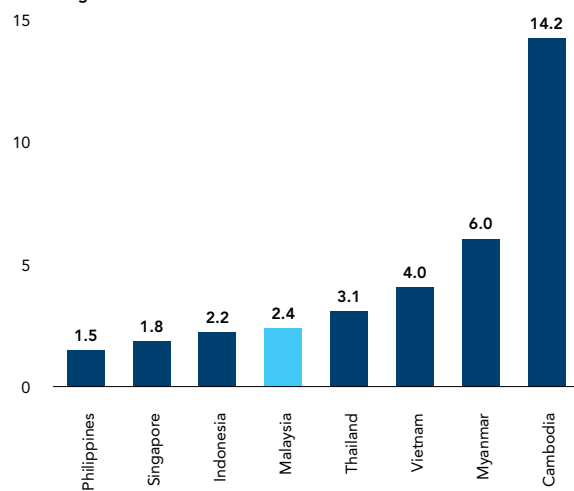
Growth in real mean wage by income level, 2011-2021, Percentage



Source: World Bank Staff Calculations based on DOSM data, ILO Global Wage Report 2022-23

FIGURE 33
When compared to ASEAN neighbors, annual real wage growth in Malaysia has been low

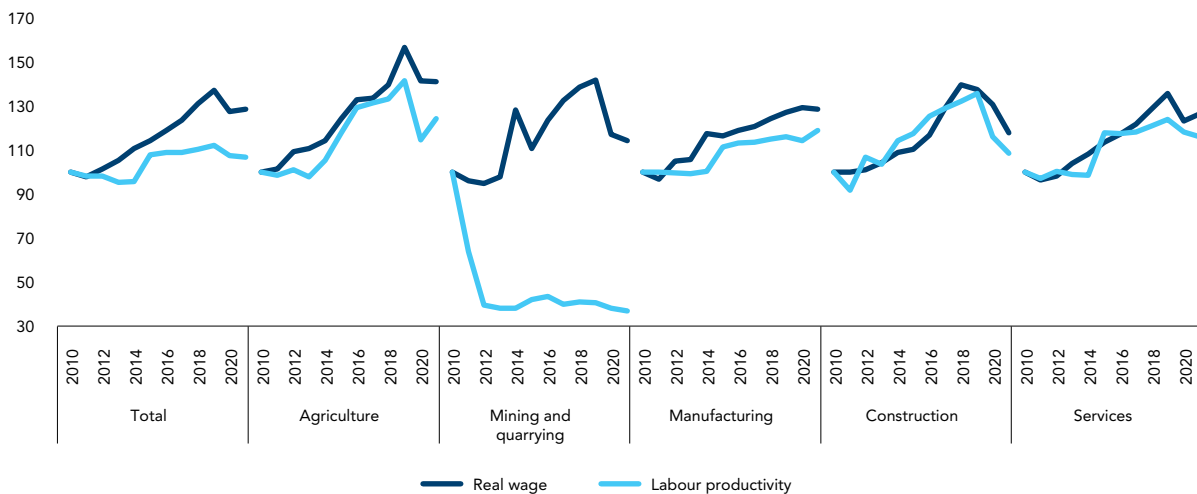
Annual growth in real mean wages of ASEAN countries, 2011-2021, Percentage



Source: World Bank Staff Calculations based on DOSM data, ILO Global Wage Report 2022-23

FIGURE 34
Real wage growth has generally outpaced labor productivity growth for all sectors since 2010

Index of labor productivity and real wage growth, by sector, 2010=100



Source: DOSM

Note: The mining and quarrying sector recorded an exceptionally high labor productivity in 2010, which resulted in a huge drop in subsequent years.

Around half of all workers in Malaysia earned less than RM2,000 per month in 2021⁹.

This is cause for concern given that this is only slightly above the current statutory minimum wage of RM1,500 nationwide. It means that many workers will earn well below the suggested “living wage”, an amount adequate enough to provide beyond affording basic necessities, such as social participation and financial security (Chong and Khong, 2018). Estimates of the living wage for a single adult living in Kuala Lumpur were RM2,700 in 2016, with the amount needed increasing for larger households. Similarly, the Employees Provident Fund (EPF) in collaboration with the Social Wellbeing Research Centre (SWRC) recently launched an updated expenditure guide, *Belanjawanku*, aimed to help households plan their finances to achieve a reasonable standard of living. This includes basic necessities such as food and housing, as well as expenses going beyond basic needs, such as personal savings, social participation and ad-hoc expenses. The guide highlights that for a single adult residing in the Klang Valley and relying on public transport, the monthly living expenses are estimated to be RM1,930 (SWRC 2023). For a single adult in the Klang Valley who owns a car, it is estimated to be RM2,600 (SWRC 2023). Both figures are well above the minimum statutory amount of RM1,500.

Recently, the government, through the Madani Economy framework, has signaled a potential move towards a progressive wage model.

This would involve a mandatory minimum increment in wages every year, as well as an adjustment of the difference in wages between the most senior and most junior workers.¹⁰ Different forms of the progressive wage model (PWM) has been a policy tool used in other countries, such as Singapore and Australia. In both countries, the PWM takes the form of a sectoral minimum wage, usually set through a tripartite negotiation process involving the government, industry players and workers’ unions. In Singapore, the progressive wage structure covers lower-wage workers in selected sectors such as those in cleaning, security, retail, food services, and waste management jobs. The annual wage increases are coupled with a skills ladder, where the PWM sets out a clear career pathway for wages to rise with additional training and upskilling.¹¹ Due to

the tripartite arrangement, the PWM typically takes two to three years to be implemented once a sector is identified to be covered by progressive wages.¹² Australia’s case is more unique and complex: on top of a national minimum wage, there is also an award wages system. The award wage can vary based on a multitude of factors, including industry, age, skill level and qualifications of an employee, which results in over 100 award wages. Both the national minimum wage and award wages are adjusted once a year. Importantly, in both cases, increases in wages are gradual, clear, and predictable. In Singapore, the wage requirements for some occupations up until the year 2029 have been published. In cases where it is not, the Ministry of Manpower provides clarity on when the wages will be reviewed. Similarly, in Australia, adjustments have typically been modest, incremental, and somewhat predictable (Bishop 2018). Study of such country experiences point to various considerations to be made in the implementation of any progressive wage policy.

Improving wages is a multi-faceted challenge. There is a robust discussion currently in Malaysia concerning labor market institutions such as the minimum wage, as well as collective wage determination models that are widely adopted in advanced economies. These are important topics and have potential to impact both wage and productivity growth but go beyond the scope of this box article.

International experience points to the importance of productivity growth in boosting wages in the long term. Productivity in Malaysia lags when compared to that in aspirational high-income countries (World Bank 2023). The competitiveness of Malaysia’s economy plays an important role, as noted by the World Bank’s Aiming High report. Improving the level of skills in the workforce through strengthening of learning outcomes, facilitation of lifelong learning and digital literacy, and by attracting and retaining talent, will also help facilitate higher productivity and wage growth (World Bank 2021). A related challenge is skills-related underemployment, which reflects skills mismatches and leads to underutilization of the productive potential of workers.

⁹ This number does not control for the number of hours worked, as this information is not available.

¹⁰ New Straits Times (2023). “Govt looking into progressive wage policy that promises mandatory salary hike”. Retrieved from <https://www.nst.com.my/news/nation/2023/07/929912/govt-looking-progressive-wage-policy-promises-mandatory-salary-hike>

¹¹ <https://www.mom.gov.sg/employment-practices/progressive-wage-model/what-is-pwm>

¹² The Strait Times (2021). “Progressive Wage Model implementation takes time due to negotiations, multiple considerations”. Retrieved from <https://www.straitstimes.com/business/singapores-progressive-wage-model-implementation-takes-time-due-to-negotiations-multiple>

Despite the economic recovery, poorer households remained vulnerable

As of 2022, Malaysia recorded 6.2 percent of absolute poverty, higher than the pre-pandemic level of 5.6 percent in 2019¹³ (Figure 35). This means that, as of 2022, nearly 490,000 Malaysian households still lived below the average national poverty line of monthly household income of RM2,589. All states, except the Federal Territories of Putrajaya and Labuan, recorded a rise in absolute poverty incidence. The highest incidence of poverty continued to be in Sabah (19.7 percent) and in Kelantan (13.2 percent). This is consistent with findings from the World Bank’s High-Frequency (HiFy) Phone Survey, which indicated increasingly higher levels of financial distress among East Malaysian households around mid-2022. Widespread employment disruptions during the pandemic, particularly in sectors that were more sensitive to mobility restrictions and more dependent on inter-person interactions, have translated into a significant rise in urban poverty. Absolute poverty also increased across main ethnic groups, namely the Bumiputera, Chinese, and Indians.

Despite the rise in the average household incomes, high inflation affected real incomes in selected households. The 2022 Household Income Survey (HIS 2022) reported an increase in the mean household gross

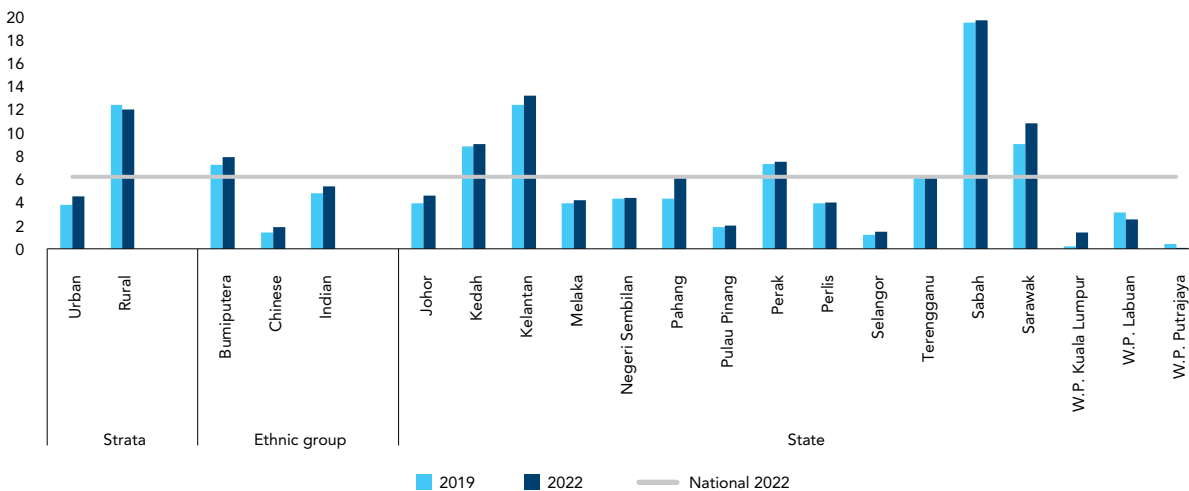
income of RM8,479 in 2022 (2019: RM7,901). However, after taking into account high inflation in 2022, several states including Federal Territories Kuala Lumpur and Putrajaya have suffered a negative growth in household real income over 2019-2022. The high inflation also affected real incomes in poorer states including Kedah and Kelantan.

All states, except the Federal Territories of Putrajaya and Labuan, recorded a rise in absolute poverty incidence

While paid employment continued to be the main source of income for the majority of households, poorer households relied more on other income sources such as remittances, pensions, and government assistance. For the poorest households with incomes lower than RM2,000, these income constituted up to 49 percent of their total gross income in 2022 (2019: 38 percent), with about one-third of them

FIGURE 35
Absolute poverty in 2022 remained higher than pre-pandemic levels for most subgroups

Incidence of absolute poverty across subgroups, 2019 and 2022, Percentage



Source: DOSM

¹³ Department of Statistics Malaysia. 2023. Poverty in Malaysia 2022.

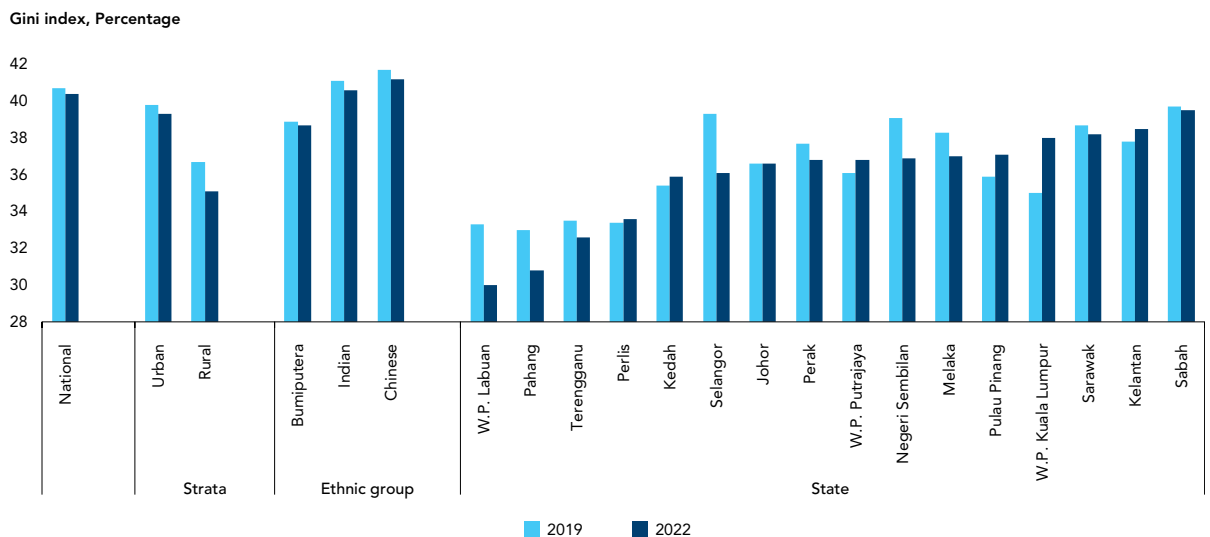


were government's assistance. This could be partly attributed to the government's multiple cash transfer programs aimed at mitigating the negative impacts of the pandemic on households. Receiving government assistance was the most common mechanism adopted by poorer households to cope with the pandemic-induced shocks.¹⁴

Income inequality remained largely unchanged between 2019 and 2022, with some regional variation (Figure 36). The Gini index¹⁵ based on

household gross income stood at 40.4 in 2022 (2019: 40.7 percent). However, the trend varied across states, with some like Kelantan, Pulau Pinang, and the Federal Territory of Kuala Lumpur experiencing a widening income gap. While income inequality *within* both urban and rural areas declined, income gap *between* urban and rural areas increased. Exacerbating inequalities across geographic areas are somewhat expected, partly reflecting some lingering effects of uneven progress in regaining employment across regions, even after two years of the pandemic.¹⁶

FIGURE 36
Income inequality across geographic areas somewhat stagnant between 2019 and 2022, but the trend varied across states



Source: DOSM

¹⁴ World Bank. 2023. COVID-19 Impact and Recovery among Malaysian Households: High-Frequency Phone Survey - Round 3 (April 10 - May 15, 2022).

¹⁵ The Gini Index is a measure of inequality which lies between 0 (complete equality where everyone has the same) and 100 (complete inequality where one person has everything).

¹⁶ World Bank. 2023. COVID-19 Impact and Recovery among Malaysian Households: High-Frequency Phone Survey - Round 3 (April 10 - May 15, 2022).

Headline inflation has steadily declined in line with the moderation in global energy and food prices

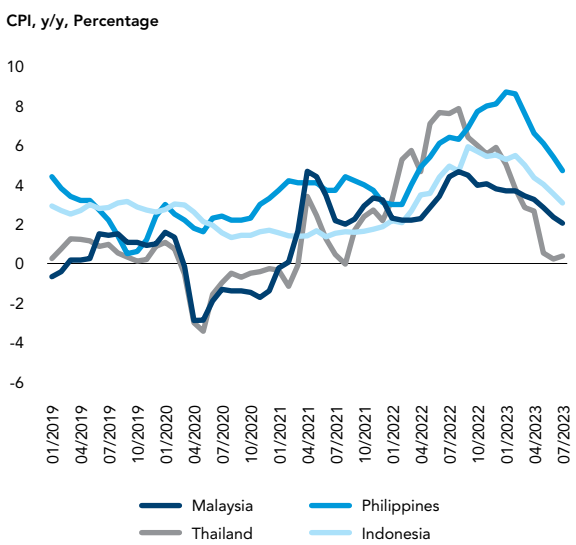
Headline inflation in Malaysia has steadily declined in line with other regional countries (Figure 37). In Malaysia, subsidies and price controls have helped to contain inflation. More recently, easing commodity prices and lower inflation for transportation and food and non-alcoholic beverages have contributed to the decline in headline inflation in Malaysia (Figure 38). Since peaking in August 2022, headline inflation has continuously declined and was estimated at 2.0 percent in July 2023. However, while headline inflation has moderated, there remains some degree of persistence in core inflation.

The producer price index (PPI) declined moderately by 2.3 percent in July 2023 (June 2023: -4.8 percent), mainly driven by declines in the PPI of mining and manufacturing sectors (Figures 39 and 40). The PPI in the mining sector recorded the largest decline of 10.8 percent (June 2023: -16.6 percent), following a sharp drop in the extraction of

crude petroleum index while the manufacturing sector recorded a slight decline of 2.1 percent (June 2023: -1.8 percent) due to decreases in the manufacture of coke & refined petroleum and manufacture of food products indices. While the PPI in mining and manufacturing declined, it significantly rose in the agriculture sector due to an increase in the animal production and growing of perennial crops indices.

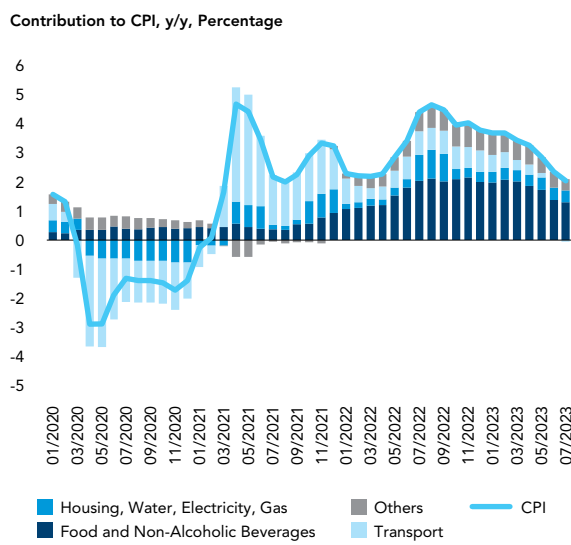
With inflation easing and growth outlook moderating, the overnight policy rate (OPR) was maintained at 3.00 percent in July and September. After the OPR was raised by 25 basis points in March 2023, the monetary policy committee decided to maintain the policy rate at 3.00 percent in July and September 2023. The central bank expects both headline and core inflation to trend lower in 2H 2023, broadly within its expectations. At this current rate, the monetary policy stance is appropriately supportive of the economy.

FIGURE 37
Headline inflation in Malaysia has steadily declined in line with other regional countries



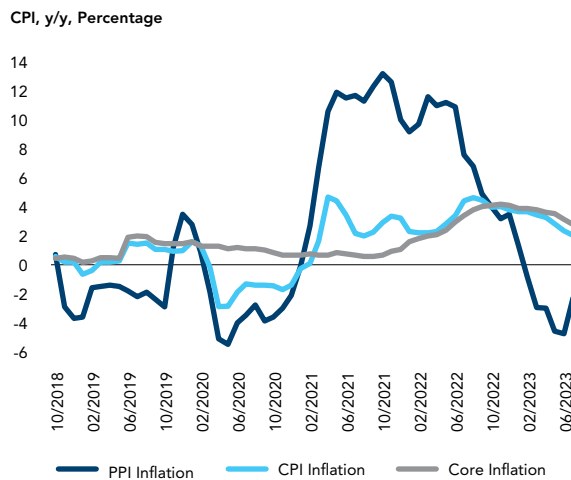
Source: DOSM and World Bank Staff Calculations

FIGURE 38
Easing commodity prices and lower inflation for transportation, food and non-alcoholic beverages have contributed to the decline in headline inflation



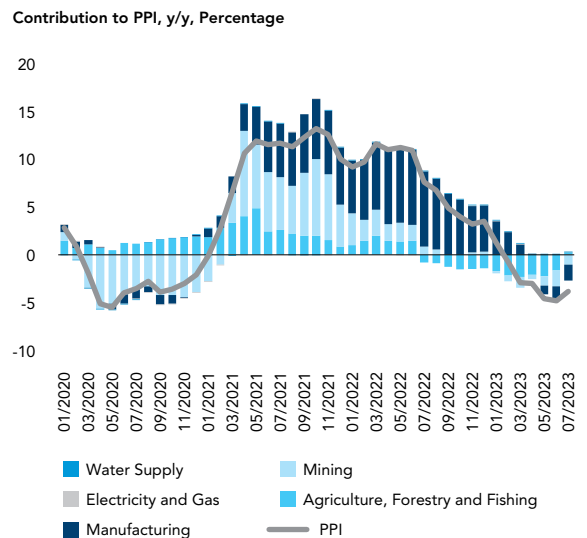
Source: DOSM and World Bank Staff Calculations

FIGURE 39
PPI declined moderately in July 2023...



Source: DOSM and World Bank Staff Calculations

FIGURE 40
...mainly driven by declines in the PPI of mining and manufacturing sectors



Source: DOSM and World Bank Staff Calculations

The Malaysian banking sector maintained adequate capital buffers, ample liquidity and healthy funding conditions

The Malaysian banking sector has maintained adequate capital buffers. The total capital ratio (TCR) remained stable at 18.5 percent as of end-June 2023, well above the regulatory minimum capital level (June 2022: 17.7 percent) (Figure 41).¹⁷ Ratios remained stable as the increase in risk-weighted assets (RM1.86 billion vs. RM1.77 billion) kept pace with the increase in total capital (RM344.6 billion vs. RM313.6 billion).¹⁸ Over the same period, Tier 1 capital ratio increased marginally by 0.4 percentage points to 15.4 percent.¹⁹

The banking sector continued to operate with robust liquidity and funding conditions. The liquidity coverage ratios (LCR) remained above the regulatory minimum, climbing to 155.3 percent as of June 2023 (June 2022: 148.4 percent). Banks have also increased holdings of high-quality liquid assets (HQLA) by 3.8

percent relative to the previous year. Banking system deposits grew by 5.9 percent and reduced the loan-to-deposit ratio (LDR) by about 1.2 percentage points annually to 85.5 percent.

Credit to the private sector has grown, at almost the same pace as the growth in deposits. The banking system's outstanding loans grew by 4.5 percent annually to RM2.1 trillion by the end of June 2023. Credit growth during the period was driven by lending to households and to SMEs, which increased by 5.1 percent and 6.4 percent annually respectively (June 2022 to June 2023). The volume of business loan applications and disbursements continued to register positive annual growth, although momentum has eased in Q2 2023 relative to previous four quarters (Figure 42).

¹⁷ Minimum capital adequacy ratios: Common Equity Tier 1 (CET1) Capital Ratio 4.5%, Tier 1 Capital Ratio 6% and Total Capital Ratio 8%.

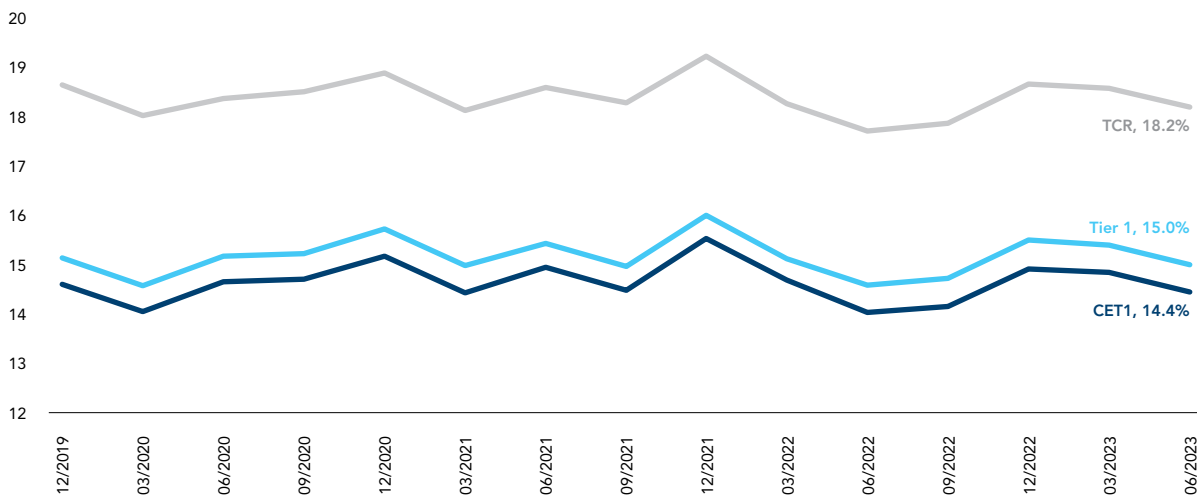
¹⁸ Year-on-year.

¹⁹ BNM defines Tier 1 Capital Ratio as Tier 1 Capital divided by Total Risk-Weighted Assets. Tier 1 Capital is the sum of Common Equity Tier 1 Capital (including share capital and retained earnings, among others) and Additional Tier 1 Capital. Further details are available in Paragraphs 12.1 and 13.1 of BNM's Capital Adequacy Framework.

FIGURE 41

Total capital ratio remained well over the regulatory minimum capital level at 18.2 percent in June 2023

Total capital ratio and Tier 1 capital ratio, Percentage

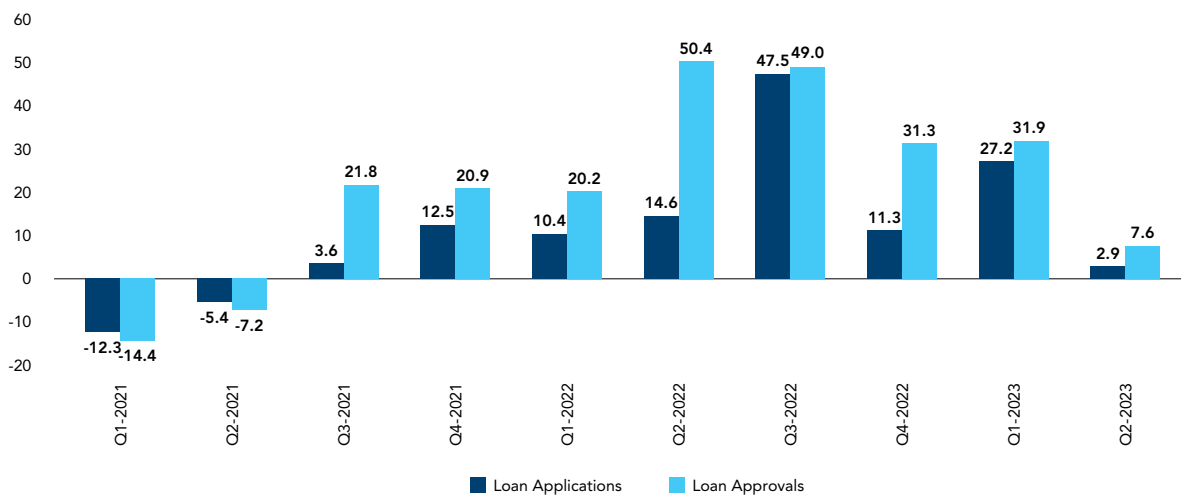


Source: BNM

FIGURE 42

Business loan applications and approvals continued to grow

Business Loan Applications & Approvals, y/y, Percentage



Source: BNM

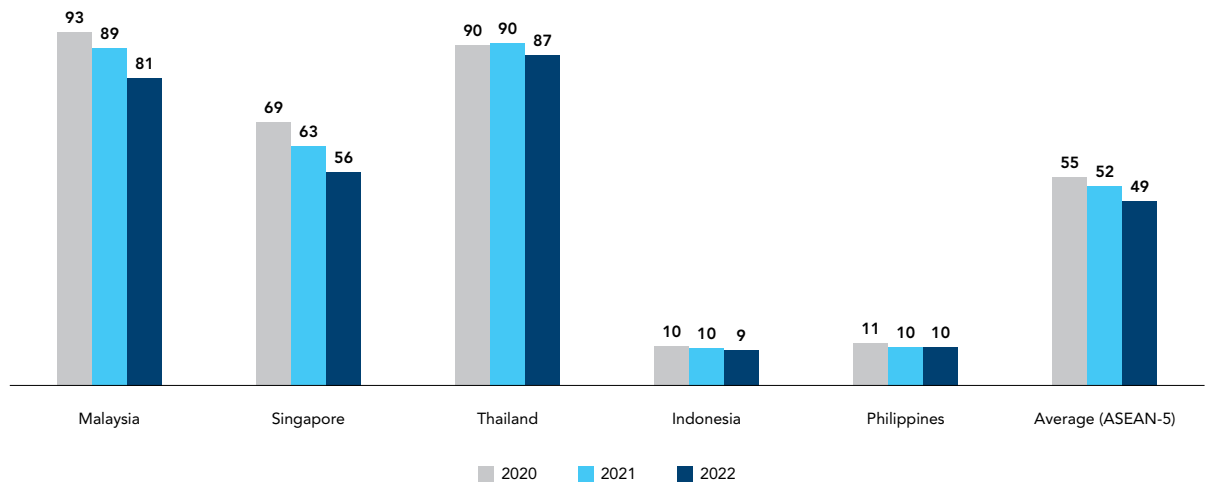
The household sector remained the largest credit segment, with debt to GDP higher than in comparator countries. The household sector represented almost 60 percent of the total outstanding loan volume as of June 2023. Although it has been on a marked declining trend, household debt to GDP in Malaysia remains among the highest in Southeast Asia, at 81.2 percent as of Dec 2022 (December 2021: 89.1 percent) (Figure 43). Of concern to financial stability risks is that 33 percent of total loans and 25 percent of household borrowers have a high debt-service ratio

(above 60 percent) in 2022.

Total non-performing loans (NPLs) continue to inch higher, although gross NPL ratios remain low compared to levels experienced in the previous crises. The total volume of non-performing loans (NPLs) has increased by 1.2 percent annually since June 2022. The gross NPL ratio declined from 1.81 percent to 1.76 percent over the same period, remaining the lowest among ASEAN countries, where ratios have ranged between 1.8 percent and 3.5 percent (Figure 44).

FIGURE 43**Malaysia has relatively high household debt to GDP compared to ASEAN peers**

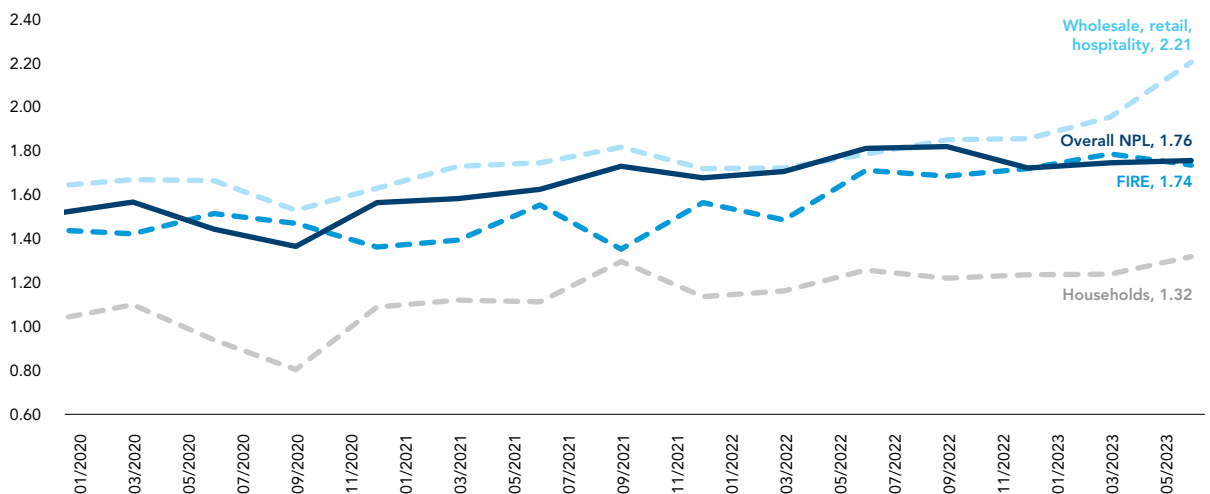
Household debt-to-GDP, Percentage



Source: CEIC

FIGURE 44**The overall NPL ratio decreased marginally to 1.76 percent as of June 2023**

Overall NPL Ratio, Main Sectors, Percentage



Source: BNM

Additionally, Malaysia's gross NPL ratio remains relatively low compared to levels experienced in the Global Financial Crisis (4.8 percent) and Asian Financial Crisis (18.7 percent) (Table 3).

