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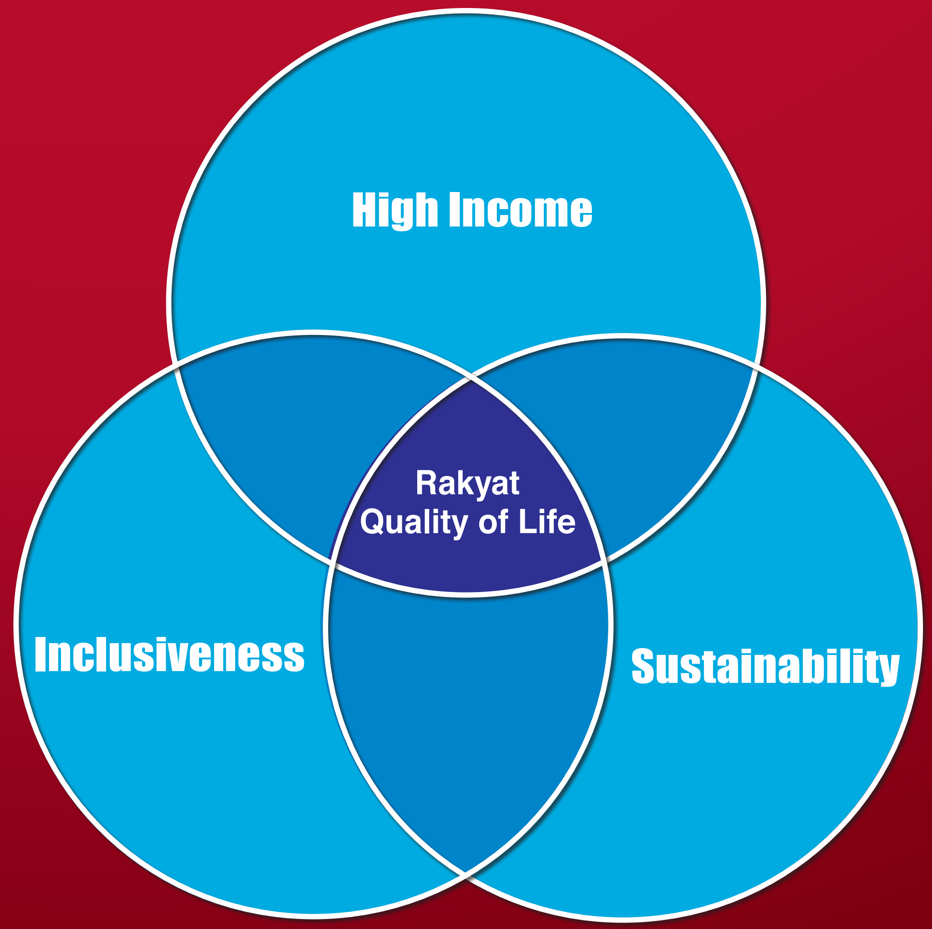
PART 1 NEW ECONOMIC MODEL FOR MALAYSIA

NEAC

NEW ECONOMIC MODEL FOR MALAYSIA
PART 1



NATIONAL ECONOMIC ADVISORY COUNCIL

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NEW ECONOMIC MODEL FOR MALAYSIA

Part I: Strategic Policy Directions

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Preface

This report is the first of two documents by the National Economic Advisory Council (NEAC) on the New Economic Model (NEM). This report presents an overall framework of the NEM for transforming Malaysia from a middle income to an advanced nation by 2020. It was developed following a series of meetings of the NEAC beginning in 2009 and consultations with stakeholders in the business sector, government, labour unions, academia and others. It is intended that this report will serve as the basis for formulating the policy measures and the implementation plan in the final document that follows.

The independent work of the NEAC is an important component of the government's 1Malaysia concept and programme. The NEM will define the Strategic Reform Initiatives (SRIs) that will propel Malaysia to the goals first set forth in Vision 2020. In the Budget 2010 Speech in October 2009, the Prime Minister and Minister of Finance, YAB Dato' Sri Mohd. Najib Tun Abdul Razak, emphasised high-skilled human capital, efficient public services, a reinvigorated private sector and equal opportunity for all Malaysians. The NEAC embraces these themes in the NEM.

The rest of the report is structured as follows.

Chapter 1: Why Do We Need the NEM and What Are Its Goals? briefly presents the goals and characteristics of the NEM. It also touches on the enabling actions and the bold policy measures underlying the Strategic Reform initiatives (SRIs) of the Economic Transformation Programme (ETP) to deliver the goals of the NEM.

Chapter 2: Where Are We? sets forth Malaysia's current position and the challenges we face going forward. In the aftermath of the Asian financial crisis the country has posted mediocre and subdued growth recovery, mainly attributed to low and stagnant private investment. While the export sector is an important growth driver, outputs are mainly low value added, reflecting a lack of innovation, a low-skilled labour force, and conditions that constrain business development. Commodities, which have benefited from price increases during the last half-decade, form the bulk of the remaining exports.

Chapter 3: What Is Happening Around Us? focusses on the much more challenging environment within which Malaysia must manage its affairs, in particular its economic management. The global landscape is changing with leading countries exhibiting a new set of distinguishing characteristics; governments responding more rapidly to economic pressures; environmental issues driving policy considerations and competitive advantages; profits and productivity being driven by openness and leveraging networks; and human capital advancing and flowing between global markets more readily.

Chapter 4: Which Advantages Do We Have? highlights some of the strengths that have contributed towards Malaysia's past successes and new ones that it can leverage to meet its present challenges. The country's advantages include its diverse population, rich biodiversity and resources, strategic location in a high growth region, a well-established manufacturing base and an attractive standard of living in urban areas.

Chapter 5: Where Do We Want To Be? describes in detail the main objectives of the New Economic Model. Malaysia wants to be a developed and competitive economy whose people enjoy a high quality of life having attained a high level of income which is the result of growth that is both inclusive and sustainable by 2020.

Chapter 6: How Do We Get There? sets forth the transformation journey for the economy; the policy measures, institutional and regulatory reforms to reshape the incentive structures to deliver the eventual outcomes. This will require political leadership to effect the necessary push anchored by a set of strategic policy initiatives.

Finally, **Chapter 7: The Time for Change Is Now – Malaysia Deserves No Less** outlines the next steps with regard to the development of specific measures for the ETP.

Message from the NEAC

The National Economic Advisory Council (NEAC) was inaugurated by the Prime Minister of Malaysia with a specific mandate to formulate a New Economic Model (NEM) that will drive Malaysia's transformation into an advanced nation by 2020.

The task is challenging but vitally necessary and urgent. Two decades have passed since Vision 2020 was launched in 1991. Malaysia is today at a crossroads. The country has come far; it is prosperous and living standards for its people are high. But Malaysia has much further still to go this next decade before it can be an advanced nation with high income, launched onto a path of inclusive and sustainable economic growth.

Achieving this goal requires speedy removal of multiple barriers that have weighed on Malaysia's growth potential. For some time now, the economy could not grow at its fullest potential. It is time to dismantle the barriers and unleash the power for Malaysia to zoom ahead. The only way this can happen is with a bold approach that is nothing less than a major overhaul – incremental tweaks here and there just will not work. With regard to this, the NEAC is honoured to have been given the mandate to provide fresh ideas and directions to transform Malaysia in a meaningful, far reaching and attainable way.

In reaching our recommendations, the NEAC has analysed Malaysia's core economic issues. It has discussed those extensively with stakeholders, ranging from business leaders and government officials to civil society groups and academia. The NEAC wishes to express its thanks to all who contributed to the ideas here.

The NEAC's work does not stop with the publication of the report. Much more needs to be done. Input and feedback are needed on the practical issues facing this formidable transformational process. With support and help from all, Malaysia will have begun the next leg of its journey to become an advanced nation. In the next few months, a strategic implementation plan complete with specific policy measures will be announced, after further consultations with all stakeholders.

30 MARCH 2010

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Glossary of acronyms

APEX	Accelerated programme for excellence
ASEAN	Association of South East Asian Nations
BNM	Bank Negara Malaysia
DDI	Domestic direct investment
EDMC	Energy Data and Modelling Centre, Japan Institute of Energy Economics
E&E	Electrical and electronics
EPF	Employees Provident Fund
EPU	Economic Planning Unit
ETP	Economic Transformation Programme
FDI	Foreign direct investment
FPI	Foreign portfolio investment
FTA	Free trade agreement
GDP	Gross domestic product
GLC	Government-linked company
GNI	Gross national income
GNP	Gross national product
GST	Goods and Services Tax
GTP	Government Transformation Programme
ICT	Information and communication technology
IPR	Intellectual property rights
ITRI	Indistrial Technology Research Institute, Taiwan
KPI	Key performance indicator
KRIS	Khazanah Research and Investment Strategy
MDI	Malaysian Development Institute
MIDA	Malaysian Industrial Development Authority
MNC	Multi-national corporation
MOE	Ministry of Education
MOHE	Ministry of Higher Education
MPC	Malaysia Productivity Corporation
NEAC	National Economic Advisory Council

NEM	New Economic Model
NEP	New Economic Policy
NKRA	National Key Result Areas
OECD	Organisation of Economic Cooperation and Development
OEM	Original equipment manufacturing
PEMANDU	Performance Management and Delivery Unit
R&D	Research and development
SME	Small and medium enterprise
SPM	Sijil Pelajaran Malaysia
SRI	Strategic Reform Initiative
TFP	Total factor productivity
UNEP	United Nations Environment Programme
WDI	World Development Indicators

Executive Summary

Executive Summary

Malaysia has reached a defining moment in its development path. Vision 2020 is not possible without economic, social and government transformation. To move the country forward, the government has crafted a framework comprising four pillars to drive change (Figure A). The **New Economic Model (NEM)** to be achieved through an **Economic Transformation Programme (ETP)** constitutes a key pillar which will propel Malaysia to being an advanced nation with inclusiveness and sustainability in line with the goals set forth in *Vision 2020*. The ETP will be driven by eight Strategic Reform Initiatives (SRIs) which will form the basis of the relevant policy measures.

Figure A – The four pillars of national transformation

Two other pillars have been launched over the past year. They are the *1Malaysia, People First, Performance Now* concept to unite all Malaysians to face the challenges ahead and the *Government Transformation Programme* (GTP) to strengthen public services in the National Key Result Areas (NKRAs). The last pillar is the *10th Malaysia Plan 2011-2015* to be unveiled later this year.

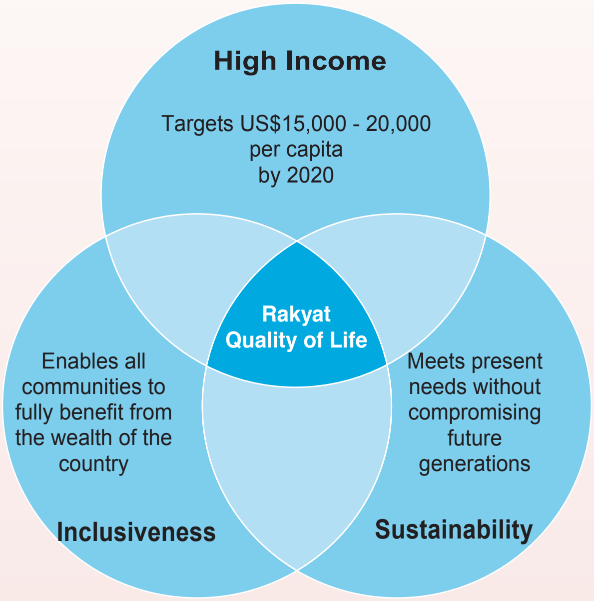
WHY DO WE NEED THE NEM AND WHAT ARE ITS GOALS?

The old growth model provided three decades of outstanding performance, permitting Malaysia to provide for the health and education of its people, largely eradicate poverty, build a world-class infrastructure and become a major exporter globally. Our people are wealthier and better educated. They live longer, travel more and have greater access to modern technologies than any previous generation.

But the progress we have made over the past half-century has slowed and economic growth prospects have weakened considerably. We are caught in a middle income trap – we are not amongst the top performing global economies. Amid changes in the external environment, many of the policies and strategies we used to achieve the current state of development are now inadequate to take us to the next stage. Our economic growth has come at considerable environmental cost and has not benefited all segments of the population. The government must confront these realities and make tough decisions.

We urgently need a radical change in our approach to economic development which will be sustainable over the long-term, will reach everyone in the country and will enable Malaysia to reach high income status. The NEM will be the catalyst to unleash Malaysia's growth potential. The ETP is designed to drive Malaysia forward from its current stagnant situation to be a high income economy which is both inclusive and sustainable (Figure B). The NEAC believes that by consistently implementing bold policies across eight SRIs, the fundamentals of doing business in Malaysia will be changed from the old approach, enabling the private sector to step up and make a full contribution to growth.

Figure B – Goals of the New Economic Model



But the NEM strives for broader goals than just boosting growth and attracting private investment. The NEM takes a holistic approach, focussing also on the human dimension of development, recognising that while we have substantially reduced poverty, a hefty 40% of Malaysian households still earn less than RM1,500 a month. Income disparity must still be actively addressed. Measures are needed to narrow the economic differences prevalent in Sabah and Sarawak as well as in the rural areas of the Peninsula.

This report examines critically the question 'Where are we?' within the context of 'What is happening around us?' and 'Which advantages do we have?' to present the case for the urgent changes required. The NEM has a clear vision about 'Where do we want to be?" and highlights the tough decisions and bold measures in charting the path to 'How do we get there?' The time for change is now – Malaysia deserves no less.

WHERE ARE WE?

Malaysia is and will remain an open economy – for better and for worse. Openness to the world economy enabled strong economic development and rising per capita income. However, being an open and small economy, Malaysia has been susceptible to external shocks, as seen during the past crises. Increases in international commodity prices, like fuel or food, have direct impact on domestic prices. Similarly, unless production costs and productivity in Malaysia can keep pace with those abroad, exports are likely to lose ground with negative effects on national employment and income.

Malaysia's economic engine is slowing. Since the Asian financial crisis of 1997-1998, Malaysia's position as an economic leader in the region has steadily eroded. Growth has been lower than other crisis-affected countries, while investment has not recovered.

Private investors have taken a back seat. Since the Asian crisis, aggregate investment as a share of GDP in Malaysia has continued to decline, with private investment remaining stagnant due to several factors. In some industries, heavy government and government-linked company (GLC) presence has discouraged private investment.

Doing business in Malaysia is still too difficult. Cumbersome and lengthy bureaucratic procedures have affected both the cost of investing, and the potential returns on investment. Malaysia's place within the Global Competitiveness Index dropped to 24th in the 2010 report from 21st previously, indicating that the country is losing its attractiveness as an investment destination.

Our exports are still strong but not generating enough value added. The economy is highly dependent on external markets, with an export-to-GDP ratio of 1.2 and a trade-to-GDP ratio of 2.2 in 2008. Malaysia's export structure has focussed mainly on electrical and electronics (E&E) products and on primary commodities such as petroleum and palm oil. However, given the large import content in the manufactured exports, the value added to the final product has been low.

Low skills jobs equal low wages. Skilled jobs are most often synonymous with higher wages. In Malaysia, not enough high wage jobs have been created and the share of skilled labour has declined across industries. In many instances, employers do not pay for skills, relying instead on a readily available pool of unskilled foreign workers and underpriced resources – made possible by government policies – to generate profits from production of low value added products and services. These factors have also largely dampened wage growth.

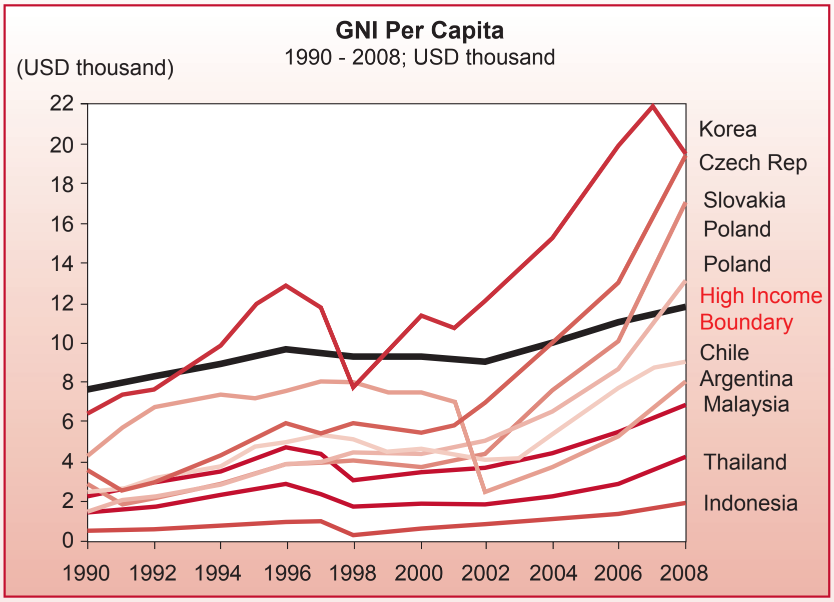
Productivity is growing but far too slowly. Before the Asian financial crisis, Malaysia was leading the region in labour productivity growth. It has since lost the pole position. The weak productivity growth highlights the stark reality that Malaysia still lacks creativity and innovation – as shown in stagnant contribution by total factor productivity and education to output growth.

Efforts to innovate and create have been insufficient. The weak track record of domestic innovation in Malaysia is reflected by the comparatively low number of researchers. Low R&D expenditure results in a lack of innovation in the industrial and export sectors.

We are not developing talent and what we have is leaving. The human capital situation in Malaysia is reaching a critical stage. The rate of outward migration of skilled Malaysians is rising rapidly. Just as serious is the fact that the number of expatriates working in the country has been steadily declining. At the same time, the education system is not producing the skills demanded by firms. The Department of Statistics reports that in 2007, 80% of Malaysia's workforce received education only up to Sijil Pelajaran Malaysia (SPM). Skill shortage, together with complaints about inadequate creativity and English proficiency, consistently ranks high among the top obstacles faced by firms according to studies on Malaysia's investment climate.

The gap between rich and poor is widening. In the past few decades, against the backdrop of strong economic growth and the New Economic Policy (NEP), Malaysia has significantly reduced overall poverty levels across all ethnic groups. Despite slower growth post-Asian crisis, the incidence of poverty continued to decline to 3.6% in 2007. Inequality, however, remains a real challenge for Malaysia. Moreover, household income surveys suggest that income growth has been strong only for the top 20% of Malaysian income earners. The bottom 40% of households have experienced the slowest growth of average income, earning less than RM1,500 per month in 2008.

Figure C – GNI Per Capita (1990-2008; USD thousand)



Source: Nationmaster, UN, World Bank

Malaysia is stuck in a middle income trap. Malaysia briskly climbed the ladder to attain upper middle income status by 1992, but its economy has become sluggish since then (Figure C). Historically, it has been much easier for a low income country to make the transition to middle income status when they make good use of their natural resources or low cost advantage to attract investment. But the low cost advantage is a fleeting moment that ends when other low-cost centres emerge. Without new niches and strategic reform plans, many countries have been unable to break out of the middle income category – a phenomenon that has been termed the 'middle income trap'.

Our shortcomings are preventing us from getting out of the middle income trap. Almost all economies of East Asia are poised to achieve high economic growth in this decade. But Malaysia runs the imminent risk of a downward spiral and faces the painful possibility of stagnation.

Ethnic-based economic policies worked but implementation issues also created problems. The NEP has reduced poverty and substantially addressed inter-ethnic economic imbalances. However, its implementation has also increasingly and inadvertently raised the cost of doing business due to rent-seeking, patronage and often opaque government procurement. This has engendered pervasive corruption, which needs to be addressed earnestly.

Controlled pricing systems and subsidies result in resource misallocations. The pricing of essential goods and services in Malaysia does not reflect market prices. The mispricing leads to excessive consumption and wastage. At the same time, the large government outlay on subsidies – mostly funded by petroleum proceeds – is not sustainable. The subsidies were meant to support the vulnerable groups but it has benefited a wider group, including the well off. It is time for a more targeted approach rather than broad-based subsidies.

Low-cost business models made possible by pricing and policy distortions encourage a private sector focus on short-term profits. The private sector is not investing in products and services that will drive future growth. This is reflected by low investment in R&D, lack of interest in innovating products and processes to move up the value chain, and hence a strong disinterest to build skills and pay higher wages for improved productivity.

We must act now before our position deteriorates any further.

WHAT'S HAPPENING AROUND US?

To act effectively, we need to understand and appreciate what is happening around us. Due to the global financial crisis, the advanced countries will grow slower in the near future and many countries are revisiting their growth strategy.

New global leaders are emerging and Malaysia must be one. The global financial crisis is creatively destroying the old order, opening up opportunities in the new. The pre-crisis era of overwhelming economic dominance by the G-7 is over. The new world growth engines, such as 'BRIC" (Brazil, Russia, India and China) and other emerging economies like Indonesia, will grow faster and richer, have strengthened their voice in the G-20 and are set to play a more prominent position on the world stage.

Globalisation has created a fierce competition for talent, forcing companies and government to recognise that people are the most valuable assets. To compete on a regional and global scale, Malaysia must retain and attract talent. Malaysia must be seen by its people and by others as a land of equal opportunity to earn a good living and provide a secure, happy life for each individual and the family.

WHICH ADVANTAGES DO WE HAVE?

While Malaysia faces daunting challenges amid rapid global changes, we can draw on a number of strengths and unique advantages as we take purposeful policy actions to move forward.

We are not poor and have good infrastructure. As a nation, Malaysia largely eradicated poverty and moved into the upper middle income category in the early 1990s. Substantial investment has resulted in the building of a world-class infrastructure in Malaysia. Good infrastructure has contributed to the leadership that Malaysia enjoys in E&E manufacturing and major natural resource exports, which can be leveraged for more high value added activities. It also provides Malaysia with the potential to further develop its logistics sector.

We have established a world-class manufacturing base. Manufacturing has been the fastest growing sector of the economy over the past. Manufacturing was primarily focussed on the E&E sector by attracting large inward investment by multinational firms. The E&E sector spawned the growth of other sectors in supply, logistics and services. Malaysia has become a major exporter of consumer and industrial electronic products. It is now poised to make the next technological leap to more innovative and higher value added, cutting-edge technology industries.

Malaysia is at the heart of a vibrant region. Malaysia's strategic location will serve to attract investment to build transportation and logistics hubs. Malaysia's rich endowments will help to attract foreign direct investment (FDI) and foreign portfolio investment (FPI) from China, India and East Asia as these countries seek currency stability through diversity, access to natural resources, and niche markets that reinforce bilateral ties.

Malaysia is a model of cultural, ethnic and biological diversity. Malaysia's rich and unique cultural heritage – and even its colonial history – are assets for forging relationships with many countries, especially in the high growth economies of China, India, the Middle East and Indonesia. Furthermore, Malaysia's diverse language networks help to support the development of tourism and industry links in those same markets. Malaysia's rich biodiversity can be harnessed to generate economic benefits from tourism, recreation, pharmaceutical applications and nutritional products.

WHERE DO WE WANT TO BE?

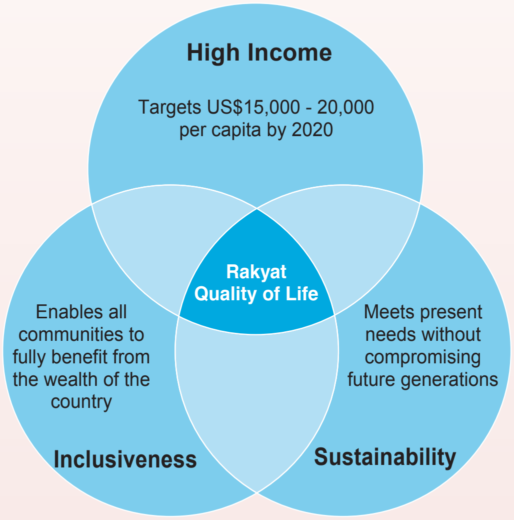
The main goals of the NEM are that Malaysia will become a high income advanced nation with inclusiveness and sustainability by 2020 (Figure D). No one goal should be achieved at the expense of the others. In striving to achieve those goals, we cannot take the short-cut of pump-priming with wealth from natural resources, which is not sustainable. Nor can we completely leave things to market forces and ignore the need to preserve social harmony. After achieving advanced nation status, maintaining that position will require continuous efforts well beyond 2020.

Breaking through to high income status

Sustained and full implementation of reform measures proposed by the NEAC will drive Malaysia's transformation into a high income economy by 2020. The NEAC foresees that bold reform measures will unlock investment, drive labour productivity and boost efficiency, lifting real growth rate to an average of 6.5% per annum over the 2011-2020 period. Per capita GNP will rise to about USD17,700 by 2020. This scenario assumes that globally there will not be another major economic crisis to derail the Malaysian economy from this growth path.

If the GDP growth target is to be achieved, aggregate demand will have to grow at a robust pace. Investment will be the main

Figure D – The New Economic Model: Goals and characteristics



Characteristics of Malaysia in 2020

- **Market Led**
- **Well-Governed**
- **Regionally Integrated**
- **Entrepreneurial**
- **Innovative**

driver of economic growth through 2020. The contribution from private investment must return rapidly to a significant level last seen in 1997, reaching almost a fifth of GDP by 2020 compared with about a tenth in 2010.

Sustained growth will also be supported by fiscal prudence. The NEM calls for a further reduction of the fiscal deficit to a near-balance by 2020. The fiscal deficit of the Federal Government, at 7.4% of GDP, reached a peak in 2009 and is expected to decline to 5.6% of GDP in 2010. Market sentiment will further improve if the fiscal deficit is brought down even lower.

Generating benefits for all Malaysians

Inclusiveness is the second goal and a key part of the NEM. It is a prerequisite for fostering a sense of belonging. Pro-poor growth will warrant that no groups will be marginalised and the essential needs of the *rakyat* will be satisfied. Families will be endowed with the opportunity and capabilities to pursue their aspirations in connected, sophisticated modern cities, townships and villages. They will live, work and study in localities free from the fear of crime, the indignity of discrimination, and the anxiety of need. Inclusiveness will enable all communities to contribute to and share in the wealth of the country. While perfect equality is impossible, an inclusive society will ensure that inequality does not worsen.

Ethnically divided societies are more prone to violent conflicts. The multi-racial composition of the Malaysian population is still its outstanding feature and this ethnic diversity will always be with us. But the excessive focus on ethnicity-based distribution of resources has contributed to growing separateness and dissension.

A key challenge of inclusive growth is the design of effective measures that strike a balance between the special position of bumiputra and legitimate interests of different groups. Hence, the market-friendly affirmative action programmes in line with the principle of inclusiveness will:

- Target the assistance to the bottom 40% of households – of which 77.2% are *bumiputera* and many are located in Sabah and Sarawak
- Ensure equitable and fair opportunities through transparent processes
- Allow access to resources on the basis of needs and merit to enable improvement in capacity, incomes and well-being
- Have sound institutional framework for better monitoring and effective implementation

Transparent and market-friendly affirmative action programmes focus on building capacity and capability of low-income households and small businesses, instead of imposing conditions to meet specific quotas or targets. The ETP will provide for mechanisms to strengthen the capability of the bottom 40% so that they can take advantage of opportunities to secure better jobs, raise their productivity and grow their income. This group will be assisted with programmes to build skills so that they can use their entrepreneurial instincts to start up and grow their businesses. This will significantly improve their livelihood, life chances and prospects. Past practices that gave rise to unhealthy and pervasive rent-seeking and patronage activities will be discontinued.

An economically and environmentally enduring solution

The sustainability component of the NEM is meant to ensure that all of the proposed measures defined under the new model must be sustainable in both economic and environmental terms. Malaysia's dependence on natural resource consumption as the primary engine of growth is clearly not sustainable on either dimension. This is not to suggest that exploitation of natural resources should not be a key component of national production. But it does mean that under the new model, investment and policy decisions will only be made after full consideration of their long-term impact on the society, the economy as a whole, and of course the environment.

Economic sustainability will be ensured through the establishment of the fiscal discipline needed to safeguard macroeconomic balance and financial stability. Public sector reform is an important component of long-term fiscal sustainability and is a key component of the NEM. Ongoing reform of the civil service, including staff up-skilling and retraining, will be key to increasing the efficiency of public services and making it more customer-focussed.

Environmental sustainability will be achieved by rejecting the traditional approach to economic growth that has grossly neglected the environment. Although there has been a veneer of concern for the environment, past policies focussed on delivering growth first, and dealing with the environment later. In the future, equal emphasis must be placed on both protection of the environment and economic growth. The conventional GDP measurement of economic growth does not take into account the costs to society arising from environmental degradation. The recent development of the 'Green GDP' concept will allow proper consideration of the impact of growth on the environment and the appropriate design of measures to address environmental concerns.

The NEM seeks sustainable growth that meets the ongoing needs of the population without compromising future generations by effective stewardship and preservation of the natural environment and non-renewable resources. This new approach will be particularly relevant to the management of water, and oil and gas resources.

The ultimate beneficiaries: Rakyat and businesses

The NEAC anticipates a series of benefits that would accrue to all Malaysians if the NEM policy measures are consistently and fully implemented. We must recognise however, that the various benefits will be realised over a period of time. In the meantime, some segments of the population may perceive greater negative impact than benefit, or that they are receiving less benefits than others. The government must be able to convey the ultimate equity of the benefits over time, urge a commitment to the process, and create a vision of the long-term common good.

In consideration of the need for proper timing and sequencing of policy actions, the ETP will put in place an enhanced safety net and a transformation fund to cushion the various communities in the transition period before the benefits are fully realised. The public will need to better appreciate that orderly adjustments and changes must take place if the goals of the NEM are to be achieved. Benefits for the rakyat from the NEM are listed in Table A.

Table A – Benefits to the *rakyat*

In a high income economy, the rakyat can expect:	All rakyat will feel included as a result of:	A sustainable approach will provide the rakyat with:
• More choices and higher purchasing power • Better quality of life • Opportunities for upward mobility • Reward for innovation and creativity • Greater confidence in the robustness of the economy	• Living and working in safe surroundings • Equal and easy access to information • Mutual respect and individual dignity • Every part of the nation – be it a state, a city, a town or a village – matters • The poor will not be forgotten	• Confidence in the government • Improved environment • Sustained growth • Sound management and preservation of resources

Benefits for businesses will result from greater equity in the environment, a more effective ecosystem and a more efficient market to facilitate investment and operations (Table B).

Table B – Benefits to businesses

An equitable environment in which investors will thrive includes:	An effective ecosystem for business operations will include:	An efficient market will provide investment and growth opportunities through:
• **Business Rights.** Due recognition of rights and responsibilities of business owners • **Rule of Law.** Ability to manage businesses with the assurance of a fair and credible legal system • **Ownership Freedom.** Freedom to fully own businesses and choose partners • **Intellectual Property.** Intellectual assets will be protected • **SME Recognition.** Regulations are appropriate and proportionate to small businesses • **Market Transparency.** Absence of rent-seeking and quotas, with support to businesses based on market principles	• **Public Services.** Faster approvals across the board • **Licensing Efficiency.** Elimination of unnecessary licensing and undue regulatory burden • **Dynamic Clusters.** Benefit derived from scale through industry clustering and networking • **Human Capital.** Improved access to the best talent based on ability to pay • **Funding.** Flexible and prompt access to SME funding under strong governance rules • **Efficient Courts.** Swift resolutions of legal disputes • **Transformation Fund.** Fair access to special assistance during the economic transition period • **Regional Integration.** An integrated regional market and support to grow into regional champions.	• **Transparency.** Confidence in the openness and fairness of government tenders • **Fair Market Pricing.** With minimal exceptions, subsidies and price controls will be eliminated • **Barrier Free.** Liberalisation of all sectors. • **Fair competition.** Ability to operate on a level playing field created by the enactment of a competition law • **Public-Private Partnership.** More opportunities to collaborate with the public sector and GLCs

Core characteristics of the NEM

What will Malaysia look like in 2020? The NEM will create a Malaysia in the future that will be renowned for vibrant transformation arising from the resourcefulness of its people exemplified by its harmonious diversity and rich cultural traditions. The economy will be *market-led*, *well-governed*, *regionally integrated*, *entrepreneurial* and *innovative*.

The private sector will be the main driver of growth in market-led investment and production increasingly dominated by high value added goods and services in a competitive environment. The government will be an efficient facilitator through a streamlined, proportionate, market-focussed and supportive regulatory framework. Government will retain a role to manage disruptions from inevitable market failures. Well-governed and leaner government institutions will be held accountable to performance-based outcomes in line with the GTP and have highly qualified staff with multi-tasking capabilities while showing flexibility as well as dynamism. Private firms, non-government entities and civil society will aspire to internationally accepted governance standards. The NEM will provide the framework and environment to engender the entrepreneurial spirit to make the most of growth opportunities from available financing. Innovative and state-of-the-art technology will generate high value added products, services and creative processes in the technical, social and institutional areas. All these will feed into an expansion of markets through regional integration in trade and services and by shaping cross-border production networks and supply chains.

The NEM – A new way of 'doing business' in Malaysia

In moving Malaysia towards the core characteristics of the NEM, the NEAC advocates a new and bold approach to unleash the country's growth potential. This new approach is best illustrated by a contrast to some elements of the old approach (Table C).

Table C – Approach to economic development: the old versus NEM

Old Approach		New Approach
1	**Growth primarily through capital accumulation**. Focus on investment in production and physical infrastructure in combination with low skilled labour for low value added exports	**Growth through productivity**. Focus on innovative processes and cutting-edge technology, supported by healthy level of private investment and talent, for high value added goods and services
2	**Dominant state participation in the economy**. Large direct public investment (including through GLCs) in selected economic sectors	**Private sector-led growth**. Promote competition across and within sectors to revive private investment and market dynamism
3	**Centralised strategic planning**. Guidance and approval from the federal authorities for economic decisions	**Localised autonomy in decision-making.** Empower state and local authorities to develop and support growth initiatives, and encourage competition between localities
4	**Balanced regional growth**. Disperse economic activities across states to spread benefits from development	**Cluster- and corridor-based economic activities**. Concentration of economic activities for economies of scale and better provision of supporting services
5	**Favour specific industries and firms**. Grant preferential treatment in the form of incentives and financing to selected entities	**Favour technologically capable industries and firms**. Grant incentives to support innovation and risk-taking to enable enterpreneurs to develop higher value added products and services
6	**Export dependence on G-3 (US, Europe and Japan) markets**. Part of production chain to supply consumer goods and components to traditional markets	**Asian and Middle East orientation**. Develop and integrate actively into regional production and financial networks to leverage on flows of investment, trade and ideas
7	**Restrictions on foreign skilled workers**. Fear that foreign talent would displace local workers	**Retain and attract skilled professionals**. Embrace talent, both local and foreign, needed to spur an innovative, high value added economy

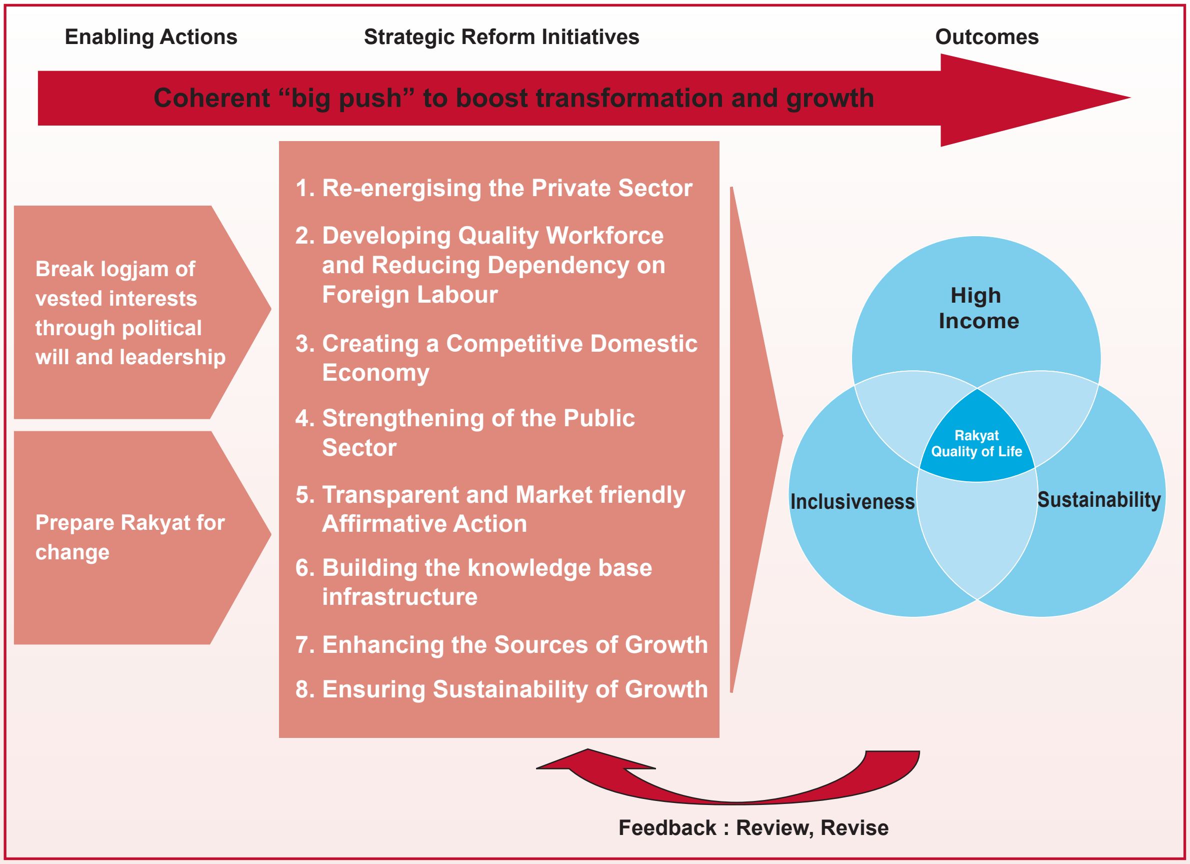
HOW DO WE GET THERE?