Since the expiry of forbearance and regulatory flexibility measures, the share of loans under repayment assistance has further declined. It reached 4.2 percent of total banking system loans

in December 2022 (December 2021: 26.1 percent). 5.6 percent of total SME loans (or 1.0 percent of total loans outstanding) remained under repayment assistance, compared to 30.9 percent in December 2021.²⁰ However, about 20 percent of SME loans that exited the repayment assistance continue to be classified by banks under Stage 2, and the delinquency ratio for these borrowers increased slightly to 0.9 percent in December 2022 (June 2022: 0.7 percent).²¹

²⁰ Source: BNM Financial Stability Review – First Half 2022.

²¹ Stage 2 refers to the underperforming loans classified under the Malaysian Financial Reporting Standard 9 (MFRS 9).

TABLE 3**Gross NPL ratios remain relatively low compared to levels experienced in the previous crises**

Banking system	1997-1998	2008	2022
No of institutions	80-86	54	54
Average total asset	RM9.6 billion	RM24.1 billion	RM62.0 billion
CCR/Tier 1	8.9%	10.6%	15.5%
ROA	-0.9%	1.5%	1.4%
Gross NPL	18.7%	4.8%	1.7%

Source: BNM

Household loans under repayment assistance have also declined to 1.9 percent of total loans outstanding as of December 2022 (December 2021: 18.8 percent). Financial institutions continue to be given the flexibility to address repayment issues on a case-by-case basis.

Banks have reduced their provisions for NPLs since the expiry of forbearance measures, but stress test results indicate that financial institutions have adequate capacity to absorb increases in NPLs.

In line with overall improvement in repayment trends,

total provisions declined by 6.1 percent from RM35.2 billion as of June 2022 to RM33.1 billion as of June 2023. The ratio of provisions to impaired loans declined to 91.8 percent (December 2022: 97.8 percent). BNM's stress testing results indicate that financial institutions can withstand increases in impairment under simulated severe macroeconomic and financial shocks. The simulated conditions include higher impaired loans and additional shocks related to a depreciation of the ringgit and increased US Federal Funds rates.

Portfolio inflows into the bond market helped offset outflows from the equity market

The Malaysian bond market recorded net portfolio inflows of US\$ 3.0 billion for the first six months of 2023, vis a vis a marginal net outflow of US\$9.6 million in 2022 (Figure 45). Inflows into the bond market in the first six months of 2023 helped offset net outflows from the equity market (US\$929.3 million). Amid such inflows into the bond market, foreign holdings of debt securities and sukuk in Malaysia increased to 13.7 percent of the total value outstanding as of June 2023 (December 2022: 13.2 percent).

Portfolio inflows into the bond market coincided with a decline in government bond yields. The 10-year yields on the Malaysian Government Securities (MGS) declined 22 basis points between end-December 2022 and end-June 2023. The decline in MGS yields also reflected BNM's pause in monetary

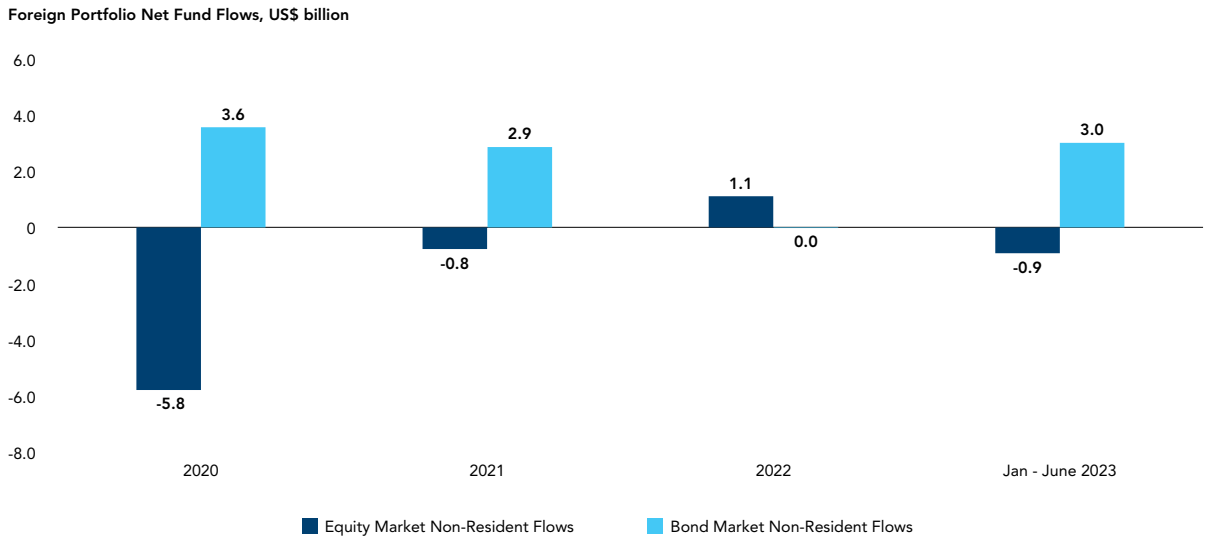
policy normalization. In tandem with such a decline in MGS yields, corporate spreads narrowed in 1H 2023, with the average 10-year AAA spread against MGS yields declining to 51.1 basis points as at end-June 2023 (December 2022: 70.4 basis points as at end-2022). Meanwhile, Malaysia's equity benchmark declined 7.94 percent in the first half of 2023, amid slowing global growth and weaker-than-expected earnings in 1Q 2023. Overall, the local market capitalization declined by 3.84 percent to RM1.67 trillion at end-June 2023 from RM1.74 trillion as at end-2022.

Concerns about weak global growth continued to be the dominant factor in domestic financial markets which partly contributed to the weakening of the ringgit. From 1 January to 24 August 2023,

the ringgit has depreciated by 5.2 percent, one of the largest among regional countries. Following this, the real effective exchange rate (REER) continues to decline (Figure 46).²² Unlike other countries in the region,

Malaysia's REER has been on a downward trend since Q2 2018 (Figure 47), depreciating by almost 8 percent between Q2 2018 and Q3 2022 (see Box 4 on the drivers of ringgit depreciation).

FIGURE 45
Foreign portfolio inflows into Malaysian bond markets helped offset outflows from equities



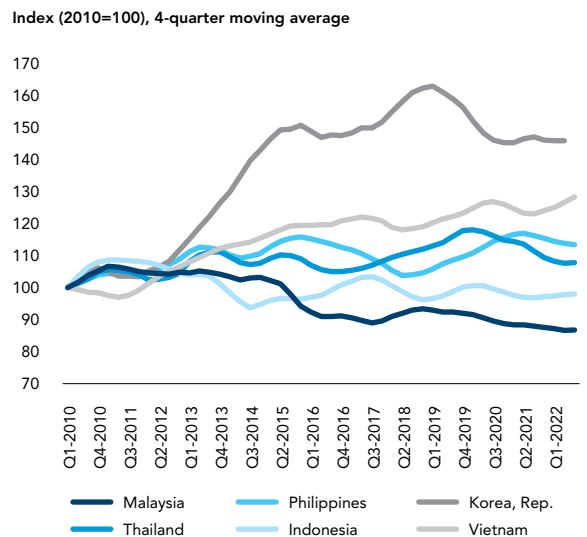
Source: Bloomberg

FIGURE 46
Malaysia's REER has depreciated by almost 8 percent between Q2 2018 and Q3 2022



Source: IMF International Financial Statistics (IFS)

FIGURE 47
Unlike other countries in the region, Malaysia's REER has been on a downward trend since Q2 2018



Source: IMF IFS, Bank of Thailand, and Haver
Note: REER for Korea is based on unit-labor cost. REER for Thailand is from the Bank of Thailand

²² The REER is a more appropriate measure of external competitiveness, compared to bilateral exchange rates since the REER is the weighted average of the bilateral real exchange rates between the country and all of its trading partners. The weights are the respective trade shares of each partner.

BOX 4

What Drives Ringgit Depreciation? A Recent (2021-2023) and Historical (2014-2016) Analysis

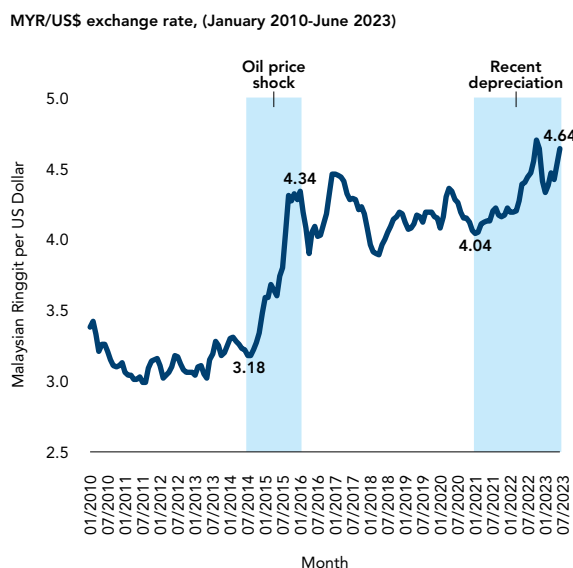


Understanding the behavior of exchange rate dynamics is among the most challenging and persistent international macro puzzles, with academics, policymakers, and investors trying to better understand the determinants of the exchange rate.²³ This section presents new analysis behind two episodes of sizeable ringgit depreciation in over a decade, one recent, and the other historical (Figure 48).

2021-2023 ringgit depreciation

U.S. monetary policy tightening observed since March 2022 is the primary reason for the recent ringgit depreciation. From January 2021 to June 2023, the nominal exchange rate went from a monthly average of 4.04 to 4.64 ringgit per U.S. dollar, implying a depreciation of 14.9 percent. This episode represents the 2nd largest depreciation of the ringgit in over a decade. Our estimations suggest that, among the determinants of exchange rates common in the literature, the differential between Malaysia and U.S. monetary policy interest rates during the 2021-2023 is

FIGURE 48
The ringgit depreciated by 15 percent against the US dollar from January 2021 to June 2023 and 37 percent from July 2014 to January 2016



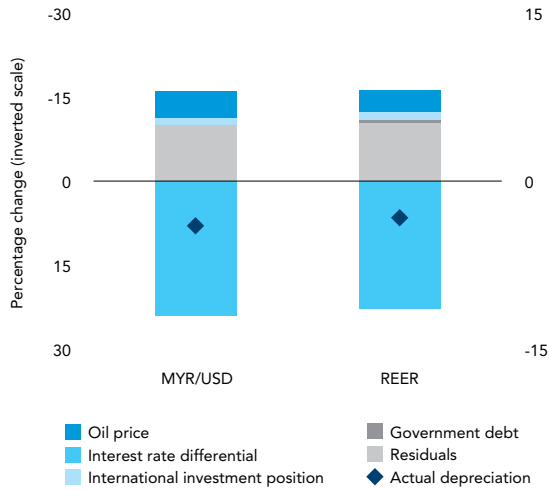
Source: International Financial Statistics, IMF

²³ Back in 1983, Meese and Rogoff showed that a random walk model outperforms a range of fundamentals-based models of exchange rate determination, concluding that macroeconomic fundamentals do not play a role in exchange rate fluctuations. Twenty-five years later, Rogoff and Stavrakeva (2008) show that the findings of Meese and Rogoff (1983) are limited to major floating currencies. See Obstfeld and Rogoff (2000) for a comprehensive literature review on the exchange rate puzzles.

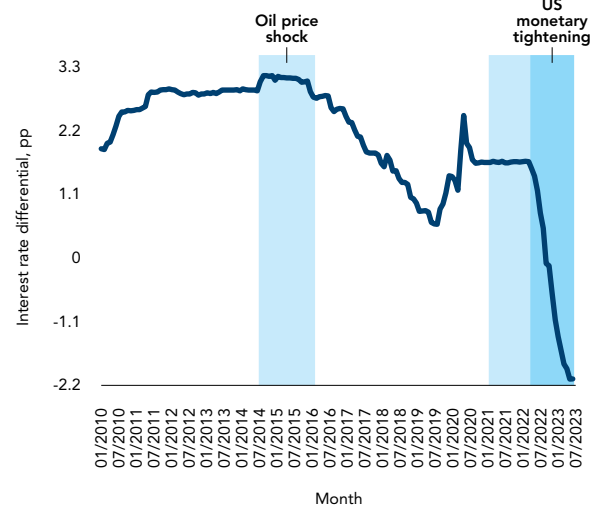
FIGURE 49

The US monetary policy tightening mainly accounts for the Malaysian ringgit depreciation observed between January 2021 and June 2023

Drivers of ringgit Depreciation, (Quarter 1, 2021-Quarter 1, 2023)



Interest rate differentials, (January 2010-May 2023)



Source: International Financial Statistics, IMF; World Bank Commodity Price Data (The Pink Sheet), World Bank; Monthly Highlights & Statistics, BNM; Board of Governors of the Federal Reserve System (US); Morgan Markets.

Note 1: "Residual" is the share of the ringgit appreciation / depreciation that cannot be accounted by oil prices, interest rate differentials, IIP, and public debt. Some potential variables that could explain the residuals are current account fluctuations, sovereign risk, and investor's preferences.

Note 2: The Real Effective Exchange Rate (REER) considers inflation differentials and provides a more accurate measure of the currency's purchasing power value. By considering the trade-weighted average of a currency against a basket of other currencies, the REER captures the impact of multiple trading partners on a country's competitiveness. In contrast to the MYR/US\$ exchange rate, an increase (a decrease) in the REER implies an appreciation (a depreciation). We find that the correlation between the REER and the MYR/US\$ exchange rate is -0.98.

the primary explanatory variable that can account for the recent ringgit depreciation (Figure 49). Indeed, U.S. monetary policy tightening led to capital outflows in all emerging economies, including from Malaysia.

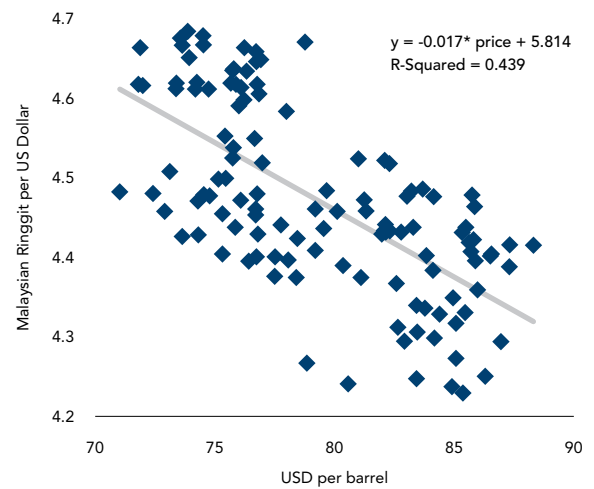
Using daily data from January 3 to July 7 of 2023, a negative association between oil prices and the MYR/US\$ exchange rate is observed (Figure 50).

This is following a popular strand of the literature that has paid particular attention to the relationship between oil price fluctuations and exchange rates in oil exporting countries.²⁴ When oil prices are high, as expected, the depreciation is less, especially in the absence of a fiscal rule that moderates the impact of oil price volatility on public finances. Indeed, in the 2021-2023 period, high oil prices did put upward pressure on the ringgit. However, the downward pressure exerted on the ringgit due to U.S. interest rate tightening far exceeds the upward pressure due to higher oil prices and other factors (Figure 49).

FIGURE 50

High oil prices suggest stronger ringgit and vice-versa

Oil Prices vs MYR/US\$, (January 2023-July 2023)



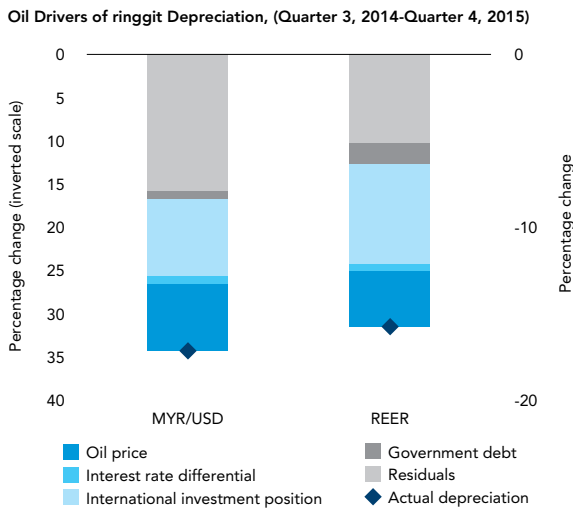
Source: Exchange Rates, BNM; U.S. Energy Information Administration (EIA).

²⁴ For instance, Dauvin (2014) documents that a 10 percent increase (decrease) in energy prices led to a 2.5 percent appreciation (depreciation) in the domestic currency. On the other hand, Buetzer et al. (2016) found no systematic evidence that domestic currencies of oil-exporting countries appreciate after oil shocks. See Coudert and Mignon (2016) for a comprehensive lit review.

2014-2016 ringgit depreciation

The largest episode of ringgit depreciation in recent times was observed between July 2014 to January 2016, and driven mainly by capital outflows and lower oil prices. During the 2014–2015 period, the ringgit depreciated by 36.4 percent. Using quarterly data from Q1 2010 to Q1 2023, we find that lower oil prices accounted for 22.6 percent of the MYR/US\$ exchange rate depreciation observed during the 2014–2015 period (Figure 51). Oil prices, however, were not the largest factor behind the depreciation. Fluctuations in the international investment position (IIP) accounted for a larger 26.0 percent of the depreciation of the MYR/USD exchange rate. This suggests that the ringgit depreciation was mainly driven by capital outflows besides the oil price shock. One potential explanation for the capital outflows observed in Q3 2015 is the 1Malaysia Development Berhad (1MDB) shock, which adversely affected market sentiment and reduced Malaysia’s attractiveness to foreign investors (Figure 52). However, more rigorous analysis is required to quantify the short and long run effects of the 1MDB shock on the ringgit, which we leave for future research.

FIGURE 51
The oil price shock accounted for 22.6 percent of the depreciation observed between July 2014 and January 2016



Source: International Financial Statistics, IMF; World Bank Commodity Price Data (The Pink Sheet), World Bank; Monthly Highlights & Statistics, BNM; Board of Governors of the Federal Reserve System (U.S.); Morgan Markets. Note: The REER considers inflation differentials and provides a more accurate measure of the currency’s purchasing power value. By considering the trade-weighted average of a currency against a basket of other currencies, the REER captures the impact of multiple trading partners on a country’s competitiveness. In contrast to the MYR/US\$ exchange rate, an increase (a decrease) in the REER implies an appreciation (a depreciation). We find that the correlation between the REER and the MYR/US\$ exchange rate is -0.98.

FIGURE 52
Capital outflows account for 26 percent of the depreciation observed between July 2014 and January 2016



Source: Monthly Highlights & Statistics, BNM

We also find that higher public debt is statistically associated with ringgit depreciation, illustrating the link between higher debt and increase in sovereign risk that affects Malaysia’s rising attractiveness to foreign investors. However, public debt accumulation only accounts for a small amount of the ringgit depreciation.

In summary, the high (negative) correlation with oil price fluctuations capital outflows, is what makes the Malaysian ringgit uniquely sensitive relative to other currencies. The U.S. monetary policy tightening is a common shock among emerging economies and as such, cannot explain why Malaysia’s currency is more adversely affected relative to others. Our analysis of recent and historical episodes – when the ringgit depreciated against the U.S. dollar by almost 15 and 36 percent, respectively – shows that (i) as an oil exporting country, exposure to oil price shocks, (ii) and vulnerability to sudden and sizeable capital outflows are the main factors that likely explain why the Malaysian ringgit stands apart.

Overall, our results are consistent with the literature highlighting the asymmetric effect of uncertainty shocks on the exchange rates in emerging market economies relative to advanced economies. Although most shocks are transitory, the effect on the nominal exchange rate could be enduring.

Continuous decline in tax revenue has contributed to revenue inadequacy

After a higher revenue collection in 2022 on higher petroleum revenue, federal government revenue is expected to resume its downward trend this year. Revenue collection stood at 16.8 percent of GDP as of 1H 2023, and is expected to decline to 15.4 percent of GDP in 2023 (2022: 16.7 percent). Malaysia's revenue collection is one of the lowest among its comparative peers.²⁵ Between 2012 to 2022, Malaysia's revenue share fell by 4.6 percentage points (Figure 53), one of the steepest revenue declines recorded globally. The downward trend in revenue is driven by several factors including sharp falls in petroleum-related incomes and low collection in personal income tax (PIT) and consumption tax. Revenue from PIT is expected to be at 1.9 percent of GDP in 2023 (2022: 1.8 percent) while revenue from the sales and services tax (SST) is projected to be at 1.8 percent of GDP (2022: 1.7

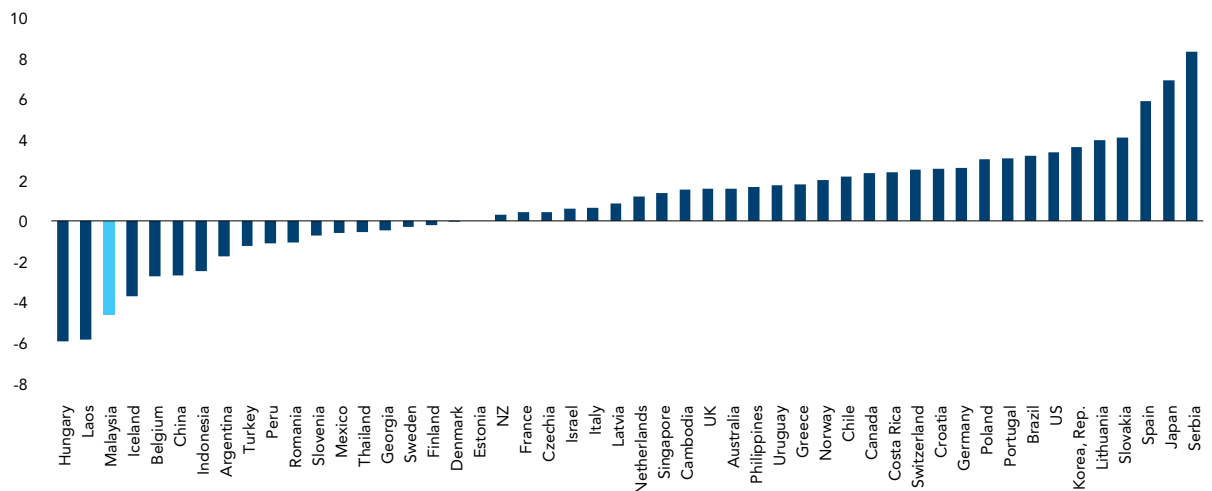
percent) (see Part 2: *Raising the Tide, Lifting All Boats*).

Malaysia's continuous decline in revenue have contributed to its revenue inadequacy. Revenue adequacy²⁶ can be measured in several ways to identify a 'target' level of tax collection for the country. This includes using (i) identifying a minimum tax collection target, and (ii) comparing a country's level of taxation and expenditure against countries that successfully transitioned from upper-middle income to high income. The first approach assumes that there is a minimum level of revenue needed to support expenditure for inclusive growth. The second approach assumes that for fiscal policy to play a role in supporting sustainable growth for a country that is targeting a high-income economy, there is a certain level of public expenditure and taxation that is the norm.

FIGURE 53

Malaysia's revenue decline between 2012 to 2022 is one of the steepest recorded among its comparative peers

General government revenue/ Federal government revenue, Percentage of GDP



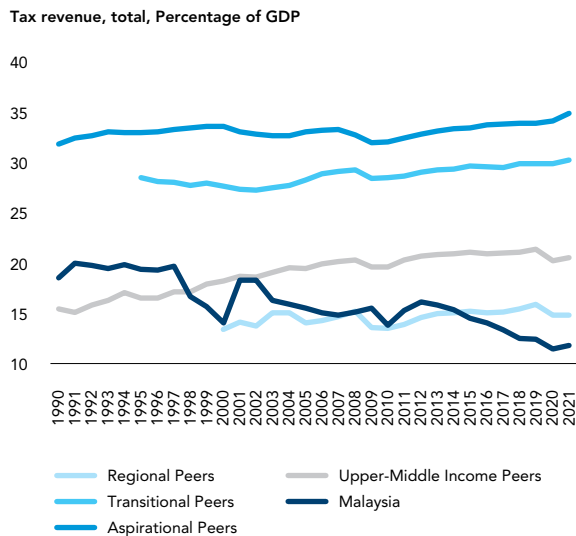
Source: World Bank Staff Calculations based on International Monetary Fund (IMF) Government Finance Statistics (2021)

²⁵ Comparative peers refer to three group of countries; (i) high-income countries (ii) countries that have graduated into high income or aspirational peers and (iii) regional countries.

²⁶ A comprehensive approach for Malaysia would be to define revenue adequacy with respect to its medium-term expenditure framework, including its medium-term expenditure plans, its debt strategy, and a forecast of baseline revenues. Under this approach, the government would forecast its baseline revenues, define its medium-term expenditure plans, and identify its target deficit and debt levels based on its fiscal rules and its medium-term debt strategy. The target deficit level assumes a theoretical revenue target that may differ from the baseline revenue forecast. From this approach, the difference between the theoretical revenue target and the baseline revenue forecast is the revenue gap needed to meet the objective of revenue adequacy. A baseline revenue forecast is typically based on a set of macroeconomic assumptions, estimated tax elasticities, and the assumption of similar levels of 'tax effort' as in previous years. It attempts to estimate likely revenue collection based on a scenario of no additional tax reform.

Currently, there is no well defined minimum tax collection in Malaysia, and using the second approach, Malaysia's tax ratio is well below other upper-middle income countries (UMICs). Meanwhile other UMICs tax ratios have been converging toward the average of countries who previously transitioned successfully. High-income countries (HICs), have had a relatively flat tax ratio over the years, averaging at about 35 percent of GDP. The same trend is observed for a group of countries that successfully transitioned in recent years from UMIC to high income, and for a group of countries who transitioned from lower-middle income to UMIC. For these two groups, the tax-to-GDP ratio has recently averaged around 20-30 percent. In contrast, Malaysia's tax to GDP ratio has been decreasing and converging toward the average of the regional peers. At 12 percent of GDP in 2023, Malaysia is far below its estimated potential tax revenues (Figure 54). This tax gap has been gradually increasing over the years, partly due to changes in tax policy that have undermined tax revenue collection and to some extent, Malaysia's tax capacity.

FIGURE 54
Malaysia's tax gap has been increasing in recent years



Source: World Bank Staff Calculations based on UNU Wider revenue data; World Bank Revenue Dashboard.

Rigid expenditures and spending inefficiency remains a challenge

High level of rigid expenditures has contributed to marked rigidity in government spending, limiting allocations for development and social spending. In 2022, almost 60 percent of the government's operating expenditures (OE) has been channeled to rigid expenditures, namely, obligations related to salaries, pensions, and debt service payments which have been on a rising trend (Figure 55).

Inefficiency in government spending exists, particularly in subsidy spending. Subsidy spending in Malaysia can be categorized into four broad categories: (i) energy, (ii) food, (iii) agriculture, and (iv) others such as housing. Energy and food subsidies in general are blanket subsidies, while the others are targeted toward specific groups such as farmers. To date, the bulk of subsidies allocation goes to untargeted blanket subsidies. In 2022, for example, it is estimated that the total expenditure on blanket fuel subsidies amounted to RM52 billion or 2.9 percent of GDP, making up 56

percent of total subsidy spending. Blanket subsidies are regressive in nature, with the benefits enjoyed disproportionately by higher-income households. The richest 20 percent of households in Malaysia received about 53 percent of the blanket fuel subsidy. The government is currently reviewing a targeted fuel subsidy mechanism to replace the blanket fuel subsidies (see Part 2: *Raising the Tide, Lifting All Boats*). In addition, other forms or more targeted subsidies such as for the production of rice in agriculture are not necessarily well targeted and leads to inefficiency. Malaysian rice costs more to produce than to import, despite generous levels of subsidization.²⁸

While Malaysia's public investment is comparable to OECD levels, implementation challenges and high levels of public debt make it more difficult to achieve development goals. In the recent tabling of the 12th Malaysia Plan Mid-Term Review, the government has allocated an additional RM15 billion

²⁷ The tax gap is derived by comparing actual tax collection with tax potential, which is estimated using a forecasting technique called stochastic frontier analysis that controls for a country's GDP-per-capita and trade. It also refers to taxable capacity - the predicted tax-to-GDP ratio calculated using the estimated coefficients of a regression specification, taking into account the country specific characteristics. Le, MorenoDodson, and Rojchaichanthorn (2008).

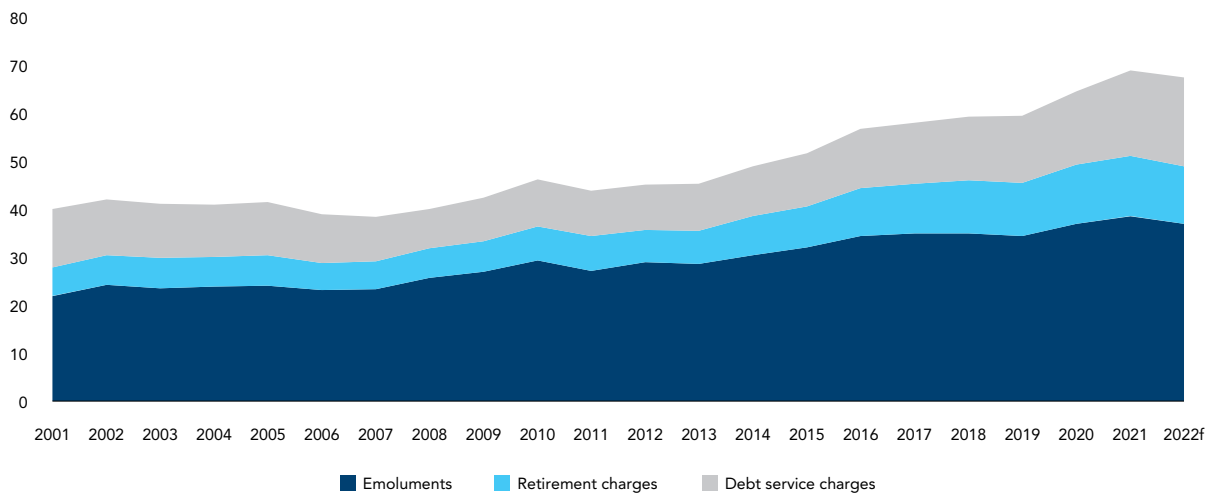
²⁸ World Bank (2020) Malaysia Economic Monitor: Sowing the Seeds.

in development expenditure. Malaysia's government investment stood at 4.0 percent of GDP, above the OECD average of 3.1 percent (Figure 56). The main challenge, however, lies in the execution of allocated budgets, which is undermined by gaps in budget planning and implementation.²⁹ Implementation of development programs remains fragmented due to

the institutional arrangements in Malaysia with various implementing agencies being under the jurisdiction of either federal or state government.³⁰ In addition, the already high debt level limits the government's ability to increase its borrowings to fund development spending.

FIGURE 55
Rigid expenditures i.e., obligations related to salaries, pensions, and debt service payments – have been on a rising trend

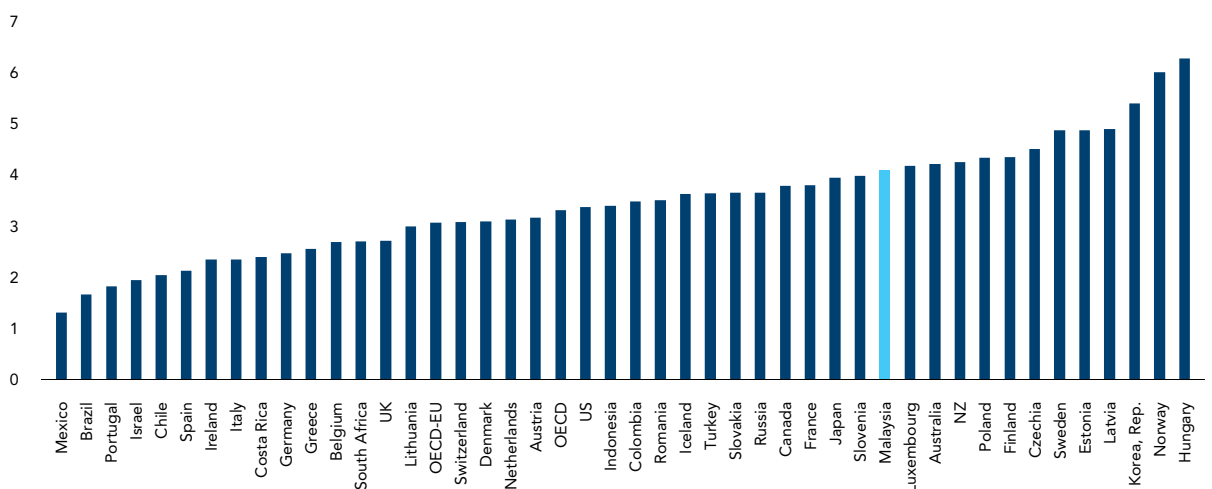
Federal government operating expenditure, Percentage



Source: World Bank Staff Calculations based on MOF data

FIGURE 56
Government investment in Malaysia stood at 4.1 percent of GDP, above the OECD average

Government investment, 2019, Percentage of GDP



OECD National Accounts Statistics (database), MOF

²⁹ In 2017, the IMF and the World Bank undertook a Public Investment Management Assessment (PIMA) exercise (<https://www.elibrary.imf.org/display/book/9781513571829/9781513571829.xml>). One of the findings from the PIMA exercise suggested that the lack of multi-year budgeting makes it difficult for line ministries to plan capital investment projects effectively because the amount of resources for planning purposes is only known for the next budget year.

³⁰ Malaysia Voluntary National Review. 2021. https://www.ekonomi.gov.my/sites/default/files/2021-07/Malaysia_Voluntary_National_Review_%28VNR%29_2021.pdf

Malaysia's fiscal space remains constrained

While Malaysia's deep capital markets have helped to keep government's borrowing costs fairly stable, higher debt levels have contributed to marked increase in debt service charges, further narrowing the fiscal space. At 60.6 percent of GDP (June 2023), Malaysia's government debt level remains slightly lower than the current statutory debt limit of 65 percent (Figure 57), with interest payments on an uptrend (Figure 58). In addition, debt service charges as a share of government expenditure is one of the highest, relative to its comparators.

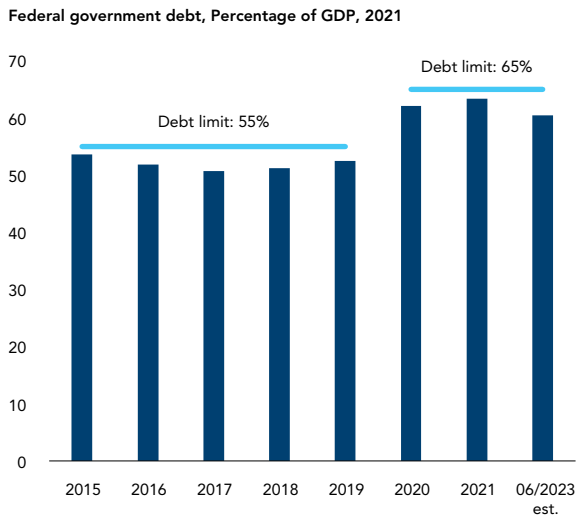
With government revenue projected to remain low and rigid expenditures to remain high, this has led to further narrowing of Malaysia's fiscal space. Using the ratio of the federal government debt to the revenue collection as an indicator³¹, it shows that Malaysia's fiscal space has gradually narrowed since 2012 and became tighter post-pandemic (Figure 59).

The government's fiscal deficit projection in 2023 is expected to decrease to 5.0 percent of GDP (2022: 5.6 percent) (Figure 60).

The government has reiterated its commitment towards consolidating the fiscal position for more sustainable public finance. In the recently announced *Madani* Economy framework, the government announced that one of its medium-term economic targets is to achieve fiscal sustainability, with the fiscal deficit narrowing to 3 percent of GDP or lower within the medium-term. This is in line with its medium-term fiscal framework (MTFF) which sets similar goals.

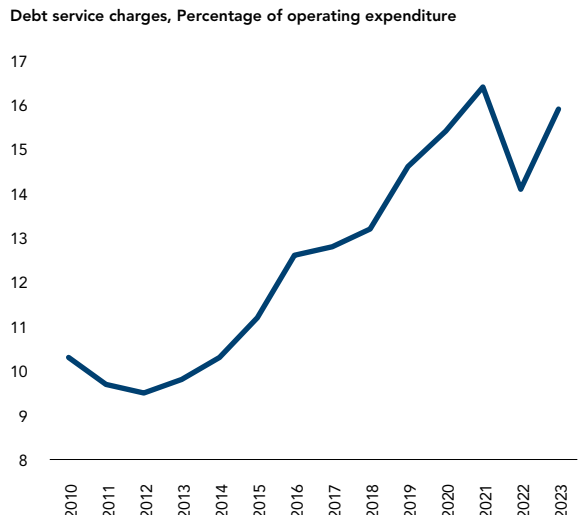
With the exception of inefficient subsidy spending³², the government's current fiscal consolidation strategy via spending reduction mainly through OE, as outlined in the MTFF, is challenging, given the current spending rigidity.³³ The combined spending

FIGURE 57
Malaysia's government debt level is relatively high



Source: MOF
Note: The statutory debt limit was raised from 55 percent of GDP to 65 percent following the COVID-19 measures and the government has maintained the 65 percent of GDP statutory limit by gazetting Loan (Local) (Statutory Ceiling for Borrowing) and Government Funding (Statutory Ceiling of Money Received) Order 2022 which came into operation on 1 January 2023.

FIGURE 58
Government's interest payments remain on an uptrend



Source: MOF

³¹ See Aizenman, Joshua, and Yothin Jinjarak. 2010. De Facto Fiscal Space and Fiscal Stimulus: Definition and Assessment. NBER. (https://www.nber.org/system/files/working_papers/w16539/w16539.pdf). The ratio of the outstanding public debt to the de facto tax base, or the tax-years needed to repay the public debt, provides information about the relative fiscal tightness of countries.

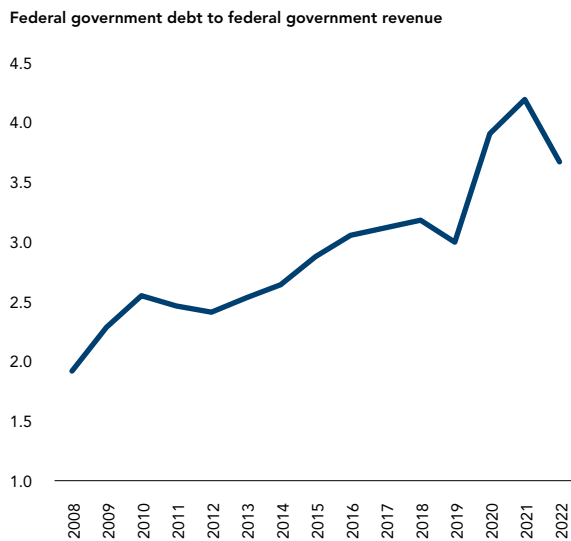
³² See World Bank (2023). Expanding Malaysia's Digital Frontier.

³³ The government's medium-term fiscal consolidation plan is guided by its Medium-Term Fiscal Framework (MTFF). The current framework pursues an expenditure-driven fiscal consolidation where the government expects operating expenditure to decline to around 14.5 percent of GDP. The government also expects revenue to decline to an average of 14.7 percent.

on rigid expenditures is expected to remain at high levels in the near term. In addition, other OE components such as grants and transfers, and supplies and services have been on a declining trend or are already at low levels (Figure 61). As such, the government’s current

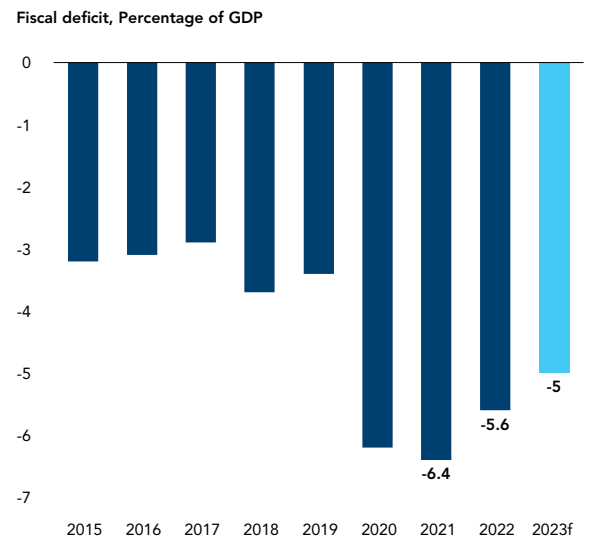
fiscal consolidation plan should also include a higher revenue collection target. With Malaysia’s revenue level remaining low and trailing comparative peers, it is important to address the persistent decline in revenue collection and explore new sources of revenue.

FIGURE 59
Malaysia’s fiscal space has gradually narrowed since 2012 and became tighter post-pandemic



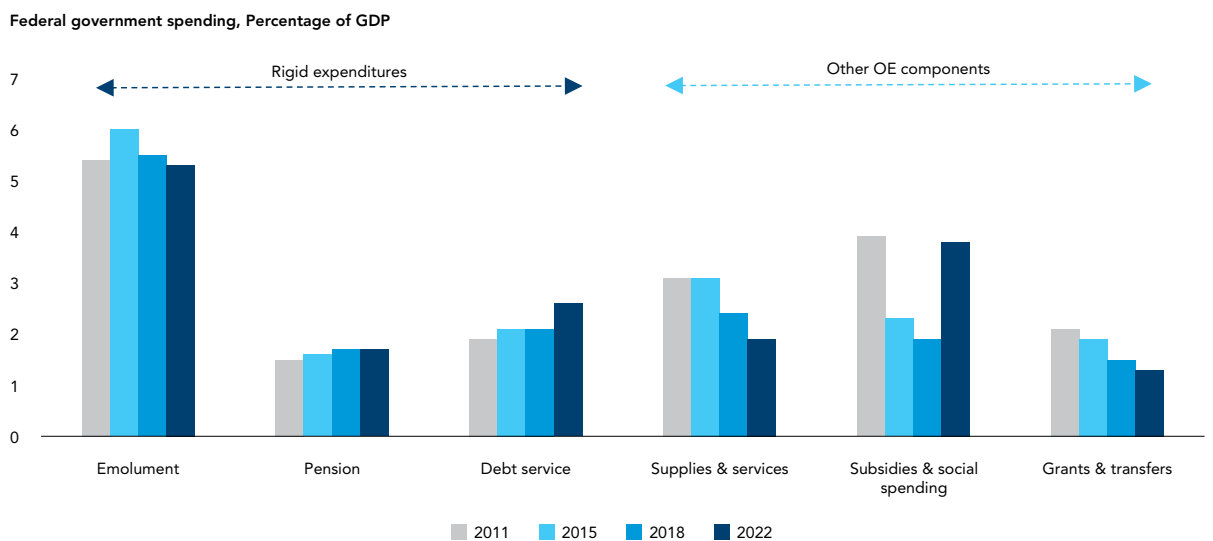
Source: World Bank Staff Calculations based on Aizenman and Jinjarak (2010)

FIGURE 60
Higher spending in response to the pandemic has led the fiscal deficit to increase significantly



Source: MOF

FIGURE 61
Fiscal consolidation via spending reduction is challenging given high rigid expenditures and other OE components have been on a declining trend or are already at low levels



Source: World Bank Staff Calculations based on MOF data

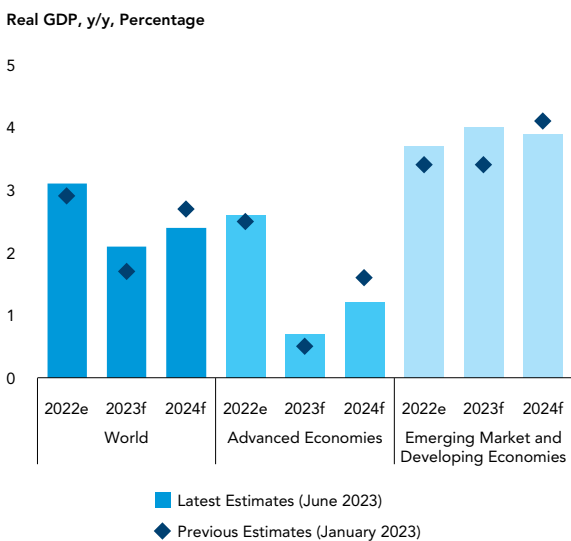
Economic outlook

Global growth is expected to slow over the near term

Global growth is projected to decelerate to 2.1 percent in 2023 before edging up to 2.4 percent in 2024 (2022e: 3.1 percent) (Figure 62). Relative to the January 2023 projections, global growth has been revised upward by 0.4 percentage point for 2023 but downward by 0.3 percentage point for 2024. While the aggregate global forecast has been revised up, projections for most economies have been revised down, with larger downgrades among countries that have had a greater degree of monetary tightening. Global trade is expected to slow in the near future due to weak merchandise trade in advanced economies, while services continue to improve. Global inflation is envisaged to gradually ease but will continue to be above its pre-pandemic level beyond 2024. Notwithstanding lower oil prices³⁴, market-based measures of long-term inflation compensation in advanced economies remain above 2 percent. Headline inflation has returned to target ranges in several large EMDEs.

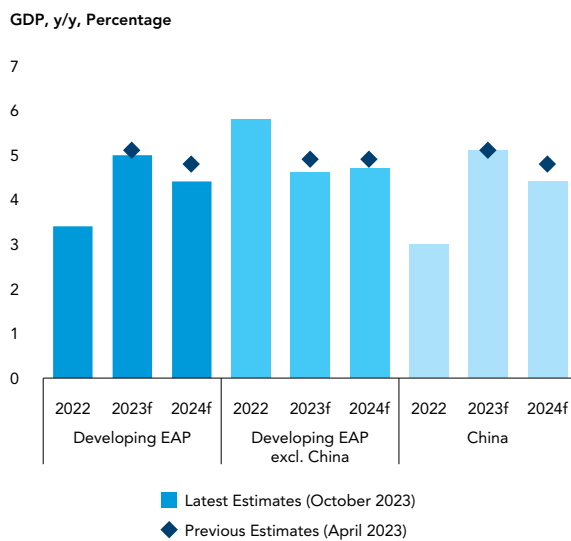
Growth in the developing EAP region is projected to strengthen to 5.0 percent in 2023 before slowing to 4.5 percent in 2024 (Figure 63). China's growth is expected to slow to 4.4 percent in 2024 after reaching 5.1 percent in 2023 (2022: 3.0 percent), as the rebound from the re-opening of the economy fades, while elevated debt, weakness in the property sector, and longer-term structural factors weigh on growth. Meanwhile, growth in the rest of developing EAP is projected to slow to 4.6 percent in 2023 amid softening global growth and tightening financial conditions (2022: 5.8 percent), before edging up to 4.7 percent in 2024. The likely recovery of global growth and the expected easing of global financial conditions are expected to offset the impact of China slowing down.

FIGURE 62
Global growth is projected to slow to 2.1 percent in 2023



Source: World Bank Global Economic Prospects June 2023

FIGURE 63
Aggregate growth in developing EAP is forecast to firm to 5.0 percent this year



Source: World Bank East Asia Pacific Economic Update October 2023

³⁴ The Brent crude oil benchmark is projected to average US\$80 per barrel in 2023.

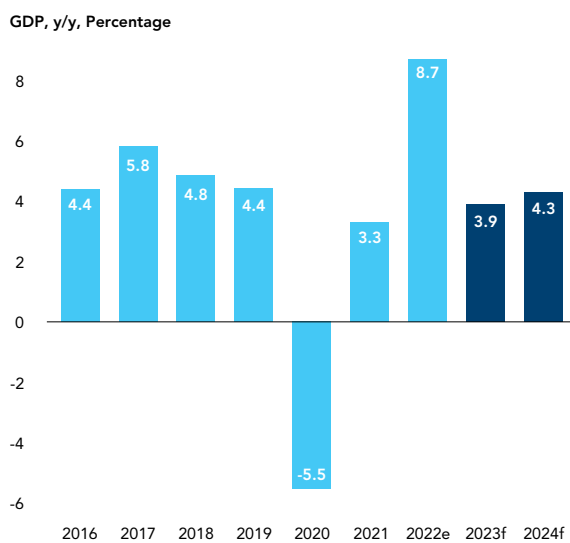
Malaysia's economy is expected to expand at a more moderate pace in 2023 and 2024

Malaysia's GDP growth is forecast to moderate in 2023 and 2024 in the face of slowing external demand (Figure 64). Following a strong recovery in 2022, Malaysia's economy is projected to expand at 3.9 percent in 2023 (2022: 8.7 percent), 0.4 percentage points lower than in the previous forecast, on account of weaker-than-assumed quarterly GDP growth in 2Q 2023 and weakening momentum in global goods trade. Malaysia's growth is forecast to edge up modestly to 4.3 percent in 2024, as the likely recovery of global growth and the easing of global financial conditions are expected to offset the impact of China slowing down. Domestic demand will continue to be the main driver of growth throughout the forecast period (Figure 65). Private consumption is forecast to expand at a more moderate rate of 5.2 percent this year (2024f: 6.1 percent), with growth primarily supported by further improvement in labor market conditions as well as continuous household income support from the government such as *Sumbangan Tunai Rahmah* cash aid. Meanwhile, public consumption is projected to grow at 0.9 percent this year (2024f: 0.8 percent) on account of higher emolument outlays. This is due to a special annual salary increment for civil servants and

the absorption of contract employees to permanent staff in the health and education sectors.

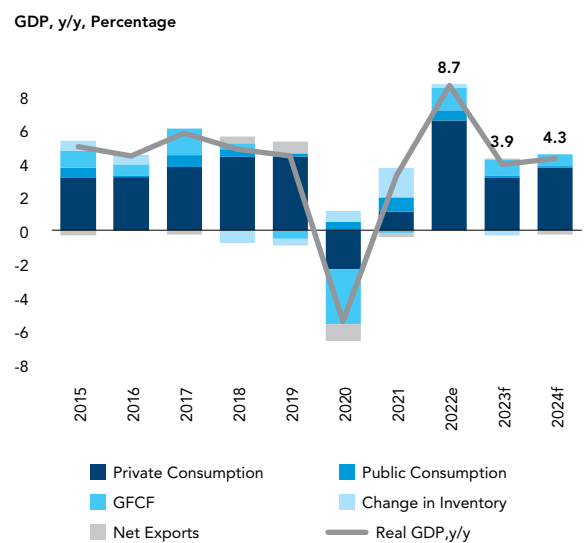
Gross fixed capital formation (GFCF) growth is expected to be sustained at 5.1 percent in 2023 (2024f: 3.6 percent), supported by ongoing capital expenditure in both the private and public sectors. Overall investment growth is largely unchanged relative to the previous projection. Private investment will continue to be supported by ongoing and new multi-year investments in the technology-intensive manufacturing and services sectors, although softening external demand and higher interest rates may weigh more heavily on investment intentions in the coming quarters, especially among firms in export-oriented and interest rate-sensitive sectors. Meanwhile, capital spending by the general government will continue to be directed mainly towards upgrading public infrastructure in the transportation, health and education sectors. Meanwhile, investment activity by public corporations will be largely supported by the ongoing and new infrastructure projects, including the East Coast Rail Link (ECRL), Light Rail Transit Line 3 (LRT3), the Pan-Borneo Highway and the 5G rollout under the MyDigital initiative.

FIGURE 64
Malaysia's economy is projected to expand at a more moderate pace in 2023 and 2024...



Source: World Bank Global Economic Prospects

FIGURE 65
...driven mainly by domestic spending



Source: World Bank Global Economic Prospects

The weakness in the external sector is likely to persist in the second half of the year, with softening growth in global goods trade weighing on export activity. Malaysia's exports is projected to contract by 5.8 percent this year (2024f: 3.7 percent), 6 percentage points below the previous forecast. This reassessment primarily reflects the weaker-than-expected performance in Malaysia's goods exports in recent months in tandem with weakening global industrial production and the ongoing E&E downcycle, as well as shift in global consumption toward less trade-intensive goods. Meanwhile, services trade will continue to benefit from the recovery in tourism activity, boosted by the continuing rise in tourist arrivals from the region following the reopening of borders. Similarly, Malaysia's imports is forecast to contract by 6.3 percent this year (2024f: 4.3 percent), in line with the expected fall in export activity and a more moderate pace of expansion across consumer spending and investment activity.

Headline consumer price inflation is expected to moderate to between 2.5 and 3.0 percent this year (2024f: 2.6 percent) because of base effects, easing global supply constraints and lower commodity prices. This forecast is largely unchanged from its previous projection and is premised on the assumption that the ceiling on retail fuel prices and price control measures on selected food items remain in place throughout the forecast period, limiting cost pressures from the prevailing global oil and food prices. Underlying inflation, as measured by core inflation, will also likely trend lower in the second half of the year but is expected to remain relatively elevated at around 3 percent this year, reflecting the broadening of cost pressures and pass-through of upstream cost pressures to consumer prices, as well as further narrowing of spare capacity in the economy.

TABLE 4

Malaysia's economy is expected to expand at a more moderate pace in 2023 and 2024

	Real GDP Growth, y/y, Percentage					Contribution to Real GDP Growth, y/y, Percentage Point			
	2021	2022e	2023f	2024f		2021	2022e	2023f	2024f
GDP	3.3	8.7	3.9	4.3					
Domestic Demand (including stocks)	3.8	9.3	4.2	4.8	Domestic Demand (including stocks)	3.6	8.7	3.9	4.5
Private Consumption	1.9	11.2	5.2	6.1	Private Consumption	1.1	6.6	3.1	3.7
Public Consumption	6.4	4.5	0.9	0.8	Public Consumption	0.9	0.6	0.1	0.1
Gross Fixed Capital Formation	-0.8	6.8	5.1	3.6	Gross Fixed Capital Formation	-0.2	1.4	1.0	0.7
External Demand					External Demand				
Exports of Goods & Services	18.5	14.5	-5.8	3.7	Exports of Goods & Services	11.4	10.3	-4.3	2.5
Imports of Goods & Services	21.2	15.9	-6.3	4.3	Imports of Goods & Services	11.7	10.3	-4.3	2.7

Source: World Bank Staff Calculations and projections based on DOSM data

Malaysia's growth outlook is subject to considerable uncertainty

The baseline growth projections for Malaysia are subject to several external and domestic downside risks. On the external front, global growth could be weaker than projected in the event of tighter-than-expected global financial conditions sparked by renewed banking sector stress. This could also be triggered by a greater-than-expected monetary tightening in response to more persistent inflation pressures. Negative supply shocks, such as a significant disruption to oil supplies caused by geopolitical disturbances, could raise commodity prices and have an adverse impact on global markets. A faster-than-anticipated fading of the post-pandemic rebound in China and an intensification of geopolitical tensions could also result in slower-than-expected expansion in global economic activity. The materialization of these risks could have considerable adverse spillovers to Malaysia given its high level of integration with the global economy and financial markets. On the upside, the resilience of economic activity to date in some major

economies despite substantial headwinds points to the risk that the global growth outlook may be stronger than currently assumed.

Domestically, the key downside risks relate to the uncertainty around domestic inflation and the strength of household consumption. Higher or more persistent domestic inflation and weaker real disposable income growth could weigh on the strength of consumption spending by more than currently assumed. This is especially so for low-income households which have been disproportionately impacted by the recent price increases. An upside shock to inflation may also prompt further monetary tightening, compounding the dampening effect on growth from existing policy normalization. On the upside, the resilience of investment activity and robust recovery in tourism-related activities point to the risk that domestic demand may be stronger than currently estimated.

Near-term policy measures should be anchored on supporting low-income households

Both financial and non-financial support measures to vulnerable, low-income households should continue. Although Malaysia's economy has recovered to its pre-crisis level, the degree of recovery remains uneven, and low-income households still struggle with the aftermath of COVID-19. While government support to households is pro-poor, the level of assistance remained insufficient and many who needed them the most are still excluded.³⁵ Putting in plans to move towards a more targeted subsidy framework for lower-income households would be relevant and timely. In parallel, access to good jobs and secure employment is fundamental to alleviate poverty and reduce income inequality. As such, more comprehensive labor market policies are essential to address labor demand and supply constraints. Given the change in the nature of work during the pandemic, active labor market policies can also play a crucial role in facilitating job transitions, for instance through upskilling and reskilling training programs and fostering formal employment creation

through matching contributions of social insurance.

Increasing the fiscal space remains a priority in the government's near-term reform agenda. In this regard, it is imperative to continue with efforts to enhance revenue mobilization in line with the growing spending and investment needs. Higher revenue collection can be achieved by undertaking tax policy and administration reforms to increase general consumption taxes, expand health taxes, streamline corporate tax incentives, and enhance personal income tax as well as other progressive taxes such as capital gains tax. Concurrently, spending efficiency could be achieved by enhancing the targeted social safety net programs. Given the limited fiscal space, improved targeting and consolidation of support instruments is needed to provide better coverage and protection to low-income and vulnerable households. This is explored further in Part 2, *Raising the Tide, Lifting All Boats*.

³⁵ As of May 2022, approximately one-quarter of households reported not having any access to government assistance programs. Moreover, nearly 80 percent of low-income households (earning RM2,000 and below) self-assessed as having inadequate financial resources to cover their monthly basic needs. Source: World Bank. 2023. COVID-19 Impact and Recovery among Malaysian Households: High-Frequency Phone Survey - Round 3 (April 10 - May 15, 2022).



PART TWO

Raising the Tide, Lifting All Boats



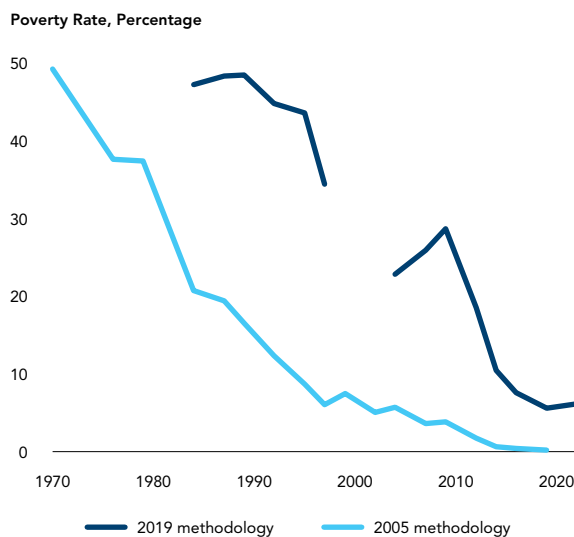
Raising the Tide, Lifting All Boats

Malaysian income inequality remains high relative to peers and is beginning to rise while the remaining poor are hard to reach

Poverty has fallen dramatically over the last 50 years, but spatial or regional disparities remain on both monetary and non-monetary dimensions. Income poverty in Malaysia is well below 10 percent³⁶, reflecting Malaysia's decades' long record of growth and development, although the remaining poor are harder to reach and poverty reduction had been slowing even before COVID-19 increased it (Figure 66). However, while ethnic income gaps have been shrinking³⁷, regional disparities in income and human capital outcomes remain significant. The average income in Kuala Lumpur is comfortably higher than the High-Income Country (HIC) threshold³⁸ that Malaysia aspires to (and should soon reach), with Pulau Pinang and Selangor right at the threshold. At the same time, all other states are below, many at less than half the level needed.³⁹ In addition, a number of states, especially those in East Malaysia, perform poorly on the education component of the Human Capital Index. Children in Sabah and Sarawak achieved only around 55 percent of their full educational potential, compared to 76 percent of those in Kuala Lumpur and 80 percent in Putrajaya.⁴⁰

Despite a long-term declining trend, income inequality in Malaysia remains relatively high compared to regional and transitional peers, and high-income countries. Income inequality, as measured

FIGURE 66
Poverty has fallen considerably over the last 50 years, but the pace of reduction has slowed in recent years



Source: World Bank (2021) Aiming High: Navigating the Next Stage of Malaysian Development. Department of Statistics Malaysia (DOSM) (2023). Poverty in Malaysia 2022

Notes: DOSM produces national income poverty estimates using data from household survey (HIES/BA). The national poverty line was increased in 2020 using 2019 methodology – more than doubled of that based on 2015 methodology.

³⁶ As discussed in Part I, the latest DOSM estimate is 6.2 percent for 2022, slightly higher than 5.6 percent in 2019, reflecting some lingering effects of COVID-19; at the height of the pandemic, poverty is estimated to have reached 8.4 percent (https://www.dosm.gov.my/uploads/release-content/file_20230731141124.pdf).

³⁷ See Rongen, Lanjouw and Simler (2021) and World Bank (2021) Aiming High: Navigating the Next Stage of Malaysian Development.

³⁸ The World Bank defines countries as HIC if their Gross National income (GNI) per capita, calculated using the Atlas method, is \$13,846 or higher in 2023. See <https://datahelpdesk.worldbank.org/knowledgebase/articles/906519-world-bank-country-and-lending-groups>.

³⁹ World Bank (2022). Catching Up: Inclusive Recovery & Growth for Lagging States

⁴⁰ World Bank (2022). Catching Up: Inclusive Recovery & Growth for Lagging States. The Human Capital Index (HCI) measures the human capital that a child born today can expect to attain by her 18th birthday, given the risks of poor health and poor education prevailing in her country, using different dimensions of human capital: health (child survival, stunting, and adult survival rates) and the quantity and quality of schooling (expected years of school and international test scores). Using estimates of the economic returns to education and health, the components are combined into an index that captures the expected productivity of a child born today as a future worker, relative to a benchmark of complete education and full health. The HCI ranges from 0 to 1. A country in which a child born today can expect to achieve full health (no stunting and 100 percent adult survival) and full education potential (14 years of high-quality school by age 18) would score a value of 1. An HCI value of, for instance, 0.5 implies that a child born today will be only half as productive as a future worker as she would be if she enjoyed complete education and full health. See World Bank. 2018. *The Human Capital Project* and <https://www.worldbank.org/en/publication/human-capital>.