Malaysia needs urgent transformation. This will be provided by the NEM through eight SRIs and the ETP. The most important enablers of the NEM are *political will and leadership to break the log-jam of resistance by vested interest groups* and *preparing the rakyat* to support deep seated changes in policy directions (Figure E). With these enablers in place, a '*big push'* in policy actions and initiatives is needed to kick start the transformation process. The push must create enough momentum to overcome the resistance which could stall progress. Once reforms are started, continuous feedback is necessary to fine-tune policies and stay on course.

Unwavering leadership and political will

Political will and leadership must put emphasis on coherent explanation of the vision and agenda of the NEM and transformation process. This requires the path of the NEM to be laid out in detail, including indications of where actions may negatively affect different segments of society. The aim is

Figure E – The New Economic Model: Enablers and Strategic Reform Initiatives



to create an unstoppable wave of support from all segments of society for this vision. But to start this process, the government is aware that it has to make extremely tough decisions in order to meaningfully put in place a critical mass of bold measures. The political leadership must be clear about the trade-offs involved in making some of these tough decisions.

The government must take prompt action when resistance is encountered and stay the course. Resistance is likely to come from the business community including protected industries, employers of foreign labour, licence holders, beneficiaries of subsidies, and experts at doing business the old way. Some segments of the *rakyat* who no longer qualify for government subsidies and grants might react strongly, and those that have enjoyed secure jobs and a stable lifestyle from protected firms may feel threatened and object. Each individual player will be tempted to look at the NEM from the perspective of "winners" or "losers". For this reason it is important to clearly communicate the vision of the NEM to bring everyone on board.

The NEAC assigns a large measure of importance to the government's proper management of the political situation. Peace and harmony must be preserved in Malaysia in the midst of the likely, but temporary, disruptions from the ETP.

Getting the rakyat to drive change together

Garnering the support of stakeholders and ordinary Malaysians for the NEM is a political process, one best understood by the political leadership. However, the NEAC envisions a number of critical steps in this national engagement to prepare for and implement the ETP. But even as that public communication proceeds, the same team tasked with monitoring the implementation of the ETP must put in place a rigorous technical process to gather information for reporting on the progress of the ETP to all stakeholders. Engagement with all stakeholders is important for two reasons: first, to foster buy-in through clear communication; and second, to see refinement and improvement in policy actions. At the same time, the political and intellectual leadership must continue to be at the forefront of this transformation process.

A 'big push' of synchronised policy measures and initiatives

With the leadership and *rakyat* on board, a *big push* in the form of a critical mass of policy measures derived from the SRIs must be announced. Due to the cross-cutting nature of the Strategic Reform Initiatives, the sequencing of policy actions is crucial for achieving impact and results. Some policy actions could be immediately implemented. Others may be introduced at a later date because they require a longer preparation period. However, this preparation must commence immediately. Piecemeal and incoherent introduction of policy would be inconsistent with the cross-cutting nature of the SRIs. The policy measures in line with the SRIs must move in tandem to deliver high income in an inclusive and sustainable manner.

Measuring our performance and adjusting as we go

Most reform efforts have strategies and implementation plans but often lack a rigorous feedback mechanism to assess implementation effectiveness and allow for adjustment measures. Often, while a policy or strategy is being implemented, the circumstances for achieving the objectives may have changed and rendered earlier policy actions less viable. Without a formal feedback mechanism, policy adjustments may become ad hoc and uncoordinated, resulting in diffused implementation with little accountability and limited channels to deal with public complaints. The result is reform failure which in turn affects credibility and gives rise to questions about accountability of the implementing institution. The NEM must have a rigorous feedback mechanism to monitor its progress, its acceptability by the public as well as the need for adjustment and fine-tuning in response to domestic and international circumstances.

Strategic Reform Initiatives (SRIs)

The NEAC believes that it is critical to seek stakeholder buy-in of the detailed implementation plans for each of the Strategic Reform Initiatives (SRIs). At this time, the NEAC only sets forth the broad parameters under each SRI, which over the coming period will be further refined following consultations and engagement with all stakeholders.

We have identified eight SRIs that are fundamental to achieving the NEM (Figure E). The NEAC fully recognises that many of the policy measures supporting the SRIs are either being planned or have been initiated by the government. The NEAC recommendations aim to add value by augmenting and supplementing ongoing policy work.

SRI 1: Re-energising the private sector

The private sector needs to step up and assume a heightened profile in the nation's transformation. Throughout recorded history, economies have experienced self-sustained, long-term growth primarily through the entrepreneurial initiatives of the private sector, guided by economic incentives which encourage individuals to take the long view and refrain from short-term opportunism. Some of the possible policy measures related to re-energising the private sector can be found in Table D.

Table D – Firing up the private sector

Policy Purpose	Possible Policy Measures
Target high value added product and services	■ Align incentives to foster investment in high value added activities which generate spill-over effects ■ Tailor incentives to meet the needs of each firm ■ Facilitate FDI and DDI in emerging industries/sectors
Remove barriers and cost to doing business	■ Remove distortions in regulation and licensing, including replacement of Approved Permit system with a negative list of imports ■ Introduce a 'Single-Window' licensing process through e-Government portals to include local and state governments
Create eco-system for entrepreneurship and innovation	■ Reduce direct state participation in the economy ■ Divest GLCs in industries where the private sector is operating effectively ■ Economy-wide broadband roll-out ■ Ensure GLCs operate on a strict commercial basis free of government interference
Encourage efficiency through healthy competition	■ Implement efficient and transparent process for government procurement at all levels ■ Level the playing field for the private sector through transparent standard settings ■ Support a stronger competitive environment with competition law
Promote SME growth	■ Provide support for SMEs in innovative and technologically advanced areas ■ Facilitate timely access to funding for business activities
Creating regional champions	■ Encourage GLC partnerships with private-sector companies ■ Pursue aggressive regional networking – ASEAN, China, India, Middle East ■ Improve leverage of FTAs

SRI 2: Developing a quality workforce and reducing dependency on foreign labour

Labour markets must work well: jobs and workers must be matched efficiently to increase productivity and thus raise wages for all. Labour market adjustment must be smooth: the right workers need quickly to find the right jobs; the right jobs must rapidly attract the right workers, including those from abroad. Simultaneously, Malaysia's talent base must improve. A quality education system which nurtures skilled, inquisitive, and innovative workers to continuously drive productivity forward is the foundation of sustained economic growth. High income emanates from skilled people applying their talents to successfully meet the economic challenges faced by society. Malaysia cannot miss the opportunity to put its most valuable resource to work. Therefore, Malaysia must remove barriers preventing its brightest people from gaining skills, while enticing these gifted people to remain within its borders (Table E).

Table E - Inspiring the workforce to draw out their best

Policy Purpose	Possible Policy Measures
Increase local talent over time	■ Review the education system – shift educational approach from 'rote learning' to 'creative and critical thinking' ■ Increase emphasis on reintroducing technical and vocational training colleges ■ Identify and nurture talent through a demand-driven process ■ Improve autonomy and accountability of educational institutions ■ Encourage R&D collaboration between institutes of higher learning and industry ■ Enhance English language proficiency ■ Deliver high quality education, within reach of all localities
Re-skill the existing the labour force	■ Upgrade skills of the bottom segment of the Malaysian labour force through continuing education and training ■ Establish a labour safety-net for displaced workers ■ Industry to partner with government in encouraging 'Continuous Employment Training' (CET) ■ Formalise international quality standards and certification of skills ■ Allow wage levels to be reflective of the skill level

Policy Purpose	Possible Policy Measures
Retain and Access global talent	■ Review existing programmes to attract highly-skilled Malaysians overseas to return home ■ Offer permanent residence for ex-Malaysians and their families ■ Centralise oversight of foreign labour and expatriates to enable coherent practice ■ Build up critical mass of skilled professionals through simpler work permit and immigration procedures ■ Liberalise professional services through mutual recognition arrangements
Remove labour market distortions constraining wage growth	■ Protect workers, not jobs, through a stronger safety net, while encouraging labour market flexibility ■ Revise legal and institutional framework to facilitate hiring and firing ■ Raise pay through productivity gains, not regulation of wages
Reduce reliance on foreign labour	■ Enforce equal labour standards for local and foreign labour ■ Use a levy system to achieve targets for unskilled foreign labour in line with sectoral needs

SRI 3: Creating a competitive domestic economy

Many distortions would be removed and the economy will experience greater competitiveness from the elimination of subsidies, price controls and a myriad of incentives which have lost their original objectives. The ETP will help individuals and firms to cushion the impact of such a bold measure by putting in place an enhanced social safety net and a special transformation fund (Table F).

Table F - Vibrant markets and greater choices

Policy Purpose	Possible Policy Measures
Improve economic efficiency through competition	■ Strengthen the competitive environment by introducing fair trade legislation ■ Improve competition law to safeguard the interest of domestic firms before liberalisation of sectors to foreign firms ■ Set up an Equal Opportunity Commission to cover discriminatory and unfair practices ■ Review remaining entry restrictions in products and services sectors ■ Adoption of international best practices and standards for local industries to become highly competitive
Build entrepreneurship	■ Revamp the seed and venture capital funds to support budding entrepreneurs ■ Simplify bankruptcy laws pertaining to companies and individuals to promote vibrant entrepreneurship ■ Provide financial and technical support for SMEs and micro businesses, to move them up the value chain
Remove market distortions leading to misallocation of resources	■ Phase out price controls and subsidies that distort markets for goods and services ■ Apply government savings to a wider social safety net for the bottom 40% of households, prior to subsidy removal ■ Create a Transformation Fund to assist distressed firms during the reform period

SRI 4: Strengthening the public sector

Public institutions must be re-engineered. Public institutions must not duplicate functions better provided by the private sector but instead should seek to undertake those tasks that the private sector cannot perform. The delivery of government services must be efficient and effective, using a 'whole of government' approach to facilitate the operations of the private sector. Fiscal management must be strengthened to include greater transparency and to provide the right incentives. The government's revenue base must be diversified and expenditure streamlined to foster better utilisation of revenue (Table G).

Table G - A lean and customer-focussed government

Policy Purpose	Possible Policy Measures
Improve decision-making processes	■ Use 'whole-of-government' approach to provide integrated services ■ Empower state and local entities to perform their tasks locally ■ Encourage greater local input and authority in economic development to support regional differences and needs ■ Develop a process for effective implementation, monitoring and evaluation of policy measures ■ Empower MIDA to become an effective one-stop-agency to facilitate foreign investment ■ Revamp MPC to be more effective in driving productivity and efficiency improvements
Improve service delivery	■ Reform the government to be lean, consultative, and delivery-focussed ■ Upgrade skills of staff to enable them to multitask ■ Modernise human resource management to match qualifications with jobs
Reduce 'friction costs'	■ Have zero tolerance for corruption ■ Address underlying weak governance structures ■ Codify best practices ■ Implement an open, efficient and transparent process of government procurement at all levels
Provide a safety net to facilitate a smooth transition	■ Retain a residual role for safety nets to stabilise and correct periods and instances of market failure ■ Apply government savings to a wider social safety net for the bottom 40% of households prior to subsidy removal ■ Create a Transformation Fund to assist distressed firms during the reform period

Policy Purpose	Possible Policy Measures
Strengthen public finance management	■ Widen the tax base (e.g. GST) ■ Lower personal and corporate income tax rates ■ Implement standardised criteria for state revenue receipts ■ Use results-based budgeting ■ Implement programme-based, medium-term budgeting ■ Adopt international standards for fiscal transparency ■ Use technology for efficient collection of duties and taxes

SRI 5: Transparent and market-friendly affirmative action

A key component of inclusiveness is the fostering of equal and fair economic opportunities. Affirmative action programmes and institutions will continue in the NEM but, in line with views of the main stakeholders, will be revamped to remove the rent seeking and market distorting features which have blemished the effectiveness of the programme. Affirmative action will consider all ethnic groups fairly and equally as long as they are in the low income 40% of households. Affirmative action programmes would be based on market-friendly and market-based criteria together taking into consideration the needs and merits of the applicants. An Equal Opportunities Commission will be established to ensure fairness and address undue discrimination when occasional abuses by dominant groups are encountered (Table H).

Table H - Escaping low income

Policy Purpose	Possible Policy Measures
Reduce income disparity	■ Continue support programmes for disadvantaged groups ■ Focus on the bottom 40% of households and business owners ■ Shift focus towards relative poverty ● Continue growth as a means of poverty reduction ● “Growth Elasticity of Poverty” – inequality can reduce impact of growth on poverty

Policy Purpose	Possible Policy Measures
Create market-friendly affirmative action	■ Use transparent procedures and criteria ■ Use affirmative action as a means to promote building of capacity and capability ■ Phase out approaches that contributed to rent seeking and patronage
Narrow regional differences	■ Leverage scale with effective development of economic clusters as a means of reducing regional inequalities, especially in Sabah and Sarawak ■ Enhance measures to raise income levels through better access and provision of quality social services in education and health, especially in Sabah and Sarawak
Encourage reward on the basis of performance	■ Encourage greater competition in the economy by removing excessive protection and accelerating sectoral liberalisation ■ Redesign affirmative action to take into account merit and needs ■ Phase out approaches that contributed to rent seeking and patronage
Promote equal and fair access to opportunities	■ Emphasise equitable and fair opportunities for employment, health and education and access to business opportunities ■ Apply government savings to wider social safety net for the bottom 40% of households prior to subsidy removal ■ Create a Transformation Fund to assist distressed firms during the reform period ■ Set up an Equal Opportunities Commission to deal with possible cases of unfair treatment and discrimination

SRI 6: Building the knowledge base and infrastructure

Economic transformation in the industrial, agricultural and services sectors is a process requiring continuous innovation and productivity growth with significant technological advancement and entrepreneurial drive. The adoption of processes in line with best practices and international standards will improve the chances for Malaysian firms to succeed in the global market place (Table I).

Table I - Innovating today for a better tomorrow

Policy Purpose	Possible Policy Measures
Create an ecosystem for entrepreneurship	■ Easing entry and exit of firms as well as high skilled workers ■ Revamp the seed and venture capital funds to support budding entrepreneurs ■ Simplify bankruptcy laws pertaining to companies and individuals to promote vibrant entrepreneurship ■ Harness Web-based expertise and industry networks
Promote an environment for innovation	■ Improve access to specialised skills ■ Ensure protection of intellectual property rights ■ Incentivise firms to embrace technology and move up the value chain ■ Enforce strict adherence to global standards and benchmarks ■ Fostering R&D links between the institutions of higher learning and the private sector ■ Immediately roll out nationwide fast broadband connectivity ■ Review and consolidate all present government R&D funding ■ Align R&D to national growth objectives particularly in innovative and hi-tech fields ■ Open access to funding to competition among researchers ■ Ensure public procurement supports local innovation ■ Establish KPIs for universities based on commercialisation
Establish stronger enabling institutions	■ Set up a technology research powerhouse and centre of excellence run on a commercial basis e.g. ITRI Taiwan cluster model ■ Operationalise the National Innovation Model announced by the government in 2007 ■ Balance the technology-driven innovation approach with market-led policies such as global procurement through technology intermediaries

SRI 7: Enhancing the sources of growth

Malaysia must build on its strategic location together with the comparative advantages arising from its natural resource endowment to establish production platforms which drive high value added growth with spillover effects. There must be a focus on economies of scale through growth corridors to energise promising expansions into new markets such as downstream agricultural outputs, eco-tourism, alternative energy generation and climate change mitigation (Table J).

Table J - Finding the economic sweet spots

Policy Purpose	Possible Policy Measures
Create value from first mover and other comparative advantages	■ Identify E&E subsectors to build depth and foster new niche industries, and to capture a greater share as a distributional hub as intra-regional trade expands ■ Focus on palm oil-related downstream industries to develop indigenous technology and innovation or acquire technology to meet new market demands ■ Encourage upstream technology innovation to develop higher yielding fresh fruit bunches ■ Capture a greater share of the education, medical tourism and ecotourism markets through domestic and regional partnerships ■ Promote climate change mitigating products and services e.g. recyclables ■ Promote products and services that comply with Islamic tenets e.g. finance, pharmaceutical
Develop greater integration between products	■ Integrate education services with industrial development, for example a centre of engineering excellence in the E&E cluster ■ Further prioritise the logistics industry, leveraging on roads, ports and ICT infrastructure readily available in Malaysia ■ Improve seamless tourism services by ensuring quality services along the value chain (examples such as the revamp of poor quality taxi services and improving personal safety for travellers)

Policy Purpose	Possible Policy Measures
Create new markets	■ Capture greater share as a distributional hub as intra-regional trade expands ■ Improve maritime and port services, leveraging on technology ■ Move into alternative energy generation as well as energy saving products and services ■ Expand service-oriented industries to regional markets based on Malaysia's inherent biodiversity
Build scale of industries and production networks for specialisation	■ Promote corridor-based development around spatially dense poles and adjacent hinterland, especially for electronics ■ Encourage competition between localities ■ Cluster industries to leverage on integration, scale and connectivity ■ Exploit economies of scale through networking of production and supply chains leveraging on location - 'Speed to market' ■ Establish global presence through international acquisitions of companies in the same field
Harness innovation potential	■ Adopt an open innovation system to acquire technology and expand networks ■ Support rapid transformation of SMEs with potential for innovation ■ Develop industries that support sustainable development such as use of traditional plants and herbs for modern applications
Integrate real sector industries with financial services	■ Develop the commodities trading platforms and products for domestic producers to benefit from financial innovation and expansion ■ Offer Malaysia as a regional hub for both futures and spot markets for commodities ■ Develop Islamic-based financial products to support domestic production and risk management of prices and production

SRI 8: Ensuring sustainability of growth

Preserving our natural resources and safeguarding the interest of future generations must be facilitated by applying appropriate pricing, regulatory and strategic policies to manage non-renewable resources efficiently.

Sustainability of public finances through stringent fiscal discipline, which necessitates reduction of wastage and cost overruns, is the cornerstone to maintaining macroeconomic balance and financial stability (Table K).

Table K - The future is bright. The future is Malaysia

Policy Purpose	Possible Policy Measures
Preserve natural resources	■ Use appropriate pricing, regulatory and strategic policies to manage non-renewable resources sustainably ■ Encourage all sectors to embrace ‘green technology’ in production and processes ■ Develop a comprehensive energy policy
Leverage on comparative advantages for high value added products and services	■ Increase focus on downstream high value added production and services ■ Develop a comprehensive energy policy
Meet international commitments	■ Reduce carbon footprint in line with government commitment ■ Enforce clean air and water standards in utilising natural resource i.e. pollution mitigation
Facilitate bank lending and financing for ‘green investment’	■ Develop banking capacity to assess credit approvals for green investment using non-collateral based criteria ■ Liberalise entry of foreign experts specialising in financial analysis of viability of green technology projects ■ Support green technology investment with greater emphasis on venture capital funds

Policy Purpose	Possible Policy Measures
Ensure sound public finances	■ Use appropriate pricing, regulatory and strategic policies to manage non-renewable resources sustainably ■ Reduce wastage and avoid cost overrun by better controlling expenditure ■ Establish open, efficient and transparent government procurement process ■ Adopt international best practices on fiscal transparency

THE TIME FOR CHANGE IS NOW – MALAYSIA DESERVES NO LESS

The discussion above outlines the main elements of the proposed NEM. The SRIs represent the key changes required to drive Malaysia to an advanced nation. But this is not the end of the journey, just a signpost to the beginning. The way ahead, however, is clear and Malaysia will lose its way if urgent action is not taken.

The work of the NEAC is not complete. The next step is for the NEAC to help formulate and detail policy with key stakeholders, in support of the proposed SRIs. The details of the policy measures will be set forth in Part 2 of the *New Economic Model for Malaysia* report, to be submitted for government consideration later this year.

CHAPTER

1

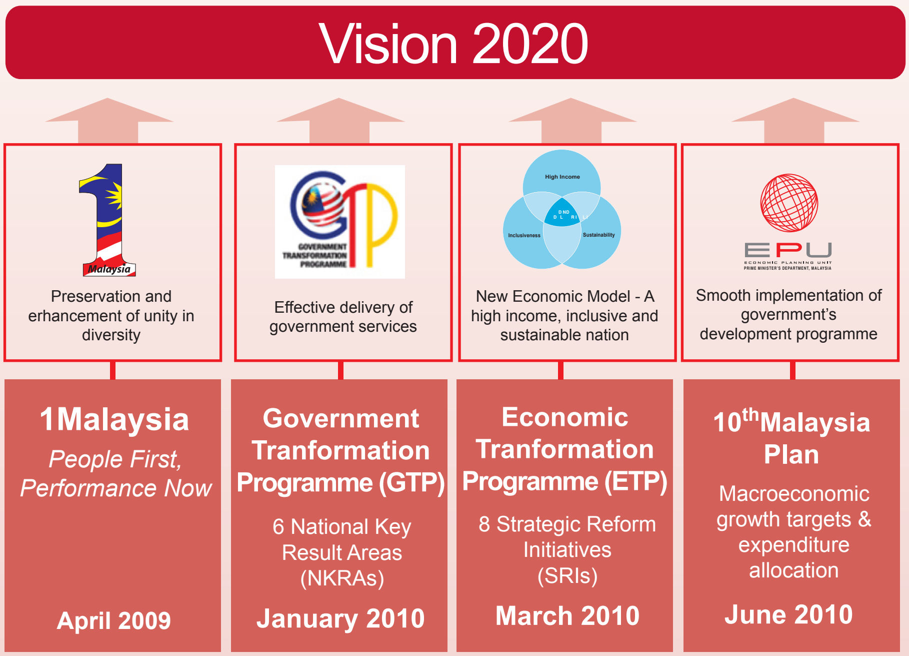
Why do we need the NEM and what are its goals?

Why do we need the NEM and what are its goals?

Malaysia has reached a defining moment in its development path. The Government has crafted a blueprint to move the country towards its next stage of development that is based on four key pillars (Figure 1).

The first pillar is embodied in the principles of *1Malaysia, People First, Performance Now* meant to unite all Malaysians who collectively represent the key stakeholder of the Government. The second pillar is the *Government Transformation Programme (GTP)* which will deliver the outcomes defined under the National Key Result Areas (NKRAs). The third critical pillar will be the New Economic Model (NEM) resulting from an ambitious *Economic Transformation Programme* (ETP) meant to transform Malaysia by 2020 into a developed and competitive economy whose people enjoy a high quality of life and high level of income from growth that is both inclusive and sustainable. The fourth pillar is the *10th Malaysia Plan 2011-2015* (10MP) which will represent the first policy operationalisation of both the Government and economic transformation programmes.

Figure 1 – The four pillars of national transformation



The Commission on Growth and Development in its report titled “The Growth Report: Strategies for Sustained Growth and Inclusive Development” recognised Malaysia as one of only 13 countries in the world to have sustained growth of more than 7% for more than 25 years since the Second World War. This is indeed a singularly remarkable achievement, one that has practically eradicated poverty and transformed the economic and social landscape of the country.

The country successfully navigated various economic as well as political crises throughout the last 50 years, but the aftermath of the 1997-1998 Asian financial crisis saw the economy slowing despite the global economy being robust during the same period. For a small open economy, this is symptomatic of a supply problem; investor confidence, capability constraints, productivity ceilings and institutional degradation have resulted in a declining growth trajectory. The economy is caught in a middle income trap – caught between low-wage producers and highly-skilled innovators and caught without a viable high-growth strategy. The policies and strategies used to achieve the current state of development are now inadequate for the next stage of development. The economic growth has also come at considerable cost to the environment, and it has not benefited all segments of the population.

There is a serious risk that the economy may regress if fundamental changes are not made. The growth thesis for the economy has to change from one that is driven by the accumulation of physical capital and the dependency on low costs to one that is driven by innovation and productivity. The present incentive structure is perverse. It promotes a dependence on cheap, low-skilled labour including foreign labour that neither induce nor reward human capital development. As a result, Malaysian talent move abroad. Of late, even Malaysian capital has flowed outside the country.

While Malaysia has benefited from continuity of policies, such continuity can be seriously constraining in a changing world. Indeed, the combination of static policies and weakened institutional structures pose serious risks to Malaysia’s ability to transform its economy towards a new growth trajectory. Delayed actions mean Malaysia will be left behind and this will threaten the very fabric of Malaysian society. The Growth Report cited earlier cautioned that of the 13 countries that have recorded over 7% growth over 25 years, only six countries eventually managed to become high income countries.

A New Economic Model is required as a catalyst to transform the economy and its attending institutions. Vision 2020 with a new economic model is not possible without a transformation of the economy, the supporting policies, and effective delivery of government mandates. The NEAC advocates a new, bold approach to obtain the right eco-system where efficient markets can operate to produce equitable outcomes. The vicious cycles of vested interests have to be broken to remove distortions and rent-seeking activities, all of which undermine productivity and entrepreneurship so vital in creating a vibrant economy. The economic logic and growth model of the economy will have to change. Only through a drastic and comprehensive ETP can we break the barriers and achieve a new economy as contemplated in Vision 2020.

The NEAC also recognises that the transition period can be painful for households as well as for firms. The definition of social safety net will need refining and the provision of social safety net programmes will be enlarged to include not just the disabled and the elderly but also for displaced workers. Furthermore, some form of industrial transformation funds may also be necessary to mitigate the impact on displaced firms. Not only must the costs of doing business be lowered, the costs of failures too must be lowered to allow for change and encourage risk-taking.

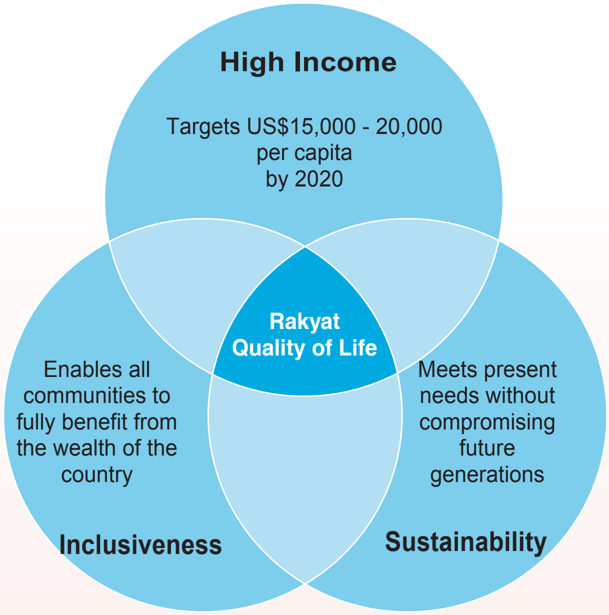
Although absolute poverty has largely been eradicated, a hefty 40% of Malaysian households remain in the low income category, earning less than RM1,500 a month. This group requires specific policy interventions especially on capability development in order to achieve upward mobility. Income disparities between ethnic groups and regions must still be actively addressed. While economic growth will lever on economic density and agglomeration, inclusiveness requires development be equally spread out and opportunities be equitably accessible.

1.1 Goals of the NEM

The goal of the NEM is for Malaysia to be a developed and competitive economy whose people enjoy a high quality of life and a high level of income resulting from growth that is both inclusive and sustainable (Figure 2). The NEM exemplifies the courage of Malaysians to take the right decision at the right time and a collective desire of Malaysians to build a better tomorrow.

The Malaysian economy will be market-led, well-governed, regionally integrated, entrepreneurial and innovative.

Figure 2 – Goals of the New Economic Model



The private sector will be the main driver of growth in a market environment that rewards innovation and creativity while the government will generally be the provider of public goods and the custodian of public interests through an effective regulatory framework. ***Well-governed*** and leaner government institutions will be held accountable to performance-based outcomes in line with the GTP. They will be staffed with highly qualified, flexible, dynamic individuals with multi-tasking capabilities. Private firms, non-government entities and the civil society will aspire to internationally accepted governance standards.

The NEM will provide the framework and environment to engender the ***entrepreneurial*** spirit to make the most of growth opportunities from available financing. ***Innovative*** and state-of-the-art technology will generate high value added products and services, and creative technical, social, and institutional processes. All these will feed into an expansion of markets through ***regional integration*** in trade and services and by shaping cross-border production networks and supply chains.

1.2 Enabling the NEM

The ETP will not be a painless journey and hard decisions must be taken and trade-offs managed. It is a journey that will require: 1) the steadfast commitment by the government to stay the course; 2) the preparedness of the *rakyat* to embrace the difficult changes; and 3) a 'big-push' of strategic policy measures, not incremental changes.

Political will

The **political leadership must be committed** and steadfast in its will to decide and follow through with implementing the SRIs. The Government will face resistance from many quarters but it must have the determination to break down the log-jam of vested interests and opposition of short-sighted factions. Opposition is expected from beneficiaries of all kinds of rent-seeking activities. Resistance from these groups must be met head on, but there must be a process to allow for feedback and review.

Preparing the rakyat

To garner the support of stakeholders and ordinary Malaysians, the NEAC will recommend an engagement framework to **prepare the *rakyat* for change in the second phase**. The NEAC places great importance on informing the public and providing coherent explanations about the vision and agenda of the NEM and the transformation process. This important groundwork will include sufficient details on the disruptions, bumps and hiccups likely to befall business firms, households and individuals.

The path forward to attain future progress will result in major adjustments in the economy which will inevitably lead to groups of winners and losers. Firms and individuals will have to cope with the new market realities and many companies will either have to restructure or be phased out. Workers in these firms may become redundant and may need to re-skill to be employable. Changes in sources of growth are often geographically imbalanced with some regions benefiting more than others. The phasing out and elimination of price controls and subsidies will affect some groups directly and others indirectly. These are just a few of the disruptions expected.

Big push of policy measures

With political commitment and the *rakyat* prepared for deep-seated changes, a **critical**

mass of bold policy measures must be implemented simultaneously. Due to the cross-cutting nature of both the challenges and the potential solutions, early and concurrent implementation of these measures will create a multiplier effect on the benefits derived, sustaining the momentum needed for real change. Piecemeal and incremental measures will not have the same effect.

Managing winners and losers

The NEAC will suggest programmes for effective government and civil society campaigns and consultations. The ETP envisages a **special transformation fund** that will support firms and individuals to adjust to the new market environment. Enhanced social safety nets will also be in place to cushion the most vulnerable segments of society and build their capacity to better contribute to the economy. A strong monitoring team of technical experts and professionals will be constituted to process feedback on the effectiveness of measures, and to make recommendations for necessary adjustments. They will also manage the resistance from vested interests and unexpected impact on vulnerable groups.

Strategic Reform Initiatives (SRIs)

The NEAC's recommendations will be anchored by the following eight Strategic Reform Initiatives (SRIs).

SRI 1: Re-energising the private sector to drive growth – Firing up the private sector will stimulate a jump in investment in high value added products and services, generating sustained growth and high income.

SRI 2: Developing a quality workforce and reducing dependency on foreign labour – Policies will focus on generating a talented workforce to meet the needs of a high-value knowledge economy while wage-restraining labour market distortions, such as excessive and indiscriminate use of foreign labour, will be removed.

SRI 3: Creating a competitive domestic economy – Subsidies, price controls and a myriad of distortion-creating incentives will be phased out. The impact on the vulnerable groups will be cushioned with an enhanced social safety net.

SRI 4: Strengthening the public sector – Public sector reform programmes will continue to improve and speed up decision making by a lean, consultative and delivery focussed government.

SRI 5: Transparent and market-friendly affirmative action – To truly foster equal and fair economic opportunities, affirmative action programmes will continue but will aim to achieve their objectives by removing the rent-seeking and market distorting features which have limited their effectiveness.

SRI 6: Building the knowledge base and infrastructure – The key focus here is to promote an environment for innovation by strengthening the delivery of high quality education that nurtures innovation and technology.

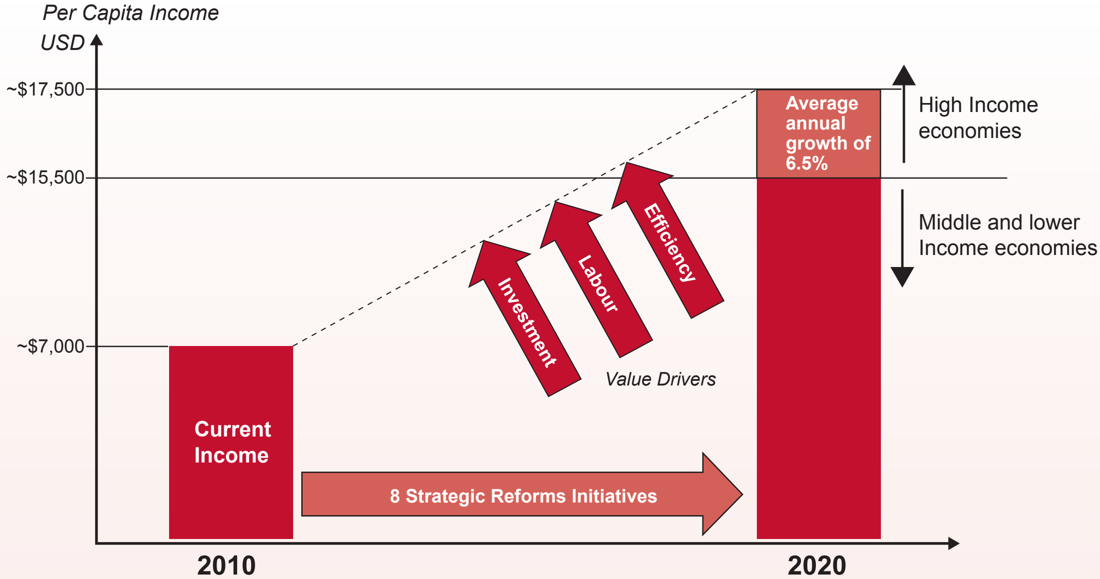
SRI 7: Enhancing the sources of growth – Malaysia will leverage its natural endowment and sectors of comparative advantage as the main sources of high value added growth maximising spillover effects into new areas of activities.

SRI 8: Ensuring sustainability of growth – Preserving our natural resources and safe-guarding the interest of future generations will be complemented by sustainable public finances through stringent fiscal discipline.

The path to an advanced nation

These SRIs will incentivise economic actors to make decisions in ways that will increase private investment and increase productivity that will result in real GNP growth at an average annual pace of 6.5% or higher from now until 2020 (Figure 3). The NEAC has set forth the main principles and broad measures of the NEM, but its work is not finished. The Council will now seek and incorporate feedback and collaborate with all stakeholders over the next few months to further analyse and detail the policy measures and implementation frameworks.

Figure 3 – Unlocking the value drivers



CHAPTER

2

Where are we?

Where are we?

Today, Malaysia's GNP per capita is about USD7,600 annually or RM2,200 a month. Inequality remains high, even with a reduction in the Gini coefficient from 50% in 1970s. Currently almost 4% of all Malaysians and over 7% of rural Malaysians live below the poverty line. The poorest 40% of Malaysian households earn incomes, on average, barely one-seventh that of the richest 20%. For millions of ordinary Malaysians, life is far worse than even the USD7,600 annual GNP figure suggests.

Half a century after independence — three decades after NEP, 10 years before 2020 — these figures provide a sobering reminder of how far Malaysia still has to go before it becomes an advanced, high income economy.

Whether in the future economic growth will improve for Malaysia depends on policy actions to be undertaken now. Without radical transformation, improvement is unlikely; all the more because recent economic performance has certainly deteriorated precipitously.

In the mid 1990s, in the run-up to the 1997 Asian financial crisis, Malaysia's GDP grew at an average rate greater than 9% annually. Since 1997, however, Malaysia's GDP growth rate has practically halved (not even taking into account the 2008 global financial crisis). Investment was 40% of GDP in Malaysia in the mid 1990s. Since 1997 it has steadily fallen, reaching just 20% of GDP right before the 2008 global financial crisis — even as investment in China, Vietnam, and Indonesia reached or exceeded their pre-1997 peaks. Worse, what little life remains in Malaysian investment has come from state direction rather than private strength: in the decade after 1997, private investment as a fraction of GDP declined to less than one-third of its pre-1997 peak.

To be clear, the circumstances now holding back Malaysia's growth are not just external. Indeed, international events such as the 1997 Asian financial crisis or the 2008 global financial crisis — damaging though they have been on their own account — have simply highlighted structural weaknesses already stored up in Malaysia's path of economic development.

The nation's relatively sizeable public operating expenses and capital investment for infrastructure development have been financed in large part by natural resource wealth. However, these resources are now rapidly depleting. The difficulty of starting businesses, enforcing contracts, and dealing with construction permits — as just specific examples — bear testimony to a sluggish bureaucracy no longer fit for purpose in a fast-moving world. The historical advantage of exporting low value added electronics, drawing on the availability of low wage, unskilled labour has locked Malaysia into a low-level vicious circle of competition based on costs alone. It is now slowing Malaysia's progress up the value chain to more sustainable, higher value, more advanced technological levels of industrial production.

A disastrous exodus of human capital has flowed from the perception that in Malaysia's labour markets, rewards have historically not been commensurate with skills, achievements, and merit. Perhaps half a million talented Malaysians now live and work outside the country — 50% of them educated up to tertiary level, all embodying valuable skills no longer available to contribute to economic development in the country. Since 2000, the number of expatriates working in Malaysia has declined 9% a year. In contrast, four-fifths of the current Malaysian workforce have received only up to SPM-level education. Even with the Government pouring relatively high spending into public education, the quality of graduates — measured by international test scores in science and mathematics — has simply not kept pace.