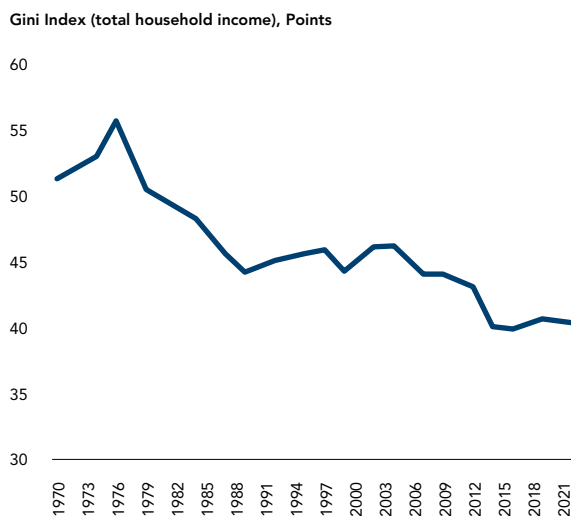
by the Gini Index, fell from a high of 56 points in 1976 to 40 by 2014, a sustained and sizeable decline (Figure 67). Since then, however, the decline has stalled and begun to rise slightly in the half decade before the COVID-19 pandemic to 41 by 2019. In addition, inequality remains high relative to comparator peer countries. Malaysia's Gini Index is higher than most ASEAN countries, those that have recently become high income and OECD countries (Figure 68).⁴¹

Most Malaysians are also concerned about the gap between rich and poor. In 2014, 95 percent of people thought that the gap between rich and poor was a major concern.⁴² These perceptions could partly due to the rise in absolute inequality despite the falling relative inequality as measured by the Gini Index.⁴³ Since the time of that survey, income inequality had begun increasing even before the pandemic disproportionately affected

more vulnerable Malaysians, with low-skilled, informal, and lower earners more exposed to employment and income shocks, while one-third of children from poor households were unable to access online learning.⁴⁴ These short-term shocks are likely to drive longer-term inequality higher still.

Addressing inequality can contribute to realizing Malaysia's high-income aspirations. The lure of greater financial rewards can provide incentives for hard work, study and entrepreneurial risk-taking, which in turn can contribute to a degree of inequality of outcomes. However, some forms of inequality can be detrimental to growth, such as high inequality of opportunity and lack of economic mobility. For instance, inequality can lower investments in human capital⁴⁵ if it lowers aspirations and expected returns to education among young people. Inequality can

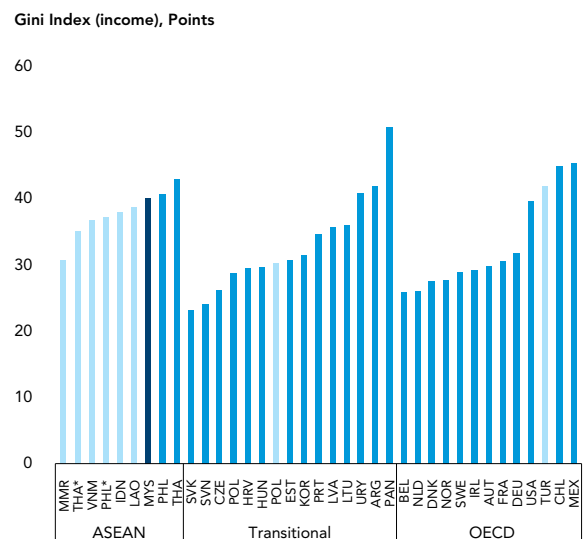
FIGURE 67
Inequality fell dramatically since 1976, but the decline began flattening in the mid-2010s before COVID-19



Source: DOSM

Note: Gini Index is a measure of inequality where 0 is complete equality (everyone has the same income) and 100 is complete inequality (one person has all the national income). DOSM calculates the income Gini on total household income not per capita.

FIGURE 68
Income inequality is the third highest in the region and higher than most recently transitioned HIC and almost all OECD countries



Source: World Bank Staff Calculations from World Bank Poverty and Inequality Platform and DOSM HIES/BA (2019)

Note: Countries that use income for the welfare aggregate are in dark blue and those that use consumption are in light blue. Malaysia and the Philippines use income for the official welfare aggregate, while other ASEAN countries use consumption. The Philippines and Thailand have income and consumption welfare aggregates available. Ginis presented are calculated from the per capita income or consumption distribution. Malaysia's Gini in this chart is adjusted to be based on per capita income rather than the official DOSM estimate using household total gross income.

⁴¹ Income inequality is generally higher than consumption inequality because the poor save little or no income (and often borrow to smooth consumption) whereas richer households save, often significantly, meaning the consumption distribution is more equal than the income distribution. Countries using consumption instead of income are marked in the chart.

⁴² Pew Research Center (2014). *Spring 2014 Pew Global Attitudes Survey*. [online] <https://www.pewresearch.org/global/2014/10/30/methods-in-detail-14/>

⁴³ World Bank (2021). *Aiming High*.

⁴⁴ World Bank (2021) *Malaysia Economic Monitor: Staying Afloat*.

⁴⁵ Ferreira, Francisco H. G., Christoph Lakner, Maria Ana Lugo, and Berk Ozler. 2014. *Inequality of Opportunity and Economic Growth: A Cross-Country Analysis*. Policy Research Working Paper 6915, World Bank, Washington, DC; Galor and Zeira (1993). *Income Distribution and Macroeconomics*. *The Review of Economic Studies*, 60(1), 35–52

increase social discontent and political instability⁴⁶ if outcome disparities are too wide or particular groups feel excluded from opportunities. In turn, this can create uncertainties in the policy environment and property rights enforcement which may then reduce savings and entrepreneurial activity.⁴⁷ Further, equity-enhancing policies can be good for growth, especially those which provide greater opportunity for human capital development and entrepreneurial activity among disadvantaged households. They help break-down the inter and intra-generational reproduction of inequalities while improving economic efficiency for example by providing credit opportunities, insurance against shocks and property rights, especially for the poor.⁴⁸

Fiscal policy plays a unique role in reducing poverty and inequality. Fiscal policy is used to provide public goods and services, to help dampen the impact of adverse shocks, to promote macroeconomic stability and to stimulate economic growth. In addition, fiscal policy has a special role to play in addressing inequality beyond most other policy instruments.⁴⁹ It finances public investments, including in human capital, that can promote growth as well as reduce poverty and inequality in the long-term. It can also affect the household income distribution by reducing inequality of outcomes. This is primarily done through taxes, transfers and subsidies in the short-term, while public spending on health and education as well as social protection can help promote opportunity and reduce poverty and inequality in the longer term. As different households pay various taxes

and benefit from public spending in different ways, the net effect of both revenue and expenditure policies determines the extent to which fiscal policy directly reduces poverty and inequality.

Part 2 of this MEM, Raising the Tide, Lifting All Boats focuses on how fiscal policy affects distributional outcomes. The results examine the fiscal system of taxes, transfers and other social spending in Malaysia and how it increases or decreases how much cash in hand different households have. Cash in hand is important because this is what allows households to afford a certain standard of living, invest in productive assets and livelihoods and save for the future or an emergency. The analysis also looks at the public provision of non-cash health and education services, which provide a current benefit by saving households from having to spend directly on these themselves.

Furthermore, this special thematic topic looks at how fiscal space can be created for important longer-term public investments. While the focus of the distributional analysis is on current incomes, some public spending can have positive distributional impacts in the longer term. For example, infrastructure can drive growth and job creation and benefit poorer household incomes in the future. This is not included in the distributional analysis for data and methodological reasons. Nonetheless, the analysis does examine how revenues can be raised or spending reallocated to support these longer-term investment objectives.

Taxes, subsidies and social spending in Malaysia reduce income inequality and poverty

This section examines the impact of taxes, subsidies and social spending on short-term poverty and inequality in Malaysia using the Commitment to Equity (CEQ) framework. The results discussed throughout are based on the CEQ framework for fiscal incidence analysis – who benefits from different

taxes and spending and by how much (see Box 5 on a discussion of the CEQ approach).⁵⁰ Essentially, administrative data on revenues and spending are allocated out to different households using the 2019 Household Income and Expenditure Survey and Basic Amenities (HIES/BA), a nationally representative

⁴⁶ Keefer and Knack (2002). Polarization, Politics and Property Rights: Links between Inequality and Growth. *Public Choice*, vol. 111 (1-2), 127-54.; Clark, Andrew E., and Conchita D'Ambrosio. 2015. Attitudes to Income Inequality: Experimental and Survey Evidence. In *Handbook of Income Distribution*, vol. 2A, edited by Anthony B. Atkinson and Francois Bourguignon, 1127-1208. Handbooks in Economics. Amsterdam: North-Holland.

⁴⁷ Alesina and Rodrik (1996). Income distribution, political instability, and investment. *European Economic Review*, 40(6), 1203-1228.; Banerjee and Newman (1993). Occupational Choice and the Process of Development. *Journal of Political Economy*, Vol. 101(2)

⁴⁸ World Bank. 2016. *Poverty and Shared Prosperity 2016: Taking on Inequality*. Washington, DC: World Bank.

⁴⁹ A forthcoming report on inequality in Malaysia being prepared by the World Bank will discuss a broader set of policies for reducing inequality.

⁵⁰ The CEQ approach was developed by the Commitment to Equity Institute (CEQ Institute) at Tulane University. The methodology, implementation guidelines, applications, and software of the CEQ approach can be found in Nora Lustig (Ed.), *Commitment to Equity Handbook. Estimating The Impact of Fiscal Policy on Inequality and Poverty* (pp. 3-55). Brookings Institution Press. 2018. A second edition of the handbook is now available (2022).

BOX 5

The CEQ Methodology for Estimating Fiscal Incidence

To determine the impact of fiscal policy on household welfare, the Commitment to Equity (CEQ) framework of fiscal incidence analysis is used (Lustig, 2018). Under this framework, household income is assessed at different stages, outlined in Figure 69. A household's market income is the total income it received from wages and salaries, rents and dividends, private transfers and remittances, and pension income.⁵¹ This is the income a household generates prior to the fiscal system and is also called its pre-fiscal income. Some households pay PIT and non-pension social security contributions, which reduce their market income. Some households receive direct transfers from the government that increase their market income. The net effect after direct taxes and transfers is a household's disposable income: how much they have to spend on goods and services or to save. When a household spends, it pays indirect taxes (such as SST or excises on particular goods such as tobacco and alcohol), which means its disposable income buys less; it might also benefit from subsidies

(such as cheaper fuel) that means disposable income buys more. The amount of different goods and services a household can afford to buy, after considering indirect taxes and subsidies, is called consumable income. When considering only cash-based fiscal instruments, this is also a household's post-fiscal income. Finally, a household may also use public services, such as send their children to public schools, or visit health centers or hospitals, although these benefits are not received in cash but in-kind. Including this spending results in a household's final income (the post-fiscal income if non-cash spending is included).

The CEQ framework has two important advantages, but also some limitations. The advantages are first, that it assesses both various tax and expenditure policies while examining their joint effect, so the net impact on households is estimated. Second, it uses a standardized methodology, making it comparable across countries and time. Because the framework takes an accounting approach, it does not include

FIGURE 69
Definition of Income Concepts and the Role of Fiscal Instruments



Source: Adapted from Lustig (2018)

⁵¹ Pensions can either be treated as deferred income – a person makes contributions when they are working and this is in effect saving, and then they draw down on this income when they retire – or they can be treated as government taxes and transfers – contributions are treated as a tax and payments are treated as a transfer. In the case of Malaysia (and all of the countries included in the international comparisons), the baseline treats pensions as deferred income. See Lustig (2018, 2022) for more discussion.

behavioral effects (such as consumer substitution and labor market decisions, although it does include tax evasion and non-take up of social benefits), general equilibrium effects (such as the multiplier effect of cash transfers on the economy and the second-round tax effects this may create), or intertemporal effects (such as the long-run benefits of public education).⁵² Neither does it cover all taxes and spending nor all people. In particular, it does not generally include corporate income tax or infrastructure spending and can suffer from low coverage of the richest people, who are often underrepresented in household surveys. In addition,

the focus is on short-term cash-in-hand. The benefits of public health and education services are valued at the cost of delivery to the government as a proxy for how much a household saves by not having to purchase them in the market; it does not account for any longer-term income generation resulting from these services or future health expenditure savings from preventative treatment today. Social assistance is similarly assessed in terms of short-term cash-in-hand impacts, with longer-term implications for human capital accumulation not captured by the analysis (for discussion of such impacts, see Banerjee et al. 2021).

⁵² See Chapter 6 of World Bank (2022) Correcting Course for an extended discussion of the long-term benefits of health and education spending as well as the short summary in Box 8: Public Returns to Fiscal spending over the Long-run.

socioeconomic survey conducted by the DOSM and used to produce official estimates of national poverty and inequality. As 2019 is the latest year of HIES/BA available, fiscal and administrative data from the same year are used. Although with some exceptions noted later, Malaysia's fiscal policy today is not significantly different than before.⁵³

Malaysia relies heavily on direct taxes, particularly corporate income tax. Malaysia's federal government collected 11.9 percent of GDP in tax revenues in 2019, not only significantly below both the average for the EAP region and UMICs but also the level in Malaysia in 1970 when data were first available, as discussed later. Three-quarters of tax revenues come from direct taxes (CIT at 4.2 percent of GDP; PIT collection at 2.6 percent) (Table 5). Indirect taxes contributed only 3.0 percent of GDP, less than the 5.5 percent of GDP collected in non-tax revenues.

65 percent of total tax revenue is captured in the current analysis. Almost all indirect taxes as well as PIT and social security contributions are included in the distributional analysis, making up 65 percent of total tax revenues (Table 5). The main tax not included is CIT; for both data and methodological reasons it is difficult to trace the direct incidence of CIT back to individual households. In addition, the analysis excludes 5.6

percentage points of non-tax revenues (for example, dividends from Petronas). These are excluded as they do not represent a direct burden to Malaysian households. Moreover, if Malaysia's tax revenues increase to be more in line with high income countries, these non-tax revenues (currently around a quarter of total revenues) will represent an increasingly smaller share, and could decline even faster if those arising from fossil fuels fall in years to come as the world transitions to greener energy.

Just over half of Malaysia's operating expenditure is on social spending. Malaysia's total government spending totaled RM317.5 billion in 2019, or 21 percent of GDP; the operating expenditure was 17.4 percent of GDP. Table 6 includes a breakdown of the social spending component, representing 8.6 percent of GDP, with a further 0.6 percent on energy, food, and agricultural subsidies. The current analysis includes nearly all of this social and subsidy spending, accounting for 9.0 percent of GDP (or 52 percent of total operating expenditures). Of this, 1.9 percent of GDP went to social insurance (mostly old-age pensions or KWAP), which are treated in the current analysis as deferred income and not social transfers.⁵⁴ In contrast, only 1.0 percent of GDP is spent on social assistance, with half of that dedicated to in-kind support rather than cash transfers.

⁵³ During the pandemic there were various emergency COVID-19 responses which were not captured in the current analysis but have since stopped. A box on the impact of the government's COVID-19 related measures appears later.

⁵⁴ Contributory pensions can be treated in two ways. The baseline CEQ approach is commonly to treat the contributions as deferred savings and the payments as drawing down deferred savings. As such, they are not treated as part of the fiscal system and are considered part of market income, and which is used for savings. An alternative approach is to treat the contributions as taxes and the payments as transfers; both would then be part of the fiscal system and would reduce and increase a household's market income respectively. The results do not change significantly in Malaysia under either approach. See Lustig 2022 for greater discussion on this topic.

TABLE 5
65 percent of total 2019 tax revenues in Malaysia are included in the CEQ analysis

	RM Million	% of GDP	% of Tax Revenue
Total Revenue	264,415	17.5	
Tax Revenue	180,566	11.9	
Direct taxes of which	134,723	8.9	74.8
Personal Income Tax	38,680	2.6	21.8
Corporate Income Tax	63,751	4.2	35.3
Other Direct Taxes ^A	32,292	2.1	17.6
Indirect Taxes of which	45,843	3.0	25.2
Sales Tax ^B	15,385	1.0	8.4
Excise Taxes (Local) ^C	5,131	0.3	2.4
Excise Taxes (Import)	5,380	0.4	3.4
Service Tax	12,283	0.8	6.7
Other Indirect Taxes ^D	7,664	0.5	4.2
Nontax Revenue	83,849	5.5	
Not included in general revenues: contributions to social insurance ^E	43,418	2.9	
Total included in CEQ analysis	115,003	7.6	63.9

Source: Ministry of Finance

Notes: A. Other Direct Taxes include Petroleum Income Tax of RM 20,783million. B. Includes sales taxes of RM 6,445million on local products and RM 8,940 million on imported products. C. Includes excise duties (local) RM 1,861 on beer, RM 66 million on cigarettes, RM 2,443million on passenger vehicles and RM 761 million on other. D. Includes RM 2,733 million of import duties, RM 1,126 million taxes on exports, RM 216 million tourism taxes, RM 169 million of levies and RM 3,420 million of other indirect taxes. E. Contributions are primarily to social security for old-age pensions (RM 38,942 million) and to other contributory programs such as unemployment insurance (RM 3,551 million). Not included in the baseline results as a tax but included in the alternative results.

TABLE 6
52 percent of total 2019 operating expenditure is included in the CEQ analysis

	RM Million	% of GDP	% of Opex
Total Expenditure	317,516	20.6	
Operating Expenditure	263,343	17.4	
Social Spending	130,449	8.6	49.4
Social Protection	53,745	3.6	20.7
Social Assistance of which	14,588	1.0	5.7
Conditional or Unconditional Cash Transfers ^A	7,750	0.5	2.9
Near Cash Transfers (Food, School Uniforms, etc.) ^B	6,838	0.5	2.9
Social Insurance ^C	39,157	2.6	14.9
Education ^D	49,331	3.3	19.0
Health ^E	27,373	1.8	10.3
Housing & Urban	5,210	0.3	1.7
Subsidies, of which	9,329	0.6	3.4
Energy ^F	4,372	0.3	1.7
Food ^G	1,267	0.1	0.6
On Inputs for Agriculture ^H	503	0.0	0.0
Other ^I	3,188	0.2	1.1
Total included in CEQ analysis	135,875	9.0	51.7

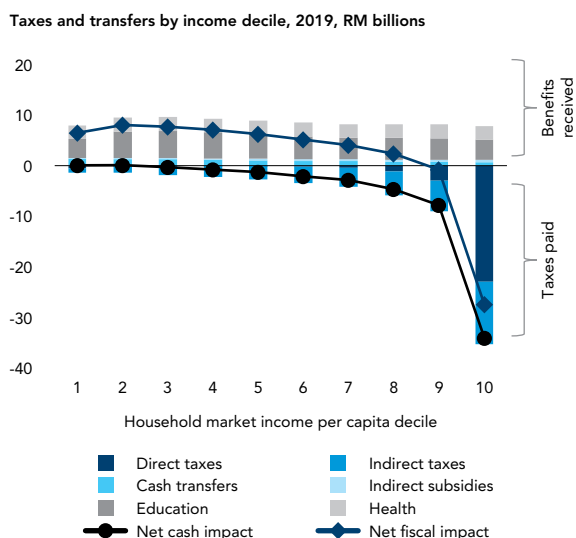
Source: MOF

Note: A. Includes RM 3,067 million on scholarships / education, RM 1,010 million on disability, RM 573 million on elderly care, RM 365 million on child assistance and RM 750 million as universal grants. B. Includes RM 5,427 million on food assistance and RM 1,411 million on education (boarding, textbooks, uniforms, etc). C. Almost entirely Old-Age Pensions (KWAP). D. Includes RM 806 million on early childhood education, RM 18,126 million on primary, RM 17,199 million on secondary, RM 379 million on vocational and technical, RM 11,914 million on tertiary. E. Includes RM 6,039 million on primary care, RM 14,410 million on hospital care, RM 1,844 million on management, RM 948 million on dental care, RM 297 million on R&D and RM 93 million on food and safety. F. Almost all fuel subsidies, with RM 140 million on electricity. G. Includes RM 627 million on rice, RM 600 million on cooking oil and RM 40 million on wheat flour. H. Includes RM 383 million on paddy fertilizer, RM 75 million on legal rice seed and RM 44 million on hill/huma paddy fertilizer. I. Other subsidies are a large number of disparate subsidies, from price stabilizations to ferry discounts to community nursing, and cannot be modelled with the current data.

Malaysia significantly increased its fiscal spending in response to the pandemic, including spending on social assistance. The key COVID-19 support measures included two large economic stimulus packages, PRIHATIN (RM 250 billion) and PEMULIH (RM 150 billion), as well as significant coverages of healthcare expenditures, and a range of short-term income and liquidity relief measures aimed at supporting firms and households, although not everyone benefited (see Box 6 on government support to households during COVID-19). Support for firms varied from fiscal exemptions to direct grants or loans to increase liquidity or retain workers through specific plans, such as the special relief facility fund for SMEs and microcredit financing plans. In addition, several plans to support labor market recovery were also introduced, such as the *JanaKerja* employment creation plan, and the *PenjanaKerjaya* and *JaminKerja* hiring and training incentives programs.⁵⁵ As the current CEQ analysis is updated later this year for the coming 2022 HIES/BA survey, the poverty mitigating impacts of the COVID-19 responses will be modelled.

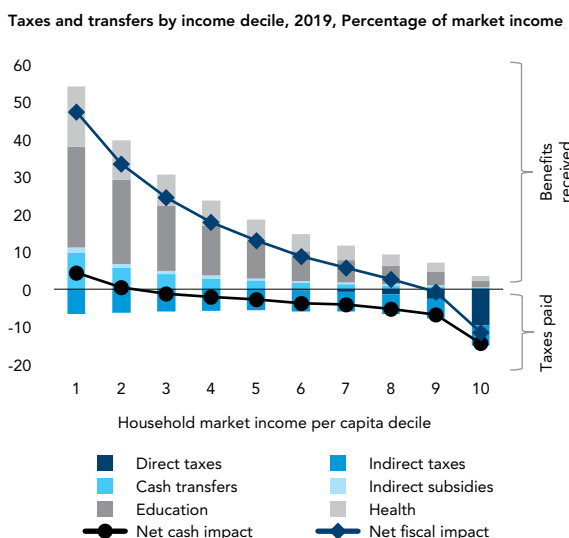
The Malaysian fiscal system relies heavily on net contributions from the richest 10 percent of people, meaning the contribution base is rather narrow. Figure 70 divides the population into 10 equal groups of 10 percent each, from the poorest 10 percent ('decile 1') to the richest 10 percent ('decile 10'). It shows the total taxes paid by each decile, the total benefits received and the net impact. In cash terms (excluding health and education), the richest 10 percent are the main contributors to the fiscal system, contributing 63 percent of the total, with another 15 percent coming from the second-richest decile. While this is progressive⁵⁶ in that the largest contributions come from the richest households, the contribution base is narrow, limiting how much money the government can spend. When health and education benefits are also included, all but the T20 are net beneficiaries; in many countries, households switch from being net beneficiaries to contributors around deciles 4-6, indicating that the fiscal burden is shared more broadly. In addition, the current burden on most households is relatively low. While the richest decile contributes 14

FIGURE 70
The richest 10 percent of households are the main net fiscal contributors but poorer households are not significant net beneficiaries in cash terms



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations

FIGURE 71
The net fiscal burden on all but the richest 10 percent is low relative to incomes while non-cash education and health benefits are significant for poorer households



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations

⁵⁵ MOF, 2022.

⁵⁶ The word 'progressive' is usually understood to mean better for the poor than the rich, in some general 'equalizing' manner. This chapter also uses it in the general sense of being 'pro-poor', with the particular effects on poverty and inequality explicitly spelled out where relevant. However, it should be noted that 'progressivity' and 'equalizing' have specific technical meanings in the fiscal incidence literature. For a detailed discussion and examples, see Box 5.3 in World Bank (2022) *Correcting Course*. In particular, note that any transfer in which poorer households receive a share that is higher than their share of pretax incomes will be equalizing, even if the share of the transfer to the poor is less than the share to the rich (as is often the case with fuel subsidies). For a tax to reduce inequality, not only must the rich pay a greater share of it but they must also pay a greater share than they already enjoy of total household income (indirect taxes are always paid in greater shares by the rich but they can still increase inequality if that share is less than the rich income share).

BOX 6

Coverage and Impact of Government COVID-19 Support to Households

To mitigate the adverse impacts of the pandemic on households, the government expanded social assistance spending, broadening the coverage of its existing social assistance programs over time, and increasing the income eligibility thresholds as well as the benefit levels of its flagship cash transfer programs.⁵⁷ Several emergency cash transfer programs were also introduced, with eligibility criteria that enabled the inclusion of even the middle class.⁵⁸ For example, *Bantuan Prihatin Nasional* (BPN) was extended to households earning up to RM8,000 (US\$1,887)⁵⁹ per month and to individuals earning up to RM4,000 (US\$943) per month, while *Bantuan Khas COVID-19* (BKC) was extended to households earning up to RM9,000 (US\$2,140) and individuals up to RM5,000 (US\$1,189) a month. With these thresholds, a much larger group of beneficiaries became eligible for assistance than for the pre-pandemic flagship cash transfer program, *Bantuan Sara Hidup* (BSH), which covered households earning up to RM5,000 (US\$1,179) per month. In addition, ride-hailing and taxi drivers received special transfers through *Bantuan E-Hailing*. The government also established mechanisms to deliver benefits swiftly, including auto-enrollment based on tax records. As such, the first payment of the BPN benefits was made 10 days after its announcement. Nonetheless, compared to other countries in the region, government's direct support to households in Malaysia in response to COVID-19 was still relatively low, with Malaysia instead relying more heavily on support to firms in the form of liquidity, credit, and lending – “below-the-line” measures.⁶⁰

According to the High-Frequency Phone (HiFy) Survey, in May 2022⁶¹, 75 percent of households reported receiving some form of assistance. This was significantly higher than the number of recipient households in June 2021 (67 percent), but slightly lower than November 2021 (79 percent). This includes about 85 percent of low-income households with monthly earnings of RM2,000 and below. According to the survey, more than one-third of these low-income households did not have access to cash transfers,

while nearly 20 percent of households earning more than RM10,000 received them, suggesting scope for improvement in targeting.

Although the government had progressively intensified its assistance response, the HiFy Survey suggests it was insufficient overall. The HiFy findings show that, in May 2022, about one in six lower-income households (those with incomes of RM4,000 or lower) had not received any government assistance since late 2021, a higher level of exclusion than regular social assistance (which reaches around 90 percent of B40 households). Moreover, at that point, three-quarters of low-income households were unable or only partially able to cover their monthly basic needs, even after combining their own incomes with the government assistance received.

While recovery has been seen across the board since the second half of 2021, as of May 2022, progress remained uneven. The HiFy Survey found that, as of May 2022, households with lower incomes, young workers, those with low education, as well as the self-employed and informally employed, continued to be more likely to experience economic shocks. Low-income households continued to be disproportionately affected by food insecurity. These households were also more likely to worry about their household finances, as they have fewer financial resources and are less able to cover their monthly basic needs. They were more likely to be pessimistic about their future spending. According to the latest official statistics, Malaysia's absolute poverty rate in 2022 was 6.2 percent, a decrease from the pandemic peak of 8.4 percent in 2020, but higher than the pre-pandemic rate of 5.6 percent in 2019.⁶² The rise in absolute poverty confirmed that the degree of recovery remained uneven, and some groups are still struggling with the aftermath of COVID-19. These prolonged shocks and slower recovery risk widening socioeconomic inequalities, diminishing the capability of the poor and vulnerable to cope with future shocks.

⁵⁷ Pre-pandemic cash assistance programs included *Bantuan Orang Tua* (BOT), *Bantuan Kanak-Kanak* (BKK), *Bantuan Orang Kurang Upaya* (BOKU), and the rebranded *Bantuan Keluarga Malaysia* (BKM).

⁵⁸ Based on the eligibility criteria in *Bantuan Prihatin Nasional* (BPN), the B40 is defined as households earning no more than RM4,000 and individuals earning no more than RM2,000 a month. The M40 is defined as households earning RM4,001–RM8,000, and individuals earning RM2,001–RM4,000 a month.

⁵⁹ At exchange rate US\$1 = RM4.24.

⁶⁰ World Bank, 2023

⁶¹ The World Bank conducted a High-Frequency Phone Survey (HiFy) to provide near real time information on socioeconomic impacts of the COVID-19 pandemic at the household level. The HiFy involves 25–30 minute telephone interviews with more than 1,000 panel respondents aged 18 years and above across the country. This nationally representative survey collected information on employment, income, food security, coping strategies and safety nets. The survey is implemented in three rounds: the first round of data collection was conducted in May–June 2021; the second round was in November 2021; and the third round in April–May 2022. Source: World Bank. 2023. COVID-19 Impact and Recovery among Malaysian Households: High-Frequency Phone Survey - Round 3 (April 10 - May 15, 2022)

⁶² Department of Statistics Malaysia. 2023. Poverty in Malaysia 2022.

percent of their market income in net cash terms, the second-richest decile contributes only 7 percent, and deciles 6-8 only 5 percent or less (Figure 71). Relatively prosperous households could afford to share the fiscal burden and contribute more, expanding Malaysia's fiscal base.

At the same time, while taxes, transfers and subsidies increase the disposable income of the poor, the share of benefits received by poorer households is relatively similar to the share of benefits received by higher income households. Despite collecting little tax from poorer households,

the relatively low spending on and poor targeting of cash transfers and subsidies means that their disposable income is not increased much by the fiscal system. The poorest half of people neither contribute nor benefit significantly in cash terms (Figure 70). In addition, even when considering the short-term cash-in-hand non-cash health and education spending, the poorest decile receives no greater share of total fiscal benefits than any other household in the poorest 40 percent (deciles 1-4 or B40) and little more than the next 40 percent (deciles 5-8 or M40). Nonetheless, the same level of benefits means more to poorer households relative to their low incomes (Figure 71).⁶³



⁶³ The relatively equal share of education spending across the income distribution reflects poorer households having more children but richer households have children who stay in education longer, particularly at the more expensive tertiary levels where half of public education spending goes.

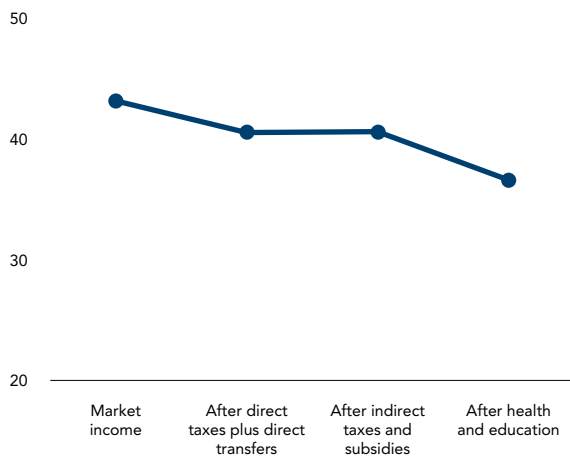
Taxes, subsidies and transfers reduce current poverty by 0.9 percentage points; with the relatively low value of social assistance benefits just offsetting the light burden of indirect taxation for the poor. Taxes and transfers have a limited impact on reducing short-term poverty directly (even if they do better in Malaysia than in other UMICs). If poverty were measured in Malaysia based on each household's market income, the poverty rate in 2019 at the national poverty line would have been 8.1 percent. Direct transfers actually lowers this to 6.5 percent, but poor households also pay indirect taxes, resulting in a final poverty rate of 7.2 percent, or an overall reduction of 0.9 percentage points (Figure 73).⁶⁴ The extent to which poor households are below the line (the poverty gap) also falls slightly, from an average of 2.0 percent of the line to 1.7 percent.⁶⁵ When including in-kind spending, the impacts of fiscal policy on poverty could be more significant. Malaysia's health and education spending enables near universal access, with health care access and school enrolment rates some of the highest in the region and among UMICs. Moreover, the cost of delivery represents 43 percent of income for

the poorest decile.⁶⁶ However, the monetary benefits of these services arise in the longer-term while their non-cash nature means they do not help reduce monetary poverty today, and so they are excluded from assessing the immediate poverty impacts of taxes and spending.

Nonetheless, the combination of taxes on the rich, and health and education benefits for the poor means that the fiscal system reduces inequality in Malaysia. Pre-fiscal income inequality – the Gini Index when measured using market income – is 43.3 points. With some rich households paying significant direct taxes and most poorer households benefiting from direct transfers, inequality falls to 40.9 (Figure 72). The pattern of indirect taxes and subsidies leaves inequality effectively unchanged, but it falls again to 36.8 points after including health and education benefits. In total, fiscal policy reduces the Gini Index by 2.4 points in cash terms and 6.4 points in total.⁶⁷ In sum, Malaysia's taxes, subsidies and transfers reduce inequality to some extent but poverty only slightly. The next section discusses how this compares to other countries.

FIGURE 72
Pre-COVID-19 fiscal policy reduced inequality in Malaysia...

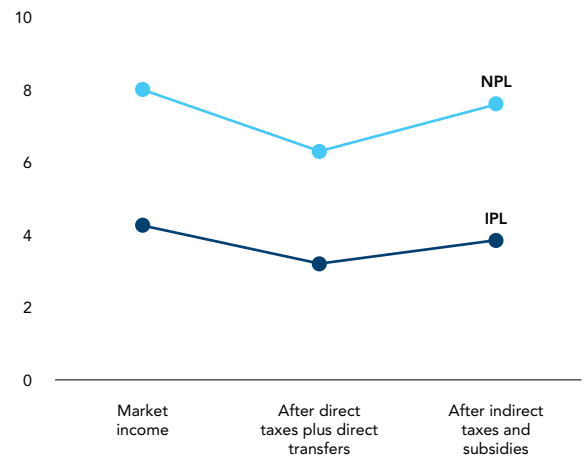
Gini Index before and after fiscal policy, 2019, Percentage



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations

FIGURE 73
...but largely leaves poverty unchanged

Poverty headcount rate at national poverty line (NPL) and UMIC international poverty line (IPL) before and after fiscal policy, 2019, Percentage



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations

⁶⁴ This is not the same as the official DOSM poverty rate for 2019, which is 5.6 percent; the official rate does not (and is not intended to) fully account for different taxes and transfers.

⁶⁵ Using the UMIC US\$5.50 per person per day poverty line instead, the initial and final poverty rates are lower, but the change is similar (0.7 percentage points). The international poverty lines use the 2011 Purchasing Power Parity exchange rates. 2017 PPP rates are now used for international poverty comparisons but most CEQ data are from studies conducted before the new rates were released. Consequently, 2011 PPPs are using the current analysis to facilitate international comparisons.

⁶⁶ Although half of all health spending in Malaysia is privately funded (MOH, 2020) and Malaysia's share of health expenditures financed by out-of-pocket spending in 2019 was relatively high (World Development Indicators).

⁶⁷ This is the baseline Pensions as Deferred Income (PDI) scenario. The results are very similar if pensions as treated as a government transfer (PGT).

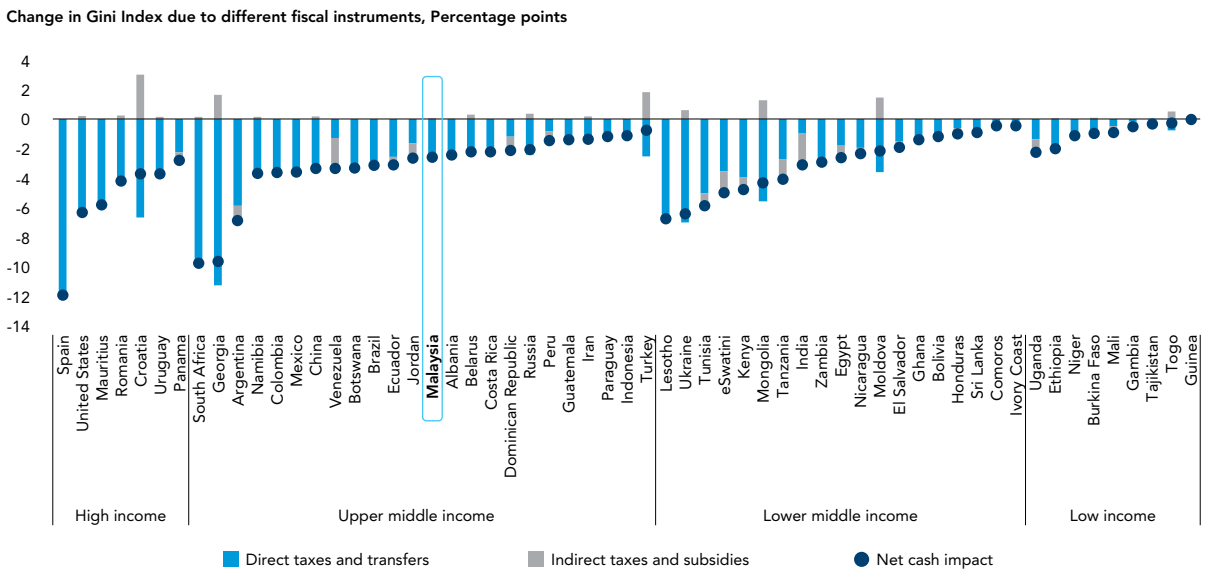
Malaysia leads many peers when it comes to poverty reduction through taxes and social spending, but trails in terms of inequality

Taxes, transfers and subsidies in Malaysia reduce inequality in cash terms by about the UMIC average, although a number of poorer countries do significantly better. Taxes and cash benefits reduce income inequality in Malaysia by 2.4 points from its pre-fiscal level. Internationally, this is 30th best out of 59 countries with available CEQ data and 14th best out of the 25 UMICs (Figure 74). Ten LMICs have a better performance. In most countries, direct taxes and transfers play the largest role in reducing inequality in cash terms. In Malaysia, they are the only equalizing instruments, with indirect taxes and subsidies having no net impact.

However, when non-cash health and education benefits are included, Malaysia's inequality reduction trails many UMIC peers. Malaysia ranks in

the lower third of UMICs for total inequality reduction. Health and education benefits are not cash but nevertheless represent real benefits to households. When valued at their cost of delivery, they further reduce inequality in Malaysia by another 4.1 points to 6.5 points in total. In spite of this, Malaysia falls further in international rankings when non-cash benefits are included – 35th out of 59 countries and 18th out of 25 UMICs – with ten LMICs doing better (Figure 75), although the non-cash nature of health and education benefits makes them difficult to value.⁶⁸ While health and education benefits do reduce inequality in Malaysia, they do so by less than elsewhere, where the 59-country average impact is 4.4 points and the UMIC average is 6.0 points. This is in part because Malaysia spends less on both than the UMIC and regional average.⁶⁹

FIGURE 74
Malaysia's impact on inequality through taxes, transfers and subsidies is around the UMIC average



Source: World Bank Staff Calculations based on CEQ Data Center on Fiscal Redistribution, OECD and World Bank data. See World Bank. 2022. Correcting Course.

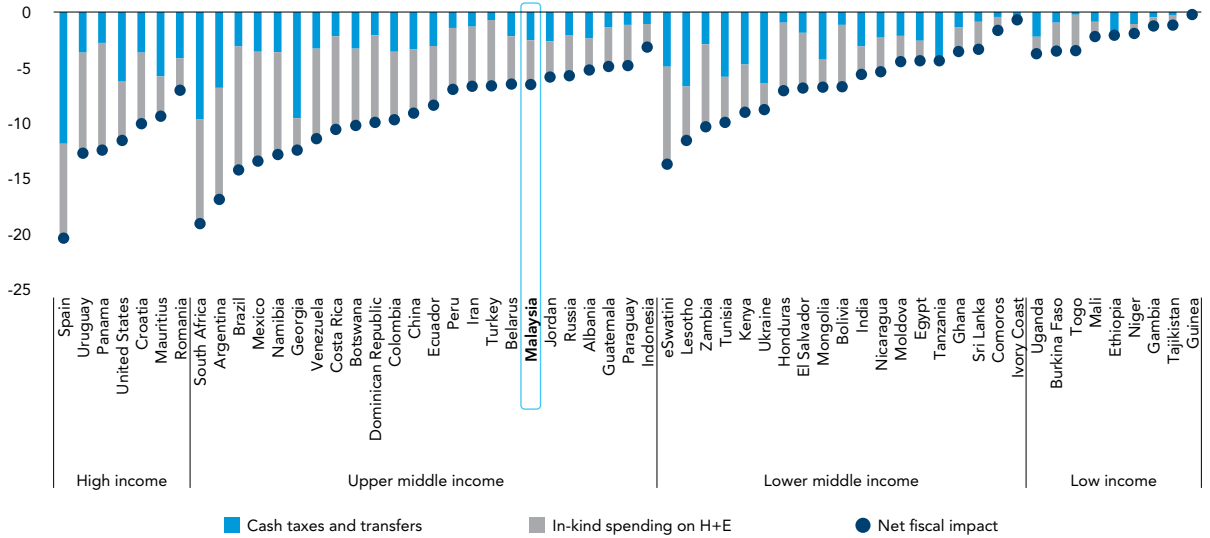
⁶⁸ There are good reasons not to think that the value of these non-cash public services to households is the same as the cost to governments of delivering them. If there are quality issues, the value to households could be significantly lower than the cost of provision; see Wai-Poi, Sosa and Bachas (forthcoming) for discussion. However, the true benefit of public health and education to households is in the returns to human capital when children become adults; these benefits are not modeled and can be both inequality- and particularly poverty-reducing. This is discussed in World Bank. 2022. Correcting Course.

⁶⁹ In per capita terms, Malaysia's public spending on health (as a percent of GDP) is less than all but one of its transitional peers. Indeed, its public spending is less than even some of its regional peers, with incomes per capita considerably lower than Malaysia's. Malaysia's public education spending as a share of GDP is also lower than its transitional peers. This is despite devoting the highest share of total government expenditures (20.3 percent), reflecting Malaysia's relatively small size of total spending. (Comparative health and education data from World Development Indicators.)

FIGURE 75

When non-cash education and health benefits are also included, Malaysia's impact compared to other UMICs is relatively small

Change in Gini Index due to different fiscal instruments, Percentage points

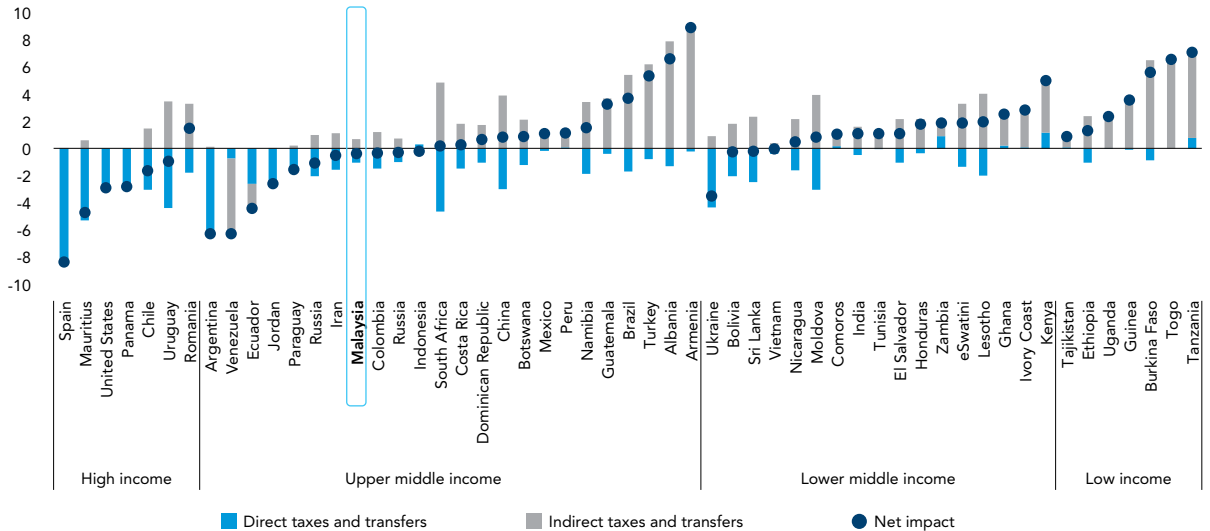


Source: World Bank Staff Estimates based on CEQ Data Center on Fiscal Redistribution, OECD and World Bank data. See World Bank. 2022. Correcting Course.

FIGURE 76

However, unlike many UMICs and most LMICs, Malaysia's taxes, transfers and subsidies do not increase short-term poverty

Change in Poverty Headcount Rate due to different fiscal instruments, Percentage points



Source: World Bank Staff Estimates based on CEQ Data Center on Fiscal Redistribution, OECD, and World Bank data. See World Bank. 2022. Correcting Course. Note: Income category-relevant international poverty lines are used for each country: \$1.90 per person per day (in 2011 PPP terms) for LICs; \$3.20 for LMICs; \$5.50 for UMICs and HICs.

Malaysia's taxes, transfers and subsidies reduce poverty slightly because even though spending is low, so are taxes, a performance which is ahead of many of its peers. In most non-HIC countries, poverty increases. Poverty at the UMIC line is reduced by 0.7 points in Malaysia when comparing pre-fiscal and

post-fiscal household incomes. While this is relatively small and below a number of other UMICs and HICs, it is 14th best out of 55 countries with comparable data and 7th best among UMICs; the majority of non-HICs actually see short-term poverty increase as indirect taxes leave poorer households out-of-pocket relative

to the cash transfers they receive (Figure 76). As the gray bar indicates, the impact of indirect taxes (partly offset by subsidies) on the poor is very low in Malaysia, meaning the relatively small impact of direct transfers (represented by the blue bar) is nonetheless enough to modestly reduce poverty.

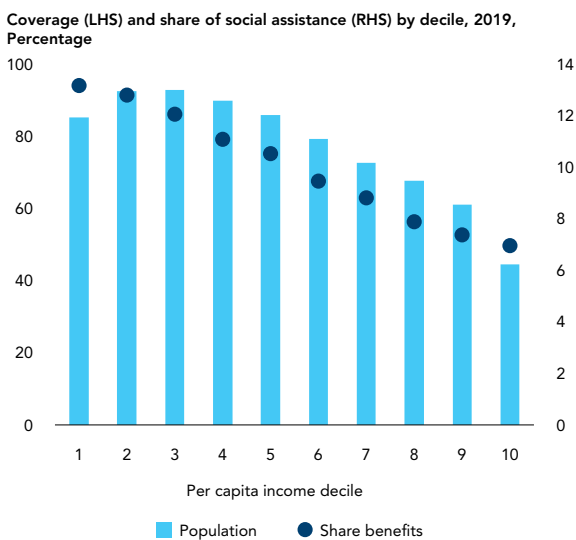
A key reason that poverty reduction is not larger in Malaysia is that the social assistance received by poor households is not adequate. For beneficiaries in the poorest decile, average transfers (in 2019) are equivalent to only 13 percent of their pre-tax pre-transfer (pre-fiscal) income, and 8 percent for the second poorest decile (Figure 78). These figures are considerably lower than the average for UMICs, which for the bottom two deciles is 25 percent of pre-fiscal income.

Low benefits for the poor are due to a combination of inadequate social assistance spending which is in turn spread over a very large share of the population (78 percent in total), diluting the benefits for the poor. At 1 percent of GDP (in 2019), social assistance spending in Malaysia is below the UMIC average (1.8 percent) and for developing and transition countries as a whole (1.5 percent), though such spending has increased in recent years, with the 2022 allocation for social assistance being almost 50 percent higher than in 2019. Moreover, while Malaysia

does well at ensuring most poor and vulnerable households receive some sort of social assistance (only around 10 percent of the B40 are excluded), many non-poor Malaysians also receive assistance. Around 68-86 percent of M40 households received assistance and more than 40 percent of T20 households also received some assistance. Consequently, only 49 percent of transfers goes to the B40 while 14 percent goes to the T20 and 7 percent to the richest decile (Figure 77). Better targeting of transfers away from richer households would mean the current budget could be spent on more generous benefits for the poor, achieving a greater impact on poverty and inequality at no extra cost, although the average benefit would still be somewhat below the UMIC benchmark of 25 percent of income. Nor would significantly higher benefits raise concerns about dependency or labor market disincentives, as the review of international lessons later discusses.

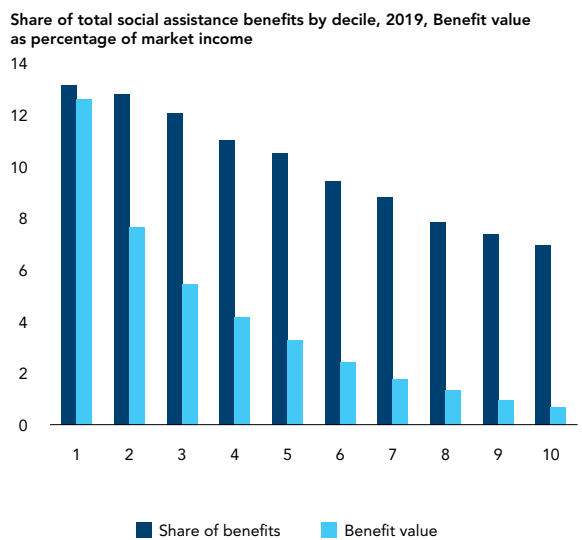
Subsidies are another way of supporting poorer households but their impact on poverty is less than the impact of more targeted transfer spending. Social assistance targeting could be improved but subsidies are not only untargeted, their benefits increase with consumption, so richer households receive a much greater share than poorer ones. The CEQ analysis models most subsidies in Malaysia, including those for food, fuel, and agriculture, all of which go more to

FIGURE 77
Most poor receive transfers, but many richer people do as well. The M40 and T20 receive 51 percent of all benefits



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.

FIGURE 78
The value of benefits is low, averaging just 8 percent on average of B40 income



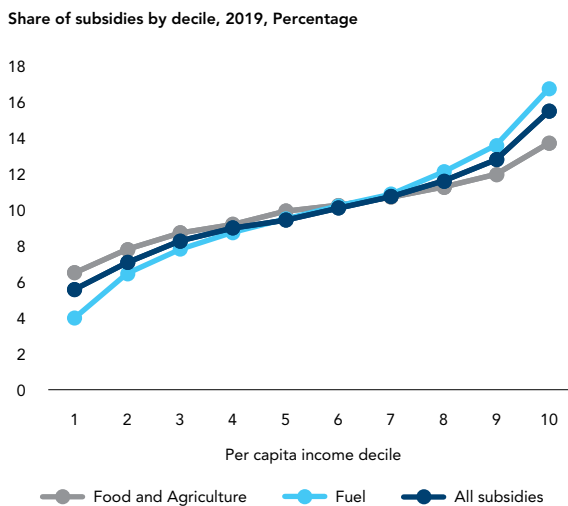
Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.
Note: Benefit value is average benefit received by beneficiaries within decile as a percentage of average market income within decile.



the rich than the poor (Figure 79). In fact, the share of benefits of subsidies increases with household income. The poorest decile receives 6 percent of total subsidies, B40 averages 8 percent per decile, M40 averages 10 percent per decile, and the richest decile receives 15 percent. Nor does the spending that reaches poorer households provide much support, being equivalent to less than 3 percent of income for all households in 2019 (Figure 80). In total, Malaysia spent 0.6 percent of GDP

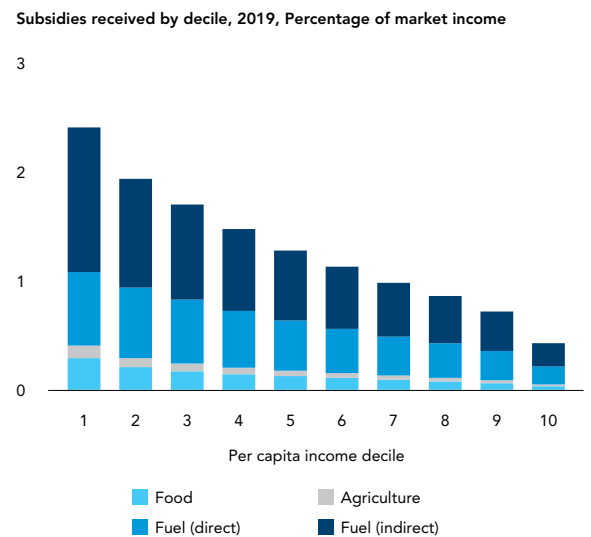
on subsidies in 2019, 0.4 percent of which are modeled here. This represents a significant opportunity cost as this spending would have provided greater benefit to the poor if channeled through social assistance transfers, despite their leakage to richer households. Moreover, with soaring fuel prices in 2022, fuel subsidy spending was far greater, reaching 2.9 percent of GDP, more than the total health budget and four-fifths of that for education.⁷⁰

FIGURE 79
A larger share of all subsidies goes to richer households...



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.

FIGURE 80
...but despite their cost, subsidies did not contribute much to household income for any decile in 2019



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.

⁷⁰ In 2019, the year of CEQ analysis, retail fuel prices were close to market prices, and fuel subsidies were only 0.3 percent of GDP, or RM4.2 billion. With the Russian invasion of Ukraine in February 2022, world prices for both energy and food spiked. Without a commensurate adjustment to domestic fuel prices, fuel subsidies are estimated by the government to have reached 2.4 percent of GDP in 2022, eight times that of 2019. The change in incidence is not yet known, but with subsidies already benefiting richer households by more in 2019 and poorer households more likely to reduce consumption in the face of shocks, it seems unlikely that poorer households enjoy a greater share of this much-higher subsidy spending than the relatively low shares already documented here.

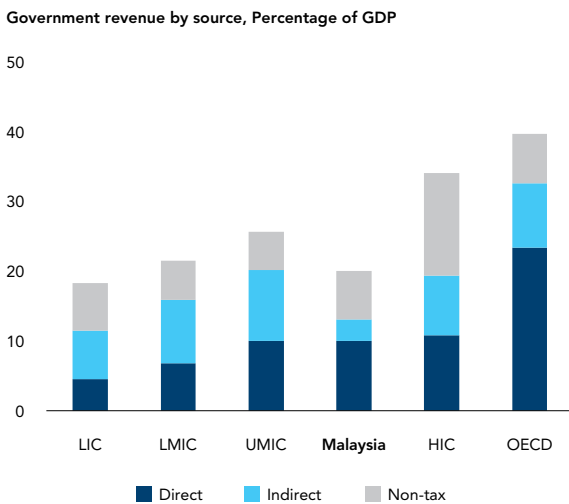
International experience suggests that greater impacts on poverty and inequality can be achieved by taxing more and using well-targeted spending

There are important lessons from international experiences in other UMIC and HICs for achieving progressive fiscal policy. International experience suggests that progressive fiscal policy is driven primarily by adequate and well-targeted social spending, financed by sufficient revenue generation. The revenue mix matters, with direct taxation more progressive (but harder to collect in non-OECD countries) than indirect taxation, but the mix is of secondary importance to the primary distributional function of generating revenues which can then finance pro-poor spending.

Direct taxes are more progressive than indirect taxes but only make up the majority of revenues in OECD countries; even UMIC countries rely more on indirect taxes to generate income. The greater the share of direct taxes, the more progressive a country's revenue base is. However, while OECD countries rely

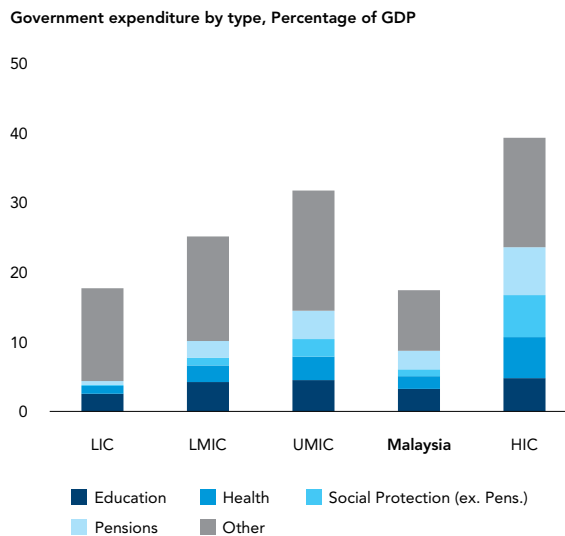
upon direct taxes for around three-quarters of their tax revenues, indirect taxes make up the majority of tax revenues in all other countries (Figure 81). A broad direct tax base requires a high degree of formal employment (allowing PIT to be withheld by employers) and strong tax administration capacity (for enforcement). This is a longer-term goal for most middle-income countries. Instead, they can generate strong tax revenue primarily through indirect taxes with few exemptions or preferential rates. Although commonly tax-exempt items such as food represent a greater share of expenditure for poorer households, richer households also consume food and spend more on it, meaning a greater share of the foregone tax revenues benefits them. For example, in Thailand it is estimated that the poorest half of Thais enjoy only 29 percent of total value added tax (VAT) subsidies while the richest fifth enjoy 39 percent.⁷¹ At the same time, health taxes can also be

FIGURE 81
Generally, richer countries collect more total tax and rely more on progressive direct taxation



Source: World Bank. 2022. Poverty and Shared Prosperity Report: Correcting Course and MOF.
Note: Malaysia data point is for 2019

FIGURE 82
The greater fiscal space of richer countries means they can spend increasingly more on health, education and social protection



Source: World Bank. 2022. Poverty and Shared Prosperity Report: Correcting Course and MOF.
Note: Malaysia data point is for 2019

⁷¹ After accounting for informality of consumption. See Wai-Poi, Sosa and Bachas (forthcoming).

used more intensively, which raise additional revenues, are progressive over a household's lifecycle and reduce long-term public and private health expenditures.⁷²

Greater revenue generation in turn creates the fiscal space for greater social spending, which is the key to more equitable fiscal policy. Countries can directly reduce inequality through a more progressive mix of taxes. However, regardless of the revenue mix, the main distributional role of revenue generation is not necessarily to reduce inequality directly but to create the fiscal space for pro-poor spending, which can more effectively reduce inequality.⁷³ In fact, each extra dollar of revenue generally creates an extra dollar of fiscal space for pro-poor spending. Empirically, there appears to be a relatively fixed cost of providing government services such as security and public administration. As countries get richer, spending on everything other than education, health and social protection on average stays relatively constant on average (Figure 82). Consequently, greater revenues mean more fiscal space for pro-poor spending, which expands rapidly as countries move from low to middle to high income; there is also more fiscal space for such growth-enhancing public investments as infrastructure.

Social spending has long-term progressive benefits as well as short-term impacts. Poorer households benefit from investment in health and education in the longer-term, which can be further enhanced by social protection. As recent evidence shows⁷⁴, investment in child education and health will likely have high value, especially if it can reach poorer households. Based on the concept of the marginal value of public funds (MVPF), spending that invests early in a child's life can be transformative (if effectively implemented) and position the child for a lifetime of higher earnings. Despite very different fiscal trade-offs in the LIC setting than in LIC and MIC settings, the results from the application of MVPF concept may still offer important insights. Hendren and Sprung-Keyser conduct a welfare analysis of 133 policy changes in the United States over the

past 50 years and find that spending on programs that improve low-income children's health and educational outcomes typically provide higher value compared with spending on programs focused on improving outcomes for adults.⁷⁵

However, Malaysia spends less than others on health and education, partly contributing to lower outcomes on some dimensions. Malaysia spends less on education and particularly health than peers. For example, even though the 20.3 percent of total government expenditure spent on education by Malaysia is the highest among peers, low public revenues and consequently low public spending means the resulting education budget is still lower as a percentage of GDP than transitional and aspirational peers.⁷⁶ Partly as a consequence, Malaysia's education outcomes are lower than would be predicted for its income level. For example, 43 percent of Grade 5 children in Malaysia are in 'learning poverty', meaning that they cannot read and understand a simple text by age 10, higher than the 34 percent predicted based on the country's GNI per capita. In contrast, Thailand and Kazakhstan have lower per-capita income levels than Malaysia and spend less on education but have significantly lower rates of learning poverty.⁷⁷ Similarly, in health, Malaysia spends less on health than countries with similar incomes or the high incomes countries it aspires to; public health spending is 2 percent of GDP, compared to 5 percent in aspirational HICs).⁷⁸ Moreover, health spending needs will increase as Malaysians age, and with the rise of non-communicable diseases (NCDs). At the same time, while Malaysia's health outcomes are often good relative to its income level, there is scope for improvement. For example, life expectancy at birth falls short of the performance of comparator aspirational and transitional countries and is also less than would be predicted by Malaysia's per-capita national income.⁷⁹ In addition, Malaysia lags its peers in addressing the growing epidemiological challenge posed by NCDs, with its share of premature mortality from NCDs in the 30-70 age group higher

⁷² Poorer households often spend a greater share of total consumption on taxed items such as alcohol and tobacco, but they are more price sensitive and reduce consumption by more when taxes are applied; over their lifetimes, the gains in life expectancy and lifetime earnings as well as reduction in health spending outweigh the welfare losses from the higher tax. See World Bank. 2022. *Correcting Course*; Fuchs, Gonzalez Icaza and Paz (2019) 'Distributional Effects of Tobacco Taxation: A Comparative Analysis'; and Jha (2018) 'The health, poverty, and financial consequences of a cigarette price increase among 500 million male smokers in 13 middle income countries: compartmental model study.'

⁷³ As richer households have much higher incomes than poorer ones, the same *absolute* change represents a much larger *proportional* change for poorer households; thus, a small absolute transfer to a poor household will have a larger effect on inequality than a small absolute tax on a rich household. In other words, it is easiest to reduce inequality through transfers to the poor for any given income change. Those transfers to the poor need to be financed, and while inequality will be reduced more if they are financed by a tax paid more by richer households, inequality will still be reduced if the tax is paid as a similar percentage of income or consumption across the distribution.

⁷⁴ World Bank. 2022. *Correcting Course*.

⁷⁵ Hendren, Nathaniel, and Ben Sprung-Keyser. 2020. "A Unified Welfare Analysis of Government Policies." *Quarterly Journal of Economics* 135 (3): 1209–318.

⁷⁶ In 2019, aspirational peers' public education spending was around 5 percent of GDP, and transitional peers around 4.5 percent, ahead of Malaysia's just over 4 percent, although this was ahead of the regional average of around 3 percent (based on Edstats and World Bank calculations).

⁷⁷ World Bank staff estimates, based on the World Bank Learning Poverty database and UIS data.

⁷⁸ World Bank calculations based on World Development Indicators.

⁷⁹ World Bank calculations based on World Development Indicators.

than would be predicted by its income per capita, and higher than its aspirational and transitional peers.⁸⁰

In the short-term, household income for the poor can be increased by adequate and well-targeted cash transfers, offsetting tax burdens and ideally providing additional income. UMICs on average spend 1.8 percent of GDP in social assistance, which in many countries would be sufficient to exceed the burden of indirect taxes on poorer households.⁸¹ As such, most of the reduction in inequality and all of the poverty reduction comes through well-designed and targeted cash transfers, rather than the tax system. Even with their very progressive tax base, three quarters of all fiscal redistribution in OECD countries also comes through generous and well-targeted direct transfers.⁸²

When benefit levels are set accordingly, there is good evidence that well-designed social assistance programs that involve cash transfers do not create dependency or reduce labor market incentives, or lead to 'undesirable' consumption. With targeted cash transfer programs being increasingly widely used in developing countries as a mainstay of social assistance, policymakers and the wider public often express concerns about potential negative consequences, including that the transfers will discourage work or increase consumption of 'bads', such as alcohol and tobacco. Indeed, the more widely a country believes that poverty is due to laziness, the less it spends on cash transfers.⁸³ However, systematic reviews of the evidence find little grounds for these concerns in developing countries. For example, a systematic review of 21 studies found they "suggest little to no effects on overall labor supply", even pooling and reanalyzing data from seven rigorous RCT studies including Indonesia and the Philippines to "find no systematic evidence of an impact of transfers on work behavior, either for men or women".⁸⁴

One reason for this is that the benefit levels are often not enough for beneficiaries to be able to afford to stop working. In Indonesia, the temporary cash transfers used to offset the impact of fuel subsidy reforms did not create work disincentives because

their value "was not enough to fulfill all living needs". In fact, while working heads of households of recipient families did not change employment status any more than non-recipients, non-working recipient heads were 10 percentage points more likely to move into employment than non-working non-recipient heads – an explanation in the short-run being that cash transfers relieve credit constraints, allowing for participation in economic activity, while in the long-run such transfers have been shown to facilitate accumulation of human capital, again with positive employment impacts.⁸⁵ Among studies with significant effects on employment, reductions in work are more likely among those with good reasons to work less such as the elderly, disabled and women with caring responsibilities or reallocation of labor from casual work to investing in own business activities.⁸⁶ Furthermore, a global review of transfer programs found no evidence of increased spending on alcohol and tobacco.