Malaysia has reached a defining moment in its development path. It risks being left behind or worse still, suffering a reversal in living standards, unless it implements far reaching and comprehensive reforms. Economic policies to date are no longer keeping Malaysia competitive enough, regionally and globally, to generate sufficient growth. Actions which were once effective now lack the attractiveness to stimulate higher private investment and innovative products and processes. Furthermore, continued reliance on low value added export activities inhibits the transition of the labour force to higher skill levels and the associated higher income opportunities. This situation is compounded by governance conditions that raise obstacles for private sector business development. All of these undermine Malaysia's growth potential and render the economy more susceptible to the volatile global environment.

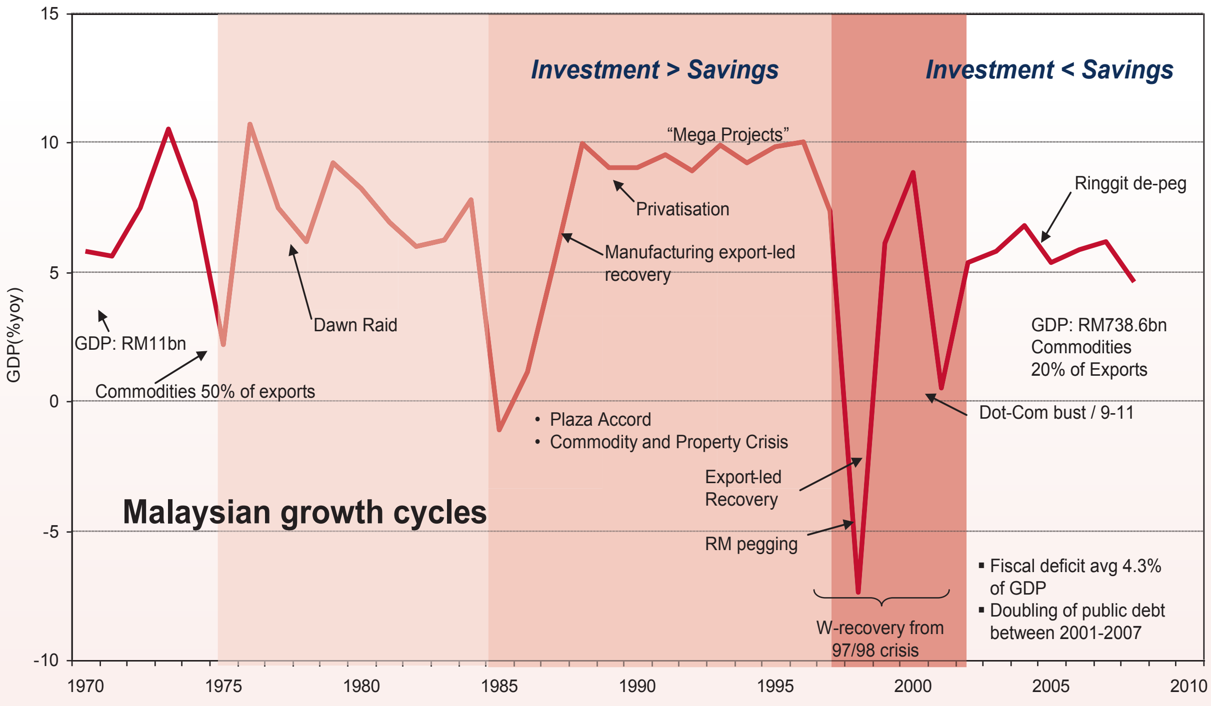
2.1 Malaysia is open – for better and for worse

From independence in 1957 until the Asian financial crisis, Malaysia's economic development was impressive by any measure. Its GDP growth rate 'hit' the 10% mark on four occasions: 1973, 1977, 1989 and 1997 (Figure 4). High growth in those years reflected a variety of factors, in particular a close partnership between the government and the private sector through initiatives such as 'Malaysia Inc' and privatisation.

Openness to the world economy was a major contributing factor in Malaysia's phenomenal economic development. As a result of targeted liberalisation and industrialisation measures, Malaysia benefited tremendously from increased manufactured exports and improved consumer welfare. However, being an open and small economy has also made Malaysia susceptible to external shocks, as reflected in Figure 4. These include the energy crisis of the 1970s, the 1980-1982 recession in the United States, the 1997-1998 Asian financial crisis, the dotcom crash in 2000-2002, and the latest global financial crisis that began in 2008. Each event has plunged Malaysia into a more severe recessionary spike than the one before – a testimony to Malaysia's increased openness but also a sign that Malaysia must keep abreast of, and move in sync with global developments.

The 'openness' of the Malaysian economy, in addition to increased vulnerability to external shocks, can also present lower-level, but equally damaging consequences. For example, any increase in international commodity prices, like fuel or food, could have direct immediate impact on domestic prices. These impacts cannot continue to be absorbed by government subsidies. Similarly, unless production costs in Malaysia can keep pace with those abroad, exports are likely to lose ground with negative effects on national employment and income.

Figure 4 – Malaysia's historical growth trends



Source: MOF, EPU, KRIS

2.2 The economic engine is slowing

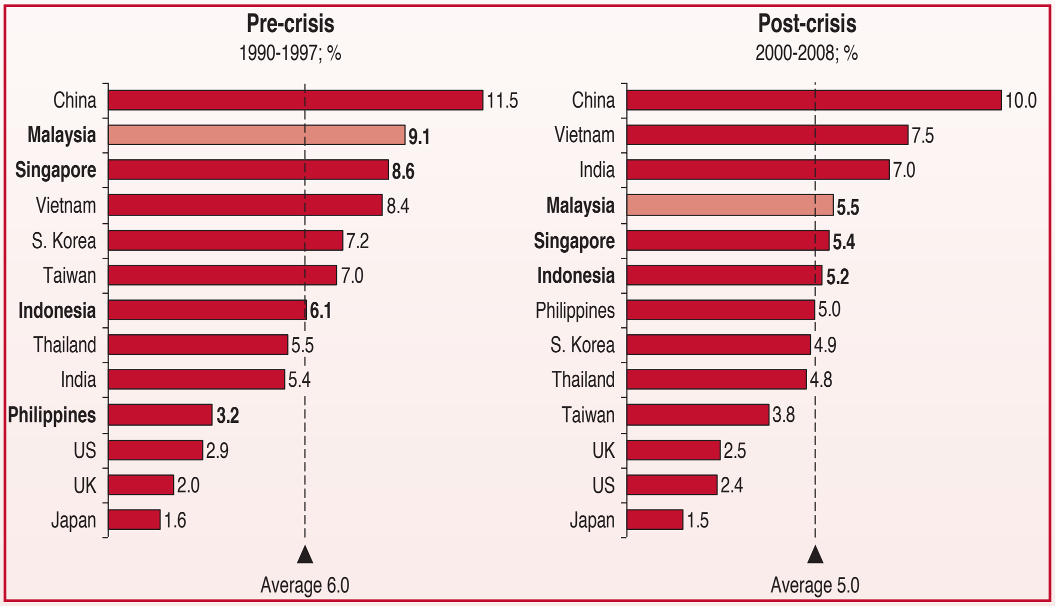
The Asian financial crisis of 1997-1998 was a watershed in Malaysia's growth. Since the crisis, Malaysia's position as economic leader in the region has steadily eroded. Prior to the crisis, Malaysia's growth rates averaged 9% from 1990 to 1997 – second only to China, and ahead of Singapore, Vietnam and Korea. Since then, growth rates have fallen to an average of 5.5% from 2000 to 2008. Vietnam and India now have registered higher average growth rates than Malaysia (Figure 5).

The crisis also caused significant outflows of foreign portfolio investment (FPI) and foreign direct investment (FDI) as well as a fall in overall investment which has not recovered. Malaysia's economic performance since the crisis indicates that neighbouring economies will soon be as large as, if not larger than ours – further diminishing our economic leadership. There are of course, a number of factors contributing to the sluggish economic growth. The NEAC has identified and analysed the most critical:

- Absence of private investment
- Difficulties of doing business
- Low value added industries
- Low-skilled jobs and low wages
- Stagnating productivity growth
- Insufficient innovation and creativity
- Lack of appropriately skilled human capital

Each of these factors is described and discussed below.

Figure 5 - Average annual GDP growth



Source: MOF, CEIC

2.2.1 *Private investors have taken a back seat*

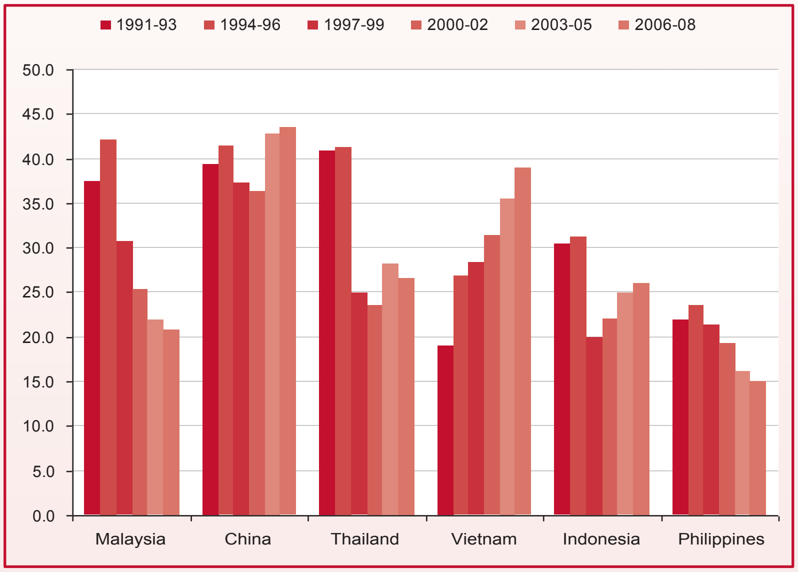
Since the Asian crisis, Malaysia has seen a major change in aggregate investment trends. While countries such as Indonesia have seen notable recovery in investment levels since the crisis, Malaysia has seen no recovery, with aggregate investment levels in percent of GDP continuing to decline (Figure 6).

This contraction in aggregate investment in Malaysia was driven mostly by a decline in private investment, which has stagnated (Figure 7). Singapore and Thailand, on the other hand, have both experienced strong recoveries in private investment since the crisis.

The low level of private investment in ecent years is likely due to several factors. In some industries, heavy government and GLC presence has discouraged private investment. In addition, cumbersome and lengthy bureaucratic procedures have affected both the cost of investing, and the potential returns on investment. The persistent shortage of skills has had an impact on investment as well.

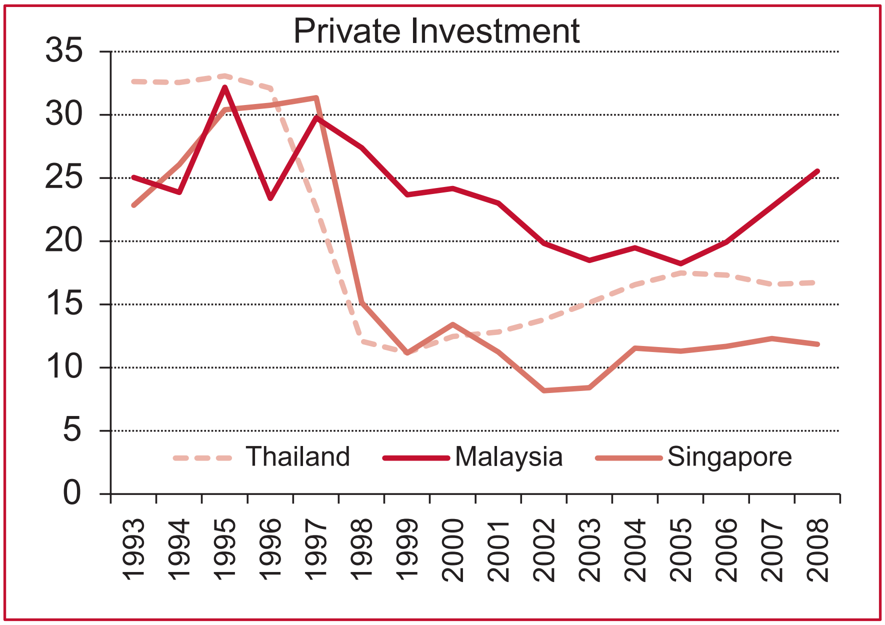
The absence of private domestic investment is further evidenced by developments in the external accounts. In recent years, the balance of payments of Malaysia has seen persistent current account surpluses, reaching almost 18% of GDP in 2008. While this current account surplus has been largely off-set by the accumulation of net foreign assets, there has been an increasing capital account outflow for financing Malaysian investment abroad.

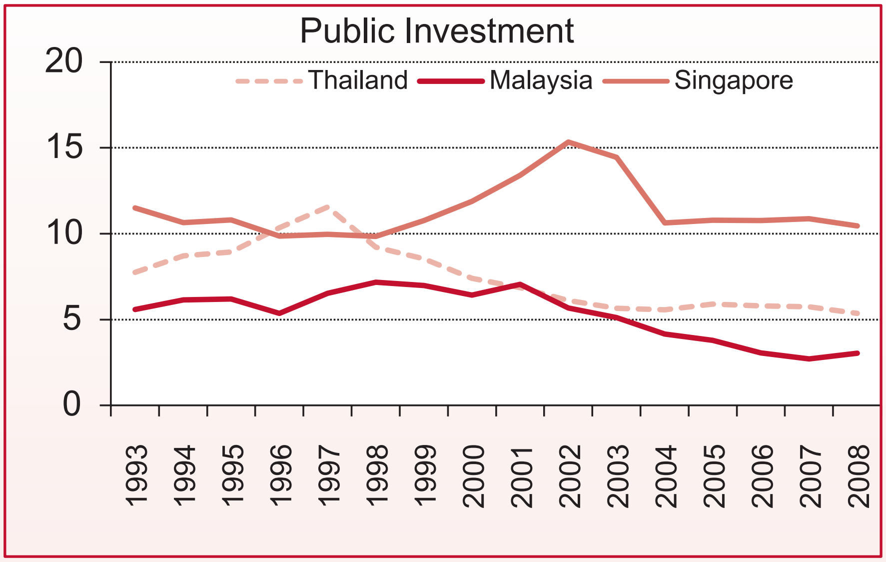
Figure 6 - Investment as percent of GDP, average (1991-2008; %)



Source: World Bank

Figure 7 – Private and public investment as share of GDP (1989-2008; %)

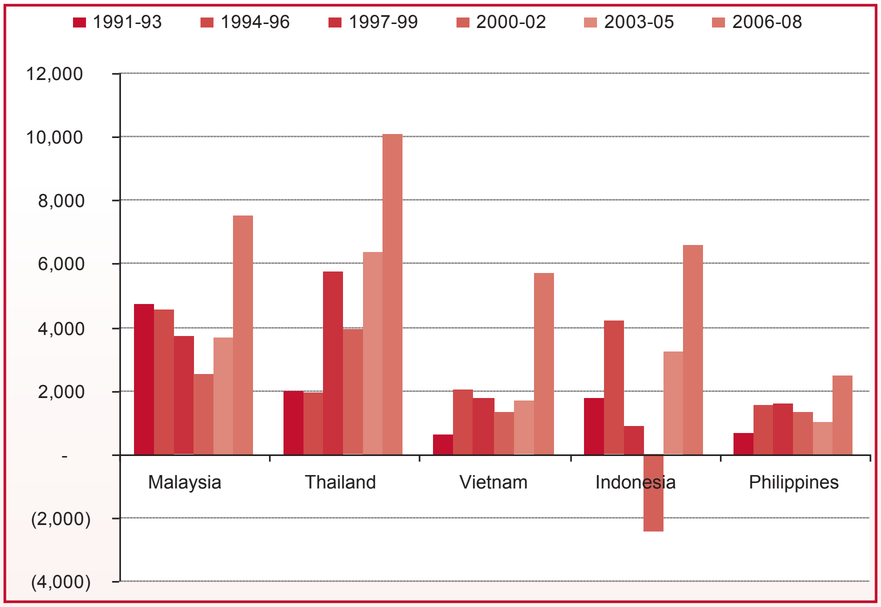




Source: BNM, CEIC, Bank of Thailand

Although Figure 8 shows that FDI inflows into Malaysia have recovered comparatively well, this rebound has not translated into higher levels of aggregate investment. This is an unusual phenomenon and suggests that Malaysia is simply not taking advantage of the inflows of FDI to augment domestic sources of investment, especially in innovative and technologically sophisticated areas. In 2008, a large portion of FDI went into the services sector. However, the bulk of it was in the financial services and distributive trade sectors, both of which involve little need for physical capital outlays but require a high degree of innovation and networking that domestic investors lack. We have to create conducive conditions that will boost domestic private investment in high value added products and services in order to raise our income levels.

Figure 8 - Foreign direct investment (1989-2008; USD million)



Source: World Bank

2.2.2 *Doing business in Malaysia is still too difficult*

Although Malaysia ranked 23rd out of 183 countries overall, doing business in Malaysia is more difficult than in competing countries, especially in aspects related to entry and exit of firms. Several measures of doing business, such as starting a business, registering property and dealing with construction permits, show Malaysia ranking behind developed countries globally and regional economies such as Singapore and Thailand (Table 1). This has the unintended effect of favouring existing businesses and hampering competition. In addition, a very long backlog of cases in

Malaysian courts appears to weigh negatively on investors' perception as this slows down resolution of commercial disputes.

Malaysia's place within the Global Competitiveness Index has dropped to 24th in the 2010 report from 21st previously, indicating that the country is becoming less attractive as an investment destination. Institutional structures, processes and policies also contribute to the difficulty of doing business in Malaysia. Furthermore, entrepreneurs have identified issues such as inconsistent government policies, corruption, tax regime, labour policy and inflation as the main impediments for establishing businesses in Malaysia.

Table 1 - Doing Business 2010 report (Global ranking)

	Ease of Doing Business	Starting a Business	Dealing with construction permits	Registering property	Trading across borders	Enforcing contracts
Singapore	1	4	2	16	1	13
New Zealand	2	1	5	3	26	10
Hong Kong	3	18	1	75	2	3
US	4	8	25	12	18	8
UK	5	16	16	23	16	23
THAILAND	12	55	13	6	12	24
JAPAN	15	91	45	54	17	20
S. KOREA	19	53	23	71	8	5
MALAYSIA	23	88	109	86	35	59

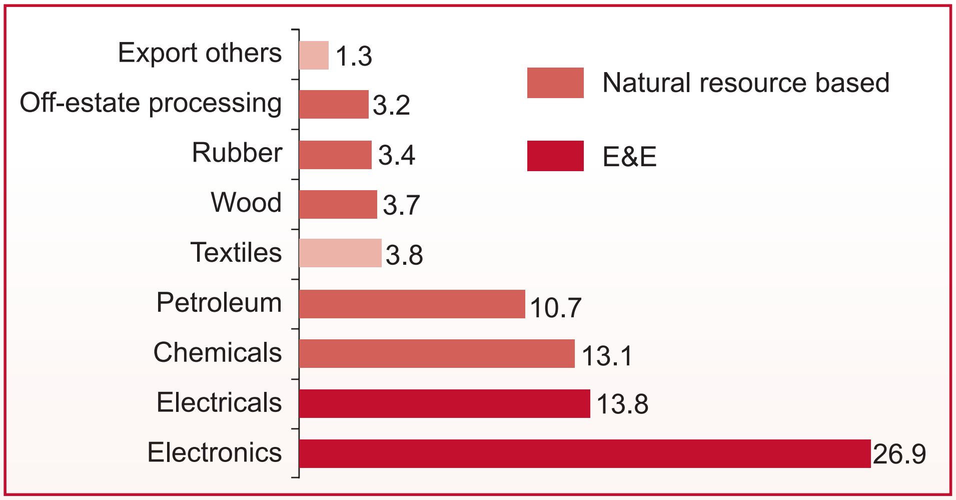
Source: World Bank

2.2.3 *Our exports are still strong but not generating enough added value*

Exports is, and has been for some time, a key focus for Malaysia. The economy is highly dependent on external markets, with an export-to-GDP ratio of 1.2 and a trade-to-GDP ratio of 2.2 in 2008. Malaysia's export structure has focussed mainly on electrical and electronics (E&E) products and on primary commodities such as petroleum and palm oil. Figure 9 shows that more than 40% of Malaysia's exports are accounted for by E&E products.

The E&E sector is a good illustration of the difficulty we face in moving up the value chain. Historically, Malaysia's E&E sector benefited from the large inflow of foreign investment, mostly from multi-national corporations. While a handful of MNCs have upgraded their operations in Penang by investing in research and development, a large majority continue to focus only on assembly operations. As a result, Penang's E&E cluster has created a huge community of component manufacturers, namely original equipment manufacturing (OEM) suppliers. Firms that become "locked" into OEM relationships are prevented from developing their own independent brand name recognition and marketing channels. Profit margins are substantially lower in OEM sales than from own brand name sales. This in turn makes it difficult for Malaysian companies to muster the capital needed to invest in R&D and make a breakthrough to new higher value added products. As a result, E&E exports continue to have high import contents and to be produced in large part by firms under foreign ownership using foreign innovation and technology.

Figure 9 – Export-oriented industries as share of manufacturing sector (2008; %)



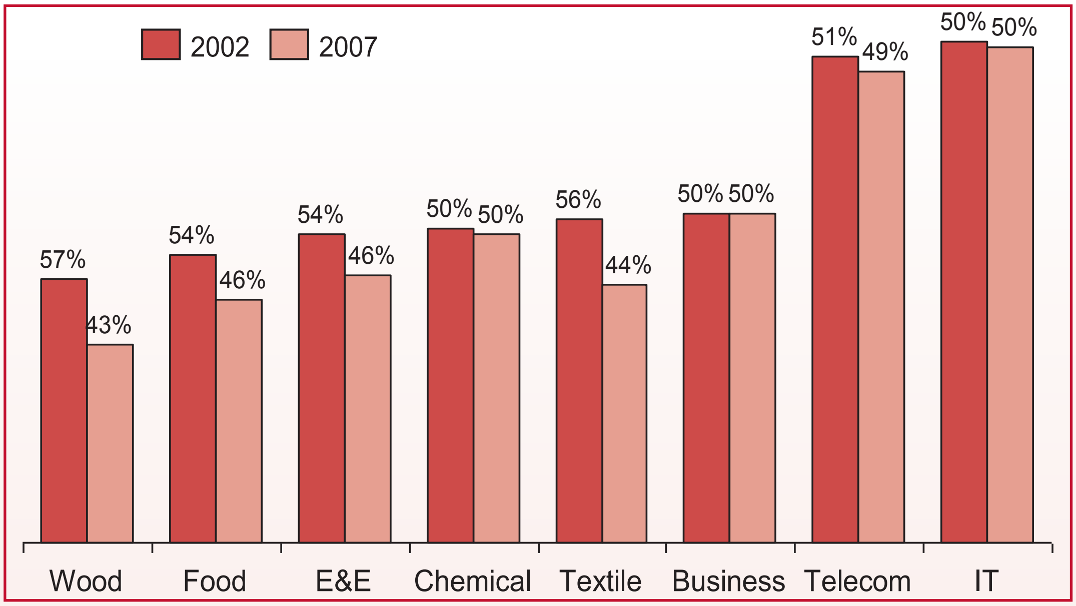
Source: BNM

The result of this effect is that Malaysia became a cost-competitive production base. However, given the large import content in the manufacturing of export goods, the value added to the final product has been low. Inability to attract talent has led to low innovation. After three decades of industrialisation, investors have yet to distinguish Malaysia as a producer of innovative and progressive goods – with the potential of yielding greater returns through enhanced demand and market leadership. Nevertheless, GDP growth in Malaysia is sensitive to the fortunes of the E&E sector, where recent decline in global growth was quickly reflected in a fall in such exports, exposing the country to volatility in global markets. Reducing Malaysia's dependence on generic E&E assembly activities requires continuous innovation to deliver high value added products and processes.

2.2.4 *Low-skill jobs equal low wages*

Skilled jobs are most often synonymous with higher wages. In Malaysia, not enough high-wage jobs have been created. In fact the share of skilled labour has declined across industries. As discussed above, this reflects the dominance in Malaysia of low value added goods, which require low-skilled labour. The use of low-skilled labour has increased between 2002 and 2007 across industries (Figure 10). The E&E sector, which is the major contributor to Malaysia's growth, has experienced some of the biggest declines in use of high-skilled labour. Experience in more developed regional economies shows that the proliferation of skilled workers occurs when workers compete to upgrade themselves in search of higher wages and when firms see an increased use of skilled workers as necessary to raise their profitability. The two factors are largely absent in Malaysia because in many instances, employers do not pay for skills, relying instead on tried and tested means such as a readily available pool of unskilled foreign workers and underpriced resources to generate profits.

Figure 10 - Use of high-skilled labour across industries (2002 and 2007; %)

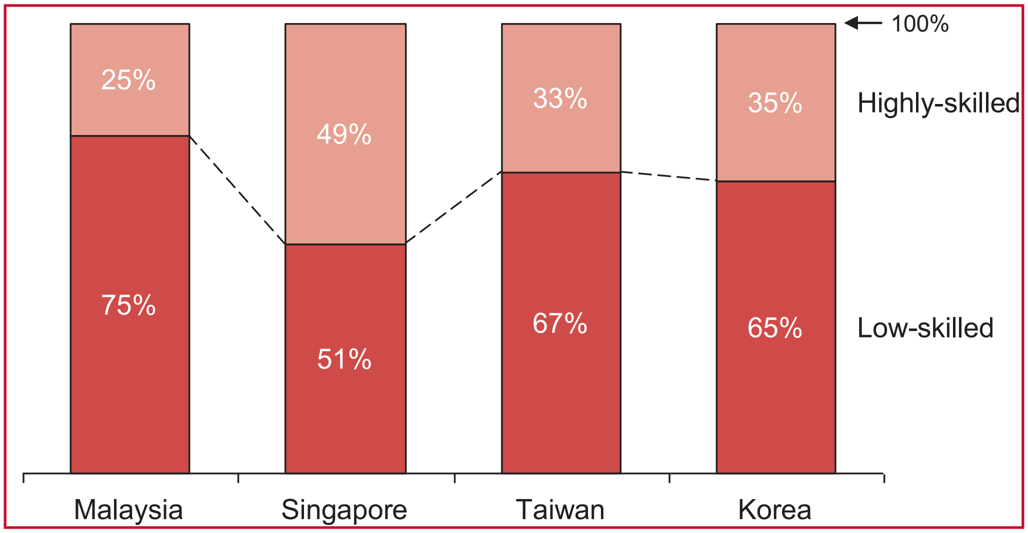


Source: EPU, World Bank

Immigration policies favour low skilled and cheap labour. Between 1990 and 2005, foreign labour contributed more than a third of the increase in total labour supply, and over 98% were low-skilled contract migrant workers. Easy access has led to over-reliance on low-cost and unskilled foreign labour, which has sustained the profitability of low value added businesses in the short term and provides no incentive to move up the value chain. It has also largely contributed to a dampening effect on wages. As a result of these trends, only

25% of Malaysia's labour force is composed of highly skilled workers, compared to significantly higher proportions in Singapore, Taiwan and Korea (Figure 11).

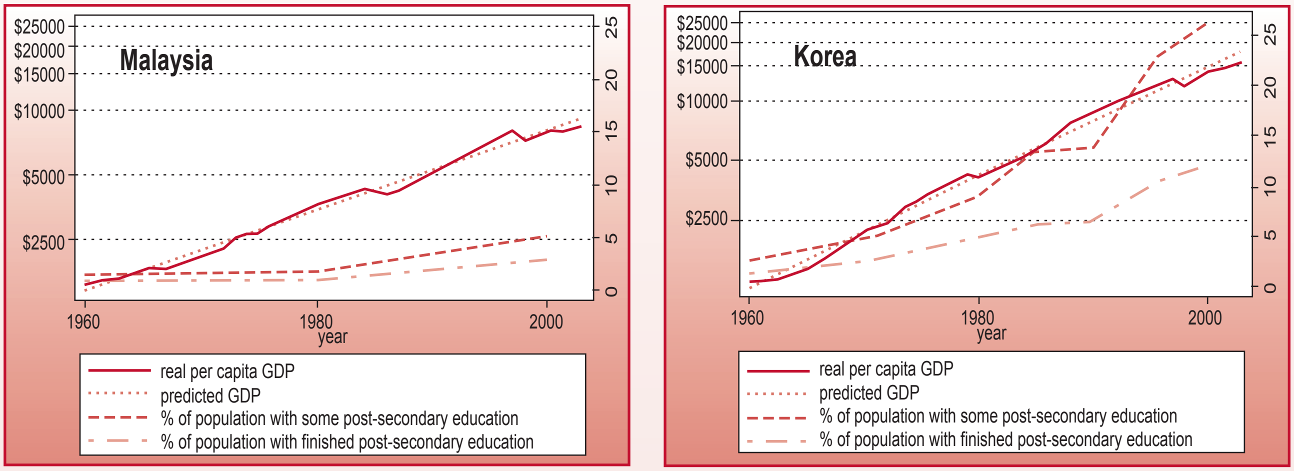
Figure 11 - Highly-skilled and low-skilled labour (2007; %)



Source: EPU, World Bank

The skill level of the labour force is also linked to education. The share of labour force with tertiary education for advanced countries is usually high, for example in Korea, people with post-secondary education greatly exceed those registered by Malaysia (Figure 12). More notably, while the upward trend in Malaysia has been unimpressive, the rate of increase in Korea of people with at least some post-secondary education has been phenomenal.

Figure 12 - Historical trends of GDP and education levels of population (USD, %)



Source: EPU, World Bank

2.2.5 *Productivity is growing, but far too slowly*

Before the Asian financial crisis, Malaysia was leading the pack within the region in terms of labour productivity growth. But it has since lost the pole position (Table 2). This has to be interpreted carefully. On the one hand, the dismal productivity growth has much to do with slowing investment post-crisis – capital contributed to over 60% of growth in output per worker during the 1987-1997 period but its share fell to just over a third from 1998 to 2006. On the other hand, the weak productivity growth highlights the stark reality that Malaysia still lacks the sort of creativity and innovation that result in technological and technical progress as well as more efficient practices and systems – as shown in stagnant contribution by total factor productivity and education to output growth (Table 3).

Table 2 – Labour productivity growth of selected Asian countries, annual average change (1987-2007; %)

	Pre-Crisis (1987-1997)	Post Crisis (1998-2007)
China	4.5	9.2
India	3.5	4.4
Asian NIEs	4.8	3.4
Malaysia	5.5	2.9
Thailand	5.2	3.1
Indonesia	3.1	3.0
Singapora	4.5	2.4
Philippines	-0.7	2.3

Source: EPU, World Bank

Table 3 – Sources of growth for Malaysia's labour productivity, annual average change (1987-2007; %)

	1987-1997	1998-2007
Labour productivity	5.5	2.9
Contribution of:		
Capital	3.4	1.0
Education	**0.3**	**0.3**
Land	0.0	-0.1
Total factor productivity	**1.7**	**1.6**

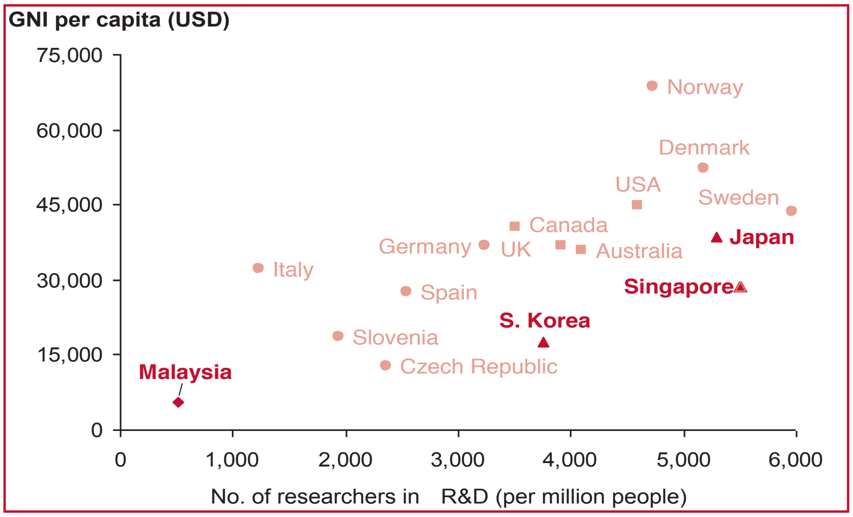
Source: EPU, World Bank

2.2.6 *Efforts to innovate and create have been insufficient*

The weak track record of domestic innovation in Malaysia is reflected by the comparatively low number of researchers (Figure 13). At the same time, the number of scientific and technical articles published in internationally recognised journals by Malaysians is also well below comparable countries (Figure 14). The lack of researchers and R&D results in a lack of innovation in the industrial and export sectors, sectors in which an unrelenting search for higher value added products and processes, and the capacity for their commercialisation are essential to global competitiveness. A World Bank survey of manufacturing indicates that Malaysian firms are doing less to develop innovative processes than those of similar countries. Surveys conducted in 2002 and 2007 indicate that Malaysian firms prefer to undertake less sophisticated activities, such as upgrading existing product lines or machinery and equipment. Activities that give rise to greater innovation and require the filing of patents are undertaken less frequently.

Even E&E manufacturing firms, supposedly the most innovative, are still focussed on less sophisticated activities. From 2002 to 2007, Malaysia's innovation efforts actually suffered an overall decline.

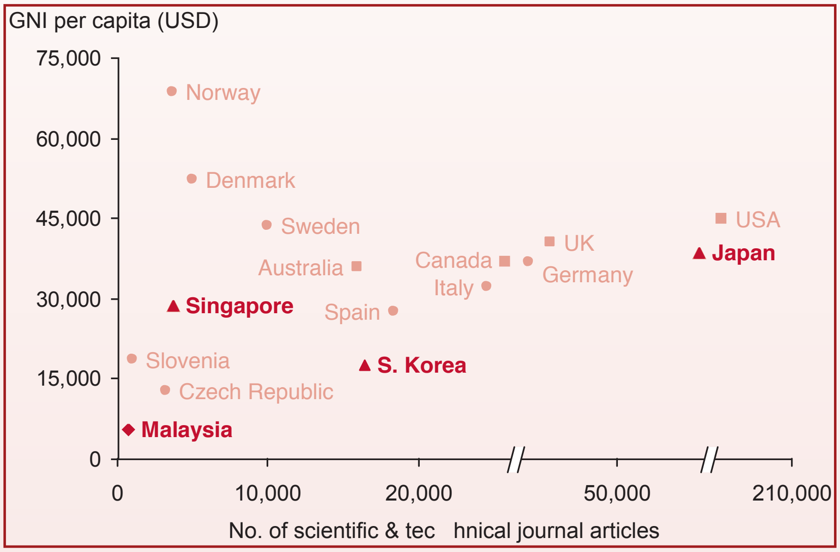
Figure 13 - Number of researchers (2006)



Source: WDI, KRIS

Innovation is a process that is self-sustaining – it pushes entrepreneurs and investors to maintain their leadership position in the market and thus sustains output growth, further contributing to Malaysia's high income goal.

Figure 14 - R&D articles (2006)



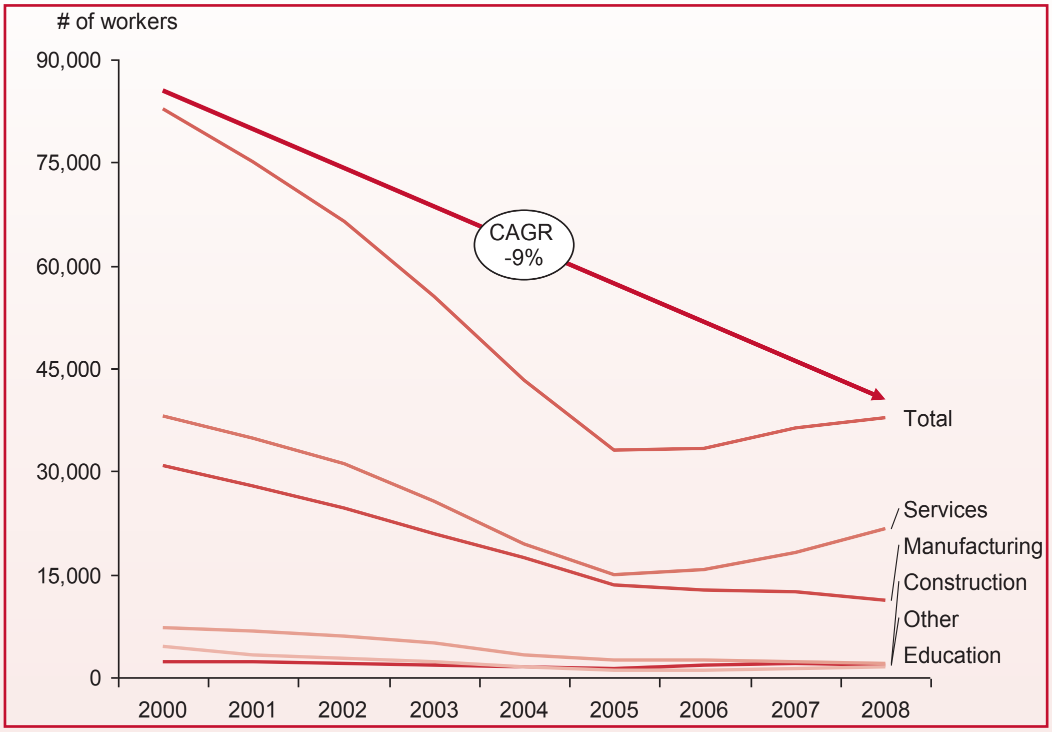
Source: WDI, KRIS

2.2.7 *We are not developing talent and what we do have is leaving*

The human capital situation in Malaysia is not improving. Instead, we are losing the skilled talent needed to drive future growth. Of great concern is increasing evidence that many talented Malaysians are leaving the country to seek better opportunities elsewhere – some 350,000 Malaysian adults are working abroad, over half of which had tertiary education, according to an estimate by the Ministry of Human Resources (MOHR) in 2008. Just as serious is the fact that the number of expatriates working in the country has been steadily declining (Figure 15).