International experience suggests that progressive fiscal policy is driven primarily by adequate and well-targeted social spending, financed by sufficient revenue generation

Subsidies are also widely used, but they are a very costly way to reduce poverty and have mixed results on inequality. Spending on subsidies has mixed results. Subsidies reduce poverty when poorer households purchase the subsidized goods or services, but the impacts on inequality will depend on how much poorer and richer households benefit relative to their incomes. The international evidence indicates that on average a much greater share of subsidy spending benefits richer households, at all country income levels

⁸⁰ World Bank calculations based on World Development Indicators.

⁸¹ World Bank. 2022. Charting a Course Towards Universal Social Protection: Resilience, Equity, and Opportunity for All. Washington, DC: World Bank. and ASPIRE database - <http://www.worldbank.org/aspire>

⁸² Causa and Hermansen. 2019. Income Redistribution Through Taxes and Transfers Across OECD Countries.

⁸³ Evans and Popova. 2014. Cash Transfers and Temptation Goods: a Review of Global Evidence.

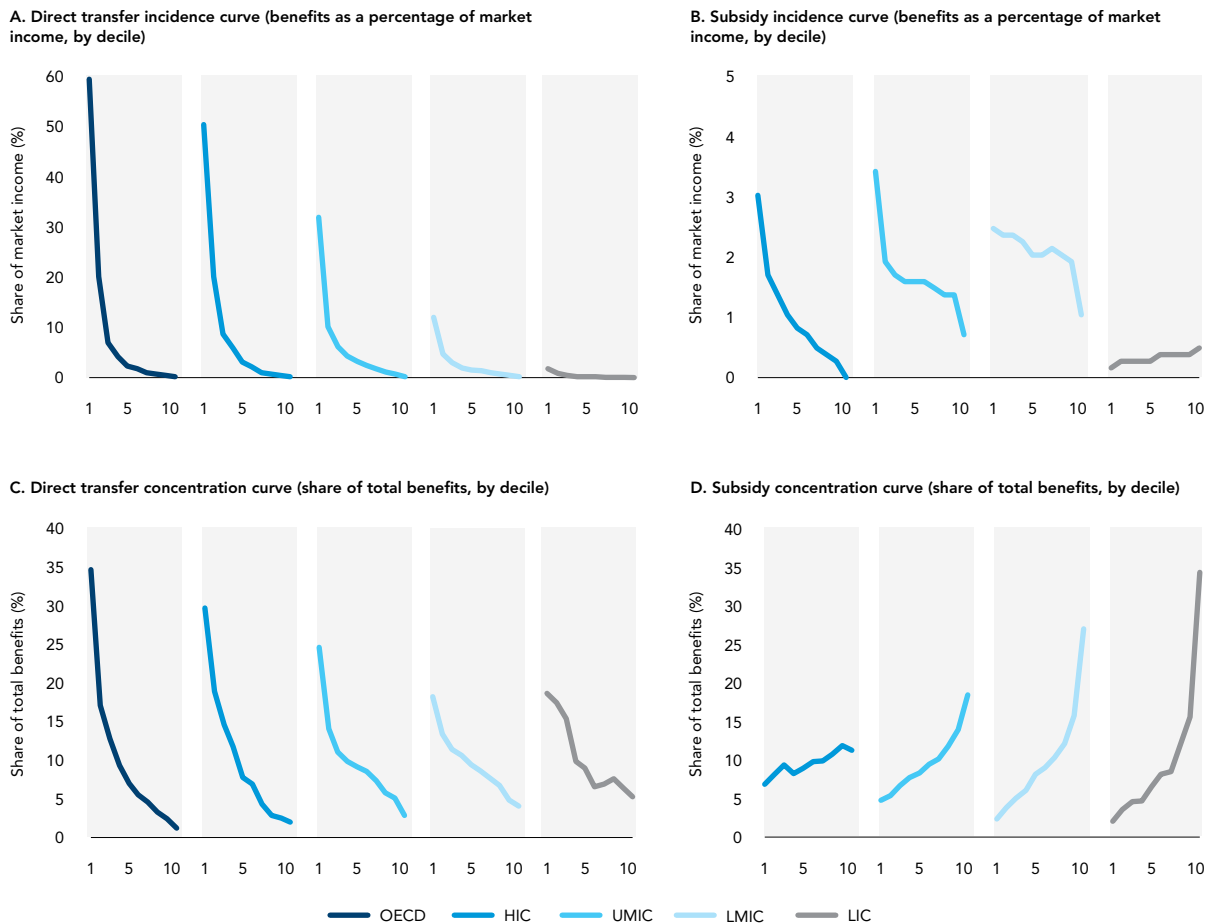
⁸⁴ Banerjee, Hanna, Kreindler and Olken. 2017. Debunking the Stereotype of the Lazy Welfare Recipient: Evidence from Cash Transfer Programs. In addition to a systematic literature review, they pooled data for seven programs from six countries (Honduras, Indonesia, Morocco, Mexico (two different programs), Nicaragua and the Philippines).

⁸⁵ World Bank. 2012. BLT Temporary Unconditional Cash Transfer. Banerjee et al. (op cit) suggest "these programs could have positive effects on work if they help relieve the credit constraints of the poor to allow them to invest in small enterprises or if they have spillover effects."

⁸⁶ Handa et al. 2018. Myth-busting? Confronting Six Common Perceptions about Unconditional Cash Transfers as a Poverty Reduction Strategy in Africa. *The World Bank Research Observer*, vol. 33, no. 2 (2018).

FIGURE 83

On average, most transfers go to poorer households and provide strong income support; most subsidies go to richer households and provide little support to poorer ones



Sources: Wai-Poi, Sosa and Bachas (forthcoming), based on data from CEQ Institute, CEQ Data Center on Fiscal Redistribution, <https://commitmenttoequity.org/dataloader/>; OECD data; World Bank data.

Note: The figure shows direct transfer and subsidy incidence curves and concentration shares, aggregated by income group. Incidence curves show transfers/subsidies as a percentage of market income by market income decile. Concentration shares show transfers/subsidies as a percentage of total benefits by market income decile. Subsidy incidence is not available for OECD countries. HICs = high-income countries; LICs = low-income countries; LMICs = lower-middle-income countries; OECD = Organisation for Economic Co-operation and Development; UMICs = upper-middle-income countries.

except for high-income (Figure 83, panel D). Even among high-income countries, the spending still slightly favors richer deciles. This compares starkly to spending on direct transfers, the large majority of which benefits poorer households (Figure 83, panel C). Moreover, even though the relatively small share of subsidy spending is still more important to poorer households relative to their incomes than richer ones (Figure 83, panel B), reducing inequality somewhat, direct transfers are worth far more to the poor on average (Figure 83, panel A), thus having a far greater impact on poverty and inequality.

In addition, subsidies encourage wasteful and environmentally damaging energy consumption. Nonetheless, many countries still employ subsidies (including in EAP⁸⁷), because they are easier to administer than transfers (not requiring targeting mechanisms) or quicker to provide support in a crisis. They also are available to all households in need when they consume the subsidized good, meaning no poor households are excluded (as is inevitable with targeted cash transfers). Subsidies are also often popular (and therefore politically unpopular to remove) or may support vested political and business interests.⁸⁸

⁸⁷ See World Bank. 2021. East Asia and Pacific Economic Update (April) and World Bank. 2020. East Asia and Pacific Economic Update (October).

⁸⁸ For more discussion on subsidies, see World Bank. 2022. Correcting Course (p175-6).



In the case of Indonesia, transfers were 2-3 times more effective than electricity and fuel subsidies in supporting the poor during the COVID-19 pandemic. To mitigate the impact of the economic shock of COVID-19 on households, Indonesia rolled out a large and multi-faceted fiscal response.⁸⁹ This included both an expansion of cash transfers, topping up existing social assistance beneficiaries but also providing temporary support to many more, as well as holding the price of subsidized fuel constant even as international prices soared and introducing targeted electricity subsidies. Forthcoming analysis shows that the temporary cash transfers had around the same benefit to poor households as the combined benefit of the energy subsidies (around 13 percent of decile 1's market income and 9 percent for decile 2). However, the more targeted nature of the transfers meant they had a much greater impact on poverty relative to their budget.⁹⁰ COVID-19 transfers reduced poverty by 5.1 points per 1 percent of GDP spent. In contrast, electricity and fuel subsidies reduced poverty by 2.2 points 0.9

points respectively, even though spending on subsidies was 3 times higher than transfers. The greater cost-effectiveness of electricity subsidies compared to fuel was driven by their semi-targeted nature, being based on both a household's installed electricity capacity and its estimate income from the country's social registry. As a consequence, nearly half of all benefits went to the B40 (47 percent), slightly more than M40 (44 percent) and little to T20 (10 percent), compared to just 22 percent of fuel subsidy benefits to B40 (37 percent to M40 and 41 percent to T20).

The Indonesian experience is backed up by the international evidence on the long-run value of cash transfers and energy subsidies. A global review of the long-run public returns to different types of public spending finds that cash transfers have on average significant positive public returns while energy subsidies generally cost more than the public benefits (see Box 7 on returns on cash transfers).

⁸⁹ See World Bank. Indonesia Economic Prospects June 2021.

⁹⁰ See the forthcoming World Bank paper on a decade of fiscal reforms in Indonesia.

BOX 7

Cash Transfers Provide a Significant Public Return on Spending; Energy Subsidies Cost More Than Their Returns



The MVPF for cash transfers and energy subsidies in LICs and MICs show that the costs exceeds the benefits. Following the methodology introduced in Box 5, for both categories of countries, the MVPF for energy subsidies is less than US\$1: the cost is greater than the public benefits. For cash transfers the MVPF ranges from US\$0.9-1.6 in LICs and US\$1.6-3.0 in MICs, indicating greater public benefits than the costs.

Cash transfers return more than they cost because beyond the value of the cash transfer itself, beneficiaries can increase their income as a result of the transfer. This is either because the transfer relieves liquidity constraints to income generation or because it enables increased investments in the education of children in the household (with benefits for their future earnings). This value is lowered if the transfer disincentivizes labor force participation. Using

systematic reviews of likely impacts as well as estimates of the likely value of future earnings increases for children in the household, the benefit to beneficiaries of US\$1 of transfer is estimated to be US\$1.11–US\$1.61 in LICs and US\$1.65–US\$2.69 in MICs.

Benefits to beneficiaries are larger in MICs in large part because MICs have a greater ability to tax the future gains in earnings of beneficiary children (which, in turn, lowers the overall net cost of the cash transfer program). Increasingly, cash transfers are shown to have an impact also on nonbeneficiaries because beneficiaries spend (or in some cases share) transfer income in the local community or market. In addition, governments receive VAT paid on transfer income that is spent, and they receive taxes paid on additional earnings and the spending that results from those additional earnings.

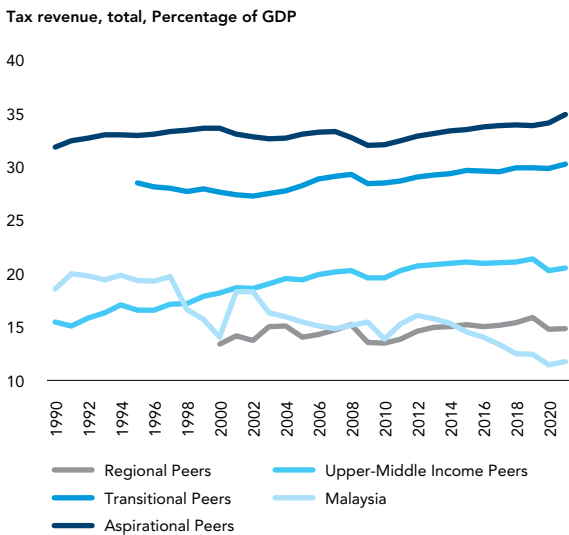
Fiscal reforms in Malaysia can focus on increasing indirect taxes and broadening the PIT base while strengthening the delivery of social assistance and rethinking subsidies

Malaysia's ability to sustain high economic growth and make progressive investments is highly constrained by low tax revenue generation. Taxes, transfers and subsidies in Malaysia do less to reduce current income inequality and poverty than in some UMICs and most HICs for both reasons of revenue and expenditure. However, while Malaysia's tax collection once compared favorably to its peers, it has now fallen far behind the averages of UMIC, regional countries and countries which have transitioned from UMIC to HIC (Figure 84). This is in part due to very low indirect tax collection compared with OECD and transitional peers (Figure 85). Indirect tax revenues in Malaysia are only slightly regressive⁹¹ but generate far too little revenue to finance adequate pro-poor spending. At the same time, while direct taxes provide the majority of

revenues, but they are still very low compared to OECD countries, driven by one of the lowest PIT collection rates (Figure 85).

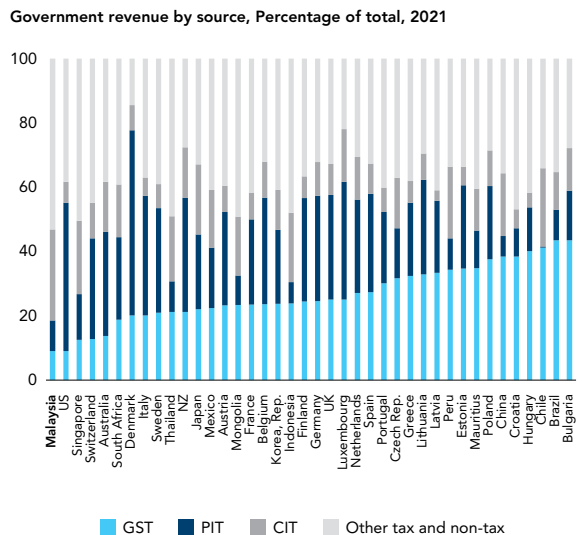
Furthermore, Malaysia does not spend current budgets as effectively as it could. It spends modestly on social assistance while also allocates some of its limited budget to a range of subsidies that are an inefficient way of supporting poor living standards. Moreover, a high degree of fragmentation, poor targeting and other issues of design and implementation mean the social assistance budget does not have the impact on poverty and inequality that it could. This section examines how Malaysia could have a greater impact on poverty and inequality through both the way it raises revenues and the way it spends them.

FIGURE 84
Malaysia's tax-to-GDP ratio has declined significantly over the years and significantly trails comparator countries



Source: World Bank Staff Calculations based on OECD

FIGURE 85
Malaysia's share of revenues generated by consumption taxes and personal income taxes is exceptionally low among regional and aspirational peers



Source: World Bank Staff Calculations based on IMF Government Finance Statistics

⁹¹ The indirect tax burden relative to decile market income in Figure 71 is 5.1 percent for D1 falling to 3.4 percent for D10, slightly regressive. When taken relative to disposable income (that is, after poorer households benefit from social transfers to boost their income and richer households pay income tax, reducing their income), the indirect tax burden is 4.3 percent for D1 and 3.6 percent for D10, still slightly regressive but even less so.

Fundamentally, Malaysia needs to raise more revenues through both direct and indirect taxes in order to achieve its high-income ambitions. To become a prosperous high-income country, Malaysia needs to make greater investments in human capital and productivity-enhancing physical and digital infrastructure, among other things.⁹² This will require financing higher levels of expenditures. In the short-term, this means greater indirect tax revenues while at the same time investing now to generate more progressive tax revenues in the longer-term. Longer-term equity can be enhanced as the direct tax base broadens, although it will take time to increase PIT to HIC levels. Meanwhile, international experience suggests that indirect tax exemptions and preferential rates are an inefficient way to promote equity. Instead, UMIC countries which do more to reduce inequality, use their indirect taxes primarily for revenue generation and offset their burden through targeted cash transfers. At the same time, they further enhance equity by broadening the direct tax base.

To become a prosperous high-income country, Malaysia needs to make greater investments in human capital and productivity-enhancing infrastructure

Indirect tax revenues need to be significantly increased, especially on general consumption. To meaningfully raise indirect tax revenues, Malaysia needs to raise more general tax on goods and services. Consideration could be given to reintroduction of VAT as it is widely regarded as one of the most efficient taxes in a country's toolkit, and is an increasingly important, if not the key, source of tax revenues globally. Moving from the current SST to VAT would improve efficiency and compliance by widening the tax base and bringing more firms into the tax framework. In addition, the VAT framework is more transparent and

is less prone to leakages compared to SST. VAT also avoids the cascading effect and reduces distortions.⁹³ International experience shows that a broad VAT base with a simplified rate structure is the most efficient approach to indirect taxation.

Poorer households have a higher degree of informal consumption which reduces their indirect tax burden. Poor households are more likely to buy from informal vendors who do not remit taxes. In 32 economies for which data are available, poorer households consume a much larger share from the informal sector than richer households do.⁹⁴ This means that poorer households generally face lower effective indirect tax rates and that indirect taxes are less regressive in practice than on paper.⁹⁵ At the same time, while consumption taxes may be less regressive because of informality, it also means that they collect less revenue.

The pattern of informality means eliminating indirect tax exemptions and preferential rates can still raise significant revenues with less burden on the poor. VAT exemptions are an inefficient way of supporting the poor, informality exacerbates this: "Consequently, when informal consumption is considered, VAT exemptions meant to reduce the burden of indirect taxes accrue disproportionately to richer households, diminishing their rationale. Further, these tax exemptions reduce total revenue collection, and the complexity in administering multiple tax rates creates additional opportunities for tax avoidance and evasion".⁹⁶ In Thailand, for example, informality means the *de facto* burden of indirect taxes is over 40 percent lower than the *de jure* burden for B40 households but less than 20 percent lower for T20 households. Moreover, because B40 consumption is a small fraction of total consumption, this has only a small impact on revenues; without informality, B40's contribution to total indirect tax revenues would increase only from 17 to 21 percent.⁹⁷ This asymmetry can be used to Malaysia's short-term fiscal advantage. Informality of consumption means higher indirect tax rates, whether through a higher base rate or elimination of lower rates for some goods and services, represent a lower effective tax increase for poorer households while still raising significant revenues because richer households

⁹² See World Bank (2021) Aiming High.

⁹³ World Bank. 2021. Malaysia Economic Monitor, December 2021: Staying Afloat.

⁹⁴ Bachas, Gadonne, and Jensen. 2020. Informality, Consumption Taxes and Redistribution.

⁹⁵ Purchases from the informal sector still bear some indirect tax if informal vendors buy goods and services from formal suppliers (including rent and utilities as well as inventory), but there will be no tax on the informal vendor's value added (including labor) so the effective tax rate will be lower than the same good sold at a formal location. For example, a haircut at an informal location may not have VAT charged on its price, but the electricity used at the shop likely does include VAT, which in turn is incorporated into the final price.

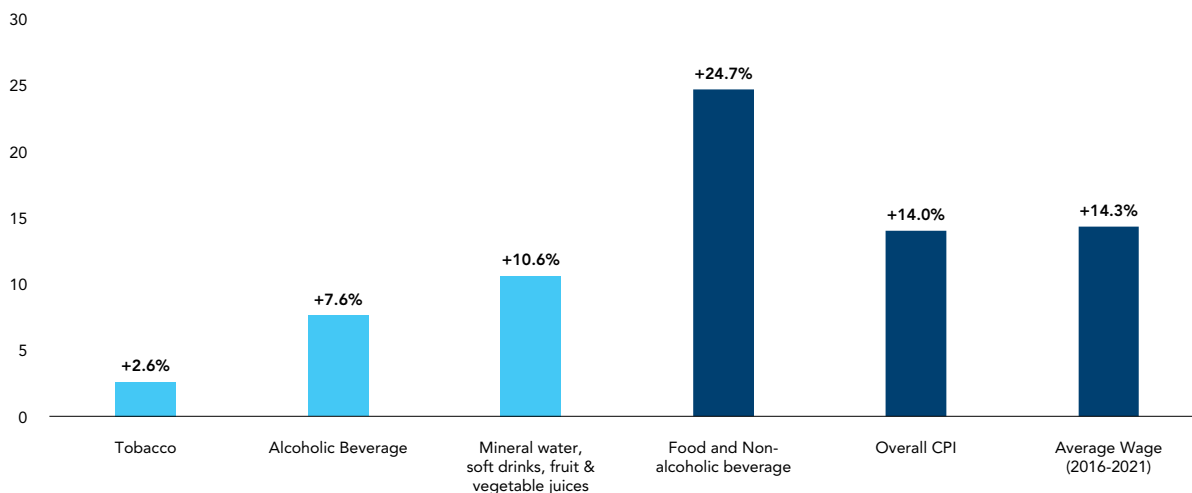
⁹⁶ World Bank. 2022. Correcting Course, p169.

⁹⁷ Wai-Poi, Sosa and Bachas (forthcoming), calculated from Thailand 2020 SES.

FIGURE 86

Health taxes can be regularly adjusted to CPI (or nominal wage growth) to counter increased relative affordability of harmful products as inflation (or income) rises

Increase in Consumer Price Index (2010=100) between Jan 2016 and Jul 2023, Percentage



Source: DOSM

pay a much higher fraction of indirect taxes (in Thailand, informality means the T20 share of total indirect taxes increases from 39 to 45 percent).

There is also scope for greater use of health taxes, which would increase revenues, reduce long-term health expenditures and improve health. As in all middle- and high-income countries, reducing the impact of non-communicable diseases (NCDs) such as heart disease and diabetes is one of the highest health priorities. Prevention focuses on reducing behaviors such as smoking, alcohol consumption and unhealthy diets that greatly increase the risk of acquiring NCDs and result in adverse macroeconomic consequences.⁹⁸ Taxes on tobacco, alcohol, and sugar-sweetened beverages (SSBs) are an integral part of a comprehensive NCD control strategy.⁹⁹

In Malaysia, consideration could be given to establishing a mechanism to periodically adjust the excise tax levels for tobacco, alcohol and SSBs to consumer price index or nominal wage growth to overcome the effects of inflation and income growth (Figure 86). The government could also consider expanding similar efforts to influencing the consumption of processed food products containing excessive salt, sugar, and unhealthy fats. By lowering the consumption of these products, health taxes could improve population health, enhance human capital, and help diminish future use of health services – making health financing more sustainable in the long term.¹⁰⁰ Recent estimates by the World Bank show that greater use of health taxes could potentially raise more than RM2 billion annually while increasing GDP by 0.1 percent.¹⁰¹

⁹⁸ Bloom DE, Cafiero-Fonseca ET, McGovern ME, Prettner K, Stanciole A, Weiss J, et al. The macroeconomic impact of non-communicable diseases in China and India: estimates, projections, and comparisons. *The Journal of the Economics of Ageing*. 2014;4(December 2014):100–111; Jha, P., Nugent, R., Verguet, S., Bloom, D., and Hum, R., 2012: *Chronic Disease in low and middle income countries*; Lomborg (ed) 2013. *Global Problems, Smart Solutions Costs and Benefits*, pp. 137 - 185 Cambridge University Press. DOI: <https://doi.org/10.1017/CBO9781139600484.005>.

⁹⁹ Higher cigarette taxes and prices have been found to reduce smoking related diseases, and premature death (including mortality from lung cancer, throat cancer, and respiratory diseases) and hospitalizations for heart failure (Chaloupka F., Powell L., Warner, K. 2019. "The Use of Excise Taxes to Reduce Tobacco, Alcohol, and Sugary Beverage Consumption" *Annual Review of Public Health* 2019. 40:187–201). Higher alcohol prices and taxes have been found to be inversely related to alcohol-related morbidity and mortality, traffic crash fatalities and drunk driving, violence (including gender-based violence and sexual assault), risky sexual behavior, and violent crime (including homicides) (Wagenaar A., Tobler A., Komro K. 2010. "Effects of alcohol tax and price policies on morbidity and mortality: a systematic review" *American Journal of Public Health*, 100(11), 2270–2278. <https://doi.org/10.2105/AJPH.2009.186007>). Higher SSB prices and taxes have been associated with reduced body weight and diabetes incidence, and create incentives for firms to lower sugar content and increase sales of healthier substitutes (such as water). Because the reduction in consumption due to increases in taxes for tobacco, alcohol, and SSBs tends to be larger among lower-income households and younger age groups, these taxes can enhance equity in population health outcomes, and reduce the risk of tobacco and alcohol addiction among youth.

¹⁰⁰ Because there is a risk that gradual price increases are internalized by consumers and may fail to induce the desired behavior change, the public health concerns need to be balanced with the desired fiscal impacts.

¹⁰¹ Authors calculations based on modelling from MOF data.

Nonetheless, any increase in indirect taxes will place a burden on poorer households and measures should be in place to mitigate this impact. There are different ways of addressing this. Careful analysis is needed to understand the fiscal and distributional implications of each approach:

- Using exemptions, zero- or preferential rates on goods and services with a higher consumption share for the poor, such as food and clothing.¹⁰² As the Thai example shows, this reduces revenue generation and more of the tax expenditure goes to richer households, but it does reduce burden on the poor and means no one is excluded from support.
- Using targeted cash transfers costs significantly less than the revenue generated by the tax and their benefits are usually much higher than the impact on cost of living. However, even well-targeted programs will still exclude some poorer households, or alternatively include many non-poor households at a higher budget cost.¹⁰³
- Fiscal subsidies could also be used to expand social insurance coverage for middle income households. Their higher income means they can absorb the higher cost of living without falling into poverty while increased coverage against risk can strengthen their resilience. The combination of social assistance and social insurance can offer broad benefits to much of the population while still raising revenues.
- Increasing spending on public services that are essential to the poor, such as health and education. The value of the services will likely benefit poorer households by more than the cost of the tax. However, the services are in-kind and as such, poorer households have less disposable income and may have a harder time meeting short-term expenses.

In addition, while the introduction of VAT can raise significant revenues in the short-term, a phased approach is required in its implementation. Ideally, indirect tax generation would use a high base rate with few exemptions; mitigating the impact on poorer households would likely require at least some expansion in social assistance. Nevertheless, given current weaknesses in the social assistance framework (discussed shortly), indirect taxation reforms could be phased in as social protection delivery is strengthened. In the earlier phase, adequate revenue generation could still be achieved. This can either be done with a higher base rate with broad exemptions to lower the effective tax rate on poorer households. Alternatively, a lower base rate with few exemptions accompanied with pro-poor spending which could take the form of increased social assistance, expanded social insurance or improvements in health and education services could be implemented. In the second phase, after the social protection chain has been strengthened over the next 2-3 years, a high base rate with no exemptions and expanded social assistance will generate strong new revenues with more progressive outcomes. That is, initially greater financing of social assistance will increase benefit levels for all, including the many M40 and T20 households receiving benefits, while in future years the increased benefits could be better channeled to B40 households. Channeling initial increased support through programs that are currently better targeted, such as STR, could strengthen first phase results.

Concurrently, the foundations for greater and more progressive future revenues can be laid now by enhancing the revenue collection and progressivity of Malaysia's PIT system. This can be achieved through addressing several suboptimal features of the current PIT policy framework, which places an inherent limit on its revenue collection. Among them are: (i) the relatively small base of high-income taxpayers; (ii) the availability of multiple reliefs with no overall cap; and (iii) the relatively narrow scope of the tax (See Box 8 on discussion on Malaysia's PIT policy framework).

¹⁰² The difference between a zero-rated and exempt good is important. Neither sellers of zero-rated goods and services nor those of tax-exempt ones charge tax on their sale, but only sellers of zero-rated goods and services can claim back the tax paid on inputs; thus exempt goods and services will include embedded tax paid on inputs to their production and distribution. The role of embedded GST on inputs for exempt goods can be seen in the case of Pakistan (discussed in Wai-Poi, Sosa and Bachas, forthcoming), where the average GST rate calculated directly on final goods is lower for poorer households than richer ones (1.5 percent of market income for decile 1 compared to 2.9 percent for decile 10) because exempt items make up a larger share of poorer household consumption. However, this also means there is a higher share of exempt goods which sellers cannot claim GST on inputs back, leading to a higher degree of embedded GST (2.3 percent of income for decile 1 compared to 1.7 percent for decile 10). As a result, the net GST incidence as a percentage of market income is still progressive but less so that the direct effects alone.

¹⁰³ The government does not observe total income for many households, particularly poorer ones with highly informal labor and self-employment incomes which are not recorded administratively. Consequently, programs aimed at poorer households are usually targeted using estimates of household income which inevitably have inaccuracies. This means some households with true incomes below the eligibility threshold are estimated as ineligible ('exclusion errors') while some with true incomes above the threshold are estimated as eligible ('inclusion errors'). See Grosh, Leite, Wai-Poi and Tesliuc (2022) for a comprehensive discussion of targeting.

BOX 8

Enhancing Malaysia's Personal Income Tax (PIT) Policy Framework

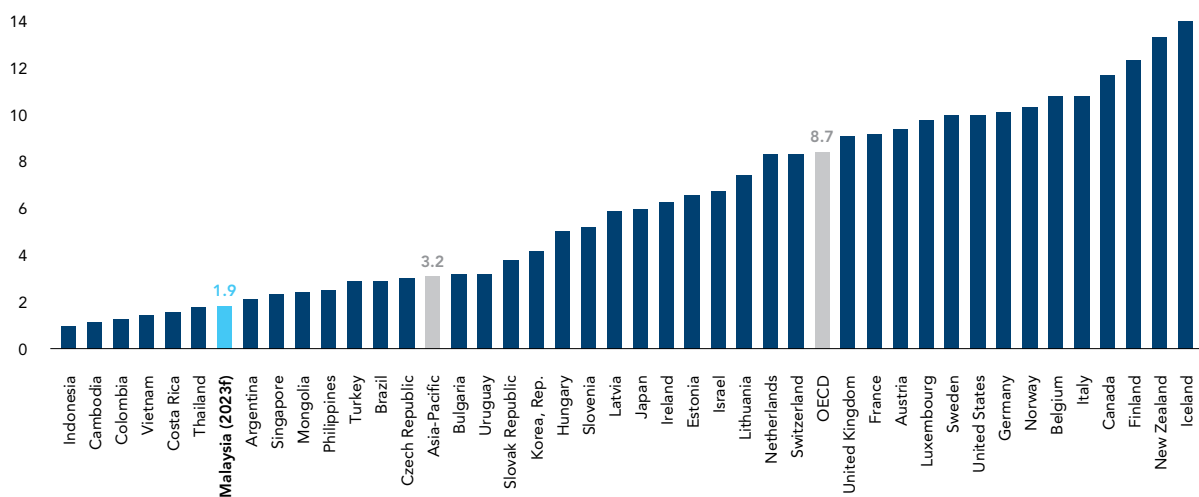
Malaysia could strengthen progressive direct taxation by enhancing its PIT policy framework. In most high-income countries, PIT forms the backbone of direct taxation, while progressive rate structures of PIT are crucial drivers of progressivity in overall tax burdens.¹⁰⁴ This starkly contrasts with Malaysia where PIT revenue collection is far more limited. It has stood below 3 percent of GDP over the past decades and below 2 percent in recent years, well below most high-income comparators (Figure 87).