Industry players often lament the absence of the right skills in the market, suggesting mismatch between the skills provided by the education system and those demanded by firms. The Department of Statistics reports that in 2007, 80% of Malaysia's workforce received education only up to Sijil Pelajaran Malaysia (SPM). Data from the Ministry of Higher Education show that about a quarter of graduates from local public universities remained unemployed six months upon completion of study in 2008. Even for those who secured jobs, almost one third were in jobs at a lower skill level. Moreover, according to MOHR, between 2001 and 2005, the government expended RM415 million on retraining some 40,000 graduates to improve their employability.

Figure 15 - Number of expatriates in Malaysia (2000-2008; no. of workers)



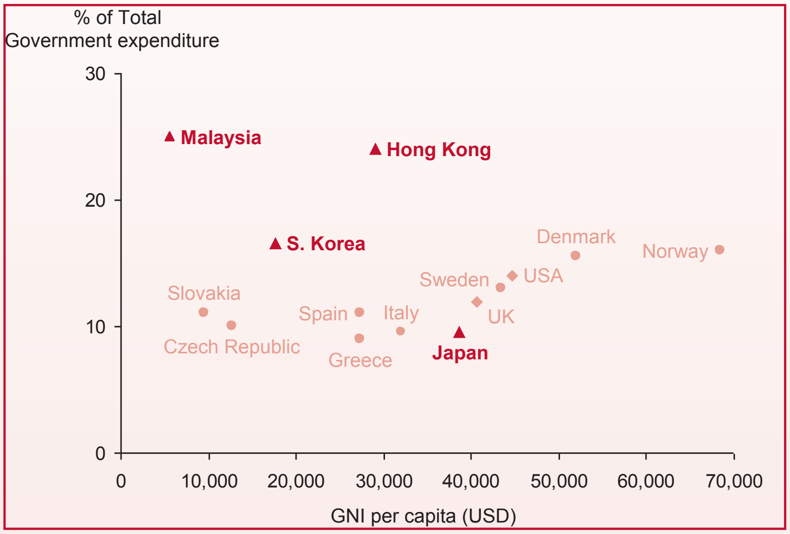
Source: Department of Statistics, EPU

Various programmes to attract skilled talent have been introduced in the past but they have achieved very little in concrete terms. The result is a shortage of the dynamic talent needed to push Malaysia into higher value added activities. In comparison with a number of advanced economies in the region such as Singapore, Korea and Taiwan, the share of unskilled and semi-skilled workers is much higher in Malaysia. Skill shortage consistently ranks high among the top obstacles faced by firms according to studies on Malaysia's investment climate. The most recent assessment by the World Bank suggests that firms have become increasingly concerned first about information technology (IT) skills and technical / professional skills of Malaysian workers, followed by complaints about inadequate creativity and proficiency in the English language.

The exodus of talented Malaysians is further compounded by the fact that the education system, despite high fiscal outlays through several reform efforts, is not effectively delivering the skills needed. The government has ploughed substantial investment into education relative to many other countries (Figure 16). But compared to other countries – both in the region and developed countries worldwide – the quality of students being produced, according to the Trends in International Mathematics and Science Study (TIMSS), continues to be inadequate. Education policies saddled with socio-political goals have stymied the national objective of producing the best talent to meet the country's needs.

The proportion of graduates in the technical and science streams continues to be lower than in the Arts. More disconcertingly, the trend

Figure 16 - Public expenditure on education (2008)



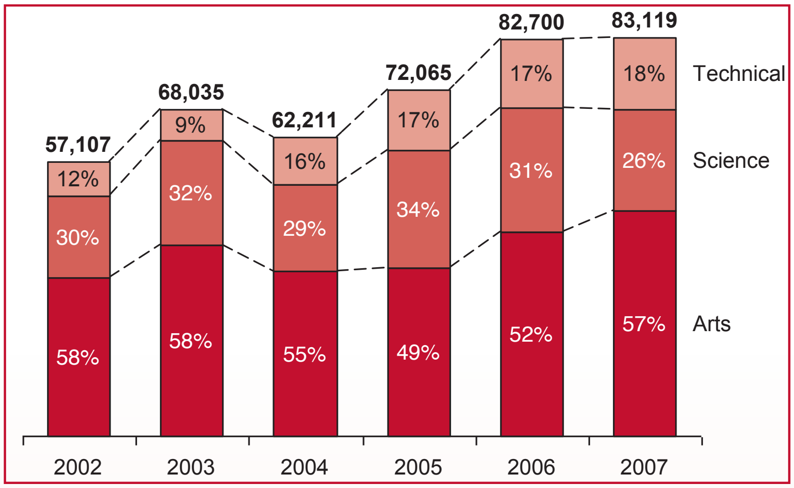
Source: World Bank, KRIS

CHAPTER 2

Where are we?

appears to have worsened in recent years (Figure 17), with Arts students accounting for well over half of graduates. At the same time, technical and vocational schools are producing declining numbers of graduates (Figure 18). Both instances clearly suggest that on the supply side, Malaysia is not producing the right talent needed for future growth. However, they also signal problems on the demand side. If employers truly value technical and science-oriented skills, it should translate into higher wages for such skills, which will attract more students into the technical and science streams.

Figure 17 - First degrees awarded in Malaysia (2002-2007; no. of graduates)



Source: MOHE

Figure 18 – Number of graduates from vocational and technical schools (1999-2009)

Source: MOE & MOHE

Larger enrolment in post-secondary education following SPM, especially in technical and vocational schools, will go a long way in improving the potential for employment in higher wage jobs and meeting the demand for mid-level skills by investors. Better collaboration between private sector employers and universities will help to correct the mismatch between industry demand and graduates as well as improve graduate employability.

2.3 The gap between rich and poor is widening

While the above discussion addresses the significant challenges contributing to the general economic malaise, recent data also indicates a growing gap between the rich and the poor.

Against the backdrop of strong economic growth and the New Economic Policy (NEP), Malaysia has made impressive headway with regard to overall poverty reduction. The incidence of absolute poverty has been cut from about 50% in 1970 to almost 20% by 1987 (Table 4). All ethnic groups recorded progress in poverty reduction. Despite slower growth post-Asian crisis, the incidence of poverty continued to decline to 3.6% in 2007.

Inequality, however, remains a real challenge for Malaysia. While overall income disparity improved as measured by the Gini coefficient[1] (with the overall Gini coefficient improving from 0.459 in 1997 to 0.441 in 2007), the disparity seem to have increased over the past decade for certain groups (Table 5). The disparity among the urban groupremains high with no improvements in the last decade.

Table 4 - Incidence of poverty by ethnicity and strata, Peninsular Malaysia (1970-2007 ; %)

	1970a	1987	1997	2007
Malaysia	49.3	19.4	6.1	3.6
Ethnic				
Bumiputera	64.8	26.6	9.0	5.1
Chinese	26.0	7.1	1.1	0.6
Indians	39.2	9.6	1.3	2.5
Other	44.8	20.3	13.0	9.8
Strate				
Urban	24.6	8.5	2.1	2.0
Rural	58.6	24.8	2.5	7.1

Source: EPU

1 The Gini coefficient is a measure of statistical dispersion of income or wealth. The closer the Gini coefficient is to 0, the smaller the dispersion - or the greater the wealth equality.

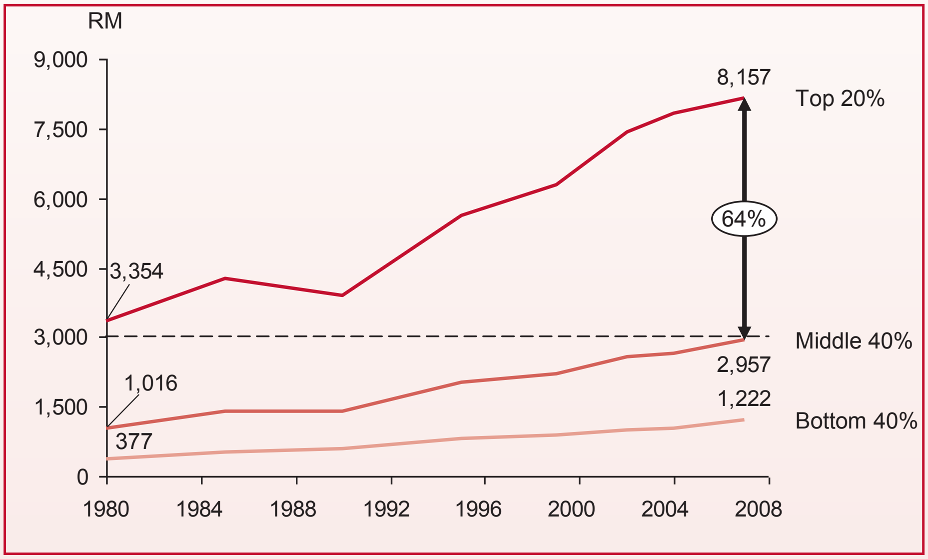
Table 5 - Gini coefficient by ethnicity and strata, Peninsular Malaysia (1970-2007 ; %)

	1970a	1987	1997	2007
Malaysia	0.513	0.456	0.459	0.441
Ethnic				
Bumiputera	0.466	0.447	0.448	0.430
Chinese	0.466	0.428	0.416	0.432
Indians	0.472	0.402	0.409	0.414
Other	0.667	0.663	0.555	0.546
Strate				
Urban	n.a.	0.449	0.427	0.427
Rural	n.a.	0.427	0.424	0.388

Source: EPU

Moreover, the results of household income surveys over the years suggest that income growth has been strong only for the top 20% of Malaysian income earners, particularly since 1990 (Figure 19). The bottom 40% of households have experienced the slowest growth of average income, earning an average of RM1,222 in 2008.

Figure 19 - National household income (Average by segment, 1980-2008; RM)



Source: MDI

Even though absolute poverty has been reduced, 40% of households continue to have very low income levels, particularly those in rural areas. This less-than-satisfactory distribution of wealth prevents a large portion of Malaysians from sharing the fruits of progress. In the long run, this hampers social mobility, again inhibiting large numbers of Malaysians from fully realising and developing their potential to contribute to the economy.

2.4 Malaysia is stuck in a middle income trap…

Starting as a low income country in 1957, Malaysia briskly climbed the ladder to attain upper middle income status by 1992. In the 1970s, the country successfully shifted from dependence on the primary sector and diversified into manufacturing, with assistance from Japan and the West. Exports of manufactured goods were soon fuelling the country's growth. A proactive government, high savings rate and strong foreign investment supported the building of one of the best developed infrastructures in the region.

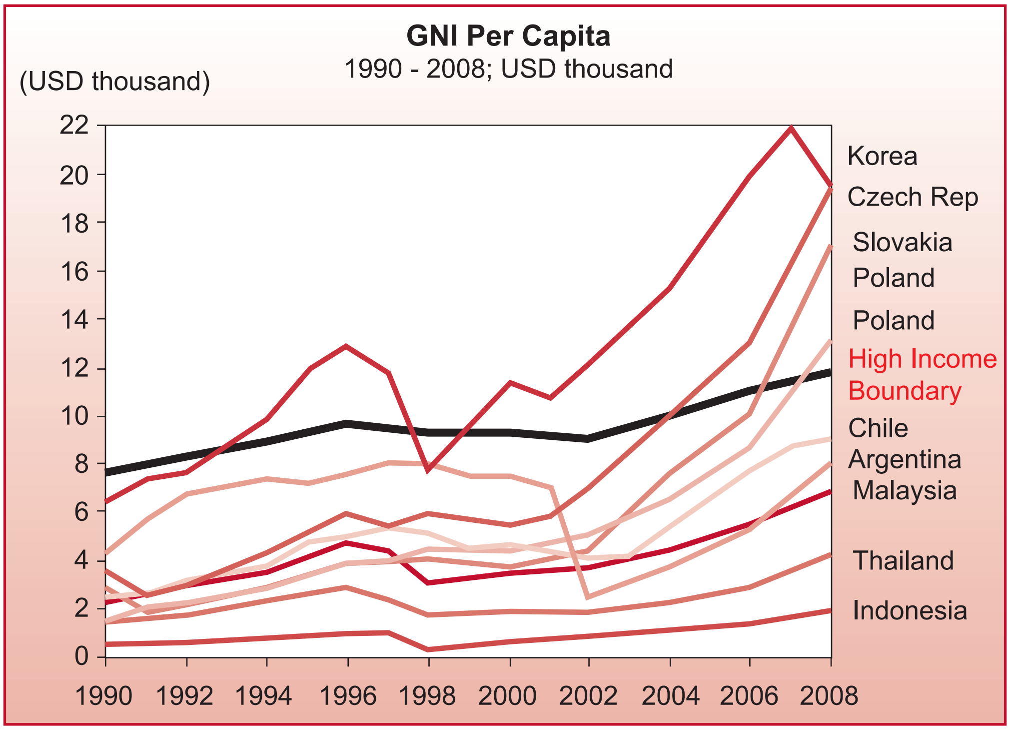
But since becoming an upper middle income country, like many others, Malaysia has largely stayed where it is[2]. Historically, it has been much easier for a low income country to make the transition to middle income status when they made good use of their natural resources or low cost advantage to attract investment. But the low cost advantage is a fleeting moment that ends when other low-cost centres emerge. Without new niches and strategic reform plans, many countries have been unable to break out of the middle income category – a phenomenon that has been termed 'the middle income trap'.

Although Malaysia's income trajectory continues to exhibit a gradual upward trend, it remains far below the 'high income' boundary (Figure 20). Several countries have been able to make the transition to the 'high income' status, including Korea, Poland, Slovakia, and the Czech Republic. In Asia, Korea broke out of the middle income trap after 1992 but regressed in the aftermath of the Asian financial crisis. Sandwiched between a rising China and a high-tech Japan, Korea recognised that its economic structure dominated by *chaebols* (politically connected family-controlled large conglomerates) could no longer sustain growth. Subsequently, they embarked on a painful but far-sighted transformation programme that propelled them back into the high income category.

For the Eastern European countries, the transition was made by pursuing reforms mandated by EU membership qualification, such as integration into a single EU market through harmonisation and standardisation of laws; enactment of an effective competition policy; and benefits from free movement of people, goods, services and capital.

2 Based on 2008 data, the World Bank classifies upper middle income countries as those with Gross National Income (GNI) per capita in the range of USD3,856 to USD11,905.

Figure 20 - GNI Per Capita (1990 - 2008; USD thousand)



Source: Nationmaster, UN, World Bank

2.5 …and these deficiencies are preventing us from getting out

In the current evolving situation, almost all economies of East Asia are poised to recover sharply. But Malaysia – already caught in the middle income trap, and facing all the challenges described above – runs the imminent risk of a downward spiral and faces the painful possibility of stagnation.

On the basis of recent trends and the fact that our economy was already one of the hardest hit by the recent global financial crisis, Malaysia is set to fall behind others in the region, given the weaknesses that we have accumulated over the years.

Labour market distortions impede productivity. The labour market in Malaysia does not function very well. High dismissal costs as required under the labour laws make investors unwilling to go into new areas of business which may involve shedding of labour. In response, some investors have found it more profitable to take on foreign unskilled labour where labour laws are not as strictly enforced. This, in turn, holds down wage levels for all workers. Unless such market rigidities are corrected, Malaysia will not be able to attract investment in new sources of growth such as medical tourism, ICT, and Islamic products and services.

Malaysia suffers from an exodus of talent. Not only is our education system failing to deliver the required talent, we have not been able to retain local talent of all races nor attract foreign ones due to poor prospects and a lack of high skilled jobs. Lack of talent will hamper

R&D and innovation in the areas of Malaysia's strength, such as E&E and palm oil. Without a critical mass of local and expatriate talent, Malaysia will not be able to prevent the erosion of its traditional advantage in commodities and manufacturing.

Ethnic-based economic policies worked but implementation issues also created problems. The NEP has reduced poverty and substantially addressed inter-ethnic economic imbalances. However, its implementation has also increasingly and inadvertently raised the cost of doing business due to rent-seeking, patronage and opaque government procurement. This has engendered pervasive corruption, which needs to be addressed earnestly. Countries in the region are combating corruption more effectively while implementing comprehensive reforms to reduce the cost of doing business. In this context, Indonesia will soon outpace us as their reform actions inject renewed vigour into their economy as evidenced by stronger growth rates.

Controlled pricing systems and subsidies result in resource misallocations. The pricing of essential goods and services in Malaysia does not reflect market prices. The mispricing leads to excessive consumption and wastage. At the same time, the large government outlay on subsidies – mostly funded by petroleum proceeds – is not sustainable.

Low-cost business models encourage a private sector focus on short-term goals. In Malaysia, the private sector appears to be focussed on and satisfied with short-term profits from low-cost operations, made possible by pricing and policy distortions. The private sector is not investing in products and services that will drive future growth. This is reflected by the little investment in R&D and lack of interest in innovating products and processes to move up the value chain. To encourage the private sector to become more agile in order to survive in an increasingly competitive global environment, such policy deficiencies must be corrected so that the private sector will take a longer term view of business prospects.

Our oil resources are depleting. Globally, prices are constantly rising, making subsidies and price-controlled items more costly. The subsidies were meant to support the vulnerable groups but it has benefited a wider group, including the well off. It is time for a more targeted approach rather than broad based subsidies which often are of most benefit to the well-off, who consume more of the subsidised goods.

Ineffective and siloed government bureaucracy discourages investment. Investors have often complained about government agencies that work in isolation with little coordination with each other (the silo scenario). This, coupled with excessive regulatory requirements and lengthy procedures, increases the financial and time costs for investors seeking to establish and expand their businesses.

As global investors are increasingly turning their eye to large scale markets to lower costs, small economies like Malaysia must remove all costly barriers to give investors compelling reasons to put their money and create high wage jobs here.

We must act now before our position deteriorates any further.

CHAPTER

3

What’s happening around us?

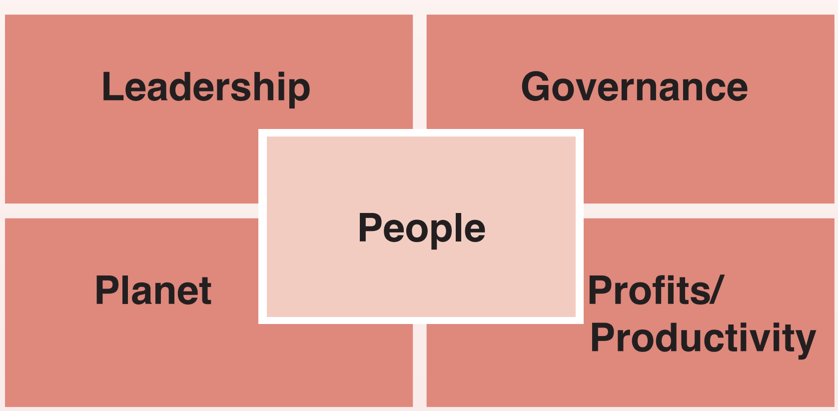
What's happening around us?

To act effectively we need to understand and appreciate what is happening around us. The global financial crisis has profoundly transformed the competitive landscape. Because the advanced countries will grow at a slower rate in the near future, the global crisis has forced many countries to revisit their growth strategy and upgrade their competitive strengths. Malaysia must meet these competitive threats and opportunities head-on. The NEAC has identified five key global trends that Malaysia must address. These are Leadership, Governance, Planet, Profits & Productivity and People (Figure 21).

3.1 New global leaders are emerging and Malaysia must be one

The global dynamics and power balance have shifted. The Global Financial Crisis is creatively destroying the old order, opening up opportunities in the new. The pre-crisis era of overwhelming economic dominance by the G-7 is over. The new world growth engines, such as "BRIC" (Brazil, Russia, India and China) and other emerging economies such as Indonesia, will grow faster and richer, will continue to strengthen their voices in the G-20, and are set to play a more prominent position on the world stage.

Figure 21 – The five dimensions of global changes



The emergence of a multi-polar power structure in a globally-connected world means that power and wealth will concentrate in those centres that have geography, timing and governance on their side. Leadership will accrue to those countries with the scale, the people and the entrepreneurship to seize the moment and the emerging opportunities. As people grow old in the advanced markets and the young come of age in emerging markets, consumer tastes and needs will change rapidly. The younger generations are more aware of the need for environmental sustainability, greater social inclusiveness, and equality of opportunity. Technology is opening up new products and services, lowering costs and speeding up delivery. Each company and country is now reviewing how to specialise, upgrade quality and become leaders in their fields.

Other than the population giants, most middle income countries realise that they cannot compete in all fields against all comers. To break out of the ‘middle income trap’, they must be niche-focussed, agile and build on their competitive strengths. In this milieu, Malaysia must make the best of what it has. Leadership is about making tough choices against tough competition.

Many countries are adopting niche strategies that build on their strengths, including geographic location and people skills. Resource-scarce countries like Korea are moving up the technology path. Taiwan focusses on strengthening innovative SMEs that capture commercial value in larger markets. Hong Kong and Singapore are upgrading financial skills to exploit the Asian time zone advantage and high Asian savings. Resource-rich countries in the Gulf are moving downstream to take advantage of their oil and gas endowments. Brazil is building on its lead in ethanol bio-fuel technology in cooperation with oil giants. Advanced countries like the UK, US, Germany and France all have serious growth and innovation plans that emphasise heavy investment in industries of the future, such as low carbon transport and energy, biotechnology, bioscience and advanced engineering and services. China and India are investing heavily in infrastructure and people to consolidate their advantages in size and scale. The competition will be fierce and formidable, even in areas where Malaysia has comparative advantages.

Malaysia is already a global leader in electronic and electrical exports and palm oil, as well as being richly endowed in tropical forests, marine reefs and talented people. Given our natural heritage, we can be a world leader in selected areas of biotechnology. We must take advantage of geography, timing, and people, by expanding trade and further strengthening our ties with regional global growth engines, while consolidating our ties with the advanced and other emerging markets.

Malaysia can be one of the first non-oil-based Organisation of Islamic Counties members to reach advanced country status ahead of both Lebanon and Turkey. Malaysia can be the world’s leading green economy in tropical forest and marine biodiversity conservation. Building upon its strategic geographic location in the fastest growing region in the world and a strong base of foreign investment, Malaysia can forge the right partnerships to succeed in the global race.

In short, Malaysia can become a global leader in selected fields, and be a strategic link between the Muslim world, resource-rich emerging markets, and high growth/ wealthy areas. Through active partnership between the government and the private sector domestically, and with multi-national companies globally, we can create domestic, regional and global champions, extending the 'Malaysia, Truly Asia' brand far beyond just the tourism sector.

3.2 Others are getting their houses in order – we should too

Leadership is all about strengthening governance at all levels – from private enterprise, civil society and the public sector to high standards of accountability, transparency, inclusiveness and fairness. The global financial crisis has revealed significant failures of governance in the advanced countries, resulting in a major overhaul of the political, economic and financial architecture to strengthen implementation, enforcement and delivery in a transparent and accountable manner. Instead of traditional top-down governance, social and economic structures have become more bottom-up with 360º surveillance and review.

As state ownership and control of banks and enterprises has increased through the crisis rescue packages, so too has the pressure to be more efficient, socially responsive, innovative and resilient. Corporate governance and public governance must adapt to the rapidly changing environment due to competition, technology and globalisation. To be best-in-class, one must not only meet, but exceed global standards of excellence and performance.

Modern governance in highly inter-connected network economies relies principally on collective actions, cooperation, and coordination, but also competition between different parts of the network. The current financial crisis has amply demonstrated the gaps, overlaps and structural weaknesses of institutional and national silos that cannot work together to address common systemic risks.

For Malaysia to compete at global levels, our governance standards must match global standards. Based on World Bank governance indicators, Malaysia is above the norms within South East Asia but well behind OECD nations who accept the principles of representative democracy and free market (Table 6).

Advanced countries demonstrate the following governance attributes that Malaysia must seek to attain:

- Transparent, open to review and scrutiny, and accountable to the citizens and stakeholders
- Strategically focussed
- Agile
- Responsive
- Inclusive
- Effectively connected both internally and externally

Table 6 - Governance indicators (2008; Percentile rank)

	Voice and accountability	Political stability	Government effectiveness	Regulatory Quality	Rule of law	Control of corruption
Malaysia	31.7	50.2	83.9	60.4	64.6	62.8
SE Asia	30.0	19.5	35.6	29.2	36.6	34.0
OECD	90.6	81.9	88.7	91.2	90.2	90.2
US	86.1	68.4	92.9	93.2	91.9	91.8
Eastern Europe	63.3	56.1	61.3	69.2	58.5	59.1

Source: World Bank

Socially-accountable growth is about partnerships not only between the state and the private sector, but also with civil society. We must break down the silos and barriers of trust and communication at all levels in order to foster quality growth and raise the standard of living in a sustainable manner for all citizens. This means that academia, business, the civil service, and civil society must work together in partnership for the greater good of the nation as a whole.

For the private sector to thrive in open competitive markets, the public sector must concentrate on its strengths and core competence. Modern advanced economies have public sectors that provide and maintain excellent social infrastructure, sound public security, effective protection of property rights, fair and efficient enforcement of laws and that address public issues of inclusiveness, social equity and environmental sustainability.

In the economics field, modern public sector governance aims at the efficient delivery of social services with the minimal levels of corruption and bureaucracy. Putting 'people first and performance now', the objective of PEMANDU, is aimed at reducing the costs of doing business, being sensitive to social needs, and fostering innovation, entrepreneurship, growth and competitiveness for all citizens.

Leading economies are innovating new processes of communications, partnership mechanisms, government procurement programmes and changing incentives in order to improve the way the private and public sector (as well as different branches of the government) interact. There is now increasing awareness that transformation to an advanced economy status is a process, where the goals are identified and incentives aligned. Institutional innovations and removal of barriers are crucial to effective implementation. As systems and environments are changing rapidly, the public-private partnerships must work flexibly to adapt and adopt new processes and systems, whilst discarding and removing barriers to social efficiency and competitiveness.

3.3 Malaysia should lead the global green revolution

As one of the top 17 mega-biologically diverse countries in the world, with rainforests covering 60% of our landmass, Malaysia is at the frontier of the global environmental and climate change debate. In recent years, global awareness of environmental deterioration, especially the impact of climate change, has become pivotal to international social and economic policy debate. There is global consensus that excess consumption and waste are major factors contributing to excessive pressures on resource supply, resulting in commodity price spikes as well as the rapid depletion of non-renewable natural resources. Improper management of water and energy resources has contributed to social conflicts and unrest. Sustainable growth can only be attained by properly nurturing a healthy ecosystem and protection of our precious natural environment. There is already a fundamental shift in mind set and attitude of global citizens that is calling for profound changes in lifestyle and stewardship of nature.

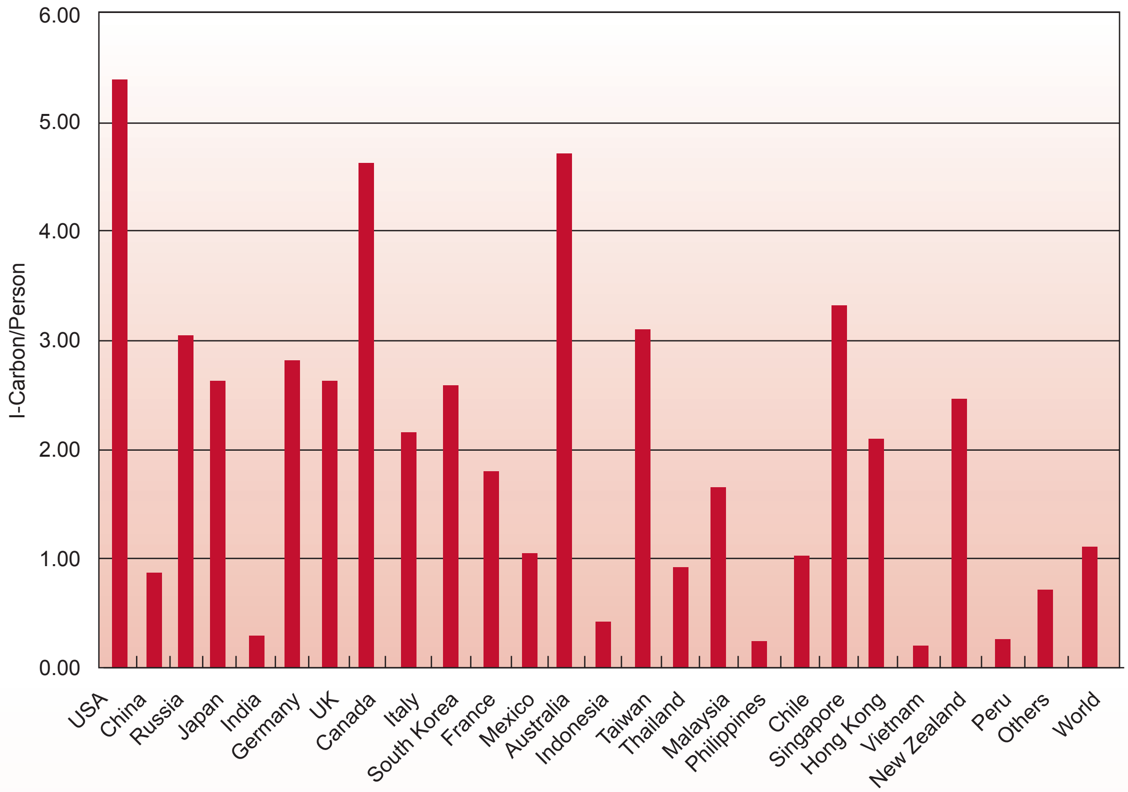
Building on Malaysia's natural resources and biodiversity is central to strengthening our comparative advantages. Having such a precious natural heritage is important not only for Malaysia, but also the world. Preserving the natural rain forests and marine reefs plays a significant role in the global carbon emission mitigation strategy. Properly managed and preserved, these natural resources have the capacity to reduce the world's carbon emission and help offset the impact of environmental deterioration on sustainable living. If mismanaged, Malaysia could face both irreparable environmental damage, but also global sanctions that could have significant economic impact on our future exports and income.

In Copenhagen, Malaysia already made significant commitments to deliver a 40% reduction in CO2 emissions by 2020 (compared to 2005). This is a major challenge for the economy and will need careful consideration, planning and implementation/ enforcement, as Malaysia's CO2 emissions are notably higher than our neighbours (Figure 22).

The global focus on environmental considerations will result in large shifts in demand for commodities and manufactured goods, to which Malaysia can adapt and is well positioned to anticipate, deliver and lead. We need to create clusters of research and development to exploit these leads.

Malaysia should embrace a leadership role in green technology and become a strategic niche player in high value green industries and services that play to our competitive

Figure 22 - Carbon dioxide emissions per capita (2003; tonnes per person)



Source: EDMC

advantages. The commercialisation of our natural biodiversity into high-value products and services will be a major national challenge. But it is also an excellent avenue for partnership between the private and the public sectors.

The major benefit of our green, high income, and inclusive strategy is that future generations of Malaysians (and world citizens) will continue to enjoy the clean air and water, and natural environment that they deserve and work so hard to preserve and enhance. Malaysians can feel proud that we are setting the pace in treasuring our heritage and delicate ecology for the mutual benefit of all mankind.

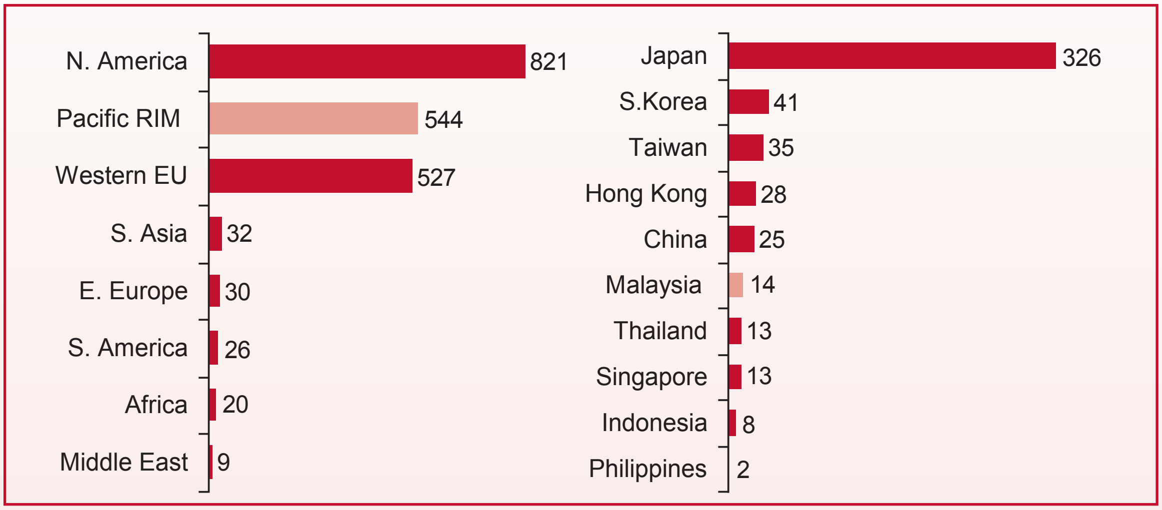
3.4 Global business is bipolar – the large are getting bigger and smarter while the small are more nimble and faster

The creative destruction of the current global financial crisis will unleash a new wave of businesses that will be smarter, bigger and faster than the old industries that they replace. At the same time, there will be symbiotic relationships between the multinational giants and the nimble, creative and specialist SMEs that are the backbone of any economy. The big must go global to survive, whilst the small can also have global reach through the Internet and plugging into regional production networks and supply chains.

Traditional manufacturing will be commoditised as computerisation, miniaturisation and value added services delivered through highly inter-connected supply chains transform global business. Profits will come from creatively opening up new brands, products and services, requiring higher levels of research and development, investment in people and infrastructure, and the creation of new entrepreneurial skills.

Growth can only be widely shared through the relationships between the global giants and SMEs, with continual creation and expansion of high-quality jobs, requiring continual investment in skills. Even as larger firms go for scale and reach, smaller firms go for niche and specialist knowledge. Large firms cannot exist in isolation. They need clusters and critical masses of SMEs to support their growth and creativity. SMEs are still the most important employment providers and sources of talent for large firms. Large firms that compete globally are based primarily in stable, advanced and open economies with excellent supply chains. Currently, many of them are located in North America and Western Europe, while the majority of companies located in the Pacific Rim can be found in Japan, with relatively few in Malaysia (Figure 23).

Figure 23 - Companies in Forbes 2000 by region (2005; no. of companies)



Source: Forbes

The lessons that can be drawn from how these successful firms operate include:

- Branding, networks, distribution, and supply chains drive profits
- Speed to market is critical
- Technology and innovation drive productivity and profits
- Trend towards high value services
- Economic imbalances are a risk to financial stability
- Risks are unpredictable but can be managed

In order to address, and keep pace with these global trends, Malaysia should undertake a variety of initiatives, for example:

- Building on our strengths in E&E, commodities and services - to find high-value niches in the regional and global supply chain
- Positioning the services sector to meet the emerging demand for high-value services
- Reducing the costs of business entry and operations, including reducing regulatory barriers and costs
- Focusing entrepreneurial skills by incorporating entrepreneurial curriculum in vocational and university training, including on-the-job training programmes
- Fostering the growth of private equity, venture funds and capital market instruments to improve the capacity of SMEs to take commercial risks
- Creating domestic, regional and global champions that can grasp the opportunities in the Asian region and compete on world standards

3.5 Growing our most important asset – people

At the heart of the global trends of leadership, governance, and business is the quality of people. Globalisation has created a fierce competition for talent, forcing companies and governments to recognise that people are the most valuable assets. In order to compete, advanced nations have realised that their labour forces must be flexible, adaptive and competitive on the global, regional and national levels. Creative destruction occurs in not just companies and industries, but also human skills. Societies and governments must facilitate orderly transition or face disruption and chaos.

In many countries the dynamics of demographics are driving change nationally and across borders through migration. Ageing societies and booming economies need movement of humans as well as capital to sustain growth. Immigration has traditionally played important roles in North America, the EU and Australia in rejuvenating their knowledge, skills and technology base.

Globalisation has enhanced the relentless competition for talent by making human capital almost totally mobile. The best people want to settle and work in desirable locations and healthy environments. The new generation of professionals and middle managers welcome diversity, exhibit greater tolerance, and place emphasis on a better quality of life. People also hunger for greater inclusiveness and equality. They want better education for their children and a place to grow their talents. To attract and retain the talent needed to sustain growth of a knowledge-based and innovative economy, companies and countries are striving to improve working and living conditions, with not just high pay, but an environment that nurtures and appreciates human creativity.

The mobility of talent has created problems for many failed states, as poor security and working environments lead to outward migration of the best people and skills, leading to a vicious circle of deterioration of production and services and hollowing out of business efficiency and competitiveness. When the best staff and their supporting skills leave, whole social services have been known to collapse, leading to further deterioration in the fabric of society. Advanced countries devote considerable attention to personal and national security risks that jeopardise the well being of society. The potential clash of values and incentives needs to be properly handled. The trend to attract away the best talent in any country from any source, have a variety of implications for Malaysia. To compete on a regional and global scale, Malaysia must not only retain the valuable skills and talent within the country, but attract the global skills that are needed to break out of the middle income trap.

A leading advanced nation must be seen by its people and by others as a land of equal opportunity to earn a good living and provide a secure, happy life for each individual and each family. In order to achieve that, government needs to be more inclusive, establishing an on-going consultation with the people to best understand and respond to their needs and aspirations. Advanced nations recognise that the best solutions are often derived from continual consultation and wide feedback in a manner that is tolerant of differences of opinion.

Conversely, a more open, comprehensive dialogue between the people and leadership will ensure that the people have a better understanding and ownership of the national agenda and aspirations. This is particularly important for the younger generation, which by virtue of modern social networking technologies, is in some ways more attuned to trends in other countries than it is to other age groups within its own country.

The fierce competition for global talent presents both threats and opportunities for Malaysia. Nurturing, upgrading and retaining domestic skills is a necessary condition for growth, but it is not sufficient. In order to achieve advanced economy status and get out of the middle income trap, Malaysia must attract the skills needed to fill the gaps and enhance the comparative advantage of the nation as a whole. We must all strive to appreciate that the same incentives and quality of life that encourage Malaysians to live and work in Malaysia will also attract highly-skilled foreigners to come and build new businesses and opportunities. The perspectives and work ethic of these new professionals will enrich the atmosphere within which to attain greater quality of life achievements.

CHAPTER

4

Which advantages do we have?

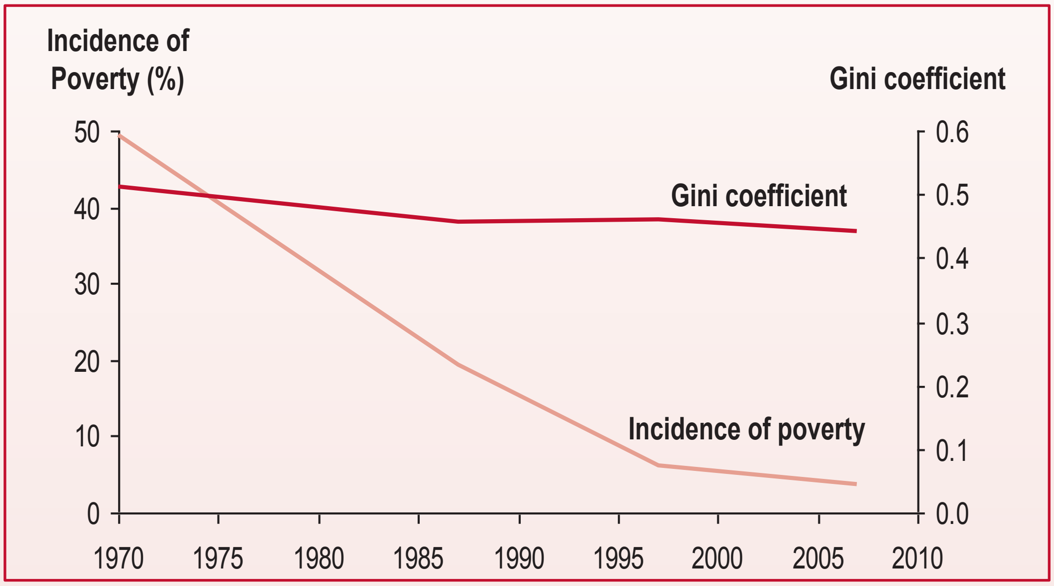
Which advantages do we have?

While Malaysia faces daunting challenges amid rapid global changes, we also have a number of strengths and unique advantages on which to draw as we take purposeful policy actions to move forward.

4.1 We are not poor and have good infrastructure

As a nation, Malaysia largely eradicated poverty and moved into the upper middle income category in the early 1990s. The successful economic approach was embedded in the New Economic Policy (NEP) which had a two-pronged focus on the eradication of poverty irrespective of race and the restructuring of society to correct the identification of race with economic function. The incidence of absolute poverty was reduced from above 40% in 1970 to 3.6% in 2007 — despite slower growth in the post-2000 period (Figure 24). All ethnic groups recorded increases in average incomes and progress in poverty reduction, including in Sabah and Sarawak. Over the last 30 years, the income disparity between *bumiputera* and non-*bumiputera* communities has narrowed.

Figure 24 - Incidence of poverty (1970-2007; %)



Source: UN

Substantial investment has resulted in the building of a world-class infrastructure in Malaysia. This has contributed to the leadership that Malaysia enjoys in E&E manufacturing, major natural resource exports and passenger aviation. In today's globalised market, our developed infrastructure will facilitate the attraction of new innovative firms that require efficient production chain networking and sophisticated inventory management.

Our strength in infrastructure is reflected in an extensive network of roads offering rapid connection to air and seaports for moving goods and people (Table 7). In addition, electricity consumption in Malaysia is high and our water and sanitation facilities have reached a large percentage of households. Our communication facilities are modern with many more people using the internet.

4.2 We have established a world-class manufacturing base

Manufacturing has been the fastest growing sector of the economy over the past generation (Figure 25). Rapid growth in manufacturing first took off in the 1980s and accounted for more than 30% of output

Table 7 – Selected infrastructure indicators

2004-2005	Malaysia	China	India	Indonesia	Thailand	Brazil	Mexico	Turkey
Electric power consumption (kwh per capita)	3166	1585	457	478	1856	1955	1838	1782
Roads, paved (% of total roads)	81.31 (2004)	82.5	47.4 (2002)	58 (2002)	-	-	49.54	41.59 (2002)
Container port traffic (mn TEU)	12	89	4.9	5.5	5.1	5.6	2	3
Telephone mainlines (per 1,000 people)	172	269	45	58	110	230 (2004)	189	263
Internet users (per 1,000 people)	435	85	55	73	110	195	181	222
Improved water source (% of population with access)	99	77	86	77	99	90	97	96
Improved sanitation facilities (% of population with access)	94	44	33	55	99	75	79	88

Source: Centennial Group

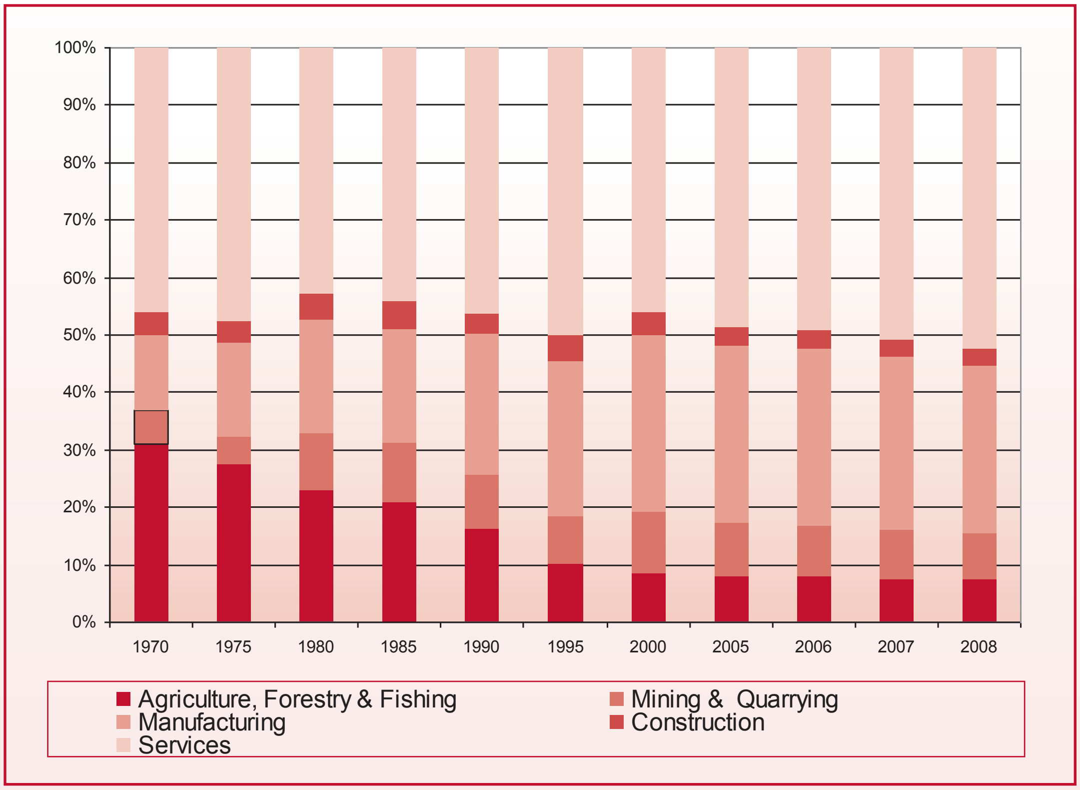
by the 2000s from less than 15% in 1970. Manufacturing was primarily focussed on the E&E sector by attracting large inward investment by multinational firms. The E&E sector spawned the growth of other sectors in supply, logistics and services. Malaysia has become a major exporter of consumer and industrial electronic products. It is now poised to make the next technological leap to more innovative and higher value added, cutting-edge technology industries. Such industries may have to be part of supply chain networks to operate within the global requirement for large-scale applications.

4.3 Malaysia is at the heart of a vibrant region

Malaysia is strategically located in a high growth region (Figure 26). In 2008, bilateral trade between Malaysia and China was USD53.5 billion, a 15% increase over 2007. Bilateral trade with India is close to exceeding USD10 billion in 2009.

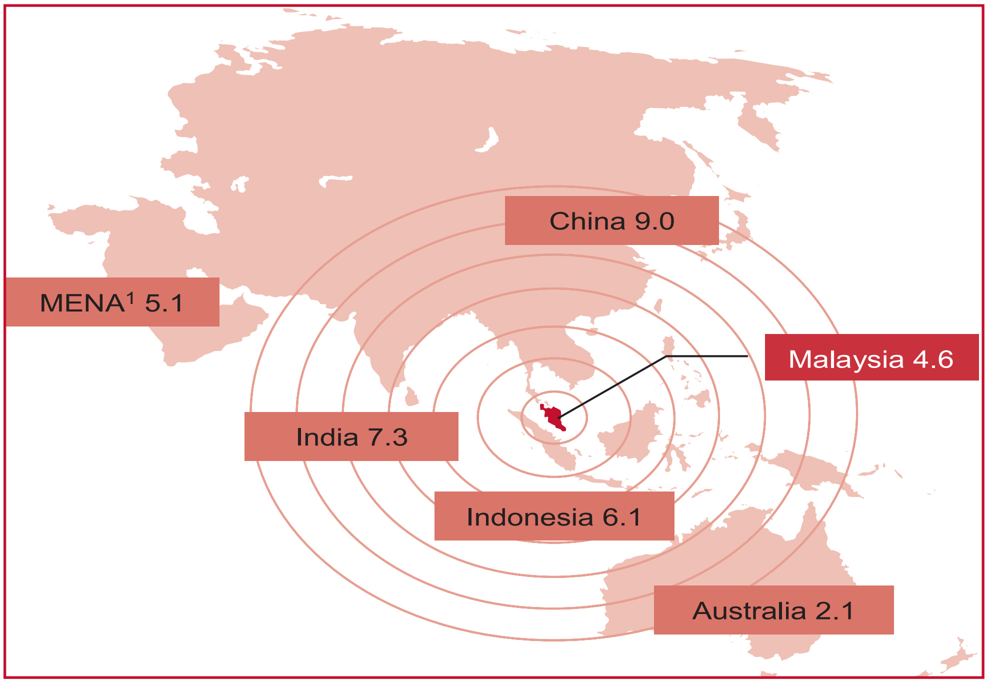
Malaysia's geographic location and its endowments help to attract FDI/FPI from China, India and East Asia as these countries seek currency stability through diversity, access to natural resources, and niche markets that reinforce bilateral ties.

Figure 25 - Sector contribution to GDP (%)



Source: BNM

Figure 26 - Real GDP growth (2008; %)



Source: World Bank

The country's strategic location, coupled with its well-developed infrastructure, will serve to attract investment to build transportation and logistics hubs. Our infrastructure is currently augmented with modern industrial parks and development corridors, which are meant to favour innovative and high value added businesses.

4.4 Malaysia is a model of cultural, ethnic and biological diversity

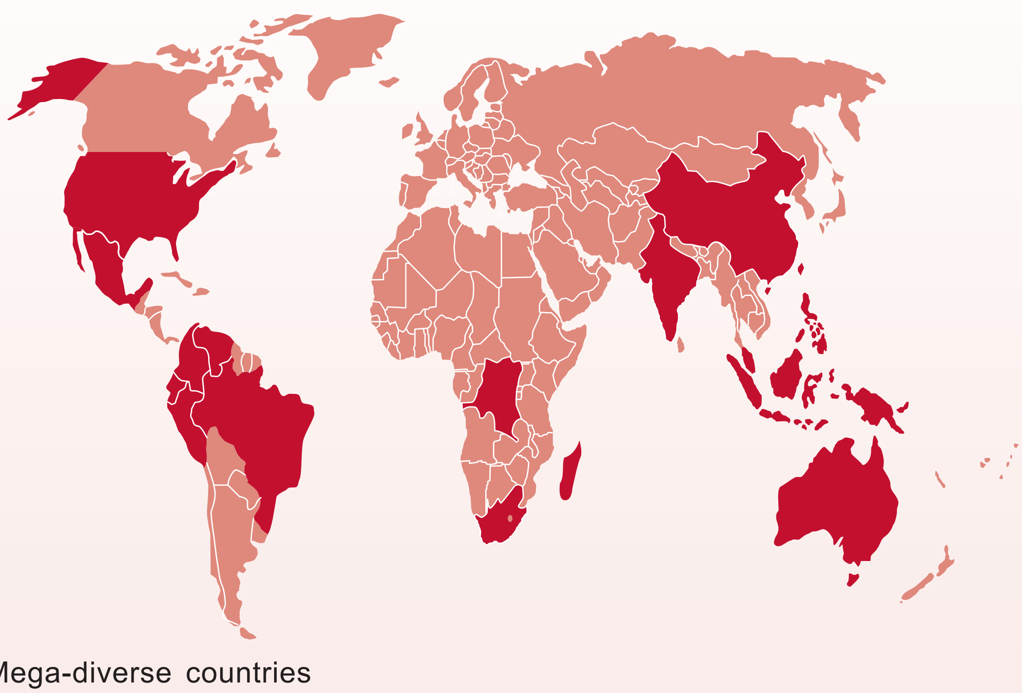
Malaysia is a culturally rich society with an array of diverse ethnic groups spread across the Peninsula, Sabah, and Sarawak. This diversity provides Malaysia with substantial advantages. Diversity of culture, ethnicity, languages, and religions enables a society to leverage the best of each group's innate skills and traits for the good of the society as a whole. Diversity of culture also stimulates imagination, creativity, and innovation. Malaysia's rich and unique cultural heritage, and even colonial history are assets for forging relationships in many countries, especially in the high growth economies of China, India, the Middle East and Indonesia. Furthermore, Malaysia's diverse language networks help to support the development of tourism and industry links in those same markets.

Malaysia is one of the 17 most important mega-biodiversity countries in the world (Figure 27), with 16 million hectares of tropical forest area, covering 60% of our land area. Over 90% of the forests remain state-owned, and 73% of total forest area is designated national parks. Two of these are World Heritage sites: Kinabalu Park and Mulu National Park. Malaysia has over 2,650 native tree species, of which 550 are vulnerable or endangered.

Malaysia has a total coastline of 4,675 km, the 29th longest coastline in the world, teeming with coral reefs (the best known being Sipadan) and marine life. A total of 16% of terrestrial and marine areas are protected in Malaysia. Malaysia has established about 14,167 km^2 of Marine Protected Areas to conserve our marine reefs, where 400 species of coral and 1,000 different species of fish exist today. Therefore, the protection of these coral reefs are becoming more important as they are increasingly under threat.

Malaysia's rich biodiversity can be harnessed to generate economic benefits from tourism, recreation, pharmaceutical applications and nutritional products. Although a shift away from reliance on heavy resource consumptive industries for economic growth is essential, Malaysia's natural resource endowment can be used in creative and sustainable ways as a base to build new, diverse, high value, high tech industries and services. A good example would be renewable energy industries such as photovoltaic and biomass technologies.

Figure 27 – Countries with mega-diverse earth's species



Source: UNEP

CHAPTER

5

Where do we want to be?

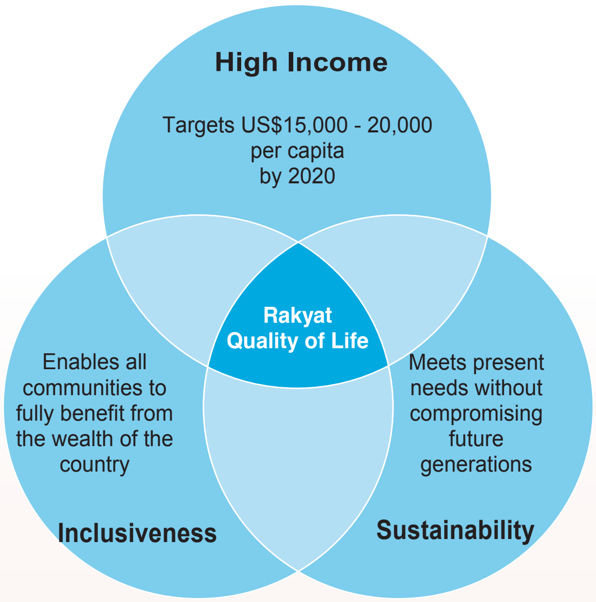
Where do we want to be?

From the analysis thus far, the NEAC and, we believe, most other informed observers would draw the conclusion that Malaysia's handicaps are starting to undermine our strengths and unique advantages, which are being made more acute amidst the changing global environment. It is clear that a new approach to growth is necessary to get us to where we want to be.

5.1 The New Economic Model – A sustainable, inclusive, high income economy

The main goals of the NEM are that Malaysia will become a high income advanced nation with inclusiveness and sustainability, which together will translate into a high quality of life for the *rakyat* (Figure 28). All three goals are critical for improving the lives of millions of ordinary Malaysians. No one goal should be achieved at the expense of the others. In striving to achieve those goals, we cannot take the short-cut of pump-priming with wealth from natural resources, which is not sustainable. Nor can we completely leave things to market forces and ignore the need to preserve social harmony.

Figure 28 – Goals of the New Economic Model



The many shortcomings of the economy must be overcome before Malaysia can transform into an advanced nation by 2020. An advanced nation is not solely about the income level. The economic structure must be more developed, specialised and technology-driven. In addition, effective institutions must be in place to ensure good governance. Good healthcare and social support will be measurable through a higher life expectancy and a superior standard of living. The benefits of these improvements will be accessible to all communities and income groups. After achieving advanced nation status, maintaining that position will require continuous efforts well beyond 2020.

5.1.1 *Breaking through to high income status*

Currently, Malaysia's estimated per capita GNP of USD7,558 puts it in the upper middle income group. Growth in recent years has fallen to a pace of about 4.5% to 5%, which lags behind the growth of neighbouring countries and will keep Malaysia trapped in a zone far below its potential.

We can and must do better. Doing better will require taking difficult reform actions to propel the economy to higher growth. Sustained and full implementation of reform measures proposed by the NEAC will drive Malaysia's transformation into a high income economy by 2020. The NEAC foresees that bold reform measures will unlock investment, drive labour productivity and boost efficiency, lifting real growth rate to an average of 6.5% per annum over the 2011-2020 period. Per capita GNP will rise to about USD17,700 by 2020 (Table 8). This scenario assumes that globally there will not be another major economic crisis to derail the Malaysian economy from this growth path.

If the GDP growth target is to be achieved, aggregate demand will have to grow at a robust pace (Table 8). Investment will be the main driver of economic growth through 2020. The contribution from private investment must return rapidly to a significant level last seen in 1997, reaching almost a fifth of GDP by 2020 compared with about a tenth in 2010. Similarly, private consumption will rise and increase its share of GDP while public consumption will slow down.

Despite the anticipated boost to domestic aggregate demand, external demand will still provide the stronger boost to growth. The growth engine will still come from the growth in exports. The openness of Malaysia will increase further with a higher total trade to GDP ratio by 2020.

The supply side highlights the shape and structural trends of the economy (Table 9). As income rises the share of agriculture to GDP will continue to slide. There will be industrial deepening but manufacturing's share of GDP is anticipated to fall slightly to 24.9% by 2015 and marginally further to 24.2% in 2020. On the other hand, service's share of GDP will increase from almost 59% in 2010 to slightly above 67% by 2020.

Sizable financial and human resources will be required to achieve the growth targets of the NEM. Both DDI and FDI will continue to be vital for financing growth. Maintaining the right environment and incentives will also be necessary. Competition for FDI is expected to continue and many of the proposed changes will have to be implemented.

Table 8 – Gross domestic product by expenditure category, 2010-2020

	RM million (in 2000 constant prices & current prices in italics)			% of GDP			Average annual growth rate (%)	
	2010*	2015	2020	2010	2015	2020	2011-15	2016-20
Consumption expenditure	365,598	490,851	715,665	67.9	67.5	70.6	6.1	7.8
	445,638	*659,572*	*1,050,975*	*67.9*	*67.5*	*70.6*	*7.8*	*9.8*
Private	294,134	407,444	614,868	54.7	56.0	60.7	6.7	8.6
	358,529	*547,494*	*902,953*	*54.7*	*56.0*	*60.7*	*8.8*	*10.5*
Public	71,464	83,408	100,796	13.3	11.5	9.9	3.1	3.9
	87,110	*112,078*	*148,022*	*13.3*	*11.5*	*9.9*	*3.9*	*5.7*
Gross Fixed Capital Formation	125,187	191,487	286,552	23.3	26.3	28.3	8.9	8.4
	152,594	*257,307*	*420,810*	*23.3*	*26.3*	*28.3*	*11.2*	*10.3*
Private	57,175	106,207	180,485	10.6	14.6	17.8	13.2	11.2
	69,692	*142,713*	*265,048*	*10.6*	*14.6*	*17.8*	*15.4*	*13.2*
Public	68,012	85,280	106,067	12.6	11.7	10.5	4.6	4.5
	82,902	*114,594*	*155,763*	*12.6*	*11.7*	*10.5*	*7.0*	*6.3*
Exports of Goods & Services	546,375	808,562	1,196,790	101.5	111.1	118.1	8.2	8.2
	665,993	*1,086,489*	*1,757,522*	*101.5*	*111.1*	*118.1*	*10.8*	*10.1*
Imports of Goods & Services	502,100	749,148	1,168,375	93.3	103.0	115.3	8.3	9.3
	612,025	*1,006,653*	*1,715,793*	*93.3*	*103.0*	*115.3*	*13.8*	*11.3*
GDP	538,069	727,510	1,013,691				6.2	6.9
	724,480	*977,577*	*1,488,636*				*6.3*	*8.8*
GNP	516,144	723,869	1,028,558				7.0	7.3
	655,869	*1,136,091*	*1,800,684*				*6.6*	*9.2*
GNP (USD million)**	149,607	219,354	311,686					
GNP per capita(USD)**	7,558	11,929	17,725					

Sources: MOF, BNM & EPU

Notes: Population growth rate in 2010 is 1.5% & currency exchange rate is RM3.4/USD in 2010. Baseline year is 2010 based on EPU latest revised numbers. Current prices are computed based on the GDP & GNP implicit price deflator forecasted numbers for 2010-2020 derived from IMF-IFS CD-ROM. For 2011-2020, average population growth rate is 1.3% & average currency exchange rate is RM3.2/USD.

* Based on EPU estimates

**At current market prices

Table 9 – Gross domestic product by industry origin, 2010-2020

Sectors	RM million (in 2000 prices)			% of GDP			Average annual growth rate (%)	
	2010*	2015	2020	2010	2015	2020	2011-15	2016-20
Agriculture, forestry & fishing	40,172	46,706	53,153	7.5	6.4	5.2	3.1	2.6
Mining and quarrying	41,867	44,309	46,615	7.8	6.1	4.6	1.1	1.0
Manufacturing	138,852	181,465	245,140	25.8	24.9	24.2	5.5	6.2
Construction	16,963	20,559	24,019	3.2	2.8	2.4	3.9	3.2
Services	317,010	453,831	682,401	58.9	62.4	67.3	7.4	8.5
GDP at 2000 constant prices	538,069	727,510	682,401	100.0	100.0	100.0	6.1	6.9

Sources: MOF, BNM & EPU

* Based on EPU estimates

The fiscal deficit of the Federal Government, at about 7.4% of GDP in 2009, has reached a peak and is expected to decline to 5.6% of GDP in 2010. Market sentiments will further improve if the fiscal deficit is brought down even lower. The NEM calls for a further reduction of the fiscal deficit with the easing and exit from fiscal stimulus, to a near-balance by 2020. Further control of public expenditure, diversifying the sources of revenue, and a much more efficient utilisation of financial resources will be required if the economy is to achieve a near-balance budget over the next 10 years.

As at end-June 2009, the national debt stood at about 34% of GDP or RM 233.9 billion, which includes debt from the private sector and the Non-Financial Public Enterprises (NFPEs), even taking into account the impact of fiscal stimulus measures in the wake of the recent global financial crisis. This level of debt is much lower than many other countries. The external debt service ratio from 2005-2009 averaged about 4.9%, reflecting the fact that Malaysia has relied far more on domestic sources for financing its growth than on external funding.

The NEM envisages a continuation of a prudent debt management policy. As public investment is reduced over time, the fall in the need for external financing from the public sector will be replaced by an increase in external financing from the private sector. Overall, in the 2011-2020 period, the NEAC envisages a slight dip in the total national debt to just under 30% of GDP by 2020.

5.1.2 *Generating benefits for all Malaysians*

Inclusiveness is the second goal and a key part of the NEM. It is a prerequisite for fostering a sense of belonging. Not having the opportunities to benefit from economic progress breeds resentment within marginalised groups in the urban and rural areas, especially those in remote locations of Sabah and Sarawak. Inclusiveness will enable all communities to contribute to and share in the wealth of the country. While perfect equality is impossible, an inclusive society will ensure that inequality does not worsen.

The NEM incorporates a new approach which can be summarised as *inclusive growth*. Inclusive growth is pro-poor growth and is concerned not only with the level but also the effect of persistent inequality on economic growth and poverty alleviation.

Unity through inclusive growth

Ethnically divided societies are more prone to violent conflicts. The multi-racial composition of the Malaysian population is still its outstanding feature and this ethnic diversity will always be with us. The more than 50 years of growth has shown clearly that economic growth by itself cannot erode the salience of ethnicity. But the excessive focus on ethnicity-based distribution of resources has contributed to growing separateness and dissension. The persistence of inequalities between ethnic groups makes it imperative that the NEM continue to address these inequalities.

It is important to remember that a community can be divided not only by ethnicity but also by class, occupation, age, regional location and numerous other ways. Even within ethnic groups there can be sharp disagreements and dissensions. Individuals are characterised by a plurality of identities. The notion of a singular identity overriding the rest can be misleading and dangerous. The notion of 1Malaysia, or a united Malaysia, should be used in a much wider sense and to transcend ethnicity. There is a plurality of identities that go beyond ethnicity and must be addressed and this will be in line with the NEM.

Reducing inequality is one of the defining features of the NEM. Equality before the law is safeguarded in the Constitution. A key challenge of inclusive growth is the design of effective measures that strike a balance between the special position of *bumiputera* and legitimate interests of different groups.

More competition and pushing ahead with liberalisation will need to be complemented by a system that recognises and rewards merit. A fair process will require, among other things, much greater recognition of merit for gaining access to opportunities. Equalising opportunities must allow for a greater contribution of merit. Merit denotes the level and quality of individual as signalled by his or her performance.

Underlying the notion of equity and fair opportunities is the concern with equality. Equality can be approached in terms of equality of income, wealth or liberty. Equality of opportunity is biased towards equality of the means rather than the ends since equal opportunities can produce unequal outcomes. A wider notion would be therefore to focus on fostering equal capabilities. Opportunities and capabilities are intertwined and mutually reinforcing. The shift towards equitable and fair opportunities is hence broadly consistent with the shift towards fair processes. Hence the market-friendly affirmative action programmes in line with the principle of inclusiveness will:

- Target the assistance to the bottom 40% of households – of which 77.2% are *bumiputera* and many are located in Sabah and Sarawak
- Ensure equitable and fair opportunities through transparent processes
- Allow access to resources on the basis of needs and merit to enable improvement in capacity, incomes and well-being
- Have sound institutional frameworks for better monitoring and effective implementation

Forces of change make reforms imperative

Forces of change make it necessary to continually reform our approaches to better attain our objective of inclusiveness. The forces of change come from: (a) globalisation and openness; (b) competition and competitiveness; and (c) new ideas on wealth distribution and social justice.

The continuing integration of the Malaysian economy in the global economy is anticipated to enhance economic growth and also, on balance, to be positive for distribution. The distributive outcome arising from greater competition depends on the the nature of industrial structure. Manufacturing industries which utilise newer technologies and more highly skilled labour will make higher profits and pay higher wages. Equitable wealth distribution and social justice should emphasise equal opportunity. Fair access to education, health and other services should be prioritised rather than excessive focus on outcomes as in the past.

NEM strategic thrusts for inclusive growth

The NEM strategic thrusts for inclusive growth embrace the following measures:

- Enhance growth for expanding economic opportunities
- Pursue equitable and fair opportunities and fairness in processes
- Accelerate liberalisation for growth
- Focus on the bottom 40% of households and small businesses
- Emphasise opportunities for inclusiveness
- Augment regional growth and inclusiveness
- Stress knowledge creation and the knowledge economy

Enhance growth for expanding economic opportunities. Economic growth will continue to be necessary to expand economic opportunities. Inclusiveness is predicated on an expanding economy. A pro-poor growth strategy will be a part of the NEM because although economic growth is expected to be associated with a narrowing of income inequality, this outcome should not be seen as guaranteed. The experience of the developed countries in recent years, especially the US and UK, shows clearly that there is no certainty that, having attained the status of a high income economy, income inequality would continue to narrow. Income inequality has been rising in the US and to a lesser extent in Europe. The nature of growth and the policy measures that have been implemented in the US, for example, shows that they have contributed to a widening in the distribution of income and hence increasing inequality in income.

Pursue equitable and fair opportunities and fairness in processes. The NEM will put far greater emphasis on opportunities and processes rather than on outcomes. The earlier growth and distribution model placed heavy emphasis on outcomes, or targets, and much less on the processes. Ends were given greater emphasis than the means or the instruments. Processes and the instruments for achieving a fair, or equitable, distribution of income place a heavier burden on the implementation of the instruments that would promote a fairer distribution of income. The shift towards opportunities rather than outcome would be broadly consistent with the changing environment to growth and the move towards greater competition and liberalisation. Procedural fairness will be incorporated in the new model.

Accelerate liberalisation to sustain inclusive growth. The range and pace of liberalisation that is to be undertaken over the next ten years will have to be clarified. Malaysian interests will need to be aware and alerted on the plan for liberalisation so that they can be better prepared to meet the expected increase in competition. The overall impact of liberalisation on inequality will be the result of opposing factors. Existing interests which are unprepared, or are uncompetitive, will lose out to new entrants who are more efficient and productive. The competitive pressure will come from Malaysian competitors and foreign competitors. The outcome from liberalisation will depend on the relative benefits for wage income and non-wage income i.e. profits. And it will also be dependent on whether the top higher income households or the top corporations, can garner more of the benefits from liberalisation. If the higher income interests benefit more from liberalisation then inequality could widen.

Focus on the bottom 40% of households and small businesses. The NEM will shift the approach from ethnicity to the low income households and small businesses. As the economy grows and progresses towards a high income economy the focus of the redistributive measures should be on those in the low income groups. This new approach can be termed as 'inclusive growth irrespective of race'. The low income will include those households that fall below the poverty line and also that are in the bottom 40% of the distribution of income.

Emphasise opportunities for inclusiveness. Affirmative action programmes have worked well to lift large segments of the population out of poverty, giving them greater opportunity to participate in the economy and have successfully reduced inequalities to a significant extent. The past practices have adopted a pervasive approach of using quotas as a key instrument. Ethnic-based quotas have been imposed extensively throughout the economy. These practices have also given rise to unhealthy and pervasive rent seeking and patronage activities which has over-shadowed and irreparably harmed the meritorious performance of key affirmative action programmes. All stakeholders are demanding that these practices be revamped and changed to make them more effective, equitable and inclusive.

The NEM will shift the emphasis to market-friendly affirmative action programmes supporting social and economic activities aimed at broadening inclusiveness efforts. This approach will focus more on building capacity and capability rather than the imposition of conditions to meet specific quotas or targets.

Augment regional growth and inclusiveness. The NEM will give greater emphasis on regional and sub-regional corridor development through clustering, especially in Sabah and Sarawak, to reduce inequality between the states and regions. For areas with high incidence of poverty and a high concentration of low income households, the policy priority should aim at building the capacity and opportunities for residents to participate in corridor development. The persistence of pockets of poverty in specific isolated areas in the low income regions will mean that the special needs of these groups will differ and the design of poverty projects will also need to be different.

Stress knowledge creation and the knowledge economy. In a high income economy the demand for knowledge workers will increase. Educational reforms will be a vital need for inclusive growth. Human capital policies must be given top priority, as they will be crucial in making more rapid inroads towards reducing income inequality. Labour market imperfections, including wage and employment discrimination, will have to be rectified. Fragmented and segmented labour markets must be made more integrated.

5.1.3 *An economically and environmentally enduring solution*

The sustainability component of the NEM is meant to ensure that all of the proposed measures defined under the new model must be sustainable in both economic and environmental terms. Malaysia's dependence on natural resource consumption as the primary engine of growth is clearly not sustainable on either dimension. This is not to suggest that exploitation of natural resources should not be a key component of national production. But it does mean that under the new model, investment and policy decisions should only be made after full consideration of their long-term impact on the society, the economy as a whole, and of course the environment.

Promoting sustainability through improved public financial management

One of the SRIs will focus on strengthening the public sector with the ultimate aim of shaping a responsive and responsible government. There must be a focus on fiscal discipline for safeguarding macroeconomic balance and financial stability. Public sector reform is an important component of long-term fiscal sustainability and is a key component of the NEM. Ongoing reform of the civil service, including staff up-skilling and retraining, is key to increasing the efficiency of public services and making it more customer-focussed.

Fiscal reforms under the NEM will emphasise a bold restructuring of all government expenditure programmes to unlock greater value from outlays and drastically reduce wastage. One major area of reform will be a complete overhaul of the government procurement system to improve efficiency and transparency. A more efficient procurement process will address wider issues covering long-term economic and social viability, environmental impact, and the residual contingency risks that government may have to bear. In particular, there must be greater emphasis on preventing costs overruns. If additional costs do arise, the burden must be better and equitably shared with contractors and other stakeholders, not borne solely by the government.

The adoption of international best practices on fiscal transparency will allow proper assessment and dissemination of public finance solvency and sustainability. The NEAC recommends that public finance operations be undertaken in the context of a medium-term budgeting framework which take into consideration the effects of public debt management to underpin sustainability.

Environmental sustainability as top priority

The traditional approach to economic growth has grossly neglected the environment. Although there has been a veneer of concern for the environment, past policies focussed on delivering growth first, and dealing with the environment later. In the future, equal emphasis must be placed on both protection of the environment and economic growth. The conventional GDP measurement of economic growth does not take into account the costs to society arising from environmental degradation. The recent development of the 'Green GDP' concept will allow proper consideration of the impact of growth on the environment and the appropriate design of measures to address environmental concerns.

The NEM seeks sustainable growth that meets the ongoing needs of the population without compromising future generations by effective stewardship and preservation of the natural environment and non-renewable resources. This new approach will be particularly relevant to the management of water, and oil and gas resources.

One of the key messages of the NEM framework is to leverage on our core strengths, one of which is our rich heritage of natural resources. The largest contribution to Malaysia's GDP is the services sector, of which the largest component is tourism. The tourism sector relies heavily on our natural resources such as tropical rainforests and marine life as key attractions. About 5% of the labour force earns their income from domestic and international tourism. In addition, 12% of the population derive their income and livelihood from agriculture, forestry and fisheries which together generate 7.5% of GDP.

The Malaysian government has made significant commitments to manage climate change, pledging a RM1.5 billion fund in the national budget for 2010 to promote green technology and announcing several incentives to encourage the construction of green buildings. Malaysia also made strong commitments to emissions reduction during the 2009 Copenhagen climate change talks.

The NEM considers that sustainable agriculture should be fostered through the development of productive, competitive and efficient agriculture, forestry and fishery techniques, while at the same time protecting and improving the natural environment and conditions of the local communities. The sustainability principles call for the production of crops with high yield and income, ensuring minimal effects on soil fertility, water and air quality, and biodiversity. They also call for optimising the use of renewable resources and enabling local communities to protect and enhance their well-being and neighbourhoods.

One example of the NEM approach applicable to agriculture is to leverage off Malaysia's successful development of its palm oil industry into the most efficient edible oil producer in the world. The commercial production of palm oil has created an important source of income and export for Malaysia. It lifted over a million people out of poverty by raising their incomes through FELDA schemes and if properly managed, can contribute to environmental sustainability. The Roundtable on Sustainable Palm Oil (RSPO) has developed Principles and Criteria with which members have to comply if the palm oil they produce is to be claimed as sustainable.