Enhancing Malaysia's PIT policy framework would require reforms to broaden the base of high-income earners, rationalize the system of reliefs and widen the scope of the tax. Some recommendations follow that could be considered as part of a broader reform package designed to achieve a more efficient and progressive PIT framework.

- **Lower the chargeable income thresholds at the upper-income tax brackets to broaden the base of high-income earners.** Relative to its high-income and regional comparators, Malaysia's marginal PIT rates at the upper-income brackets are relatively low and are applied to relatively high taxable income thresholds. For instance, taxpayer's income must be more than 50 times the average wage before entering the highest income bracket of RM2 million and above, subject to the top PIT rate of 30 percent. By contrast, in most OECD countries, a higher maximum PIT rate is applied to taxpayers whose incomes are less than 10 times the average wage (Figure 88). Similarly, the top PIT rates are higher and are applied to lower chargeable income thresholds in most ASEAN comparators, except Singapore (at a lower top rate) and Indonesia (at a higher income threshold).

FIGURE 87
Malaysia's PIT revenue as a share of GDP is well below most high-income comparators

Tax on income and profits of individuals, Percentage of GDP, 2021 or latest available year



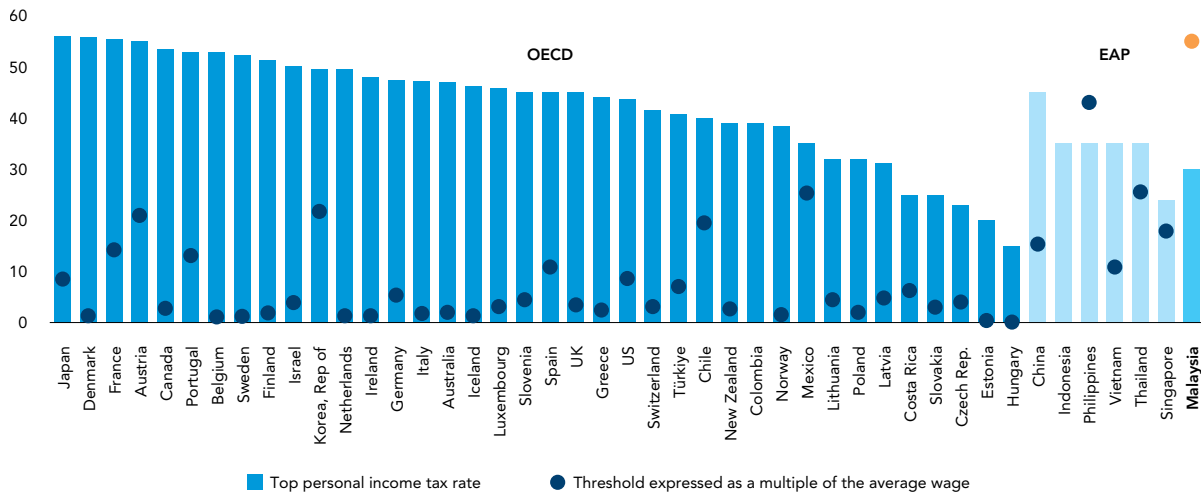
Source: OECD Global Revenue Statistics; MOF

¹⁰⁴ Dom, Roel, Anna Custers, Stephen Davenport, and Wilson Prichard. 2022. Innovations in Tax Compliance: Building Trust, Navigating Politics, and Tailoring Reform. Washington, DC: World Bank.

FIGURE 88

Malaysia's top marginal PIT rate is applied to a much higher income threshold than that of high-income and ASEAN comparators

Top statutory personal income tax rate and the wage earnings threshold at which it first applies, Percentage, 2022 or latest available year



Source: OECD, ILOSTAT, National authorities, and World Bank Staff Calculations

- Limit the total amount of reliefs claimed and reduce the share of reliefs benefitting high-income taxpayers.** In the current framework, all taxpayers can claim a wide range of PIT reliefs with no overall cap. As reliefs are deducted from total income, their values increase as a person's marginal tax rate increases, thereby benefiting high-income earners the most. Capping the total amount of itemized reliefs would reduce the share of reliefs benefiting higher-income taxpayers. Additionally, some reliefs could be better targeted, rationalized or merged with those that address similar circumstances. For instance, the tax subsidy for smartphones may no longer be needed to drive digitalization as the penetration of smartphones and internet usage has exceeded 97 percent. Adjustments could also be made to rationalize incentives for saving by high-income earners (which involve significant deadweight costs by rewarding behavior that would have taken place anyway), and simplify the way the system recognizes medical-related expenditure and the costs of disability.
- Expand the scope of the tax.** Resident income earned in Malaysia is taxable with important

In most high-income countries, PIT forms the backbone of direct taxation, while progressive rate structures of PIT are crucial drivers of progressivity in overall tax burdens

exemptions. The main income categories commonly included in the PIT base among high-income and regional countries that are tax-exempt in Malaysia include investment income, pensions and gratuities, and foreign income. In terms of investment income, interest earned on bank deposits and securities is tax-exempt. Dividends paid to shareholders of resident companies are also not taxable as Malaysia only taxes corporate profits at the company level.¹⁰⁵ Including these interests and dividends earned, even at a lower rate, would help broaden the PIT base.

¹⁰⁵ A 2018 OECD report on the taxation of household savings found that 34 out of 40 countries surveyed applied some form of tax on dividend income received by individuals. Source: OECD (2018), Taxation of Household Savings, OECD Tax Policy Studies, No. 25, OECD Publishing, Paris.

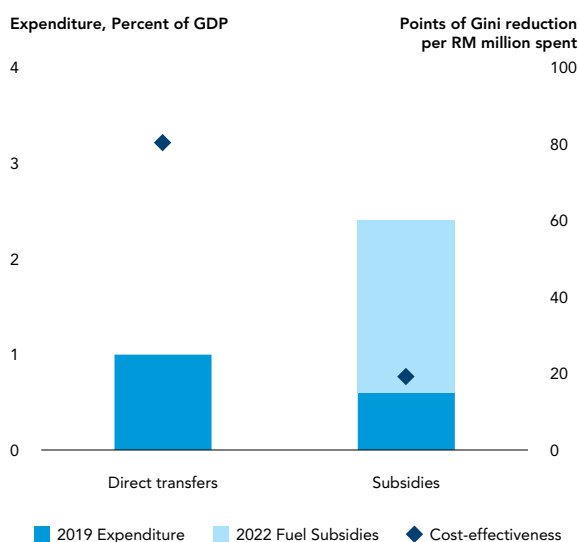
As important as revenue generation is, effective spending is key to greater equity. Because the incomes of poorer households are low, public spending benefits can represent a large share of their income even if relatively small in absolute terms (and thus fiscally affordable). Accordingly, public spending is the key to using fiscal policy to reduce poverty and inequality. Income support – whether through transfers or subsidized prices – can offset the burden of taxes or facilitate macroeconomic reforms, while additional income support can increase real living standards further, leaving poorer households better off today as well as tomorrow. Maximizing the impact of public spending on equity has two aspects. First, limited budgets need to be allocated to those spending instruments which achieve greater poverty and inequality reduction for each ringgit spent. Second, even among those instruments with greater cost-effectiveness, efficiency improvements can be sought.

Low revenues and ineffective subsidy spending restrict the fiscal space for needed spending in social protection, health and education

Given that Malaysia’s fiscal space is further constrained by subsidy spending which primarily benefits richer households, the efficiency of pro-poor spending could be increased. Low revenues and ineffective subsidy spending restrict the fiscal space for needed spending in social protection, health and education, all of which are below international benchmarks. In 2019, Malaysia spent 0.6 percent of GDP on fuel and other subsidies. As international fuel prices soared with the Russian invasion of Ukraine, fuel subsidy spending rose to 2.9 percent of GDP in 2022, more than the total health budget and over double that of social protection. However, social assistance reduced income inequality in 2019 by four times more for every ringgit spent compared to subsidies. That is, direct cash and

non-cash transfers are four times more cost effective at reducing inequality than subsidies (Figure 89); the impact of 2022’s much higher fuel subsidy spend is considered later.

FIGURE 89
Direct transfers are four times more cost effective at reducing inequality than subsidies



Source: MOF, 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations. Note: Cost-effectiveness is points of Gini Index reduction per RM million spent. Direct transfers include all cash and non-cash social assistance benefits.

One reason why subsidies are popular in Malaysia is that many people do not realize the extent to which they primarily benefit richer households. As Figure 79 previously highlighted, T20 households enjoy the same share of total fuel subsidy benefits (29 percent) as B40 households, despite numbering only half of the people. However, in a recently conducted national survey, only 38 percent of people correctly believed that the rich benefited more. Those least likely to benefit in reality (the poorest 20 percent of respondents) were the most likely to think they benefited more; only 28 percent correctly thought the rich benefited more.¹⁰⁶ There are a number of lessons about successfully implementing fuel subsidy reforms from other countries that Malaysia could examine, including the importance of a strong communications campaign (see Box 9 on international experience on subsidy reforms).

¹⁰⁶ Full results will be presented and discussed in the World Bank’s forthcoming report on inequality in Malaysia.

BOX 9

International Experience in Subsidy Reforms



The negative consequences of energy subsidies are well-documented, while removing their distortions may support productivity growth. Poorer households receive a relatively small share of energy subsidies, but a significant assistance for them, while a large share often goes to richer households. These subsidies are often being distortionary, difficult to remove and not well-suited for their intended purposes. Moreover, they encourage wasteful energy consumption, exacerbating climate change.¹⁰⁷ Faced with increased energy costs, firms may pass them on, absorb them, substitute with cheaper alternative energy sources, or enhance energy efficiency through green innovation.¹⁰⁸ In Indonesia, energy price increases had limited impacts on long-term micro and small manufacturing firm competitiveness, as they responded by substituting

fuels, improving energy efficiency, and passing on costs.¹⁰⁹ There is also growing evidence that while electricity price shocks can harm firm performance, fuel price shocks do not and can even drive higher productivity and profits. For example, larger firms in Mexico and Indonesia replaced older, fuel-powered capital with more efficient and electricity-intensive capital;¹¹⁰ fuel price increases positively impacted productivity and efficiency, while electricity prices did not have significant effects;¹¹¹ while higher fossil fuel prices had a positive effect on Chilean manufacturing firm investment and productivity but higher electricity prices had negative effects, although the benefits were particularly evident for large firms, while small and domestically oriented firms were more adversely affected.¹¹²

¹⁰⁷ Inchauste and Victor. 2017. The Political Economy of Energy Subsidy Reform. They observe “below-market costs encourage overconsumption of subsidized products as well as distortionary efforts by consumers to switch toward subsidized products. In Indonesia, for example, large differences in fuel costs affected motorists’ choice of vehicles ... [while] more generally, the literature has noted that below-market energy prices can lead to excessive energy intensity in an economy and can harm productivity (Cornillie and Fankhauser 2004; Hang and Tu 2007). They can also lead to higher emissions of energy-related pollutants, which is why many studies identify energy subsidy reform as a strategy for controlling emissions that often has large “co-benefits” for societies (Fattouh and El-Katiri 2012; UNEP 2008; Victor 2011).”

¹⁰⁸ Rentschler and Bazilian. 2017. Reforming fossil fuel subsidies: drivers, barriers and the state of progress.

¹⁰⁹ Rentschler, Flachenecker and Kornejew. 2018. Assessing carbon emission savings from corporate resource efficiency investments: an estimation indicator in theory and practice.

¹¹⁰ Cali, Cantore, Iacovone, Pereira-López and Presidente. 2022. Too much energy: The perverse effect of low fuel prices on firms.

¹¹¹ Amann, Cantore, Cali, Todorov and Cheng. 2021. Switching it up: The effect of energy price reforms in Oman.

¹¹² Amann and Grover. 2023. The Energy Prices and Firm Competitiveness: Evidence from Chile.

The political economy of fuel subsidy reform is far more challenging than getting the technical design right, but some lessons emerge from international experience.

In particular, it is essential to offer credible future benefits for those who would be affected by the higher prices. Inchauste and Victor (2017) assess the political economy of energy reforms, reviewing over 30 distinct reform episodes. They emphasize that reform strategies vary with the underlying political economy problems, but that the two most difficult tasks depend on who has benefited most from subsidies: (a) mitigating opposition from special interest groups, or (b) credibly compensating the broader public for the reduction or removal of subsidies, the latter of which may be most relevant for Malaysia.¹¹³ This is much harder for policy makers to address – when the beneficiaries of the subsidy are large in number and highly diffused in the public, as was the case in Indonesia and Jordan, where even though most subsidy spending went to richer households, the benefits for poor and vulnerable households were still relatively large as a percentage of their incomes. In these settings, the benefits from the subsidy are visible to the broader public, while the costs – also born by the public through the state budget – are much less visible. Here, Inchauste and Victor find that the key task is to make a credible offer to the public that the removal of visible benefits will deliver new yet currently invisible gains. A new study in 12 large middle-income countries confirms the importance of credible commitment on what it is that the government is going to do with the savings from subsidy reform. Specifically the study shows two important findings that subsidies are in many ways embedded parts of the social contract and showing ability to deliver the benefits of the state in other ways appear be pre-conditions to building support for reform; and (ii) these benefits could be cash but just as well be non-cash benefits citizens enjoy in the form of quality of services.¹¹⁴

Strong social protection systems are critical to the success of reforms and need to be in place as reforms are initiated. The central importance of the government’s administrative capacity to design and implement better-targeted social assistance is emphasized by Inchauste and Victor (2017) and Mukerjee et al (2023), particularly in the case where

energy subsidies are intended to help the poor, as simply removing them is not a viable option. Cutting expensive and poorly targeted subsidies must go hand in hand with credible policies to introduce better mechanisms for social protection. In all cases, reformers only remove the subsidies after first laying the groundwork for better social assistance systems, which can take years and often includes administrative and technological innovations (such as smart cards and extensive data collection) to improve targeting and delivery. In Indonesia, new targeting data covering 30 percent of the population was collected in five months to target the temporary cash compensation. Over the next decade, this database was improved and became one of the bedrocks of a social protection system which facilitated fuel subsidy reform episodes in 2008, 2013 and 2015 (as well as in responding to the COVID-19 crisis). Getting social protection systems – targeting, payment and delivery channels and grievance and redress mechanisms – right was also seen as a key element in the successful Dominican Republic reform in 2008.

Cutting expensive and poorly targeted subsidies must go hand in hand with credible policies to introduce better mechanisms for social protection

Compensation through cash transfers is a very common approach and considered the best option, although broad and inclusive measures are often tapered over time. As Inchauste and Victor (2017) note, one approach to “the offer” is to make energy consumption subsidies more efficient by improving how they are allocated. Examples include targeting electricity subsidies to poorer households in South Africa and Indonesia and creating smart card systems for allocation. Ghana expanded its rural electrification scheme as part of a major expenditure

¹¹³ “When subsidies generate benefits for highly concentrated interest groups, the central task for reformers involves inoculating themselves against the political power of the special interests—or satisfying the interest groups with some alternative policy they prefer even more” (Inchauste and Victor 2017). For example, to mollify the very powerful passenger transportation unions in the Dominican Republic, the replacement of LPG subsidies with a targeted transfer was accompanied by a sister program benefiting drivers of LPG-fueled taxicabs, while monthly quantities of diesel were awarded to the major (and most powerful politically) public and cargo transport unions. See also Gallina, Inchauste, Isa, Lee and Sánchez. 2017. The Dominican Republic: From Generalized to Targeted Subsidies.

¹¹⁴ Hoy, Christopher. A., Yeon S. Kim, Minh Nguyen, Mariano E. Sosa and Sailesh Tiwari (2023). “Building Support for Energy Subsidy Reforms: Evidence from Middle Income Countries”. forthcoming World Bank Policy Research Working Paper.

package announced at the same time as the fuel price increases. However, Inchauste and Victor find that the best practices lie with direct income transfers. While developing social safety nets is important in ensuring consumers cope with higher prices successfully in the long run, tariff and fuel price increases should be accompanied with immediate short-term measures. A recent review examined the use of cash transfers in the context of energy subsidy reform in 24 reform episodes in 18 countries. Common findings included: (i) cash transfers benefits were larger when price adjustments are significant; (ii) countries used existing cash transfer programs where they existed (40 percent of cases) or created new ones where they did not (60 percent), and in cases of multiple reforms, new programs created in earlier reform episodes were then expanded in subsequent episodes (e.g., Ghana, Indonesia, Mauritania, Ukraine); (iii) energy compensatory transfers – specifically for higher price impacts – are varied in approach but tend to be limited to less than one-third of the population with benefits correlated to the degree of price adjustment, and one-off, temporary (e.g., Indonesia) or scaled back over time (e.g., Iran and Jordan).

Effective communications are essential to a successful reform. Major global reviews note the importance of communications, including the importance of: (i) communicating to consumers that what they pay is often only a fraction of the full cost of the service; and (ii) the imperfect nature of subsidies and their leakage to higher income groups, for which the subsidy is not intended, as well as the benefits from reallocation of the subsidy savings. Jordan and Iran are two of the few countries in the MENA region to have succeeded in implementing fuel subsidy reforms and both deployed strong communications strategies. In Jordan, a large public communication campaign aimed to inform and appease people, to prevent protests. Reforms were coordinated with various stakeholders and preceded by consultations with parliament, the local NGOs, the business community and labor representatives. Successful reform episodes in Indonesia were accompanied by strong communications campaigns (e.g., 2005 and 2015) while failed episodes had weak ones (2012). In 2005, there was a coordinated plan across government and media training for key officials, a comprehensive public communication campaign launched and a professional firm employed, while prominent economists and public figures took out a newspaper advertisement in support, using pertinent factoids such as the number of schools built with annual subsidies to Mercedes. In contrast, in 2012 there was no

communications strategy, no linking of subsidy reform to needed funds for popular development sectors and no response to media inaccuracies and frequent criticisms by opposition politicians and some economists. In addition, careless parliamentary statements further undermined political support.

The motivation, timing and size of reforms is context-dependent, in part because governments vary in their capacity to implement politically difficult energy subsidy reforms. Reforms can be initiated for different reasons, including crisis, political strategy and reform strategy (Inchauste and Victor 2017). In a survey of recent reform episodes, 20 out of 24 occurred between 2008-12, a time of the global economic crisis and global energy price shocks. This included Iran's 2011 reform, which was one of largest energy subsidy reforms of all time, in the face of a fiscal crisis from the cost of covering rapidly growing oil product imports. At other times, governments can "engineer" reform strategies such that they minimize the political resources needed while maximizing the degree of reform. "Reform Engineering" include governments adjusting prices to solve short-term issues such as unexpected fiscal pressures, but also include governments taking a strategic approach and addressing energy subsidies as central to retaining political power and of reorganizing how the government delivers benefits to the population. Central elements can include: (i) creating the capacity to implement alternative policies (such as of alternative mechanisms to targeting benefits more efficiently); (ii) depoliticizing tariffs (avoiding being drawn into subsidy politics by removing the government's capacity to control prices and thus inoculating itself from political criticism when price pressures increase, removing price manipulation as an instrument of politics (as is now standard for monetary policy with central banks); and (iii) building credibility for delivering alternative benefits (in Ghana, the government agreed with the local commercial vehicle transport union to increase transport fares by one-third of fuel price increases only when cumulative fuel prices within the year exceeded 10 percent). There are different windows of opportunity for reform. Many occur during a drop in energy prices, although political windows of opportunity can open in often unpredictable ways, both when prices are low (because the cost of reforms is low) and when prices are high (because the cost of failure to reform is high). Ukraine provides an example that a big jump in price (six times) is possible even in difficult geopolitical environment, mitigated through rapid scale up and expansion of cash transfers.

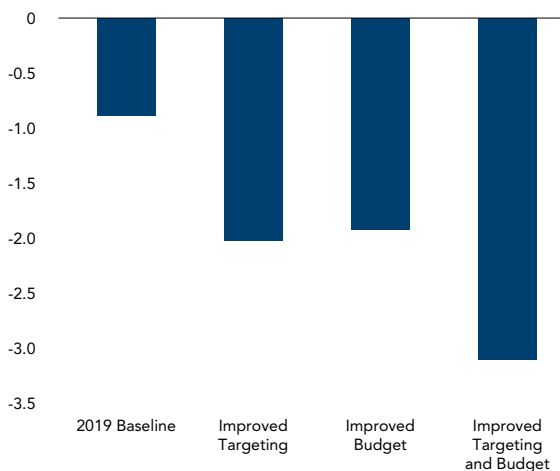
The impact of social assistance can also be improved, particularly in terms of directing more of the current budget into the hands of those who need it most. Social assistance spending in Malaysia is lower than international benchmarks, though there has been an increase in such spending in recent years. Notwithstanding this, poverty and inequality could be reduced further within the existing budget. The effectiveness of social assistance spending is limited by both the design of targeting and by problems in the delivery chain (with the significance of the latter being different across Malaysia's many cash transfer programs). As noted earlier, most poor receive transfers – although the poorest decile do worse than the rest of the B40 indicating outreach issues – but so do many people in the high-income brackets; M40 and T20 together receive 51 percent of all social assistance. Moreover, the value of benefits is low at just 8 percent of B40 income, a consequence of the dilution of benefits due to the relatively high coverage of M40 and T20 households, spreading the benefits out over many households. This reduces the level of individual transfers and so they are of only modest help to poorer households. A highly fragmented social assistance system only exacerbates the situation.

Improving targeting of existing social assistance budgets could double the poverty reducing impact of fiscal policy, equivalent to increasing the existing budget by half with current targeting; improving both is best. As Figure 77 indicates, 78 percent of Malaysians reported receiving some sort of social assistance in 2019; in a global survey of cash social assistance programs, the vast majority cover 40 percent or less of the population.¹¹⁵ This dilution of the social assistance budget reduces the impact on poverty because the benefit levels for poor beneficiaries are not high enough to pull many out of poverty. Figure 92 compares the 2019 impact with the results of three simulations. First, the 2019 budget is held constant at 1.0 percent of GDP but with improved targeting, restricting benefits to those estimated to be B40 according to a Proxy Means Test, a common targeting method used when actual household income is not observed directly, as is the case for many poorer households in Malaysia.¹¹⁶ This would more than double the total

poverty reduction of fiscal policy in Malaysia from 0.9 points under the 2019 baseline to 2.0 points at no extra cost.¹¹⁷ In fact, this would have about the same impact as the second scenario of increasing the budget to 1.5 percent (the average for developing and transition countries) but without improving targeting. Of course, increasing the budget while improving targeting would have the largest effect (reducing poverty by 3.1 points, which would be the 4th best result of the 24 UMICs in Figure 90, compared to 9th currently).

FIGURE 90
Improved targeting of existing SA budgets would have the same impact as increasing the budget by 50 percent with current targeting; doing both triples the impact

Fiscal policy impact on poverty under different SA budgets and targeting scenarios, Percentage points



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.
Note: 2019 Baseline is the reduction in national poverty from the main CEQ analysis. Improved targeting simulates a Proxy Means Test across the whole population; the 2019 SA budget is then allocated to the poorest 40 percent of people according to their PMT scores. Improved budget scales all 2019 SA beneficiary benefits up by 50 percent. Improved targeting and budget is the same as the improved targeting scenario with 50 percent higher benefits.

The design of social assistance expansion requires an important consideration – greater coverage often reduces targeting errors for the poorest but also reduces their benefit level. For a given budget, social assistance can cover fewer people with

¹¹⁵ See Figure 2.10 of Grosh, Leite, Wai-Poi and Tesliuc (2022). This is not a strictly comparable dataset as the global survey focuses on specific cash assistance programs whereas the 78 percent coverage figure in Malaysia represents those benefiting from any sort of social assistance and so spans all programs in Malaysia. Nonetheless, it emphasizes that such broad coverage of social assistance (excluding social insurance programs aimed at health, employment and old age) tend to be much more focused than the current Malaysian framework.

¹¹⁶ Inchauste and Victor. 2017. The Political Economy of Energy Subsidy Reform.

Rentschler and Bazilian. 2017. Reforming fossil fuel subsidies: drivers, barriers and the state of progress

Rentschler, Flachenecker and Kornejew. 2018. Assessing carbon emission savings from corporate resource efficiency investments: an estimation indicator in theory and practice.

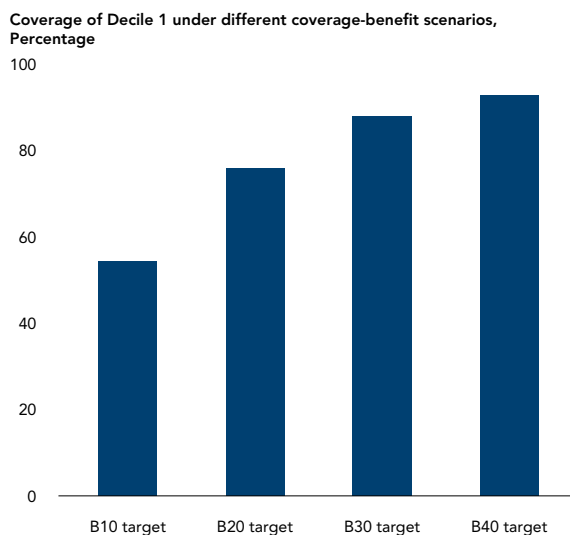
¹¹⁷ Cali, Cantore, Iacovone, Pereira-López and Presidente. 2022. Too much energy: The perverse effect of low fuel prices on firms.

Amann, Cantore, C li, Todorov and Cheng. 2021. Switching it up: The effect of energy price reforms in Oman.

higher benefits or more people with lower benefits, or somewhere in between. As coverage expands, the number of poor excluded from assistance should fall unless there are significant flaws in the targeting approach or the poor are particularly concentrated in hard-to-serve areas. The impact depends on both the measure of interest (for example, poverty or inequality), the shape of the income distribution and where it is cut by the poverty line. Managing such trade-offs between coverage and the level of benefits for any given social assistance budget is inherently political, based as it is on normative judgements that are informed by the social contract.

Cash transfers that are both narrowly and well-targeted may be more effective at reducing poverty, given that benefit levels are higher, but by definition their limited coverage reduces the number of people that they support. Exclusion errors are also of concern. Such targeting errors rise with tighter targeting criteria as the burden of proof for applicants increases. This means, for example, that more B10 households are excluded when cash transfers specifically target B10 households than when cash transfers are targeted towards a broader target group, such as B40 households (Figure 91). This can lead to concerns about equity and fairness.

FIGURE 91
Broader coverage of social assistance reduces average benefits but increases coverage of the poor for a given budget



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.
Note: All new scenarios are based on a 1.5 percent targeted social assistance budget using a simulated PMT. The same budget is spread over different targets ranging from the poorest 10 percent (B10) to the poorest 40 percent (B40) with lower coverage being associated with higher benefits for the fixed budget.

Some social protection systems, and the cash transfer programs they encompass, are more narrowly targeted towards the poor than others – managing these trade-offs is an essential part of social protection policy. The progressive realization of universal social protection demands that social protection is available to all whenever and however they need it. Ideally, a social protection system should ensure that the poor receive more generous benefits than other groups, given their greater need. At the same time, use of a range of programs – some of which may be categorical, such as in the case of an elderly benefit – ensures that broad coverage is achieved, often while achieving other objectives, such as long-term human capital accumulation in the case of a child benefit. This layered approach helps to ensure that there is universal access to social protection by those who need it, and that such protection is sufficient.

In Malaysia, strengthening the social protection system could build upon recommendations in the National Social Protection Policy which is currently under development. The improved poverty reduction impacts of the simulations in the previous paragraph are presented as targeting improvements, but in fact require improvements throughout the delivery chain. A current government priority involves ongoing efforts to ensure that existing beneficiary databases are updated regularly (i.e., are dynamic) and interoperable with a broader set of administrative data. This is an important exercise that can facilitate improved support for the poor. Malaysia's many programs and duplicative administrative functions should also ideally be consolidated into a smaller number of expanded programs. In doing so, targeting systems can be harmonized and improved to reduce exclusion of the poor, including through outreach, and to minimize the inclusion of affluent households that are not in need of support. In the medium- to long-term, these efforts will also contribute to the development of a dynamic social registry that underpins all social protection programs (a registry being of benefit to programs that are both categorical or targeted in nature), to the establishment of strong grievance redress mechanisms across all social assistance programs, and to coverage of new beneficiaries (see Box 10 on social protection reforms in Malaysia).

Meaningful fiscal reforms such as increasing indirect taxation and eliminating subsidies will require sustained strengthening of the social protection system, but together can raise significant net revenues while doing more to reduce poverty and inequality. Increasing consumption taxes or PIT or reducing fuel subsidies will increase the cost

BOX 10

Social Protection Reform in Malaysia

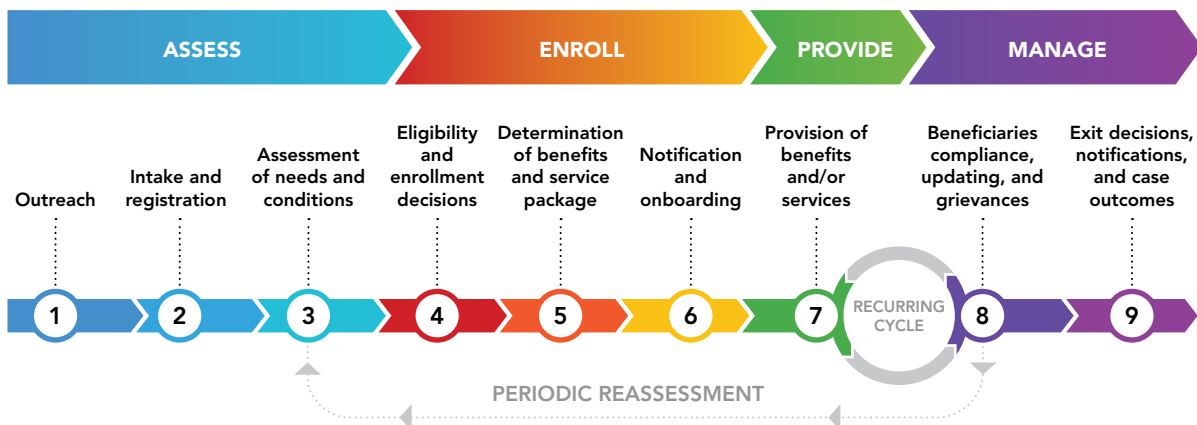
Effective social protection delivery requires the careful execution of several interconnected functions. Figure 92 illustrates the different component activities/processes of social protection delivery grouped under four broad headings: assessment, enrollment, provision of assistance, and management of beneficiaries. In an effective social protection delivery system, each of these functions are carefully developed, provided for (through necessary infrastructure, human resources, financing, and other inputs), and implemented. Weaknesses in any one or more of these links can harm the effective rollout of social protection programs.

A strong foundation for the delivery of social protection exists in Malaysia. Malaysia has strong foundational systems that can be leveraged for unified assessment, enrolment, provision, and management. This includes a universal unique ID system, effective payments systems, and digitization of administrative records and government processes, such as online tax filing, checking eKasih status, and e-services. The MyKad, which is the national identity card with a built-in chip that incorporates photo identification, biometric data, and links to the Touch 'n Go payment system, has the potential for serving as a platform for unifying

administrative data from multiple agencies, identifying, and verifying information of applicants/beneficiaries, and making payments to intended beneficiaries.¹¹⁸

Malaysia has also progressively strengthened its social protection delivery systems in recent years. The Ministry of Finance, which administers *Sumbangan Tunai Rahmah*, Malaysia’s largest cash transfer program, gathers data from a range of other agencies to help minimize exclusion of potential beneficiaries. This includes data from eKasih, which is used to administer the more narrowly targeted welfare programs managed by the Ministry of Women, Family, and Community Development (MWFCD), data on public housing residents, indigenous groups, homeless and single mothers registered with MWFCD, and recipients of unemployment benefits under the Employment Insurance Scheme managed by SOCSO. Verification of self-reported income and assets also occurs, with cross-checks against a growing list of databases (now numbering almost 40). In 2024, the Ministry of Finance will make it possible to undertake such cross-checks using Application Programming Interface (API), which is considered best practice globally, allowing as it does for the two-way transfer of information specific to individual applicants.