The NEM approach implies increasing higher value- added and revenue per hectare of usable land, rather than pure output per tonne, without damaging our environment. In other words, we should maximise the quality of our income from our environment, rather than focusing on quantity as at present. A case study on the palm oil industry example is included as Appendix 1.

5.2 The ultimate beneficiaries: *rakyat* and businesses

The NEAC anticipates a series of benefits that would accrue to all Malaysians if the NEM policy measures are consistently and fully implemented. We must recognise however, that the various benefits will be realised over a period of time. In the meantime, some segments of the population may perceive greater negative impact than benefit, or that they are receiving less benefits than others. The government must be able to convey the ultimate equity of the benefits over time, urge a commitment to the process, and create a vision of the long-term common good.

The ETP will put in place an enhanced safety net and a transformation fund to cushion the various communities in the transition period before the benefits are fully realised. The public will need to better appreciate that orderly adjustments and changes must take place if the goals of the NEM are to be achieved.

5.2.1 Benefits for the rakyat

Expected benefits for the *rakyat* from the NEM are as follows:

Table 10 – Benefits for the *rakyat*

In a high income economy, the *rakyat* can expect:	All *rakyat* will feel included as a result of:	A sustainable approach will provide the *rakyat* with:
• *More choices and higher purchasing power.* An upward spiral of consumption and high income career choices. • *Better quality of life.* Not only higher incomes, but quality healthcare and social support, accessible to all *rakyat* and income groups. • *Opportunities for upward mobility.* Readily available skills development programmes. Access to resources, jobs, contracts and licenses based on merit and effort. • *Reward for innovation and creativity.* A more developed, specialised, innovative, technology-driven and knowledge-based economic structure.	• *Living and working in safe surroundings.* Individuals will live, work, study and play in localities free from the fear of crime, the indignity of discrimination and the anxiety of need. • *Equal and easy access to information.* Families will be endowed with the opportunity and capability to pursue their aspirations in connected, sophisticated, modern cities, townships and villages. All communities will be able to contribute to and share in the wealth of the country. • *Every individual counts.* The affirmative action approach will shift from ethnicity to low income households and individuals on the basis of needs and merit. Mutual respect and dignity accorded. • *Every part of the nation matters.* Regional and sub-regional development will be given more emphasis, especially in Sabah and Sarawak, to reduce regional disparities. Everyone will be consulted and their voices heard.	• *Confidence in the government.* Fiscal discipline will keep the economy well-balanced. Improvements in bureaucratic processes will ensure timely, fair, and respectful service delivery. • *Improved environment.* Future generations will be assured of continued access to clean air, water, healthy recreational living conditions and well-preserved biodiversity. • *Sustained growth.* Development will prioritise of sustained economic growth, fiscal management, social needs, and the environment.

In a high income economy, the *rakyat* can expect:	All *rakyat* will feel included as a result of:	A sustainable approach will provide the *rakyat* with:
• *Greater confidence in the robustness of the economy.* Sustained high private investment rates on the back of high savings, foreign capital and globally mobile talent.	• *The poor will not be forgotten.* A prolonged growth period will be pro-poor as it further eradicates poverty and narrows inequality. No one is to be left behind. A coherent and comprehensive needs-based social safety net will support vulnerable groups, particularly those with disabilities.	• *Continued resource management.* Renewable and non-renewable natural resources will be prudently utilised to maximise savings for future generations.

5.2.2 *Benefits for businesses*

Benefits for businesses will result from greater equity in the environment, a more effective ecosystem and a more efficient market to facilitate investment and operations.

Table 11 – Benefits for businesses

An equitable environment in which investors will thrive includes:	An effective ecosystem for business operations will include:	An efficient market will provide investment and growth opportunities through:
• *Business Rights.* There will be due recognition of the rights and responsibilities of business owners. • *Rule of Law.* Businesses will manage their affairs with the assurance of a fair and credible legal system. • *Ownership Freedom.* Entrepreneurs will be free to fully own their businesses and work with partners they choose. • *Intellectual Property.* Intellectual assets will be protected.	• *Public Services.* Approvals will be faster. • *Licensing Efficiency.* Unnecessary licensing and undue regulatory burden will be removed. • *Dynamic Clusters.* Industry clustering and networking will create benefits from scale. • *Human Capital.* Employers will enjoy open and efficient access to the best talent they can afford. • *Funding.* Increased flexibility and timeliness of access to SME funding. • *Efficient Courts.* Resolution of legal disputes will be swift.	• *Transparency.* There will be confidence in the openness and fairness of government tenders. • *Fair Market Pricing.* With minimal exceptions, subsidies and price controls will be eliminated. • *Barrier Free.* Entrepreneurs will thrive in liberalised sectors. • *Fair competition.* A level playing field will be created by the enactment and proper enforcement of a competition law.

An equitable environment in which investors will thrive includes:	An effective ecosystem for business operations will include:	An efficient market will provide investment and growth opportunities through:
• *SME Recognition.* Regulations for SMEs will be appropriate and proportionate to the risks faced by small businesses. • *Market Transparency. Business* operations will be free from rent-seeking, quotas and preferential treatment.	• *Transformation Fund.* Entrepreneurs will have access to special assistance during the economic transition period. • *Regional Integration.* Businesses will benefit from an integrated regional market and government support to become regional champions.	• *Public-Private Partnership.* There will be more opportunities for the private sector to collaborate with the public sector and GLCs

5.3 Getting help to those who need it the most

The NEAC also wants specific measures to deal with inequality by targeting the 40% of households in both urban and rural areas that have a monthly income of less than RM1,500. For everyone to enjoy the benefits of a high income economy, the gap between the bottom 40% and others must be narrowed within a reasonable timeframe.

The NEM provides for mechanisms to strengthen the capability of the bottom 40% so that they can take advantage of opportunities to secure better jobs, raise their productivity and grow their income. This group should also have opportunities to use their entrepreneurial instincts to start up and grow their businesses, which will significantly improve their livelihood, life chances and prospects. The social safety net, better health services and access to quality education referred to in the previous section would target the bottom 40% to improve their capability.

While all Malaysians will feel the impact from disruption and dislocation caused by the NEM transformation process, the NEAC recognises that the bottom 40% will be least prepared to manage the changes. For this reason, it is crucial that a coherent safety net be put in place swiftly to help the households to better cope with the inevitable distress.

5.4 Core characteristics of the NEM

To be *market-led* implies that investment and production should be private sector driven. The government should facilitate businesses by simplifying processes, increasing transparency and improving delivery of services. It should also ensure that essential regulatory requirements are market focussed and supportive. Also, the private sector must have fair access to all business opportunities, underpinned by a competitive environment made possible by effective competition legislation. The government should retain a role to restore stability in the face of disruption from market failures.

Malaysia is *well-governed* when government institutions are dynamic, flexible and held accountable to performance-based outcomes. There should be ample opportunities for locally empowered economic ecosystems to operate through appropriate decentralisation of functions and processes. Comprehensive social and health safety nets should be in place to facilitate economic participation by all segments of society. Working with the private sector, the government should draw up rules and regulations to foment good business governance and integrity while ensuring that excessive risk taking is avoided.

Regional integration would involve not only integration in trade and services, including financial services, but also broader in the research, cultural, political and other arenas. There should be open market access to goods and services as well as the movement of capital and labour, particularly skilled workers. Integration through trade and capital flows, especially within the Asian region, is expected to continue to drive the long-term growth of the economy. More integration within ASEAN should continue and be expanded to cover East Asia. With Malaysia's small domestic market and the potential for a larger contribution from SMEs, scale can be developed through greater integration into regional networks and supply chains which will allow the country to tap into the abundant opportunities emanating from a high growth region.

The country is *entrepreneurial* when it can freely attract and develop global entrepreneurs, and where an integrated government mechanism supports entrepreneurs. The NEM will strive to provide a framework and environment to engender entrepreneurial spirit to take advantage of growth opportunities and the available funding options. These will include facilitating the availability of R&D and encouraging venture capital support for commercialisation of innovative products and services.

We are recognised to be *innovative* when innovation is present in all sectors of the economy, whether in the technical, social, institutional or process areas. New products and services will excite market demand, utilising state-of-the-art technology from home-grown and global innovation centres. Creative processes will be the driving forces of the economy as it moves to a high income economy status. While innovative ideas and knowledge may be converted into lucrative commercial undertakings, there would also be many incidences of failure which need to be managed. Above all, intellectual property rights (IPR) and other rights should be protected.

5.5 The NEM – A new way of 'doing business' in Malaysia

Many analysts are promoting a vision of Malaysia leapfrogging to a knowledge economy. While it is true that advanced countries achieve growth through knowledge-intensive activities, reflected in high rates of innovation, it is not easy to develop a knowledge-driven economy. Some crucial preconditions for a knowledge economy are:

- Excellence in institutions of higher education
- Deep capital markets that encourage risk-taking and allow for successes and failures in commercialising ideas
- Certainty in regulation and stable macroeconomic conditions to permit investors to confidently develop long-term perspectives

In Malaysia, these pre-conditions are not yet adequately developed – and thus building these conditions is the focus of the NEM. While knowledge will doubtlessly play an increasing role in economic growth, it is still too weak to play a dominant role in the near future. Therefore, the NEAC feels that an unrealistic emphasis on the knowledge economy, which leads to a premature departure from traditional manufacturing or resource-based activities, would be a costly mistake.

The reality is that Malaysia's strengths and unique advantages should not be ignored but built upon. The NEM advocates a new and bold approach to unleash the growth potential from these strengths. This new approach is best illustrated by a contrast to some elements of the old approach (Table 12).

These elements of the new approach, as described below, are inter-related and linked. One cannot build technological capabilities without a system that recognises and retains talent. The human capital base must be world-class, implying that talent from the rest of the world, in the form of people and institutions, must be seamlessly integrated into Malaysia. The expansion of the professional and creative class requires minimum threshold levels of economies of scale. Skilled human capital from abroad increases domestic productivity, it does not substitute for local talent.

5.5.1 *Greater reliance on productivity to drive growth*

The old approach of growth through capital accumulation and sectoral transformation has become inadequate. Up to now, growth has come from large-scale physical capital investment, sustained human capital investment and the exports of manufactures, natural resource based goods and petroleum products. At the same time, total factor productivity growth was achieved by a shift of workers from low-productivity sectors, like agriculture, to higher productivity manufacturing and some service jobs. Merely increasing investment levels and the quantities of low skilled labour

Table 12 – Approach to economic development: the old versus NEM

	Old Approach	New Approach
1	**Growth primarily through capital accumulation**. Focus on investment in production and physical infrastructure in combination with low skilled labour for low value added exports	**Growth through productivity**. Focus on innovative processes and cutting-edge technology, supported by healthy level of private investment and talent, for high value added goods and services
2	**Dominant state participation in the economy**. Large direct public investment (including through GLCs) in selected economic sectors	**Private sector-led growth**. Promote competition across and within sectors to revive private investment and market dynamism
3	**Centralised strategic planning**. Guidance and approval from the federal authorities for economic decisions	**Localised autonomy in decision-making.** Empower state and local authorities to develop and support growth initiatives, and encourage competition between localities
4	**Balanced regional growth**. Disperse economic activities across states to spread benefits from development	**Cluster- and corridor-based economic activities**. Concentration of economic activities for economies of scale and better provision of supporting services
5	**Favour specific industries and firms**. Grant preferential treatment in the form of incentives and financing to selected entities	**Favour technologically capable industries and firms**. Grant incentives to support innovation and risk-taking to enable enterpreneurs to develop higher value added products and services
6	**Export dependence on G-3 (US, Europe and Japan) markets**. Part of production chain to supply consumer goods and components to traditional markets	**Asian and Middle East orientation**. Develop and integrate actively into regional production and financial networks to leverage on flows of investment, trade and ideas
7	**Restrictions on foreign skilled workers**. Fear that foreign talent would displace local workers	**Retain and attract skilled professionals**. Embrace talent, both local and foreign, needed to spur an innovative, high value added economy

will no longer suffice to drive growth to a higher level or moving up the value chain. Future growth must come from higher factor productivity, nurtured by more innovative processes as well as supported by a healthy dose of private investment and talent.

5.5.2 *Shifting from state-led to private-led investment and production*

Traditionally, Malaysia's growth has been largely driven by public investment and the initiatives of GLCs. While this approach may have served the country well in the past, it is unlikely to provide the dynamism needed to spur the country to developed country status. That will come from new ventures, fresh products and emerging niche markets. What is striking is that productivity in Malaysia's services sectors – the largest segment of the economy and the segment where the direct and indirect role of government is greatest – is not growing, even as it expands in the rest of the world.

Competition can provide a remedy. Competition through firm entry and exit is perhaps the most important area for the manufacturing sector to move up the value chain, while competition through delicensing, import liberalisation, more open and equitable entry access and a balanced approach to regulation is needed for the services sector. There is also concern that the size of GLCs and their mere presence may inhibit expansion of new firms. With the right policy framework, a strong competition authority can perhaps reduce these concerns.

5.5.3 *Greater local autonomy – with accountability*

Malaysia's regions and localities differ considerably in terms of resource endowments, competitive experiences and location advantages. Their strategic policy choices and expenditure needs vary widely. There is less to be gained in focusing purely on national strategic choices or plans compared to the better pay-off from developing regional or locality based approaches which support key growth centres, thus building the necessary concentration for scale economies. Corridor authorities may be an avenue that can be used more effectively to reflect these differential local conditions. In this process, competition between localities can be one of the strongest drivers of service delivery and growth as it is in many other countries.

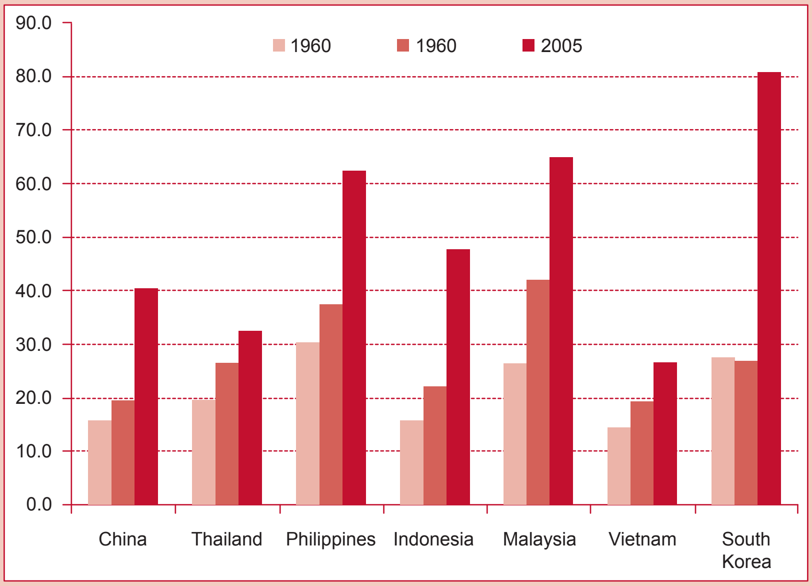
Similar approaches – involving a fundamental culture change – are also needed to give public institutions more autonomy but with performance-based accountability. The bureaucracy and key agencies have traditionally operated with top down and centralised approval processes – leftover from the colonial legacy. This inhibits initiative, slows down response capacity and ultimately works against changes in strategic approaches. Timely decision-making processes that support rather than constrain informed decisions must emerge in the future. This would emphasise delegation of authority wherever possible and a 'whole-of-government' approach to provide integrated services (APEX programmes for universities are already showing the

Box 1: Clustering is good for reducing spatial disparities – the Korean experience

In many economies, income disparities are characterised by significant regional or locational dimensions. Often, governments feel the need to give priority to the allocation of resources to rural areas or lagging regions in order to achieve 'balanced growth'. However, the Korean experience suggests that the alternative of making basic living standards more uniform across space will benefit the lagging regions more.

Evolving from a low income into a high income economy in less than 50 years, Korea's approach was to target the building of density in the capital region which centres on Seoul. This led to concentration of industries in the capital region, allowing for agglomeration where firms benefited from economies of scale and network effects. The government also continued to improve connectivity – mainly through transport and communication technology – between the more dynamic centres and rural areas across provinces. More importantly, the government adopted a 'spatially blind' approach to social expenditure in health, education and social protection. The objective was to provide the same level of social services to all, which meant providing extra resources to serve hard-to-reach or high-cost areas.

Box 1 Figure: Asia's urban population as a portion of the total (%)



Over time, this approach paid off. With equal access to good social services, the less well-off rural population saw a strong improvement in their labour quality, which translated into greater labour mobility. Skilled labour was attracted in particular to Seoul and its surrounding areas in the capital region. The trend was reflected in Korea's rapid urbanisation rate (Box 1 Figure). But labour also benefited from spillover of economic activities from the capital region into other regions which offered attractive low-cost settings. These shifts in location ultimately led to a marked decline in spatial disparities – a remarkable convergence in regional living standards and incomes that could not have been achieved through 'balanced growth' within the same time frame. A World Bank study shows that the gap between per capita GDP for the capital region, which is the highest internationally, and that for the lowest region – the southwest – dropped from about 40% in 1985 to about 10% by the late 1990s.

benefits of such an approach). Information and accountability measures, including benchmarking data and scorecards for cities, can be a powerful tool to encourage a race-to-the-top.

5.5.4 *Greater economies of scale from clustering*

In the past, the approach was to give undue weight to political dynamics by spreading economic development geographically. While this was done with the intention to achieve balanced growth between regions, it is outdated and does not generate the economies of scale that dynamic investors are looking for. Malaysia should draw lessons from the Korean experience with regard to this (Box 1). Accordingly, the NEM approach is to form clusters of firms that find opportunities in collaborating and competing with each other within the same location. Agglomeration of firms in such clusters makes them less prone to move to new locations abroad. As an added bonus, clustering of innovative firms comes with networks for talented people to exchange and share ideas that may turn into major hits. For this to happen, a range of actions are needed as discussed below but it will also require a more deliberate approach to concentrate activities in key growth centres or corridors to achieve economies of scale.

5.5.5 *Attracting technologically capable firms*

Past approaches to promoting growth have relied on identifying specific winners in the form of industries and firms. With the increasing complexities associated with specialisation and change in high income economies, such approaches are unlikely to succeed. The focus for the government in the future should be on developing a supportive environment for innovation and risk-taking and providing firms the opportunities to develop higher valued products for new markets.

The range of factors that would support a more innovative environment include attracting global entrepreneurs, simplifying investment procedures, providing integrated government support, and fostering more competitive opportunities. But it also involves a range of more strategic and complex interventions to price and manage natural resources more sustainably; encourage clustering of firms and globally connected networks of specialised talent into a vibrant economic ecosystem; eliminate distortionary labour market practices; and foster vibrant venture capital markets.

But the NEAC accepts that governments will continue to intervene to attract investment in key sectors. Such intervention, however, is best left to experts and professionals who are well-versed in the specific industry dynamics and trends. In addition, the costs of government support should be appropriately quantified. The NEM would favour investment in high value added products and services, building upon the comparative advantages that Malaysia already enjoys in certain sectors. Several downstream agricultural activities show such potential. Our rich natural resources can offer more in tourism, green technology, pharmaceutical and petrochemical industries. The combination of our well-developed infrastructure and geographical location in the region opens up possibilities for attracting investment in the logistics sector and for hosting regional headquarters and R&D centres for MNCs and other businesses. Malaysia can also reinforce its leadership in Islamic finance and expand into other Syariah-compliant products.

5.5.6 *Tapping the emerging Asian and Middle Eastern dynamism*

Malaysia has started to strengthen its links with the Middle East by building on its natural Islamic ties. However, the country is not as well integrated into the East Asian production and financial networks compared to other countries, nor is it tapping into the emerging Indian and Chinese economies despite links with both these countries. There are considerable first-mover advantages in developing regional networks. Already, Malaysia is benefiting from tapping into Indian higher education expertise. But Malaysia's natural advantages in having close social and network ties are not being exploited to its full benefit despite the fact that the flow of investment, trade and ideas within Asia is poised to accelerate.

5.5.7 *Embracing skilled talent*

The current system discourages rather than encourages the retention of indigenous talent and inflows of foreign talent. Constraints include cumbersome immigration and incentive policies which discourage recruitment of foreign expertise along with restrictive practices of professional associations which restrict foreigners from working in Malaysia. No one agency in Malaysia currently looks at talent at the aggregate level and the need for a critical mass in specific areas of expertise. The number of skilled foreigners working in Malaysia has been going down, not up, despite evidence showing that trade, investment and the diffusion of ideas are closely linked with the presence of expatriate talent. More generally, the education system is widely seen as failing in producing the dynamic talent that Malaysia needs in a more globalised and competitive world. Priorities range widely from providing greater autonomy to public universities to strengthening vocational education and enhancing the quality of instruction in rural areas. Above all, Malaysia must revert to sustained and systematic programmes to give Malaysian students the high level of English proficiency required to compete in global markets.

CHAPTER

6

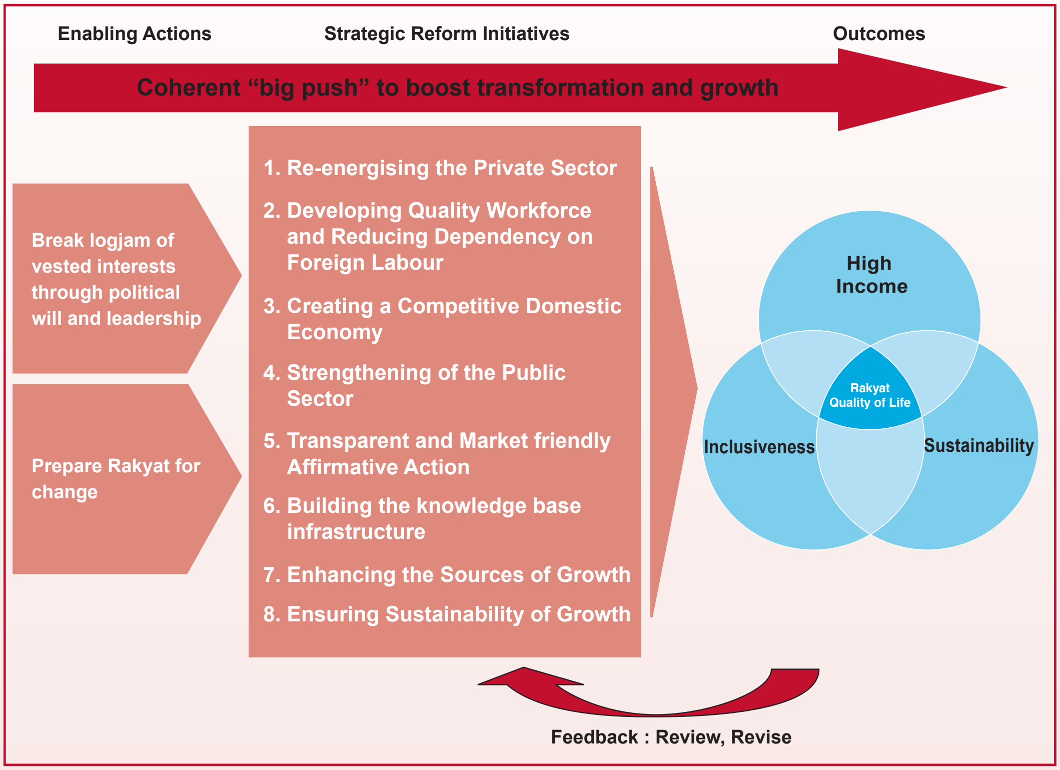
How do we get there?

How do we get there?

Malaysia needs urgent transformation. The Malaysian economy needs to advance and transform into one that is capable of delivering high income, of inclusively sharing the benefits from improved economic performance, and that is sustainable across multiple dimensions of environment, society and economic stability.

Malaysia's economy must transform so that it becomes fundamentally capable of achieving these goals and maintaining its position against other economies through its capabilities and strengths. We can no longer rely on our wealth from natural resources to mask our economy's weaknesses and our inability to generate sustained economic growth.

Figure 29 – The New Economic Model: Enablers and Strategic Reform Initiatives



The NEM will power this profound transformation. Malaysia is in a vicious circle of underperformance. Breaking that circle calls for a big push, not incremental change.

For the NEM to succeed, political leadership must unite to break the logjam of vested interests; it must overcome the scepticism and convince the *rakyat* that Malaysia is indeed embarking on a path that will improve their lives and those of generations to come (Figure 29).

The heart of the NEAC's work will centre on the design and implementation of policy measures and requirements to deliver the objectives of the NEM. International as well as Malaysia's own experience demonstrate that while it is relatively straightforward to identify Strategic Reform Initiatives and develop their associated objectives, such ambitious programmes usually fail because their implementation efforts cannot be sustained.

Three factors may explain such failures. The first is insufficient buy-in by stakeholders affected by the required reform measures because they were not engaged at the policy formation stage. Secondly, reform programmes have often met with strong resistance from powerful and vested interests, which subsequently forced their derailment. Lastly, the implementing authorities failed to stay the course, either due to a lack of political will or inherent administrative weaknesses.

More importantly, experience has shown that partial implementation of reform programmes usually leaves a country in a more vulnerable and unstable situation than if the programme were not implemented at all. Given where Malaysia finds itself at this juncture, failure to act or to fully implement the needed reforms is not an option.

For this reason, the NEAC has dwelt long and hard on the processes that would be needed to make the NEM an effective mechanism for turning Malaysia into an advanced nation. The NEM defines the eight SRIs to be undertaken by the ETP. Implementing these initiatives, coupled with close monitoring and feedback to review and adjust policy actions, will deliver the desired objectives.

6.1 Core enablers for the NEM

The most important enablers of the NEM are *political will and leadership needed to break the log-jam of resistance* and *preparing the rakyat* to support deep seated changes in policy directions. With these enablers in place, a *'big push'* in policy actions and initiatives is needed to kick start the transformation process. The push must create enough momentum to overcome resistance. Once reforms are started, continuous feedback is necessary to fine-tune policies and stay on course.

6.1.1 *Unwavering leadership and political will*

Political will and leadership requires that there be an emphasis on a coherent explanation of the vision and agenda of the NEM and transformation process. This requires the path of the NEM to be laid out in detail, including indications of where actions may negatively affect different segments of society. The aim is to create an unstoppable wave of support from all segments of society for this vision. But to start this process, the government is aware that it must make extremely tough decisions in order to meaningfully put in place a critical mass of bold measures. The political leadership must be clear about the trade-offs involved in making some of these tough decisions, for example:

- Restoring market prices for goods and services will improve economic efficiency but may initially raise consumer prices and costs of doing business
- Practices that promote fair and equal opportunity will inspire market confidence and create a competitive economy but may lead to political repercussions
- Reduced dependence on foreign labour encourages firms to move up the value chain or embrace automation while those that cannot will exit, costing some local jobs
- Flexible hiring and firing reduces entry and exit costs for businesses while wage levels will better reflect skills; but the perception of less job security will irk unions
- Faster connectivity will facilitate further integration into global markets but requires greater openness in the telecommunication market
- Greater decentralisation in decision making will achieve speedier implementation and effectiveness but may result in diluting federal government power

The government must take prompt action and stay the course. Resistance is likely to come from the business community including protected industries, employers of foreign labour, licence holders, beneficiaries of subsidies, and experts at doing business the old way. Some segments of the *rakyat* who no longer qualify for government subsidies and grants might react strongly, and those that have enjoyed secure jobs and a stable lifestyle from protected firms may feel threatened. Both these groups might then turn to their political representatives and politicians may then attempt to lobby and water down the needed measures. The resistance from these vested interest groups must be dealt with fairly and transparently, following genuine consultation.

Each individual player will be tempted to look at the NEM from the perspective of 'winners' or 'losers'. For this reason it is important to clearly communicate the vision of the NEM to bring everyone on board. Through effective campaigns and consultations, individuals and firms must be made to appreciate the benefits that would accrue to them over the coming period and not just focus on the possible negative effects on their immediate well-being. In this regard, it is important to explain that the NEM will put in a stronger and more comprehensive social safety net to mitigate the negative effects.

The NEAC assigns a large measure of importance to the government's proper management of the political situation. Peace and harmony must be preserved in Malaysia in the midst of the likely disruptions from the NEM. This might involve not only close consultations within the political partners of the government but also conscious efforts to forge bipartisan interaction. Special efforts must be devoted to explaining the impact of the NEM to the international audience. This will help to portray Malaysia in a favourable light abroad and generate a positive perception of the country among potential investors.

Above all, the government must put in place a strong team made up of technical experts and other professionals who will be empowered to monitor the implementation of the ETP, interact in close consultations with the *rakyat*, and manage the fallout from resistance of vested interests.

6.1.2 *Getting the rakyat to drive change together*

Garnering the support of stakeholders and ordinary Malaysians for the NEM is a political process, one best understood by the political leadership. However, the NEAC envisions a number of critical steps in this national engagement to prepare for and to implement the ETP. The NEAC will be fully involved in drawing up an execution framework in collaboration with the respective implementing authorities.

Political and intellectual leadership must demonstrate the necessary commitment to the NEM. Public communication must be compelling and convincing on why change is urgently needed. At the same time, the NEM must have both rational and emotional resonance with the *rakyat*, and must clearly articulate their roles in the transformation process.

But even as public communication proceeds, the same team tasked with monitoring the implementation of the ETP must put in place a rigorous technical process to gather information for reporting on the progress of the ETP to all stakeholders.

We envision a constant process of feedback and adaptation to changes in the Malaysian economy. We anticipate responses from the population. At the same time, it will be important to remain steadfast on the goal of transforming Malaysia into an advanced nation.

Engagement with all stakeholders is important for two reasons: first, to foster buy-in through clear communication; and second, to see refinement and improvement in policy actions. At the same time, the political and intellectual leadership must continue to be at the forefront of this transformation process.

6.1.3 *A 'big push' of synchronised policy measures and initiatives*

With the leadership and *rakyat* on board, a *big push* of new policies must be announced. This *big push* would consist of a critical mass of policy measures supporting the SRIs. Due to the cross-cutting nature of the Strategic Reform Initiatives, the sequencing of policy actions is crucial for achieving impact and results. Some policy actions could be immediately implemented. Others may be introduced at a later date because they require a longer preparation period. However, this preparation must commence immediately.

Piecemeal and incoherent introduction of policy would be inconsistent with the cross-cutting nature of the SRIs. The policy measures supporting these SRIs must move in tandem to deliver high income in an inclusive and sustainable manner.

A big push event will leave a lasting impression and foster buy-in. Without a big push, the task of monitoring and the benefits of a feedback mechanism run the risks of being compromised. This may eventually lead to implementation fatigue and, ultimately, derail the NEM.

6.1.4 *Measuring our performance and adjusting as we go*

Most reform efforts have strategies and implementation plans but often lack a rigorous feedback mechanism to assess implementation effectiveness and allow for adjustment measures. Often, while a policy or strategy is being implemented, the circumstances for achieving the objectives may have changed and rendered earlier policy actions less viable. Without a formal feedback mechanism, policy adjustments may become ad hoc and uncoordinated, resulting in diffused implementation with little accountability and limited channels with which to address public complaints. The result is reform failure, which in turn affects credibility and gives rise to questions about accountability of the implementing institution.

Given an ever-changing environment and the growing bottom-up trend in governance, the ETP must have a rigorous feedback mechanism to monitor its progress, its acceptability by the public as well as the need for adjustment and fine-tuning. This view implies that while the goals of a high income, inclusive and sustainable nation remain unchanged, the means and tools for achieving these goals need to be aligned with practical realities and changing times.

6.2 Managing adjustments – Aligning old expectations to the new reality

The NEM paves the way for more opportunities for advancement across the spectrum of society, especially the private sector. Nevertheless, the path forward also requires major adjustments producing both winners and losers. Losers will be those firms whose viability depended on subsidised commodities, notably energy and those with privileged access to controlled imports or contracts. These firms and individuals will have to cope with the new market realities. Many companies will either have to restructure or be phased out. Workers in these firms may need to find other positions and in the process retool their skills to become more employable. Moreover rapid growth is often spatially unbalanced with some regions benefiting more than others – increasing pressures for social services to rectify differing regional needs.

Globalisation also has increased the stakes for each country to have efficient labour markets. Rapid technological progress, trade in goods, mobility of labour, and international sourcing of services have combined to create new openings for economic players and a more integrated global market for labour. The impact is tempered by differences in skills, technology, and know-how available to workers. Although globalisation widens the breadth of export markets and improves access to a wider range of cheaper imported products (thereby boosting productivity and average living standards), it can also impose adjustment costs on certain groups within countries, primarily by influencing wages and job security, and triggering the need for retraining.

To cushion these adjustment costs, some phasing of the reforms may be advisable, but experience has shown that reforms which are carried out too slowly are often ineffective or even reversed. Thus it is far better to have in place social protection systems which can cushion adjustment costs but in ways which do not impede requisite reforms. Moreover, by allowing firms and households to seek higher but often riskier economic returns and reducing the need for precautionary savings, such programmes help spur a more dynamic economy. The general objective is to build a more competitive but also more compassionate society. With a well structured social safety net, economic reforms become politically more acceptable, thus improving the chances of effecting real change.

Building a stronger safety net is urgent

Malaysia's social protection system, as in many Asian countries, is still evolving. While it is relatively well-developed, there are major gaps and inefficiencies. Poverty is less widespread but there remain selective, vulnerable groups and pockets of intractable poverty. Inequality remains a pressing issue. Despite substantial subsidies available to the population, the disadvantaged are still not getting access. Safeguards are needed to protect individuals from catastrophic outcomes and to soften income shocks for the most vulnerable. Some have suggested that a formal minimum wage might be helpful to cushion workers against such shocks or downturns. The NEAC strongly believes this would be a wrong approach and in fact could exacerbate the situation by reducing competitiveness and reducing employment opportunities.

Existing weaknesses in the social safety net need to be addressed. An evaluation of the current social safety net raises a number of these issues:

- The portion of social spending targeting poor households is quite limited;
- Targeting criteria should be refined to achieve more equitable and consistent outcomes; and
- The structure of systems and programmes differs across agencies and needs to be made more consistent.

More generally to overcome obstacles to subsidy reform, social assistance programmes will have to be more efficiently structured. An important step in the government's reform effort should be to catalog all existing social assistance programmes to identify their policy objectives, eligibility criteria, benefit structure, administrative costs, and target beneficiaries. To improve targeting, proxy measures of a household's consumption per capita could be constructed to create better means-test benefits. Other measures could be implemented to avoid the current vertical inequity in the system by gradually phasing out eligibility and reducing horizontal inequity by restructuring certain benefits to make them less lumpy.

Making labour markets more efficient is part of the solution

Pressures on the social safety net are reduced if the labour market functions well:

- In an efficient labour market, workers are likely to find jobs quickly that match their skills. At the same time, upward movements in wages must not outstrip labour productivity, otherwise no firm could survive.
- Labour markets also need to minimise the costs of job loss and associated risks. The international experience is that effective unemployment insurance can provide a short-term solution and usually does a better job than strict reliance on severance payments.

Training programmes can help but need to be linked to market demand. During adjustment periods, revamped training programmes are often helpful in enhancing employability in a shifting labour market.

Is a special transformation fund needed?

Financing costs for augmented social safety nets and related needs will be significant in the coming years, especially for new initiatives, such as unemployment insurance or revamped welfare programmes. Some options can be designed with built-in partial or full cost recovery mechanisms – such as with firm or employee contributions for insurance or training. But these funding mechanisms will not be enough.

A special transformation fund may be needed to cover the additional but often temporary costs involved. Malaysia's fiscal situation will be tight in the coming years as the stimulus programme is phased out and budgetary deficits are scaled back to more sustainable levels. Within a tighter fiscal envelope, a transformation fund, designed like a special "holding account" to support the cushioning of adjustment costs, would provide tangible recognition of the government's intent to foster more inclusive outcomes. This holding account or fund would initially be the recipient of the potentially large savings which would arise from cutting back wasteful subsidies, such as those for energy and food products, and rationalising other public expenditure programmes.

6.3 A close look at the Strategic Reform Initiatives

The NEAC believes that it is critical to seek stakeholder buy-in of the detailed implementation plans for each of the Strategic Reform Initiatives (SRIs). At this time, the NEAC only sets forth the broad parameters under each SRI, which over the coming period will be further refined following consultations and engagement with all stakeholders.

We have identified eight SRIs at the core of the ETP. The NEAC fully recognises that many of the policy measures derived from the SRIs are either being planned or have been initiated by the government. The NEAC recommendations aim to add value by augmenting and supplementing ongoing policy work. These initiatives are as follows:

1. *Firing up the private sector*. The private sector needs to step up and assume a heightened profile in the nation's transformation. Throughout recorded history, economies have experienced self-sustained, long-term growth primarily through the entrepreneurial initiatives of the private sector, guided by economic incentives which encourage individuals to take the long view and refrain from short-term opportunism.

2. *Inspiring the workforce to draw out their best*. Labour markets must work well: jobs and workers must be matched efficiently to increase productivity and thus raise wages for all. Labour market adjustment must be smooth: the right workers need quickly to find the right jobs; the right jobs must rapidly attract the right workers, including those from abroad. Simultaneously, Malaysia's talent base must improve. A quality education system which nurtures skilled, inquisitive, and innovative workers to continuously drive productivity forward is the foundation of sustained economic growth. High income emanates from skilled people applying their talents to successfully meet the economic challenges faced by society. Malaysia cannot miss the opportunity to put its most valuable resource to work. Therefore, Malaysia must remove barriers preventing its brightest people from gaining skills, while enticing these gifted people to remain within its borders.