FIGURE 92
Component activities/processes of social protection delivery grouped under four broad headings: assessment, enrollment, provision of assistance, and management of beneficiaries



Source: World Bank, 2020, Sourcebook on the Foundations of Social Protection Delivery Systems

¹¹⁸ Amann and Grover. 2023. The Energy Prices and Firm Competitiveness: Evidence from Chile.

Notwithstanding these positive developments, there remains further scope for improvements over time. These could include:

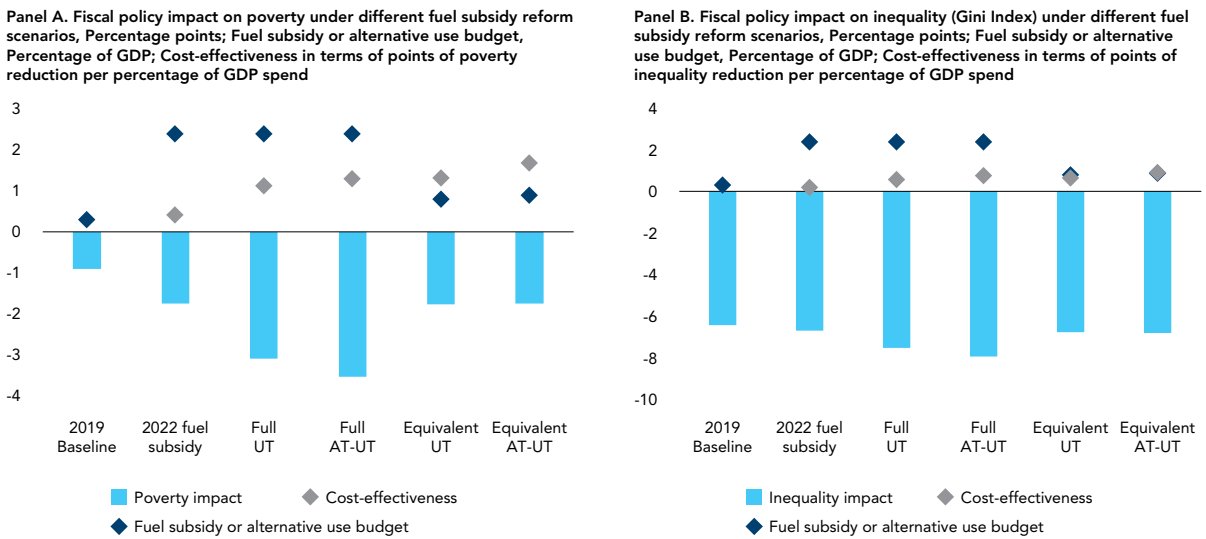
- **Consolidation of targeting systems (Medium-term, High priority):** Despite emphasis on targeting “hardcore poverty” and the B40, there is no standardized targeting system in place in Malaysia. Three beneficiary databases are relied upon by most programs: *eKasih*, *eBantuan*, and the targeting system for the STR cash transfer program (previously BKM, myBSHR and eBR1M). Each adopts different mechanisms for determining beneficiaries of the programs. *eKasih* and *eBantuan* rely on self-reporting and validation by home visits, while the targeting system for STR relies on tax records and self-registration, validated through cross-checking against independent registries. Approaches vary also in terms of defining the unit of targeting (household, nuclear family, individual), method of determining eligibility (detailed survey for assessing eligibility, cross-validation of self-declared income), and income thresholds for eligibility (hard-core poor, the B40). Existing eligibility criteria based on household income instead of household income per capita are also problematic, as they fail to account for the greater need of larger households (23 percent of Malaysians in the B40 of the population according to per-capita household income are not in the B40 according to total household income).
- **Establishment of a Social Registry (Medium/long-term, high priority):** A current government priority is to better integrate and make Malaysia’s various beneficiary registries interoperable. As this work progresses, and Malaysia’s many social assistance programs increasingly utilize common data, a next step will be to extend such registries so that they capture a broader segment of the population. A social registry is a foundational platform that supports and underpins interventions in (and beyond) social protection, comprising information drawn from multiple data sources on households and individuals that both receive social assistance benefits or may do so at some point in the future. This typically includes information on ID, household composition, members’ incomes and asset ownership and status of receipt of various forms of assistance. Social registries are increasingly at the heart of modern social protection systems, as they enable integrated intake, outreach, and delivery, across multiple social assistance programs and other social protection services (such as active labor market policies). They can also serve as the basis for the expansion of social assistance in times of crises. A dynamic social registry routinely updates
- information on households and individuals, thereby allowing dynamic decision-making on entry and exit from specific programs as a result of changed household circumstances or eligibility criteria.
- **Outreach (Short-term, medium priority):** Outreach activities are important for informing target populations about programs and their related delivery systems, with a view to secure engagement, participation, and support. There is some evidence of under-coverage of target populations for social assistance (i.e., exclusion errors) in Malaysia; for instance, around 35 percent of the poorest income band of workers surveyed during the COVID-19 pandemic for the World Bank’s HiFy survey in Malaysia reported not receiving any government assistance. Outreach is especially important for under-privileged groups such as the *Orang Asli*. Outreach is already undertaken to reduce exclusion from social assistance programs amongst potential beneficiaries, and in the case of the STR program administered by Ministry of Finance, has been expanded in recent years. However, its use across social assistance programs remains varied, with scope for improvement by some agencies.
- **Grievance Redress Mechanisms (GRM) (Medium-term, medium priority):** Robust GRM systems can generate valuable inputs for rectifying gaps in program implementation, strengthen citizen participation and accountability in social protection programs, and alert administrators to any emerging needs for program modification. GRM for social assistance programs in Malaysia vary by program – in the case of STR, there are clear channels and processes for resolving grievances and disputes; this is not the case for all programs, however. Investment in and further development of such systems should be a priority going forward.
- **Monitoring and Evaluation (Medium-term, high priority):** Monitoring and evaluation is a critical element of social protection programs. Routine monitoring and evaluation can help track Key Performance Indicators such as the extent of inclusion and exclusion errors, access and uptake of benefits, quality of assistance provided, and beneficiary experience vis-à-vis the receipt of benefits. The existing monitoring systems of social assistance programs in Malaysia are able to track the number, types of beneficiaries, and budgets of individual programs. However, there is no standardized periodicity and coverage of reporting applied, making it difficult to consolidate comparable and consistent information across programs that are implemented by several institutions.

of living for all, including poorer households. However, improving social assistance targeting could offset much of this increase. Moreover, some of the new revenues or saved expenditures could be used to increase social assistance budgets, further reducing poverty and inequality while still making fiscal gains.

The much higher 2022 fuel subsidy spending does provide more poverty protection than in 2019 but simple universal transfers could provide the same protection at a much lower cost, or much more at the same cost. In 2019, international oil prices were relatively low and fuel subsidies cost just 0.3 percent of GDP. Taxes, transfers and subsidies reduced poverty overall by 0.9 percentage points. With much higher oil prices in 2022, fuel subsidy spending soared to 2.4 percent of GDP. At the same time, keeping domestic prices at their fixed levels protected poorer households from higher prices; accounting for this, the comparable tax, transfer and subsidy impact on poverty is

estimated to be 1.8 points.¹¹⁹ Thus, the overall poverty impact of taxes, transfers and subsidies in 2019 would have doubled if oil prices had been at 2022 levels, but at the cost of an extra 2.6 percent of GDP in subsidy spending. Note, the analysis in this section onwards uses 2.4 percent of GDP for 2022 fuel subsidies, an earlier estimate.¹²⁰ Figure 93 Panel A provides some simple examples of the opportunity cost of this additional spending. If domestic fuel prices had not been subsidized and allowed to increase (increasing the cost of many other goods and services as well) but the 2022 level of fuel subsidies instead distributed equally as a flat cash transfer to everyone in Malaysia – equivalent to RM 780 per person – poverty would have been reduced by 3.1 points instead.¹²¹ If T20 households were excluded, the transfer for everyone else would be RM 975 and poverty reduction up to 3.5 points. Alternatively, the same poverty impact (1.8 points) as with the 2022 fuel subsidies could be achieved through a universal transfer of RM 280 at a fraction of the cost,

FIGURE 93
The much higher 2022 fuel subsidies provide more protection for the poor than in 2019 (and greater redistribution), but the same impact could be achieved at a much lower cost



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations.
 Note: 2019 Baseline is the reduction in national poverty from the main CEQ analysis with a fuel subsidy cost of 0.3 percent of GDP. 2022 fuel subsidy increases international oil prices to 2022 average prices and increases government subsidy spending to maintain fixed domestic prices (analysis uses an earlier estimate of 2.4 percent of GDP; final 2022 fuel subsidy spending was 2.9 percent of GDP). Scenarios: (i) Full UT removes fuel subsidy direct and indirect benefits and replaces it with a universal transfer to all households, benefits are flat per capita and set to exhaust the full 2.4 percent budget; (ii) Full AT-UT is the same as (i) but affluence-tests the universal transfer to exclude the estimated richest 20 percent of people (based on a simulated PMT); (iii) Equivalent UT is the same as (i) but instead of exhausting the 2.4 percent of GDP budget, it sets universal transfer benefits to the level required to achieve the same poverty impact as the fuel subsidies (with the remaining budget representing fiscal savings); (iv) Equivalent AT-UT is the same as (iii) but with the top 20 percent of people excluded.

¹¹⁹ “When subsidies generate benefits for highly concentrated interest groups, the central task for reformers involves inoculating themselves against the political power of the special interests—or satisfying the interest groups with some alternative policy they prefer even more” (Inchauste and Victor 2017).
¹²⁰ See Malaysia Economic Monitor February 2023 (World Bank). Consequently, the budget savings under different scenarios would be 0.5 percentage points higher (the difference between the 2.4 percent used in the analysis and the 2.9 percent final 2022 fuel subsidy expenditure) while the poverty and inequality estimates reflect the smaller budget reallocations under a 2.4 percent of GDP setting, meaning these poverty and inequality reductions would be higher if a greater amount of the 2.9 percent 2022 fuel subsidy budget was reallocated.
¹²¹ The impact of removing fuel subsidies includes loss of direct and indirect benefits, which combine the reduce prices. As such, the exercise has factored in inflationary impacts on households.



0.8 percent of GDP, or just 0.6 percent of GDP if T20 was excluded. The same pattern of results holds when the impact on inequality is considered instead of poverty (Figure 93 Panel B).

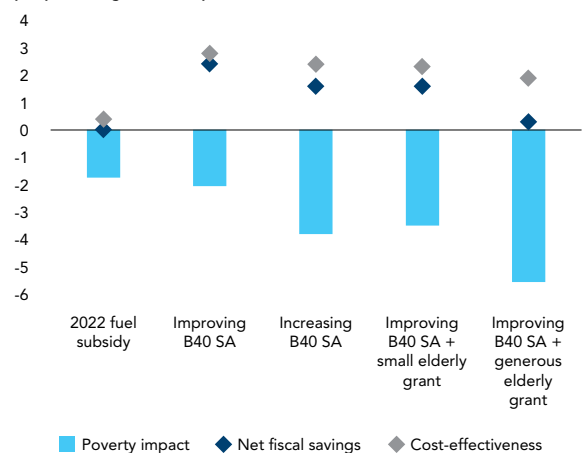
In other words, fuel subsidies are a very cost-ineffective way of supporting poorer households.

Distributional cost-effectiveness is a key measure in assessing how much fiscal ‘bang-for-the-buck’ different policies achieve. Figure 93 also presents the cost-effectiveness of each scenario: specifically, how poverty or inequality is reduced for each 1 percent of GDP spent. In Panel A, 2022 fuel subsidies reduce poverty by 0.4 points for every 1 percent of GDP spent. This compares to 1.1 points of reduction for every 1 percent spent for universal transfers using the full fuel subsidy budget, and 1.3 points if that transfer excludes T20. The smaller universal transfers which do not spend the entire fuel subsidy budget but that instead aim to achieve the same degree of poverty reduction also have a cost-effectiveness of 1.3 which rises to 1.7 if T20 is excluded. These simple examples illustrate that while fuel subsidies do provide economic support to poorer households, they are a very inefficient way of doing so.

The size of current fuel subsidy spending could instead be used to expand a range of social assistance initiatives, achieving significantly greater poverty and inequality reduction while still achieving fiscal savings. A universal transfer to all Malaysians is also an expensive way to support poorer households and is not proposed as a replacement for fuel subsidies. Instead, Figure 94 compares the fiscal

FIGURE 94
Redirecting fuel subsidy spending into expanded and refocused social assistance could double poverty reduction while also generating 1.6 percent of GDP in fiscal savings

Fiscal policy impact on poverty under different fuel subsidy reform scenarios, Percentage points; Fiscal savings under scenarios, Percentage of GDP; Cost-effectiveness in terms of points of poverty reduction per percentage of GDP spend



Source: 2019 Household Income and Basic Amenities Survey (HIS/BA) and Household Expenditure Survey (HES) and World Bank Staff Calculations. Note: 2022 fuel subsidy uses the 2019 CEQ baseline and increases international oil prices to 2022 average prices and increases government subsidy spending to maintain fixed domestic prices (costing 2.4 percent of GDP). Scenarios: (i) Improving B40 SA retains the 2019 1.0 percent of GDP for social assistance transfers but restricts coverage to B40 households only using PMT targeting; (ii) Increasing B40 SA is the same as (i) but increases the budget to 1.8 percent of GDP with higher benefit levels; (iii) Improving B40 SA + small elderly grant is the same as (ii) but adds a RM 125 per month transfer for all elderly in a B40 household and RM 85 transfer for all elderly in a M40 household; (iv) Improving B40 SA + generous elderly grant is the same as (iii) but increases the benefit to RM 400 for B40 elderly and RM 265 for elderly in Quintile 3 of the income distribution (M41-60).

cost, impact on poverty and cost-effectiveness of more focused social assistance initiatives to the 2022 fuel subsidy baseline. The four options examined all eliminate fuel subsidies and redirect the spending; the introduction of an elderly transfer is also considered in some scenarios, given its discussion amongst social protection practitioners. The four options considered are: i) save the entire fuel subsidy budget (based on 2.4 percent of GDP, meaning all budget savings scenarios which follow would be 0.5 points higher or the poverty and inequality impacts greater¹²²) while improving the targeting and delivery of the 2019 social assistance budget of 1.0 percent of GDP to cover just B40 households (“Improving B40 SA”); (ii) improve targeting of B40 households while also increasing the budget to 1.8 percent of GDP with higher benefit levels (“Increasing B40 SA”); (iii) improved targeting of B40 households with 1.0 percent of GDP budget and introduce a RM 125 per month transfer for each elderly member in a B40 household and a RM 85 transfer for each elderly member in a M40 household (“Improving B40 SA + small elderly grant”); and (iv) the same as (iii) but changing the elderly benefit levels and coverage to RM 400 for B40 elderly and RM 265 for elderly in Quintile 3 of the income distribution (M41-60) (“Improving B40 SA + generous elderly grant”). The first scenario – “Improving B40 SA” – achieves only slight improvements in poverty reduction (2.0 points) but banks the entire fuel subsidy budget as fiscal savings. The second – “Increasing B40 SA” – more than doubles poverty reduction to 3.8 points while still saving 1.6 percent of GDP. The third – “Improving B40 SA + small elderly grant” – achieves the same savings as the second with slightly less poverty reduction (3.5 points). The final – “Improving B40 SA + generous elderly grant” – reduces poverty the most, by a considerable 5.6 points, albeit while spending most of the fuel subsidy budget, with only 0.3 percent of GDP saved. All scenarios show much higher cost-effectiveness than the 2022 fuel subsidy of 0.4, ranging from 1.9 for “Improving B40 SA + generous elderly grant” to 2.8 for “Increasing B40 SA”. Fiscal savings from the elimination of fuel subsidies could also be redirected to improve health and education delivery to build human capital and reduce poverty and inequality in the long-term.

Overall, Malaysia’s taxes, transfers, subsidies and health and education spending reduce poverty and inequality but existing spending could have greater impact while reforms are possible which would further strengthen distributional outcomes while raising higher net revenues. Key tax capacity

and social protection building blocks are in place to implement reforms. The mix of tax and social spending in Malaysia reduces income inequality but does less so than the UMIC average when health and education spending are included. It reduces poverty by more than average but still by less than 1 percentage point. With an expansion of PIT and indirect taxation, it could raise significant revenues over the next 3-5 years. Costly blanket fuel subsidies which disproportionately benefit richer households could be used for more progressive spending on health, education and social protection, bringing Malaysia’s spending levels in these key areas more in line with international benchmarks. A relatively small fraction of the new revenues and saved expenditures could more than offset the impact on households, whether focused more on those in the B40 or more broadly to include the M40 as well. Implementation of social protection programs would require strengthening, particularly with respect to targeting and fragmentation, but the building blocks are in place to do so within the medium-term.

¹²² As the final 2022 fuel subsidy budget was 2.9 percent of GDP; see footnote 120. Under the current scenarios, the budget savings would be 0.5 percentage points of GDP higher. Alternatively, an additional 0.5 points of the fuel subsidy budget could have been reallocated to the different scenarios, meaning the budget savings are as presented but the poverty and inequality reductions would be larger.

References

- Addo, Sheila, Morgan Bazilian, and Samuel Oguah. 2017. Ghana: Lessons Learned, New Strategies in Inchauste and Victor (eds.)
- Aizenman, Joshua, and Yothin Jinjarak. 2010. De Facto Fiscal Space and Fiscal Stimulus: Definition and Assessment. NBER. (https://www.nber.org/system/files/working_papers/w16539/w16539.pdf).
- Alesina and Rodrik (1996). Income distribution, political instability, and investment. *European Economic Review*, 40(6), 1203–1228.; Banerjee and Newman. 1993. Occupational Choice and the Process of Development. *Journal of Political Economy*, Vol. 101(2)
- Amann, J., Cantore, N., Cali, M., Todorov, V., & Cheng, C. F. C.. 2021. Switching it up: The effect of energy price reforms in Oman. *World Development*, 142, 105252.
- Amann, J. and Grover, A. (2023) "The Energy Prices and Firm Competitiveness: Evidence from Chile" World Bank Working Paper
 Bachas, Gadenne, and Jensen. 2020. Informality, Consumption Taxes and Redistribution. NBER. (https://www.nber.org/system/files/working_papers/w27429/w27429.pdf).
- Banerjee, Hanna, Kreindler and Olken. 2017. Debunking the Stereotype of the Lazy Welfare Recipient: Evidence from Cash Transfer Programs (<https://elibrary.worldbank.org/doi/abs/10.1093/wbro/lkx002>).
- Banerjee, Abhijit, Esther Duflo, and Garima Sharma. 2021. "Long-Term Effects of the Targeting the Ultra Poor Program." *American Economic Review: Insights*, 3 (4): 471-86.
- Bank Negara Malaysia (BNM). 2022. Financial Stability Review, First Half 2022.
- Beaton, Christopher, Lucky Lontoh and Matthew Wai-Poi. 2017. Indonesia: Pricing Reforms, Social Assistance and the Importance of Perceptions in Inchauste and Victory (eds).
- Bloom DE, Cafiero-Fonseca ET, McGovern ME, Prettner K, Stanciole A, Weiss J, et al. The macroeconomic impact of non-communicable diseases in China and India: estimates, projections, and comparisons. *The Journal of the Economics of Ageing*. 2014;4(December 2014):100–11
- Buetzer, S., Habib, M.M., Stracca, L., 2016. Global exchange rate configurations: do oil shocks matter? *IMF Econ. Rev.* 64 (3), 443–470.
- Cali, M., Cantore, N., Iacovone, L., Pereira-López, M., & Presidente, G. (2022). Too much energy: The perverse effect of low fuel prices on firms. *Journal of Environmental Economics and Management*, 111, 102587; and Cali, M., Cantore, N., Marin, G., Mazzanti, M., Nicolli, F., & Presidente, G. (2023). Energy prices and the economic performance of firms in emerging countries. *Structural Change and Economic Dynamics*.
- Causa and Hermansen. 2019. Income Redistribution Through Taxes and Transfers Across OECD Countries
- Chaloupka F., Powell L., Warner, K. 2019. "The Use of Excise Taxes to Reduce Tobacco, Alcohol, and Sugary Beverage Consumption" *Annual Review of Public Health* 2019. 40:187–201.
- Christensen, J. M., G. A. Mackenzie, L. Nygaard, and M. B. Pederson. 2015. Enhancing Access to Electricity for Clean and Efficient Energy Services in Africa. Copenhagen: UNEP DTU (Technical University of Denmark) Partnership.
- Cornillie, J., and S. Fankhauser. 2004. "The Energy Intensity of Transition Countries." *Energy Economics* 26 (3):283–95.
- Coudert, V., Mignon, V., 2016. Reassessing the empirical relationship between the oil price and the dollar. *Energy Policy* 95, 147–157.
- Dauvin, M., 2014. Energy prices and the real exchange rate of commodity-exporting countries. *Int. Econ.* 137, 52–72.
- Davidson, O., and S. Mwakasonda. 2009. "Electricity Access for the Poor: A Study of South Africa and Zimbabwe" *Energy for Sustainable Development* 8 (4): 26–40.

References

- Dom, Roel, Anna Custers, Stephen Davenport, and Wilson Prichard. 2022. *Innovations in Tax Compliance: Building Trust, Navigating Politics, and Tailoring Reform*. Washington, DC: World Bank.
- Evans and Popova. 2014. *Cash Transfers and Temptation Goods: a Review of Global Evidence*.
- Fattouh, B., and L. El-Katiri. 2012. *Energy Subsidies in the Arab World*. Arab Human Development Report Research Paper Series, United Nations Development Programme, New York.
- Ferreira, Francisco H. G., Christoph Lakner, Maria Ana Lugo, and Berk Ozler. 2014. *Inequality of Opportunity and Economic Growth: A Cross-Country Analysis*. Policy Research Working Paper 6915. Washington, DC: World Bank
- Fuchs, Gonzalez Icaza and Paz. 2019. *Distributional Effects of Tobacco Taxation: A Comparative Analysis*
- Gaspar, Jaramillo and Wingender, *Tax Capacity and Growth: Is there a Tipping Point*, *IMF Working Paper*, WP/16/234. 2016.
- Gallina, Andrea, Gabriela Inchauste, Pavel Isa, Catherine Lee and Miguel Sánchez. 2017. *The Dominican Republic: From Generalized to Targeted Subsidies in Inchauste and Victor (eds.)*
- Galor and Zeira. 1993. *Income Distribution and Macroeconomics*. *The Review of Economic Studies*, 60(1), 35–52
- Grosh, Leite, Wai-Poi and Tesliuc. 2022. *Revisiting Targeting in Social Assistance: A New Look at Old Dilemmas*.
- Guillaume, D., R. Zyttek, and M. R. Farzin. 2011. "Iran—The Chronicles of the Subsidy Reform." Working paper WP/11/167, International Monetary Fund, Washington, DC.
- Handa et al. 2018. *Myth-busting? Confronting Six Common Perceptions about Unconditional Cash Transfers as a Poverty Reduction Strategy in Africa*. *The World Bank Research Observer*, vol. 33, no. 2 (2018).
- Hang, L., and M. Tu. 2007. "The Impacts of Energy Prices on Energy Intensity: Evidence from China" *Energy Policy* 35 (5): 2978–88.
- Hassanzadeh, E. 2012. "Recent Developments in Iran's Energy Subsidy Reforms." Policy Brief, Global Subsidies Initiative and International Institute for Sustainable Development, Geneva.
- Hendren, Nathaniel, and Ben Sprung-Keyser. 2020. *A Unified Welfare Analysis of Government Policies*. *Quarterly Journal of Economics* 135 (3): 1209–318.
- Hoy, Christopher. A., Yeon S. Kim, Minh Nguyen, Mariano E. Sosa and Sailesh Tiwari (2023). "Building Support for Energy Subsidy Reforms: Evidence from Middle Income Countries". forthcoming World Bank Policy Research Working Paper.
- Howells, M., D. G. Victor, T. Gaunt, R. J. Elias, and T. Alfstad. 2006. "Beyond Free Electricity: The Cost of Electric Cooking in Poor Households and a Market-Friendly Alternative." *Energy Policy* 34 (17): 3351–58.
- Inchauste, Gabriela, Yusuf Mansur and Umar Serajuddin. 2017. *Jordan: Reform amid Turmoil in Inchauste and Victor (eds.)*.
- Inchauste, Gabriela and David Victor (eds.). 2017. *The Political Economy of Energy Subsidy Reform*. Washington, DC: World Bank.
- Jha. 2018. *The health, poverty, and financial consequences of a cigarette price increase among 500 million male smokers in 13 middle income countries: compartmental model study*. (<https://pubmed.ncbi.nlm.nih.gov/29643096/>).
- Jha, P., Nugent, R., Verguet, S., Bloom, D., and Hum, R., 2012: *Chronic Disease in low and middle income countries*; Lomborg (ed) 2013. *Global Problems, Smart Solutions Costs and Benefits*, pp. 137 - 185 Cambridge University Press. DOI: <https://doi.org/10.1017/CBO9781139600484.005>

- Keefer and Knack. 2002. Polarization, Politics and Property Rights: Links between Inequality and Growth. *Public Choice*, vol. 111 (1-2), 127-54.; Clark, Andrew E., and Conchita D'Ambrosio. 2015. Attitudes to Income Inequality: Experimental and Survey Evidence. In *Handbook of Income Distribution*, vol. 2A, edited by Anthony B. Atkinson and Francois Bourguignon, 1127–1208. Handbooks in Economics. Amsterdam: North-Holland.
- Kingdon, John W. 1995. *Agendas, Alternatives, and Public Policies*. New York: HarperCollins College Publishers.
- Kojima, M. 2016. "Fossil Fuel Subsidy and Pricing Policies: Recent Developing Country Experience." Policy Research Working Paper 7531, World Bank, Washington, DC.
- Lustig (Ed.) 2022. *Commitment to Equity Handbook. Estimating The Impact of Fiscal Policy on Inequality and Poverty* (pp. 3-55). Brookings Institution Press. 2018. A second edition of the handbook is now available (2022).
- Meese, R.A., Rogoff, K., 1983. Empirical exchange rate models of the seventies: do they fit out of sample? *J. Int. Econ.* 14, 3–24.
- Mukherjee, Anit, Yuko Okamura, Ugo Gentilini, Defne Gencer, Mohamed Almenfi, Adea Kryeziu, Miriam Montenegro, and Nithin Umapathi. 2023. *Cash Transfers in the Context of Energy Subsidy Reform: Insights from Recent Experience*. ESMAP and World Bank.
- New Strait Times. 2023. Government approves entry of 500,000 foreign workers. Retrieved from <https://www.nst.com.my/news/nation/2023/01/871302/government-approves-entry-500000-foreign-workers>
- Obstfeld, M., and Rogoff K., 2000. The six major puzzles in international macroeconomics: is there a common cause? *NBER macroeconomics annual* 15 (2000): 339-390.
- OECD. 2018. *Taxation of Household Savings*, OECD Tax Policy Studies, No. 25, OECD Publishing, Paris
- Pew Research Center. 2014. Spring 2014 Pew Global Attitudes Survey. [online] (<https://www.pewresearch.org/global/2014/10/30/methods-in-detail-14/>).
- Rentschler, J., & Bazilian, M. (2017). Reforming fossil fuel subsidies: drivers, barriers and the state of progress. *Climate Policy*, 17(7).
- Rentschler, J., Flachenecker, F., & Kornejew, M. (2018). Assessing carbon emission savings from corporate resource efficiency investments: an estimation indicator in theory and practice. *Investing in Resource Efficiency: The Economics and Politics of Financing the Resource Transition*, 107-137.
- Rogoff, K.S. and Stavrakeva, V., 2008. The Continuing Puzzle of Short-horizon Exchange Rate Forecasting. NBER Working Paper 14071, National Bureau of Economic Research.
- Qiang, Christine Zhenwei; Liu, Yan; Steenbergen, Victor. 2021. *An Investment Perspective on Global Value Chains*. Washington, DC: World Bank
- UNDP. 2021. *Unified Social Registry: Towards an Efficient Social Protection System*. Issue Brief, March 2021.
- UNEP (United Nations Environment Programme). 2008. *Reforming Energy Subsidies: Opportunities to Contribute to the Climate Change Agenda*. Report commissioned by the Division of Technology, Industry and Economics, UNEP, Geneva.
- Vagliasindi, Maria. 2012. *Implementing Energy Subsidy Reforms: An Overview of the Key Issues*. World Bank Policy Research Working Paper 6122. Washington, DC: World Bank.
- Victor, D.G. 2011. *Global Warming Gridlock: Creating More Effective Strategies for Protecting the Planet*. New York: Cambridge University Press.

References

Winkler, H., ed. 2006. Energy Policies for Sustainable Development in South Africa: Options for the Future. Rondebosch, South Africa: Energy Research Centre, University of Cape Town.

Wagenaar A., Tobler A., Komro K. 2010. Effects of alcohol tax and price policies on morbidity and mortality: a systematic review. *American Journal of Public Health*, 100(11), 2270–2278. <https://doi.org/10.2105/AJPH.2009.186007>

World Bank. 2012. BLT Temporary Unconditional Cash Transfer. Washington, DC: World Bank.

World Bank. 2012. Targeting the Poor and Vulnerable in Indonesia. Washington, DC: World Bank. World Bank. 2016. Poverty and Shared Prosperity 2016: Taking on Inequality. Washington, DC: World Bank.

World Bank. 2019. Aiming High: Navigating the Next Stage of Malaysia’s Development. Washington, DC: World Bank.

World Bank. 2020. Investing in People: Social Protection for Indonesia’s Vision 2045. World Bank. 2021. East Asia and Pacific Economic Update (April) and World Bank. 2020. East Asia and Pacific Economic Update (October). Washington, DC: World Bank.

World Bank. 2021. Malaysia Economic Monitor: Staying Afloat. Washington, DC: World Bank.

World Bank. 2021 Indonesia Economic Prospects June 2021. Washington, DC: World Bank.

World Bank. 2022. Collapse and Recovery: How the COVID-19 Pandemic Eroded Human Capital and What to Do about It. Washington, DC: World Bank.

World Bank. 2022. Catching Up: Inclusive Recovery & Growth for Lagging States. Washington, DC: World Bank.

World Bank. 2022. Correcting Course. Washington, DC: World Bank.

World Bank. 2022. Charting a Course Towards Universal Social Protection: Resilience, Equity, and Opportunity for All. Washington, DC: World Bank. and ASPIRE database - www.worldbank.org/aspire

World Bank. 2023. COVID-19 Impact and Recovery among Malaysian Households: High-Frequency Phone Survey - Round 3 (April 10 - May 15, 2022). Washington, DC: World Bank.

World Bank. 2023. Crisis and Recovery: Learning from COVID-19’s Economic Impacts and Policy Responses in East Asia, Chapter 3: Malaysia. Washington, DC: World Bank.

World Bank. 2023. Global Economic Prospects, June 2023. Washington, DC: World Bank.

World Bank. 2023. East Asia and Pacific Economic Update, September 2023. Washington, DC: World Bank.



CONNECT WITH US



wbg.org/Malaysia



[@WorldBankMalaysia](https://www.facebook.com/WorldBankMalaysia)



[@WB_AsiaPacific](https://twitter.com/WB_AsiaPacific)



http://bit.ly/WB_blogsMY