3. *Vibrant markets and greater choices*. Many distortions would be removed and the economy will experience greater competitiveness from the elimination of subsidies, price controls and a myriad of incentives which have lost their original objectives. The ETP will help individuals and firms to cushion the impact of such a bold measure by putting in place an enhanced social safety net and a special transformation fund.

4. *A lean and customer-*focussed *government*. Public institutions must be re-engineered.

Public institutions must not duplicate functions better provided by the private sector but instead should seek to undertake those tasks that the private sector cannot perform. The delivery of government services must be efficient and effective, using a 'whole of government' approach to facilitate the operations of the private sector. Fiscal management must be strengthened to include greater transparency and to provide the right incentives. The government's revenue base must be diversified and expenditure streamlined to foster better utilisation of revenue.

5. *Escaping low income*. A key component of inclusiveness is the fostering of equal and fair economic opportunities. Existing affirmative action programmes and institutions will continue in the NEM but, in line with views of the main stakeholders, will be revamped to remove the rent seeking and market distorting features which have blemished the effectiveness of the programme. Affirmative action will consider all ethnic groups fairly and equally as long as they are in the low income 40% of households. Affirmative action programmes would be based on market-friendly and market-based criteria together taking into consideration the needs and merits of the applicants. An Equal Opportunities Commission will be established to ensure fairness and address undue discrimination when occasional abuses by dominant groups are encountered.

6. *Innovating today for a better tomorrow*. Economic transformation in the industrial, agricultural and services sectors is a process requiring continuous innovation and productivity growth with significant technological advancement and entrepreneurial drive. The adoption of processes in line with best practices and international standards will improve the chances for Malaysian firms to succeed in the global market place.

7. *Finding the economic sweet spots*. Malaysia must build on its strategic location together with the comparative advantages arising from its natural resource endowment to establish production platforms which drive high value added growth with spillover effects. There must be a focus on economies of scale through growth corridors to energise promising expansions into new markets such as downstream agricultural outputs, eco-tourism, alternative energy generation and climate change mitigation.

8. *The future is bright. The future is Malaysia*. Preserving our natural resources and safeguarding the interest of future generations must be facilitated by applying appropriate pricing, regulatory and strategic policies to manage non-renewable resources efficiently. Sustainability of public finances through stringent fiscal discipline, which necessitates reduction of wastage and cost overruns, is the cornerstone to maintaining macroeconomic balance and financial stability.

Active management of policies supporting the SRIs is essential through a continuous feedback mechanism that allows for the timely adoption of corrective actions as required. Many additional benefits flow from this confluence of changes. Investment, from both domestic and foreign sources, would experience a revival because investors would be confident that they will benefit from a stable, productive environment supported by efficient public institutions and highly-capable workers.

6.3.1 *SRI 1: Re-energising the private sector to drive growth*

Table 13 – Firing up the private sector

Policy Purpose	Possible Policy Measures
Target high value added product and services	■ Align incentives to foster investment in high value added activities which generate spill-over effects ■ Tailor incentives to meet the needs of each firm ■ Facilitate FDI and DDI in emerging industries/sectors
Remove barriers and cost to doing business	■ Remove distortions in regulation and licensing, including replacement of Approved Permit system with a negative list of imports ■ Introduce a 'Single-Window' licensing process through e-Government portals to include local and state governments
Create eco-system for entrepreneurship and innovation	■ Reduce direct state participation in the economy ■ Divest GLCs in industries where the private sector is operating effectively ■ Economy-wide broadband roll-out ■ Ensure GLCs operate on a strict commercial basis free of government interference
Encourage efficiency through healthy competition	■ Implement efficient and transparent process for government procurement at all levels ■ Level the playing field for the private sector through transparent standard settings ■ Support a stronger competitive environment with competition law
Promote SME growth	■ Provide support for SMEs in innovative and technologically advanced areas ■ Facilitate timely access to funding for business activities
Creating regional champions	■ Encourage GLC partnerships with private-sector companies ■ Pursue aggressive regional networking – ASEAN, China, India, Middle East ■ Improve leverage of FTAs

Raising the private sector profile is a bold attempt to redefine the relationship between the government and the private sector. The government will encourage the private sector to take the lead in identifying areas of future growth. The government will no longer compensate the private sector for all the risks it takes or provide incentives simply for doing normal business. Instead it will try to reduce the level of risk by providing the private sector with a stable, rules-based business-friendly environment.

The thrust of the proposals under the NEM serves to address several realities of the current situation:

- Distortions and other barriers in the economy have resulted in an elevated cost for doing business in Malaysia, and this is reflected in the very low levels of private investment.
- A recognition that vested interests in the private sector have become powerful forces seeking to maintain the status quo of concentration in low value added output.
- A need for a big push to reinvigorate a private sector that appears to be losing its dynamism and willingness to invest, innovate and take risk.
- A desire to encourage labour to realise their full potential to add value to society, not to divert efforts to protect jobs in outmoded businesses or in the public sector.

The NEM calls for several actions to raise the profile of the private sector and to make Malaysia globally competitive for investors. These actions seek to: (i) reform the complex array of incentives made available to the private sector; (ii) boost private investment through improving the business environment by removing distortions and the high costs of doing business; and (iii) rebalance the roles of the public and private sectors, giving greater prominence to private firms.

Rationalising business incentives

The old business model used tax incentives to spur private investment, which over time has grown in variety. Government proactively sought to affect the level and direction of domestic and foreign private investment by the use of tax incentives, special zones and other preferences. These strategies worked well in the past but they are now ineffective and insufficient for generating higher income.

Private investors have become dependent on incentives as a major driver of profitability. This is not sustainable. Under the NEM, these incentives will be consolidated and rationalised to focus more on the new priorities of the economy. Fiscal and other incentives for low value added industry and services will be phased out and not renewed. The Approved Permit (AP) system will be replaced by a negative list of imports. A dynamic ecosystem for entrepreneurship and innovation will be created, where priorities for incentives will focus on firms developing high-value activities with spill-over benefits to the rest of the economy. They rely on attracting innovative firms that introduce new business products, processes and techniques to Malaysia in a transparent way. Often these firms are new start-ups. They require grants and matching funds for specific start-up costs, unlike traditional investors who exclusively sought tax incentives.

Creating a conducive environment for private investment

The logic of providing good infrastructure and logistics in industrial zones in order to attract multinational export activities has brought many international firms to Malaysia, including major players in the E&E industry. But this approach is not enough to encourage such firms to move to higher value added activities within Malaysia. At the same time, many firms, especially those engaged in assembly operations, are gradually moving offshore to cheaper regional competitors, as distortions and barriers in Malaysia drive up costs. Malaysian industry is otherwise at risk of becoming hollowed out.

Many manufacturing firms in Malaysia have the potential for moving to higher value added products and services in R&D, design, testing, global procurement and other areas. As a chief executive of a Malaysia-based foreign firm has remarked, "We came for low cost labour, we stayed for talent". Such firms should be encouraged to stay and move up the value chain into new activities. The NEM approach is to form clusters of firms that find opportunities in collaborating and competing with each other within the same location. Firms in such clusters are less prone to move to new locations abroad.

The NEM focus will be on new firms, which will likely be SMEs. Those firms investing in innovative and technologically advanced production and services with spill-over effects across economic sectors will be supported by the government. Such new start-ups will need help with specific problems, especially distortions and restrictions in the licensing and regulatory environment. To ease such problems, the Malaysian Industrial Development Authority (MIDA) should be empowered to take decisions and coordinate among the many government departments to facilitate start-ups and licensing. It must become a real and effective one-stop agency, not only one in name and aspiration.

Rebalancing public-private sector role

Malaysia's economic development has been heavily influenced by the government. The government, through GLCs, has directly championed growth of some sectors. The sectors in which government companies dominate have shown the lowest rates of growth of productivity in recent years. Public investment has become larger than private investment. The private sector's role has receded. This trend must be reversed if the private sector is to be the engine of growth to high income status.

GLCs dominate many sectors in Malaysia. The government as both business owner and regulator of industries faces conflicts of interest that can result in decisions which give GLCs an unfair advantage over private firms. This effect discourages new private investment in market segments where GLCs are strong. Such market segments could well be the ones which could attract private investment in high value added products and services.

A more competitive environment can be facilitated by legislation. The proposed Fair Trade Practices Act will be the first step in establishing an explicit competition law. This Act is the culmination of five years of consultation on state ownership, on the treatment of GLCs and on other competition issues. This change would demonstrate the government's commitment to raise the profile of the private sector. A Competition Commission to be established thereafter will be able to uphold a level playing field and fair business environment. In addition, government will review all regulatory and licensing requirements with the objective of allowing greater flexibility and removing barriers resulting in additional financial and time costs. Regulation must be streamlined and proportionate while being transparent. Regulatory bodies charged with oversight must be supportive of industry and contribute to nurturing healthy private sector competition. A dynamic ecosystem for entrepreneurship and innovation will be created.

In sectors where the private sector is operating effectively, GLCs will be privatised. Remaining GLCs will be required to operate on a commercial basis free of government interference and without government preferential treatment. The government will not seek to use its regulatory powers to protect GLCs from competition by the private sector. Instead, it will encourage competition from all quarters, secure in its belief that competition will only encourage firms in both the public and private sectors to improve their efficiency and provide new value added services. Reduced direct participation of government in the economy would minimise the crowding out of the private sector.

Competition aside, there is room for GLCs to partner more effectively with the private sector. In particular, collaboration between GLCs and domestic companies could take advantage of scale economies and symbiotic networking, and could be especially worthwhile when they venture abroad. This outcome would be positive for turning Malaysian companies into regional and global champions.

Box 2: Targeted actions needed for micro-enterprises and SMEs

Actions to re-energise the private sector must be accompanied by programmes which are based on needs and merit, and which build up the bottom segments of the domestic private sector. Some common problems faced by these segments, and the possible approaches to tackling the problems, can be found in Appendix 3.

Both informal businesses and micro-enterprises are at the bottom of the economic pyramid and likely constitute enterprises, existing and potential, that reside among the bottom 40% of income earners. These segments include the rural population and also those who migrate from the rural to the urban environment seeking to better their lives. It also includes the wide range of women in the rural and urban areas who seek work opportunities. These are motivated individuals who, but for the lack of knowing how, wish to better their lot in life.

While there are some 30 government programmes to help the micro-enterprises and SME segments, the effectiveness of the outreach for the bottom 40% of the economic pyramid is wanting. It requires greater awareness of their needs and facilitation to bring them to the table of opportunities.

While not exactly at the bottom of the economic pyramid, SMEs – accounting for 35% of GDP, 57% of total employment, and 20% of exports – should be given more support and assistance as well. Many SME operations remain low-tech and exhibit low growth rates – due to lack of capital, lack of entrepreneurial skills and management capacity, and high illiteracy rates.

6.3.2 *SRI 2: Developing a quality workforce and reducing dependency on foreign labour*

Table 14 - Inspiring the workforce to draw out their best

Policy Purpose	Possible Policy Measures
Increase local talent over time	■ Review the education system – shift educational approach from 'rote learning' to 'creative and critical thinking' ■ Increase emphasis on reintroducing technical and vocational training colleges ■ Identify and nurture talent through a demand-driven process ■ Improve autonomy and accountability of educational institutions ■ Encourage R&D collaboration between institutes of higher learning and industry ■ Enhance English language proficiency ■ Deliver high quality education, within reach of all localities
Re-skill the existing the labour force	■ Upgrade skills of the bottom segment of the Malaysian labour force through continuing education and training ■ Establish a labour safety-net for displaced workers ■ Industry to partner with government in encouraging 'Continuous Employment Training' (CET) ■ Formalise international quality standards and certification of skills ■ Allow wage levels to be reflective of the skill level
Retain and Access global talent	■ Review existing programmes to attract highly-skilled Malaysians overseas to return home ■ Offer permanent residence for ex-Malaysians and their families ■ Centralise oversight of foreign labour and expatriates to enable coherent practice ■ Build up critical mass of skilled professionals through simpler work permit and immigration procedures ■ Liberalise professional services through mutual recognition arrangements

Policy Purpose	Possible Policy Measures
Remove labour market distortions constraining wage growth	■ Protect workers, not jobs, through a stronger safety net, while encouraging labour market flexibility ■ Revise legal and institutional framework to facilitate hiring and firing ■ Raise pay through productivity gains, not regulation of wages
Reduce reliance on foreign labour	■ Enforce equal labour standards for local and foreign labour ■ Use a levy system to achieve targets for unskilled foreign labour in line with sectoral needs

Education driven by growth priorities

Malaysia's future education system must be driven by national growth priorities to nurture the talent needed for an advanced nation, while at the same time, serve as the platform to imbue national unity. The national schools should become the schools of choice where students of all races can interact freely. The education system should focus on achieving international quality standards by adopting best practices. A creative and critical thinking pedagogical approach should replaced ingrained outmoded practices of rote learning processes. Students should have strong language competencies especially in English. The education system should take into consideration industry needs and produce students with the requisite skills. Building the national talent base will need to cover the entire education system – involving primary, secondary, vocational and technical as well as tertiary education.

A more flexible and autonomous environment, backed by a strong research culture and funding at all levels of education, is conducive to innovation and creativity. This environment must be supported by a sustainable, critical mass of talent. Many universities in developed economies have engaged entrepreneurs through setting up incubator laboratories and 'technology transfer' offices. In this regard, although Malaysia's allocation for education has been large, its R&D spending is well below that of our neighbouring countries. Promoting the growth of knowledge and innovation parks with links to local universities is one way to boost R&D investment.

A key indicator of success of the concentrated efforts to strengthen education will be when firms no longer cite shortages of skilled workers as a key adverse feature of the investment climate. Today we have the worst of both worlds, as the education system has been unable to produce the requisite talent and the labour market is ineffective in conveying information on the type, quantity and quality of skills needed for employers.

Training and reskilling the labour force

Besides the provision of education, training and the reskilling of workers to take on higher value jobs are an integral part of expanding the national talent base. In particular, the skills of the lower segment of the Malaysian working population must be upgraded through life-long learning. When this goal is achieved, Malaysia can reach its full potential as a high income and advanced country. It is estimated that some 60% of the Malaysian population or about 80% of the Malaysian workforce have education only up to SPM level or equivalent. This relatively low level of educational attainment is a major barrier to leveraging on human capital as the key factor to spur growth. Therefore, it is imperative to improve access to quality training and reskilling courses, especially in rural areas and marginalised urban centres, with the objective of meeting the needs of industry. More technical and vocational schools should be built to cater for the non-academically inclined students.

Training and skills development is key to expanding the talent base as it allows workers to undergo a continuous improvement, particularly those that may be displaced from low value added jobs in the course of the economic transformation. By supporting training programmes undertaken jointly with the private sector, the government will ensure that the skills mix meets industry needs.

Employees should be provided with incentives including those from the government to upgrade themselves through continuing education and training (life-long learning). The government should facilitate the establishment of a joint council between employer and employee representatives to expand continuing education and training. At the same time all stakeholders should agree on the standardisation of competency levels so that skilled workers can become more productive. Upon completion of training, the new skills acquired should be recognised by employers in the form of better wages, which would help with staff retention. In addition, wage increases should be based on productivity gains reflecting skill levels, not on the regulation of wages.

Retaining and attracting global talent

The government and private sector must work together to improve the conditions that are driving Malaysian and expatriate talent to locate abroad. This effort should be complemented by a review of existing programmes to attract high skilled Malaysians overseas to return home and to attract foreign talent. A key consideration drawn from lessons of other high income countries is the offer of permanent residence to these workers and their families, including ex-Malaysians. Better management of talents will require a centralisation of oversight over foreign labour and expatriates to enable a coherent practice. To facilitate a move up the value chain there needs to be a build-up of a critical mass of skilled professionals through simpler work permit and immigration procedures.

Greater use of foreign talent will increase demand for Malaysians with similar qualifications and send strong signals for nationals to upgrade their skills. The end result of an aggressive policy to tap global and domestic talent coupled with better managed inflows of the semi-skilled would be a virtuous cycle that would maintain profits, encourage higher productivity activities and pave the way for more robust future increases in wages.

Another barrier that has to be addressed is the regulation of professional associations which prohibit domestic employment of foreign professionals. This is a critical issue since Malaysia's policies are unusually restrictive compared with other East Asian countries. Without substantial inflows of foreign talent, firms do not have the incentive to move up the value chain but still have to cope with wage cost pressures.

Removing labour market distortions

The labour market does not perform well in Malaysia. There are insufficient high wage jobs and skilled labour is not well remunerated. Use of low wage foreign labour has become excessive, contributing to low wage levels. Rigid labour laws inflate dismissal costs, reducing incentives to invest in new businesses and pay higher wages.

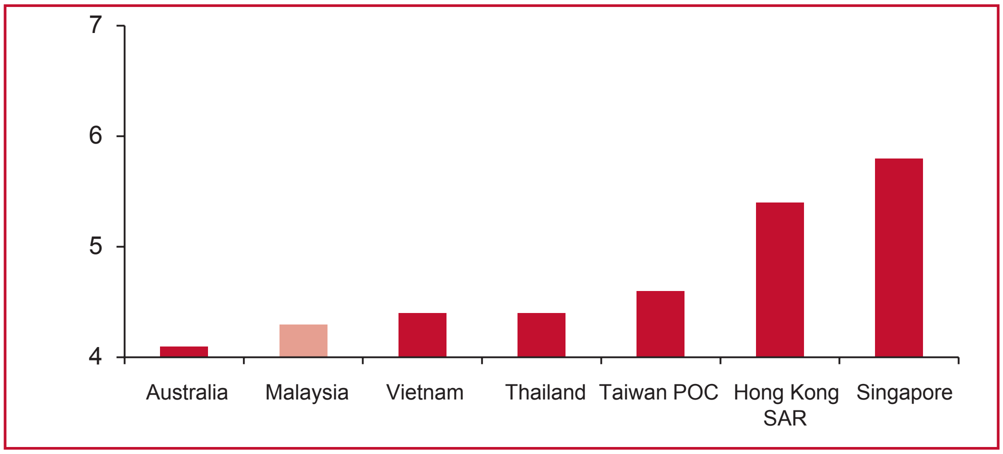
Due to outdated regulatory burdens on the hiring and firing of local workers (Figure 30), firms become overstaffed because it is costly to shed labour or they seek to avoid such burdens by using contractual staff – usually foreign labour. There are also serious problems with the mix of skills available. In some sectors, workers are performing tasks that do not match their training. In others, many positions remain vacant due to lack of qualified candidates. When faced with a skill shortage, a firm should be able to either hire expatriates or retrain existing workers. However, retraining workers can be costly. At the same time, Malaysia has lost its attractiveness to expatriates due to cumbersome immigration policies. Even programmes to encourage skilled Malaysians to return home have failed to meet their targets.

Excessive use of foreign labour undermines high income objective

Up to the late 1990s, inflows of foreign workers served the country well in moving from low to middle income status. Since then, Malaysia's policies on foreign workers have become incoherent and run counter to the national objective of achieving high income status. Firms' obsession with the pursuit of short-term profits makes them focus solely on keeping costs down. This obsession makes them prefer to tap into the large pool of low cost workers available in neighbouring countries, leading to excessive use of foreign labour in Malaysia (Figure 31).

Government policies should work to correct the excessive use of foreign labour in ways which would enhance Malaysia's longer-term growth objectives rather than feed into the short-term cost considerations of firms. Existing policies, however, are doing the exact opposite. Foreign workers are not subject to the same labour standards

Figure 30 – Hiring and firing index (1=Rigid, 7=Flexible)



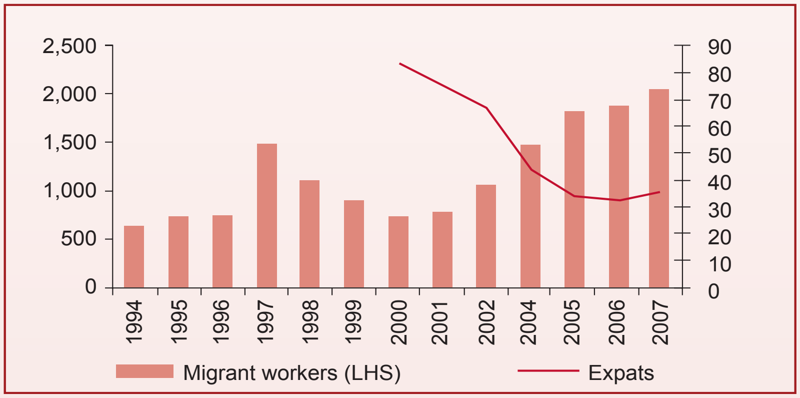
Source: World Bank

as nationals. Foreign workers have access to social services like health but the cost is borne by the government. Thus, they are less costly to hire than nationals – giving foreign workers an unintended advantage in the domestic labour market.

Moreover, the large differential in wages between Malaysia and labour-originating countries has created a recruitment and outsourcing industry that thrives on rent-seeking. Recruitment fees now generate huge profits for private agencies, which in turn spawns a range of abusive practices. Reports of firms recruiting foreign workers for jobs which do not exist is one glaring example.

Reforms should begin with rationalising the use of the levy mechanism, subjecting foreign workers to the same labour standards, granting them access to a comparable social service as nationals. It would also address international concerns about Malaysia's poor treatment of foreign workers. A more rational system of levies and the utilisation of the proceeds to fund social services for migrant workers would address equity concerns. In

Figure 31 – Inflows of low skilled foreign workers and outflows of expatriates



Source: World Bank

addition, funds could be used to finance programmes that drive innovative practices among Malaysian firms, thus reinforcing pressure to move up the value chain.

Stronger safety net for the unemployed needed

Before hiring and firing is made more flexible across the board, the safety net for the unemployed must be strengthened. The current system does not protect workers from the risks associated with unemployment, illnesses, disability and old age. A stronger safety net would provide support to cushion the adjustment costs for employees and facilitate the restructuring of firms. Current weaknesses include the absence of unemployment insurance, limitations in the eligibility and adequacy of the EPF, as well as the narrow reach of health insurance programmes for the poor. While strengthening such services could be costly, the problem can be eased through improved targeting and reduced fragmentation of services across multiple agencies and levels of government.

6.3.3 *SRI 3: Creating a competitive domestic economy*

Table 15 - Vibrant markets and greater choices

Policy Purpose	Possible Policy Measures
Improve economic efficiency through competition	■ Strengthen the competitive environment by introducing fair trade legislation ■ Improve competition law to safeguard the interest of domestic firms before liberalisation of sectors to foreign firms ■ Set up an Equal Opportunity Commission to cover discriminatory and unfair practices ■ Review remaining entry restrictions in products and services sectors ■ Adoption of international best practices and standards for local industries to become highly competitive
Build entrepreneurship	■ Revamp the seed and venture capital funds to support budding entrepreneurs ■ Simplify bankruptcy laws pertaining to companies and individuals to promote vibrant entrepreneurship ■ Provide financial and technical support for SMEs and micro businesses, to move them up the value chain
Remove market distortions leading to misallocation of resources	■ Phase out price controls and subsidies that distort markets for goods and services ■ Apply government savings to a wider social safety net for the bottom 40% of households, prior to subsidy removal ■ Create a Transformation Fund to assist distressed firms during the reform period

Substantial financial resources are being allocated to subsidies – the bulk of which goes to petroleum products – representing a considerable burden to the government. Subsidies for fuel and various price-controlled items account for a large part of the government's operating expenditure and contribute to rising fiscal deficit. The large government outlay on subsidies – mostly funded by petroleum proceeds – is not sustainable. The pricing of essential goods and services in Malaysia does not reflect market prices. Price controls and subsidies distort price signals, often resulting in overconsumption and waste.

Globally, prices are constantly rising, making subsidies and price-controlled items more costly. The subsidies were meant to support the vulnerable groups but it has benefited a wider group, including the well off. It is time for a more targeted approach of direct financial assistance for the poor rather than broad based subsidies which often are of most benefit to the well-off, who consume more of the subsidised goods.

At the same time, the private sector is becoming ever more reliant on government subsidies which are numerous, complex and expensive to administer. Such support by the public sector to the private sector is not leading to innovation and high levels of private investment. As a result, domestic and foreign investors have a vested interest in maintaining low value added production. Adding to that burden are the numerous tax incentives granted by the government. While tax incentives are necessary measures to encourage private investment, they contribute to foregone tax revenue if used indiscriminately.

The NEM recommends a steady removal of subsidies and price controls, with a rationalisation of tax incentives. Removing subsidies and price controls can reduce operating expenditures over time and restore a better balance to fiscal deficits. Furthermore, savings from the removal of subsidies will be used to fund a social safety net scheme targeted at beneficiaries from poor households and vulnerable groups. This savings can also be applied to a Transformation Fund to help firms displaced by the reforms to adjust to the new market environment. With this solution, price distortions will be removed, allowing for the restoration of market signals to regularise the demand and supply of products previously controlled.

6.3.4 *SRI 4: Strengthening the public sector*

Table 16 - A lean and customer-focussed government

Policy Purpose	Possible Policy Measures
Improve decision-making processes	■ Use "whole-of-government" approach to provide integrated services ■ Empower state and local entities to perform their tasks locally ■ Encourage greater local input and authority in economic development to support regional differences and needs ■ Develop a process for effective implementation, monitoring and evaluation of policy measures ■ Empower MIDA to become an effective one-stop-agency to facilitate foreign investment ■ Revamp MPC to be more effective in driving productivity and efficiency improvements
Improve service delivery	■ Reform the government to be lean, consultative, and delivery-focussed ■ Upgrade skills of staff to enable them to multitask ■ Modernise human resource management to match qualifications with jobs
Reduce 'friction costs'	■ Have zero tolerance for corruption ■ Address underlying weak governance structures ■ Codify best practices ■ Implement an open, efficient and transparent process of government procurement at all levels
Provide a safety net to facilitate a smooth transition	■ Retain a residual role for safety nets to stabilise and correct periods and instances of market failure ■ Apply government savings to a wider social safety net for the bottom 40% of households prior to subsidy removal ■ Create a Transformation Fund to assist distressed firms during the reform period
Strengthen public finance management	■ Widen the tax base (e.g. GST) ■ Lower personal and corporate income tax rates ■ Implement standardised criteria for state revenue receipts ■ Use results-based budgeting ■ Implement programme-based, medium-term budgeting ■ Adopt international standards for fiscal transparency ■ Use technology for efficient collection of duties and taxes

Improve the decision making process

National governance worldwide is becoming less top-down and more decentralised as the complexities of business and society exceed the capability and effectiveness of traditional top-down management. Civil society is playing an increasingly important and influential role in public policy matters. Communication technology and the internet are used widely to promote transparency and discourse. Effective partnerships between the state, market and society are gaining ground. Various measures have been implemented to integrate and improve public service delivery. One such measure was the establishment of e-government portals, but all measures in general have produced limited results. Government agencies are still perceived to be bureaucratic, operating in silos and very much patronage-based.

Re-engineering of public institutions requires a revamp of the administrative system and the governance structure with greater efforts to combat corruption. Urgent initiatives to restructure the key agencies are critical for the success of ETP implementation. The duplication of agencies undertaking similar functions needs to be eliminated. In this regard, immediate attention is needed for strengthening oversight on policy development and implementation, in particular for the services sector due to its increasing importance for generating growth.

The government should become leaner, delivery-focussed and more consultative. Work in this area has started with the launch of the Government Transformation Programme (GTP). Cumbersome regulations, processes and procedures must be simplified to improve their effectiveness and reduce rent-seeking.

Achieving the outcomes of the NEM critically depends upon the ability of public institutions to effectively implement the policies underlying the SRIs. Quality public institutions staffed with committed civil servants are needed to create the big push of policy measures to boost growth and accelerate transformation.

Strengthen public finance management

The central issues in reform of fiscal management are diversification of revenue sources as well as improved expenditure management. Better accountability for government outlays should target reducing waste and preventing cost-overruns. The specific areas of concern that need to be addressed are: 1) diversifying government revenue base; 2) strengthening revenue collection; 3) rationalising subsidies, price distortions and tax incentives; 4) improving budget management; and 5) greater fiscal transparency.

Diversifying government revenue

Historically, Malaysia's development expenditure has depended greatly on revenue from natural resources. Export duties on tin, palm oil and rubber, for example, substantially financed the early five-year plans. From the mid-1970s, the contribution from oil and gas rose and now accounts for about 40% of total government revenue.

The NEM recommends a number of reforms in the sources and distribution of revenue. A wider tax base is an important part of reforms, where the introduction of the Goods and Services Tax (GST) is a key component. A more diversified tax base is needed to compensate for an expected future reduction in the share of revenue from oil and gas. Overall, another aim of the fiscal reform is to lower the rates of personal and corporate taxes, which will incentivise individuals and firms to increase their income and profits.

Under the fiscal reform, distribution of revenue in the forms of loans and grants to states should be reviewed to align them better with state requirements. At the same time, the criteria for revenue sharing with states should be standardised. In particular, royalties from exploitation of natural resources such as oil should be transferred as established by clear criteria to the producing states.

Strengthening revenue collection

Revenue leakage is a pervasive problem and has an impact on overall revenue collection. The current, largely manual approach to revenue collection is archaic, difficult to control and open to abuses. The development and implementation of effective technology-based revenue collection and management system is a high priority of the NEM.

Improving budget management

The current government budgeting process needs to be reviewed and re-designed to meet the demands of a high income economy. The NEM advocates a shift away from line item budgeting to results-based and programme budgeting. In addition, a medium-term budget framework should be introduced. This framework should incorporate the results from debt management analysis.

The annual budgeting process should also be improved to accelerate programme implementation. Consultations with the private sector should be more focussed on the implementation of tax measures to ensure sufficient understanding and more rapid implementation.

Greater fiscal transparency

Public finance management must be made more transparent. The current culture of confidentiality must be replaced by timely dissemination and disclosure of assessments of fiscal outturn. There should be greater openness in government expenditure programmes. A special focus will be the re-establishment of an open tender system for all government procurements. This system should be transparent at all stages and the results of tenders should be made public, taking into account confidentiality. The findings of external audits of public finances should be disclosed. Where it is feasible, this solution should be supplemented by greater use of independent external audits.

Sanctions for poor budgetary management and failure to observe accepted procedures on expenditures should be balanced by recognition of prudent fiscal management among agencies. Decentralisation of budgets and its managements with proper accountability and transparency will improve efficiency and responsiveness among government agencies.

Review of federal-state fiscal arrangements

A review of the allocation of funds to states by the federal government should be undertaken. Allocation based solely on a per capita criterion should be supplemented by the use of more varied indicators such as poverty levels in the respective states. In this exercise, state governments should be allowed to provide inputs into how federal funds are allocated to states. This will contribute to improvements in the efficiency and effectiveness of state expenditure programmes. Assessment of the impact and results of expenditure programmes must be provided by states in return.

A 'whole-of-government' and accountable approach

The 'whole of government' approach is essential to provide more integrated public service delivery. The existing 'top-down' approach should be rebalanced to empower state and local entities to decide and manage resources more effectively. Greater local input and authority in economic development are needed to support regional differences and needs. With regard to this objective, proper mechanisms should be put in place to enhance collaboration between the different levels of government. Greater inter-governmental collaboration will result in faster decision-making and better coordination among government agencies, especially in resolving complex cross-jurisdictional issues. Government agencies will be the major contributors to an effective implementation, monitoring and evaluation process.

An integrated public service delivery system has the elements of a networked government. In a networked government, the design and delivery of public policies, programmes and services will not only involve multiple government agencies, but also include non-governmental stakeholders such as private firms, NGOs and other civil society groups. The NEAC believes that an effective mechanism that holds government agencies accountable would lead to eradication of corruption and wastage. The quantification of the economic costs of corruption and wastage will raise public awareness about their debilitating effects on society. The Auditor-General's Office is performing part of that role but the perception is that its main task is to produce an annual report, with limited powers to take remedial actions. This calls for significant acceleration in enforcement and prosecution. In this regard, the Auditor-General's authority should be expanded to deal more effectively with misappropriation and mismanagement of resources within the government.

Developing processes and redesigning organisation structures

The role of central agencies in Malaysia should be reviewed and restructured to identify areas where line agencies can be further empowered to improve effectiveness and efficiency in decision making. Further enlargement of agencies must be avoided and any restructuring must focus on streamlining and mergers. Distinctive organisational processes are required for governance to be effective. There is a need to better align intermediate results with overall policy outcomes. The right processes and reporting requirements should be established for this purpose. This approach will help to explain the inter-relationships between results and outcomes.

6.3.5 *SRI 5: Transparent and market-friendly affirmative action*

Table 17 - Escaping low income

Policy Purpose	Possible Policy Measures
Reduce income disparity	■ Continue support programmes for disadvantaged groups ■ Focus on the bottom 40% of households and business owners ■ Shift focus towards relative poverty ● Continue growth as a means of poverty reduction ● "Growth Elasticity of Poverty" – inequality can reduce impact of growth on poverty
Create market-friendly affirmative action	■ Use transparent procedures and criteria ■ Use affirmative action as a means to promote building of capacity and capability ■ Phase out approaches that contributed to rent seeking and patronage
Narrow regional differences	■ Leverage scale with effective development of economic clusters as a means of reducing regional inequalities, especially in Sabah and Sarawak ■ Enhance measures to raise income levels through better access and provision of quality social services in education and health, especially in Sabah and Sarawak
Encourage reward on the basis of performance	■ Encourage greater competition in the economy by removing excessive protection and accelerating sectoral liberalisation ■ Redesign affirmative action to take into account merit and needs ■ Phase out approaches that contributed to rent seeking and patronage
Promote equal and fair access to opportunities	■ Emphasise equitable and fair opportunities for employment, health and education and access to business opportunities ■ Apply government savings to wider social safety net for the bottom 40% of households prior to subsidy removal ■ Create a Transformation Fund to assist distressed firms during the reform period ■ Set up an Equal Opportunities Commission to deal with possible cases of unfair treatment and discrimination

The main purposes of this Strategic Reform Initiative are to reduce income disparities, continue with market friendly affirmative action programmes, narrow regional differences especially in Sabah and Sarawak, encourage reward on the basis of performance and promote equitable and fair access to opportunities.

Affirmative action and equitable and fair opportunities

Progress has been made on the affirmative action front. The reduction of absolute poverty has been exemplary and commendable, and inter-ethnic economic imbalances were substantially addressed. But the implementation of past approaches to affirmative action has serious shortcomings and has produced some undesirable outcomes, practices and attitudes.

Although there have been some progress these successes have been achieved at considerable costs. It is now accepted that the past affirmative action programmes have also inevitably propagated and embedded a distributive and entitlement culture and rentier behaviour. Shortages of qualified *bumiputera* and capital have encouraged the setting up of spurious fronts. Excessive use of ethnic quotas has encouraged the use of less qualified recipients and bred inefficiency. Ethnic-based quotas have been imposed extensively throughout the economy in the past and currently some still exist. The quotas for limited companies in certain industries still require at least 30% *bumiputera* ownership of share capital. Preferential pricing and quotas have led to distortions.

Rent-seeking behaviour is market distorting and has been a serious, undesirable outcome of the past approach to affirmative action. Rent-seekers do not really create wealth, or add to economic growth. Rent-seekers are engaged in unproductive activities and can add sizably to the cost of doing business. The growth of bribery and corruption is closely associated with the growth of rent-seeking in the economy.

Affirmative action would still be desirable in the light of persistent inequalities. Affirmative action policy expressly considers that the relatively economically disadvantaged should be given the opportunities to overcome their disadvantaged position. The New Economic Policy (NEP) was an affirmative action policy. Affirmative action is part of inclusive growth. But the approach to affirmative action must be revised and reformed to take into account the effectiveness of past practices, and make adjustments for the flaws and abuses while drawing lessons for strengthening future programmes. Challenges that have arisen with the new forces of change also make it imperative to reform the past approach to affirmative action. For example, because wealth means more than mere equity ownership, having a 30% target for *bumiputera* equity ownership may not be as meaningful as previously thought.

The principle of the new affirmative action policy that will be part of inclusive growth under the NEM is that it must be market friendly, or it must be an affirmative action policy that is market-based. A market friendly affirmative action would ensure that it does not violate, or negate, the workings of the market. Market friendly affirmative action should not cause, contribute or perpetuate distortions in the economy. The efficient functioning of the market should not be hindered by distortions so that scarce resources are misallocated.

Growth can be maximised if resources are used efficiently. Prices play a role as signals to where and how resources should be utilised to maximise profits. Entry into and exit from markets should not be constrained. Unsuccessful enterprises must be allowed to fold, if they are no longer competitive and the resources are freed for other economic activities. Land, labour, capital and entrepreneurship should be allowed to flow in and out of the economy with minimum restrictions.

Markets, however, can malfunction even without any form of intervention through affirmative action. Monopolies and collusions can hinder the efficient functioning of markets. Excessive risk taking can lead to crises. Markets can fail when it is manipulated by interest groups that seek to maximise their own interest at the expense of society. In such cases of market failure government intervention would be necessary to regulate and correct the failures of the market. But government intervention itself can also worsen market failure and thus has to be kept under vigilant review. Excessive protection, for reasons other than affirmative action, can inevitably introduce market distortions.

The NEM proposes that the revised affirmative action policy should be based on the bottom 40% of households. An affirmative action policy based on the low income group i.e. giving preferential treatment to the relatively disadvantaged group would be in the interest of distributive justice. It will treat equally those who are in the low income group. Affirmative action will consider all ethnic groups equally as long as they qualify for access to resources under affirmative action.

Affirmative action should be seen as a means of equalising opportunities but applicable to the low income group. A market-friendly or market-based affirmative action will be implemented progressively. Liberalisation and the opening up of sectors to market forces will be implemented in stages. Whenever and wherever possible, sectors should be liberalised as speedily as possible.

Policy measures and instruments

The section above on inclusiveness has outlined the strategic thrusts of the NEM on wealth distribution and social justice. For this SRI, the NEAC has some suggestions on specific measures and instruments. These proposals are made on the basis that the broad strategic thrusts are acceptable so that the specific measures and instruments complement, or supplement, the strategic thrusts. In considering policy instruments it should be mentioned that the most contentious of the strategic thrusts have to do with the proposal for greater liberalisation, competition, the shift towards the bottom 40% low income group for distributive purposes, as well as emphasis on opportunities. In reviewing the existing measures and instruments, they can be retained, modified or removed. New measures and instruments can be introduced to replace or supplement the instruments that are in place. The policy measures or instruments can be divided into the following categories:

- Macro-economic
- Affirmative action programmes and Quotas
- Prices
- Subsidies
- Government procurement and tenders

Macro-economic. Macro-economic policies do have an impact on income distribution. In less developed countries, inequality tends to rise during recession because wages are flexible downwards, social safety nets are less developed and there is less labour hoarding. In developed countries, recessions tend to have a greater impact on profits than wages.

Overall, monetary, fiscal and exchange rate policies should continue to aim for stabilising the economy and to sustain growth. Inflation has more adverse effects on the low income groups and the poor and cross-country evidence shows that inflation can worsen inequality. The poor have not been able to index their income with inflation. Fiscal policy, on the revenue side apart from expenditure, can impact on distribution. Maintaining a progressive tax regime could check a widening in inequality. Tax exemptions for low income groups will increase their income. A value added tax which starts at a low level could be a progressive tax on consumption and less inimical to the low income groups. Exchange rate policy should aim at maintaining an orderly and stable exchange rate. Households dependent on the export sector for employment and income would be favoured with a depreciating exchange rate which could boost exports.

Affirmative action programmes *and quotas.* Quotas have been used extensively in the past. The streamlining of quotas will require a re-examination of how quotas have been applied, their transparency and effectiveness. The NEM recommends the shifting of affirmative action programmes to emphasise opportunities rather than outcomes. The remaining quotas should be progressively phased out. As for the enrolment quota, a hybrid approach may be workable and worth considering i.e. using the ethnic quota but taking into account the need and merit of the applicants. If quotas are to be progressively phased out, their continued use in the interim should be targeted at the bottom 40% low income group.

Subsidies. The subsidy bill of the Federal Government is sizable and has been increasing. A large part of the subsidy goes to suppressing the impact of international prices for fuel and petroleum products on Malaysian consumers. It has been estimated that subsidies have accounted for more than a fifth of operating expenditure. The subsidy regime needs to be re-assessed to ensure that it is broadly consistent with the financial resources of the government and that it is fairly distributed to benefit the neediest. There are serious leakages in the subsidy schemes and subsidies should be redirected to ensure that the poor are really the beneficiaries of the subsidies. Some estimates indicate that more than 70% of the beneficiary of the subsidies for fuel products has been enjoyed by the higher income groups. Subsidies should be reformed to benefit the poor.

Government procurement and tenders. Government procurement and tenders are the two broad policy instruments that have and will continue to have distributive implications. A review, therefore, is required to take into account the shift in approach with the adoption of the NEM. Supplies and services are the key items and areas for government procurement and they account for about 17% of the total operating expenditure of the Federal Government. The key items for supplies and services include repair and maintenance, professional and other services, communication and utilities, supplies and rentals. The thrust of the tender system should be towards a much more open system without direct negotiated tenders. Some schemes for tilting tenders towards the bottom 40% will have to be considered.

Institutions for equitable and fair opportunities

Competition and liberalisation of the economy under the NEM will reduce the extent of controls over the functioning of the economy. Private enterprise will become less fettered. Abuses clearly may continue to flourish and must be stemmed. Discrimination in many forms will appear and must be explicitly managed. Checks and balances need to be introduced in anticipation of a possible rise in abuses and discrimination. The NEM proposes that an institution, or agency, be established to counteract and check these unwelcome tendencies in abuses, discrimination and unfair treatment. An Equal Opportunity Commission (EEC) is proposed with the responsibility of monitoring and considering cases of discrimination and unfair treatment in the economy to cover both the public and private sectors. The Commission will focus on the implementation of the measures that have been proposed under the NEM.

Inclusive growth will require a new institutional regime. The present institutions and approaches were designed more than 30 years ago to support and administer the affirmative action programmes but conditions and ideas have changed. It is timely that a serious review of the key institutions that have been entrusted with affirmative action is undertaken, for the purpose of re-engineering and re-designing these institutions to support inclusive growth under the NEM.

6.3.6 *SRI 6: Building the knowledge base and infrastructure*

Table 18 - Innovating today for a better tomorrow

Policy Purpose	Possible Policy Measures
Create an ecosystem for entrepreneurship	■ Easing entry and exit of firms as well as high skilled workers ■ Revamp the seed and venture capital funds to support budding entrepreneurs ■ Simplify bankruptcy laws pertaining to companies and individuals to promote vibrant entrepreneurship ■ Harness Web-based expertise and industry networks
Promote an environment for innovation	■ Improve access to specialised skills ■ Ensure protection of intellectual property rights ■ Incentivise firms to embrace technology and move up the value chain ■ Enforce strict adherence to global standards and benchmarks ■ Fostering R&D links between the institutions of higher learning and the private sector ■ Immediately roll out nationwide fast broadband connectivity ■ Review and consolidate all present government R&D funding ■ Align R&D to national growth objectives particularly in innovative and hi-tech fields ■ Open access to funding to competition among researchers ■ Ensure public procurement supports local innovation ■ Establish KPIs for universities based on commercialisation
Establish stronger enabling institutions	■ Set up a technology research powerhouse and centre of excellence run on a commercial basis e.g. ITRI Taiwan cluster model ■ Operationalise the National Innovation Model announced by the government in 2007 ■ Balance the technology-driven innovation approach with market-led policies such as global procurement through technology intermediaries

Malaysia has benefited from globalisation, especially through integration into production processes and networks at the global and regional levels. However, in the current economic environment, firms are continuously refining their strategies and restructuring their supply chains through relocation, outsourcing and in-sourcing. Against this changing landscape, Malaysia can no longer rely on global firms which will constantly seek and relocate their investment to more attractive markets. Through entrepreneurship, local firms will increasingly have to drive industrial upgrading by developing their capabilities and innovation infrastructure. There is nothing automatic about this process. Government support can facilitate such upgrading.

Moving up the value chain implies a continuous process of change, innovation and productivity growth. Under the NEM, Malaysia's economy will grow by developing new technology, innovating products and processes, and designing new management methods.

Infrastructure critical to high value added activities, such as high-speed broadband, must be rapidly put in place to facilitate the new production processes that rely on networking to create scale and efficiently connect supply chains.

Still, technology alone is not enough. Other 'soft' innovative capabilities covering the social, organisational and cultural aspects are more difficult to attain but are also critical. Malaysia must respond to market trends and tap into the global pool of knowledge, supported by education and training policies embedded in the other SRIs.

Upgrade institutions of higher learning

To enhance the knowledge base, education institutions should be allowed to compete for the best students, government grants and other academic resources. The present system of closely controlled operations by the Ministry of Education (MOE) and Ministry of Higher Education (MOHE) should be changed to a system with autonomy and accountability. The views of the local community should be sought and given due consideration to improve the quality of schools.

Autonomy and accountability are also very important for universities. Public universities should have the authority to decide on matters pertaining to course offerings, student enrolment, staff emolument, financial management and daily operations. Similarly, students should be free to pursue education at a university of their choice. Accountability would focus on compliance with uniform performance indicators set by the government. Development of curriculum to meet market needs as well as collaboration with industries in R&D should feature among the performance indicators. However, R&D must be aligned to national growth objectives particularly in innovative and hi-tech fields. Access to R&D funding must be open freely to competition and not be monopolised by established research providers. Also, priority should be given to research with potential for commercialisation.

6.3.7 *SRI 7: Enhancing the sources of growth*

Table 19 - Finding the economic sweet spots

Policy Purpose	Possible Policy Measures
Create value from first mover and other comparative advantages	■ Identify E&E subsectors to build depth and foster new niche industries, and to capture a greater share as a distributional hub as intra-regional trade expands ■ Focus on palm oil-related downstream industries to develop indigenous technology and innovation or acquire technology to meet new market demands ■ Encourage upstream technology innovation to develop higher yielding fresh fruit bunches ■ Capture a greater share of the education, medical tourism and ecotourism markets through domestic and regional partnerships ■ Promote climate change mitigating products and services e.g. recyclables ■ Promote products and services that comply with Islamic tenets e.g. finance, pharmaceutical
Develop greater integration between products	■ Integrate education services with industrial development, for example a centre of engineering excellence in the E&E cluster ■ Further prioritise the logistics industry, leveraging on roads, ports and ICT infrastructure readily available in Malaysia ■ Improve seamless tourism services by ensuring quality services along the value chain (examples such as the revamp of poor quality taxi services and improving personal safety for travelers)
Create new markets	■ Capture greater share as a distributional hub as intra-regional trade expands ■ Improve maritime and port services, leveraging on technology ■ Move into alternative energy generation as well as energy saving products and services ■ Expand service-oriented industries to regional markets based on Malaysia's inherent biodiversity

Policy Purpose	Possible Policy Measures
Build scale of industries and production networks for specialisation	■ Promote corridor-based development around spatially dense poles and adjacent hinterland, especially for electronics ■ Encourage competition between localities ■ Cluster industries to leverage on integration, scale and connectivity ■ Exploit economies of scale through networking of production and supply chains leveraging on location - 'Speed to market' ■ Establish global presence through international acquisitions of companies in the same field to
Harness innovation potential	■ Adopt an open innovation system to acquire technology and expand networks ■ Support rapid transformation of SMEs with potential for innovation ■ Develop industries that support sustainable development such as use of traditional plants and herbs for modern applications
Integrate real sector industries with financial services	■ Develop the commodities trading platforms and products for domestic producers to benefit from financial innovation and expansion ■ Offer Malaysia as a regional hub for both futures and spot markets for commodities ■ Develop Islamic-based financial products to support domestic production and risk management of prices and production

The old emphasis has been for Government to identify the sources of growth, usually through the 5-year Malaysia Plans and the Industrial Master Plans which then provide the incentives to drive the growth sectors/ industries. This was the case in developing the commodities and later the manufacturing sectors, in particular the electronics sub-sector. In the late 1980s and over the following two decades, selected services sectors were identified as having export potential and again, government introduced incentive schemes (e.g. financial and tax breaks) to promote their growth (e.g. education, tourism and shipping).

The new emphasis within the framework to transform the economy would be to strengthen overall competitive capacity of the private sector and remove the barriers for private sector to drive sectoral growth. The Government's role would be facilitative, ensuring distortions are not created in order that private sector can allocate resources more efficiently, putting in place the required enablers to support high value industries and giving special attention when required for specific sectors.

In the context of the new mode by which the Government supports sectors/industries with high growth potential, the approach would be to identify criteria that will make sectors/industries as important sources of growth, as well as the necessary support and facilitative arrangements that must be put in place and/or the barriers that must be removed for these industries to realise their growth potential.

In developing further sectors and industries which can lead growth, the NEAC believes that Malaysia must harness its natural endowment, sectors with comparative advantage, and industries where Malaysia has developed early mover advantages as the main sources of high value added growth with spillover effects into new areas of activities:

- In developing natural resources, the future growth momentum requires a focus on the present growth corridors to leverage economies of scale to drive progress with an increased focus on high value added natural resource downstream activities in product and services. For example, in the palm oil sector, a market driven approach will be to acquire technology. The other alternative is a technology driven approach to develop indigenous technology to produce what the market wants, including healthy fats and oils, biofuel from biomass, cosmetics, organic nutraceuticals (food products that provide health and medical benefits) and bio-degradable plastics.

- In the E&E sector, early mover advantage should be leveraged through national approaches to taking advantage of the skill set and concentration of firms to further develop high value add segments within the sector. The transformation requires a change from the low and medium technology industries which create low value added products. Innovation will be a powerful driver to deepen the contribution of this sector to growth (Appendix 4). Potential for innovation can be enhanced through leveraging on the global proliferation of industries in the Penang corridor to drive knowledge intensity. Shared services will facilitate specialisation and productivity. Partnerships will foment innovation and new products. The incentive structure should shift to support SMEs supplying to the large MNCs.

- There is potential for developing commercial agriculture with Government support for insurance schemes within a risk management framework that will expand commercial agriculture activities into innovative planting, harvesting and processing technologies, as well as venturing into downstream high value new products. Growth industries in agriculture would be integrated agriculture industries (as in aqua-culture) which can create value in rural space and build new skills and capacity to earn higher incomes among rural populations, and have high potential to service the growing international markets.

- In the services sector, we should harness potential for a higher share of the regional market in tourism and education. Manufacturing or commodities development should be better integrated with education services to support R&D. An example is the centre for engineering excellence where industrial training in electronics firms combined with research institutes supported by the electronics industry can ensure skills growth that is in tandem with industry requirements. Similarly, in health tourism, medical colleges can be integrated with hospitals to service demand for medical training from the region and medical services from within and outside the region.

Developing scale is important to building competition and growth. Concentration of industries within a region/corridor creates scale advantages through multiplier growth effects for all kinds of related and support service industries. It is critical that Federal decisions on location place priority on this criterion when approving new investment. In addition, industries (such as telecommunication and mobile services) which are able to attract foreign interests and operate in regional markets, should be encouraged to locate in the corridors. Our endowments support promising expansions into new markets such as eco-tourism and moving into alternative energy generation as well as promoting climate change mitigating products and services e.g. recyclables. Our strategic location is conducive for further developing the distributional hub potential to capture a greater share of expanding intra-regional trade in both goods and services.

Overall, industries and sectors with high growth potential should include those with the capacity to become champions and turn Malaysia into a regional hub for specific goods and services.

In financial services, Malaysia needs to optimise its early mover advantage in Islamic finance, and exploit the potential to become a dominant global champion by further expansion of products and services that comply with Islamic tenets. Better coordination among agencies is required for Malaysia to become a hub for cross-border Islamic finance products to support growth sectors within the region. This coordination of policies is also important for implementing the ASEAN Capital Market Framework Agreement, where Malaysia already has the skills and scale.

In the commodities field, Malaysia needs to exploit the potential for widening the trading platform in commodities to give better trading and hedging options to commodity firms. Partnerships with external parties can be exploited to build synergies and widen trading opportunities, including commodity derivatives and other hedging options to reduce risks as well as costs of doing business.

Support from the financial industry would take the form of a change in credit assessments in lending to innovative SMEs, giving less emphasis to asset- as well as collateral-based lending by shifting to partial guarantees. The financial sector must build capacity to evaluate companies' performance through the use of project and cash flow credit assessment. Action now is required for financial institutions to become sophisticated and to help drive economic growth. Similarly, priority funding for technology and green tech firms requires financial institutions to build the right capability to evaluate and finance new green technology related investment.

In implementing the strategies to realise the growth potential of sectors and industries, there are major cross-cutting barriers that must be removed. Major ones include a 360-degree policy shift from decentralisation to locational concentration for scale. Related services also benefit from concentration of people and skills. Issues of Federal policy that may disadvantage States will need to be addressed. This issue is dependent on policy decisions affecting growth and employment being based primarily on economic considerations. A host of measures to improve efficiency in government agencies and adopting transparency rules and processes in the government regulations will be required. A move to benchmark against international standards for all delivery of products and services will raise quality and prices of exports. Setting up a Complaints and Dispute Settlement bureau for investors can provide an avenue for quick resolution of problems faced in setting up businesses in Malaysia. Above all, a comprehensive review of regulations, their consolidation and elimination of inconsistent regulations at both the general and sector-specific level, will go a long way to enhance growth sectors and industries.

6.3.8 SRI 8: Ensuring sustainability of growth

Table 20 - The future is bright. The future is Malaysia

Policy Purpose	Possible Policy Measures
Preserve natural resources	■ Use appropriate pricing, regulatory and strategic policies to manage non-renewable resources sustainably ■ Encourage all sectors to embrace 'green technology' in production and processes ■ Develop a comprehensive energy policy
Leverage on comparative advantages for high value added products and services	■ Increase focus on downstream high value added production and services ■ Develop a comprehensive energy policy
Meet international commitments	■ Reduce carbon footprint in line with government commitment ■ Enforce clean air and water standards in utilising natural resource i.e. pollution mitigation
Facilitate bank lending and financing for 'green investment'	■ Develop banking capacity to assess credit approvals for green investment using non-collateral based criteria ■ Liberalise entry of foreign experts specialising in financial analysis of viability of green technology projects ■ Support green technology investment with greater emphasis on venture capital funds
Ensure sound public finances	■ Use appropriate pricing, regulatory and strategic policies to manage non-renewable resources sustainably ■ Reduce wastage and avoid cost overrun by better controlling expenditure ■ Establish open, efficient and transparent government procurement process ■ Adopt international best practices on fiscal transparency

The NEM places strong emphasis on preserving our natural resources and safe-guarding the interest of future generations. While progress and development is all important, government must not overlook the value of careful usage of its natural resources by applying appropriate pricing, regulatory and strategic policies to manage non-renewable resources sustainably.

A green economy platform policy for development must be set by the government. In line with the government commitment in Copenhagen to reduce Malaysia's carbon footprint, a comprehensive energy policy is to be introduced. At the same time, greater efforts are needed to put in place pollution mitigation practices, enforce clean air and water standards, as well as maximise the stewardship of our scarce natural resources.

Fiscal discipline is needed for sound and sustainable public finances. Healthy government finances contribute directly to maintaining macroeconomic balance and facilitating financial stability. Fiscal reform programmes, including measures initiated under the GTP, should continue to improve services and reduce the size of the government.

The government should adopt international best practices in budget management and fiscal transparency. Public finance management should be undertaken within a medium-term budgeting framework to underpin sustainability.

A green technology platform must be supported by financial facilities to fund investment in this area. Malaysian banks must move away from collateral-based credit. For that to happen, Malaysian financial institutions need to develop capacity and educate their credit officers to evaluate such investment proposals. Given the complexity of these projects and the technical expertise required, partnership and collaboration with external parties could be an interim arrangement until a critical mass of local expertise is developed.

Malaysia also has the comparative advantage for developing home grown green technology. A comprehensive energy policy should include venture capital support for green technology and for bringing in experts that can develop local expertise in this area. Malaysia has opportunities to be a centre for development of environmentally sustainable products and services.

CHAPTER

7

The time for change is now – Malaysia deserves no less

The time for change is now – Malaysia deserves no less

The preceding chapters outline the main elements of the proposed NEM and the key changes required to drive Malaysia to an inclusive high income economy. But this is not the end of the journey, just a signpost to the beginning. The way ahead, however, is clear and Malaysia will lose its way if urgent action is not taken.

The NEM calls for specific changes following eight SRIs. These changes will profoundly affect a wide range of interests and sectors, players and participants in the Malaysian economy. The cross-cutting nature of these proposals and the significance of the task ahead calls for a big push, a drastic change in perspective and policy. Determination and resolute leadership will be needed, together with constant monitoring and course correction as changes unfold in the Malaysian economy.

The big push of the NEM is required to bolster the momentum for change already started by the '1Malaysia' and 'Government Transformation Programme' initiatives. The big push will also reassure Malaysians that change has indeed begun. Only real change and clear economic improvements, however, will convince the *rakyat* that the SRIs in the NEM can drive our economy forward to advanced nation status. Malaysia would then have an economy capable of sustaining high income growth, of delivering improvements in the lives of all Malaysians, and of providing a sustainable environment for all our futures. Malaysia deserves no less.

The NEAC is an independent advisory body and implementation of the NEM recommendations will be undertaken by the appropriate government ministries and agencies. But the work of the NEAC is not complete. The next step is for the NEAC to help formulate and detail policy with key stakeholders, in support of the proposed SRIs. The details of the policy measures will be set forth in Part 2 of the *New Economic Model for Malaysia* report, to be submitted for government consideration later this year.

APPENDIX

1

Sustainability and the palm oil industry

Appendix 1: Sustainability and the palm oil industry

The following case study on how to develop the Palm Oil industry is an illustration of how to achieve the sustainability goal of the NEM.

The history and current problems of the palm oil sector

In 2009, Malaysia produced 17.7 million tonnes of palm oil. Palm oil covered 4.69 million hectares in Malaysia in 2009 and contributed 3.2% of real GDP in 2008, increasing from 2.9% in 2000. Exports of palm oil grew by 13.8% a year since 2005 to RM38.5bn in 2009, capturing a share of 7% of exports compared to 4.3% in 2005.

Malaysia was the 'first-mover' in the large-scale commercial planting of the African oil palm, Elaeis guineensis, in the 1960s, and was the largest producer of palm oil, until the emergence of Indonesia, which relative to Malaysia has the advantage of a larger land mass and cheap labour. Latin America has started commercial oil palm plantations and Western Africa is also beginning to expand acreage and production, but from a low base.

Factors that contributed to Malaysia's success include political stability, ideal climate and agronomic conditions.

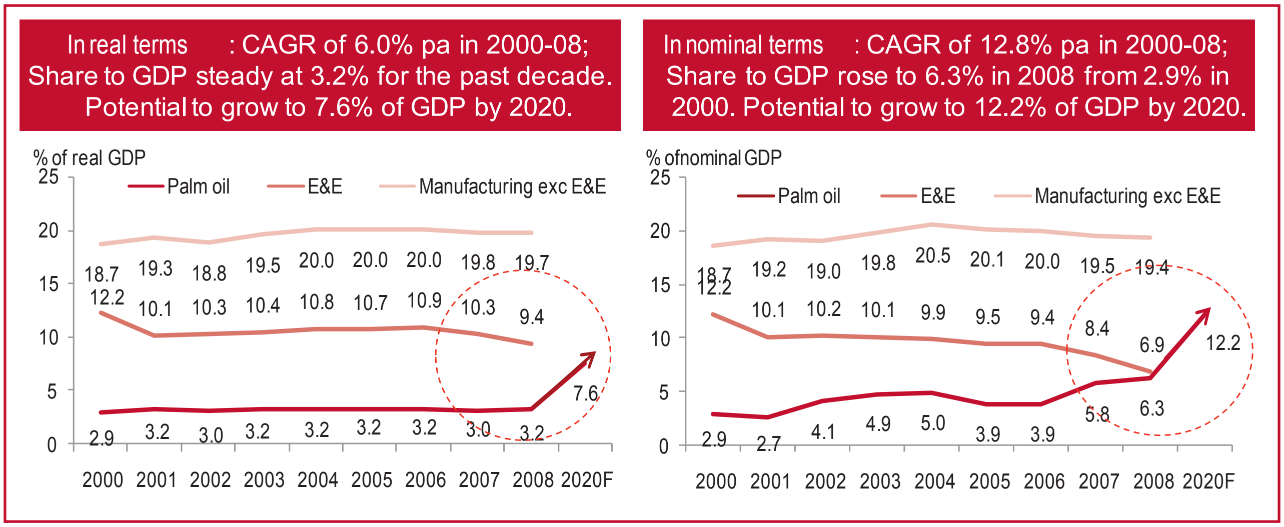
Despite its success, Malaysia's competitive advantage in the upstream palm oil sector is being eroded due to:

1. **Land scarcity**: From urbanisation and industrialisation
2. **Labour scarcity**: Over dependence on foreign workers while local workers are reluctant to enter this sector.
3. **Rising production cost:** Land, labour and input costs are on an increasing trend

Relative importance of the palm oil industry

While palm oil activity is on the rise, the share of electrical & electronics (E&E) to GDP had declined from 12.2% of GDP in 2000 to 9.4% in 2008. E&E exports amounted to RM227.5bn, accounting for 41.1% of exports in 2009 (49.6% in 2005). NEAC estimates show that unless the E&E sector is dramatically upgraded, the palm oil sector

Figure I: Contribution of the Palm Oil sector to the economy



Source: CEIC

Source: CEIC

will become a larger component than E&E rising in nominal terms to 12.2% of GDP by 2020 (7.6% in real terms) (Figure I).

The palm oil sector fulfills the three goals of the NEM

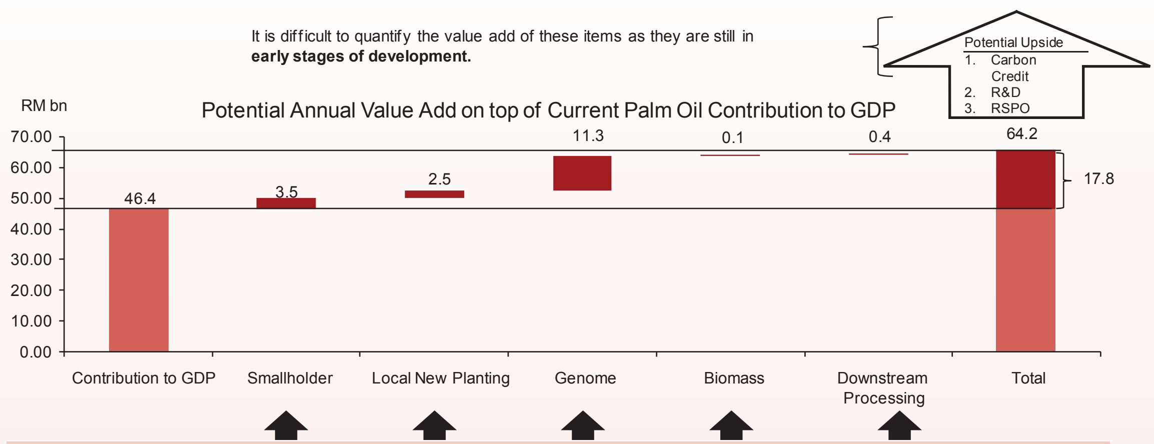
High income: Industry calculations suggest that the sector's share of real GDP can grow to 7.6% by 2020 if the value-added gains from efficiency and innovation can be realized. This would translate into a yearly growth of 13.7% from 2009-2020. Palm oil exports can also grow by 7% p.a. to RM84.6 billion by 2020, probably more if new palm oil-based products and services can be successfully marketed.

Inclusivity: This sector employs 590,000 direct workers compared to 316,956 in the E&E sector. More than one third of palm oil production comes from smallholders, who currently have lower yields than commercial estates. The initiatives by the Government and market leaders should aim to help smallholders, chiefly by timely replanting of old, low yielding palms with better yielding stock. This, together with better maintenance and upkeep will serve to ensure that the smallholders in this sector generate higher yields and thus income. This will help achieve the inclusivity goal of the NEM.

Sustainability: Research & Development (R&D) efforts in the Palm Oil sector will improve the productivity of the sector, enable better conservation of the environment and lower the net carbon impact of operations. Better use of land should see high value timber and other crops planted on hilly terrain which is not suitable for oil palm, but can yield significant value through future sales of timber from managed forests. Similarly, riverine reserves should be rigorously maintained as wildlife corridors to increase biodiversity as well as mitigate flooding. There are several initiatives in the Palm Oil sector including mechanization, biomass, biofuel, moving downstream and carbon trading initiatives that will help achieve this goal. But two appear to have the quickest win and highest value added potential. These are the Genome research in unlocking the full potential of palm oil production and upgrading smallholding production.

Palm oil industry estimates suggest that there are different sources of new value added that the palm oil sector can contribute to the future growth of Malaysia, paving the way for the goals of the NEM (Figure II). These initiatives will generate new investments in the industry, including in research and development. The NEAC recommends that new forms of cooperation be initiated with the key stakeholders in the industry to unlock resources and to break-through barriers in the commercialization of research and development of the industry. New forms of co-operation are particularly relevant where genome research is concerned. There has been duplication of effort in this area between estate groups.

Figure II: The palm oil sector's potential value add



Capex (RM bn)	**1.9**	**7.4**	**0.5***	**0.7****	**1.8**	**12.3**
Period (years)	10	10-15	25	10	3	N/A
Capex/annual income after full implementation^	10	3.0	0.04	5.38	4.89	N/A

Source : Sime Darby

^ This measure shows the ratio of profit contribution after full implementation of the initiatives over the initial investments. It does not take into account the gestation period.

* Continuous development to be the R&D hub of palm oil sector.

** The estimated contribution from biomass could be subjected to current regulatory and structural limitations in the sector.

Key Assumptions

1. Smallholders: 20% of planted area needs full scale rehabilitation (RM3k per ha); remaining planted area (RM500 per ha)
2. Smallholders: Increase output from 15MT/ha to 25MT/ha
3. Local Planting: RM14k per Ha
	6. R&D Genome[1] : RM 20m per year
	7. Biomass[2]:
	▪ Sample
	  ▪ Size - 3.1m MT of milling capacities
	  ▪ Savings - RM18.5m
	  ▪ Capital expenditure - RM96m
	▪ Total milling capacities in Malaysia: 92.5m MT
		8. Downstream Processing:
		▪ CPO Production (2020): 24.6m MT
		▪ CPO exports: 13m MT
		▪ All CPO exports are processed in Malaysia
		▪ Long term CPO price: RM2,250 per tonne
		▪ Downstream margin 5%

Out of these value added activities, the quick wins are:

1. Realising full potential of small holders and;
2. Genome

1. Realising full potential of small holders

The establishment of land schemes by FELDA and FELCRA has resettled landless farmers who mainly grow oil palm. The land schemes are provided with basic amenities such as potable water, electricity, communications, roads, schools and healthcare, and offer further employment opportunities in these economic activities.

Palm oil cultivation has been instrumental in the socio-economic development of Malaysia:

- Overcoming rural poverty and improving the livelihood qualities of rural areas by providing food security and employment
- Acting as a needed brake on migration from rural to urban areas
- Bringing education and healthcare to the rural economy
- Modernizing behavior and culture of rural areas through infrastructure such as roads, public transport, etc.

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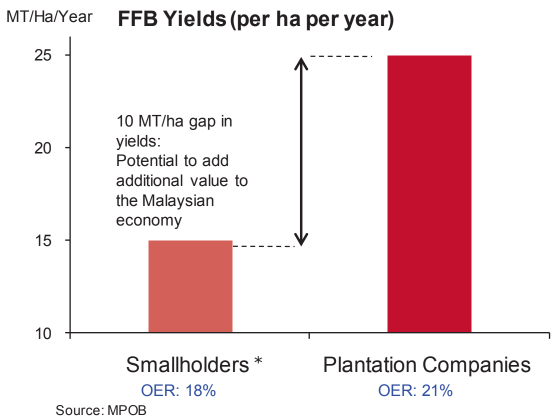
1 Assumes that best estate management practices are in place.

2 While it can be shown that using biomass for generating electricity can add value relative to other uses, the additional value from converting biomass to electricity is quite small. In addition, there are unresolved issues relating to the opportunity costs for using biomass for fertilizers as opposed to electricity usage. The removal of biomass for energy generation will result in the depletion of the soil. Currently, the depletion of soil is counteracted by pouring mineral based nitrogenous fertilizers onto the soil. But this produces various nitrous oxides when applied in mineral form, which are highly damaging to the atmosphere, far more than CO2. The best use of biomass from the estate operations is to return it to the estate, preferably composted in the case of EFB, to reduce transport costs from the mill.

Figure III: Smallholder yields vs plantation companies



* Smallholders include independent, government schemes (Felda, Felcra and Risda) and state schemes

- However, smallholders are less productive due to the lack of economies of scale and the lack of expertise (Figure III)

- The issue can be solved by introducing training and awareness by large plantation companies to smallholders through consultancy services

- An extra 10 tonnes FFB (Fresh Fruit Bunch) per hectare, involving 1.69 million hectares of smallholder area (inclusive of government schemes and state schemes), would generate another 16.9 million tonnes of FFB. With oil extraction rate (OER) of 21%, CPO production in 2008 could be increased by 20%, increasing exports by RM8 billion at RM2,250 per tonne

This initiative will provide knowledge, management and technology transfer opportunities to smallholders to boost productivity levels and close industry gap, enhance human capital development and income opportunities among smallholders. This initiative will contribute to the inclusivity goal of the New Economic Model as it will move the rural smallholders up the value chain.

Nonetheless, while improving the results of smallholders is highly desirable, we note that in the 1970s, in the case of rubber, turning this idea into a workable solution proved to be a pretty intractable problem. Therefore, should the Government embark on this effort, it must have a very well thought out strategy and must get the buy-in from all stakeholders including the Government, estates and smallholders.

The potential additional GDP Contribution alone equals to RM3.5bn.

1. **Genome: Unlocking the future value of Palm Oil through innovation and R&D**

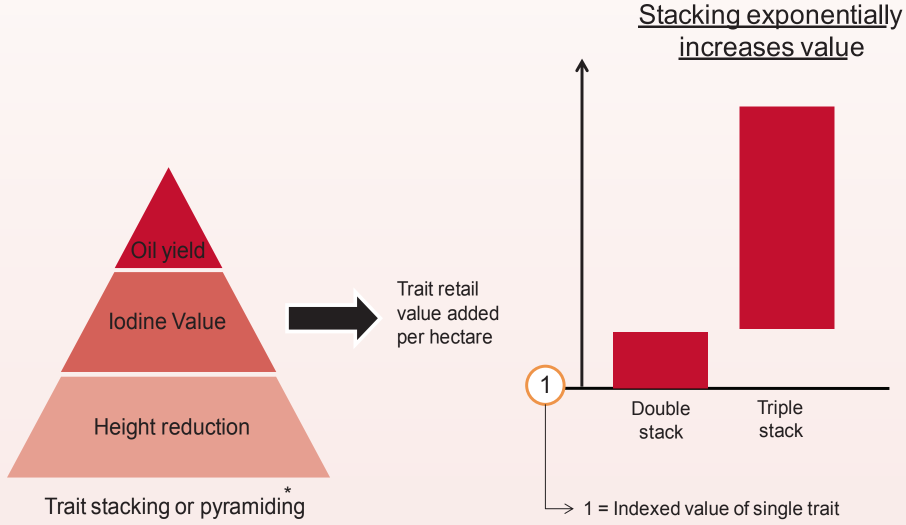
A new era of genome engineering and design has emerged to provide significant improvements in tools for sequencing and synthesizing DNA at the molecular level. The traits that are discovered through the Genome project on Palm oil have unlocked the potential to increase efficiency and productivity of the Pam Oil industry. The palm oil crop can be altered to produce higher oil yield, higher iodine value and height reduction in the palm oil tree to make it easier to harvest. Other traits that can be altered from the Genome project are resistance to pest and disease, resistance to weather, longer fruit stalk and tolerance to salinity (Figure IV).

Trait stacking will exponentially increase the retail value added per hectare and therefore the Genome project will also enable us to shift towards a sustainable economy largely based on renewable resources or known as the “bio-based” economy.

Carbon trading potential

The potential of Palm Oil sector becoming the lead in terms of the sustainability pillar in the NEM depends also on the fu ture of carbon trading – which is uncertain due to lack of agreement on setting binding international targets at the recent Copenhagen negotiations.

Figure IV: Trait stacking to increase the retail value added per hectare



* Trait stacking is when two traits like herbicide-tolerance and insecticide-tolerance are introduced simultaneously into a crop in one transformation event.

The current dangers

Plantations have 3 impacts on carbon stocks:

1. Removal of the original above and below-ground biomass (e.g. forest) *increases* carbon emissions
2. Growing oil palm to store carbon *reduces* carbon emissions.
3. Operating plantations on peat requires ongoing drainage causing peat oxidation, leading to *increasing* carbon emissions

Palm Oil total operations produce 4,180 to 6,225 tonnes of CO2 emissions. Total emissions from carbon stock change (the cutting down of forests and land to replace with plantation) produce an estimated 12,040 to 90,340 Tonnes of CO2 emissions.

The carbon trading benefits

If the carbon trading and emissions regulation are set up globally, Malaysian oil palm carbon remissions can trade for between €10-25 per tonne, earning extra revenue. On the other hand, for carbon increases, Malaysian companies potentially pay penalties, depending on the strategies adopted.

We can see that the emissions from peatland clearly outweigh the carbon stock remissions in plantations.

Based on the above rough and preliminary estimations, Malaysia should consider:

1. Intensifying efforts to get plantation land to be recognised internationally as natural carbon sinks.
2. Developing an intra-community market using the Roundtable on Sustainable Palm Oil (RSPO) in tandem with development of Certified Sustainable Palm Oil (CSPO). Downstream RSPO members can buy carbon credits from upstream growers. CSPO premium is currently tied to operational process improvements (i.e. current RSPO certification), whereas equating CSPO with a carbon abatement means it can be branded to the end-consumer (because carbon is already a tangible market commodity).

Carbon revenue example:

Basis	Average **carbon stock** in plantation	Average **emissions** from drained peatland
Tonnes of CO2-equivalent Per hectare	129.3 tonnes CO2-eq/ha over 25 years	Average 45.5 tonnes CO2 p/ha*year = 1,137.5 tonnes CO2 p/ha over 25 years
@ €15 p/tonne	€77.6 p/ha/yr	€682.5 p/ha/yr

3. Realizing potential additional value on remaining 1.3m ha of peat land by replanting with peat land forests as peat lands account for about 2.8m ha of total land area in Malaysia. Potential emissions avoided as carbon revenue:

Emissions Avoided	Potential Carbon Revenue (€ bn per annum)
For all Malaysian peat land	**1.94**
For cultivated land on peat land	0.59
For palm oil plantations on peat land	0.23

Carbon instruments that can be used by Malaysia in its efforts to become sustainable

REDD (Reduced Emissions from Deforestation and Degradation)

An initiative to cut greenhouse gas emissions associated with forest clearing by the inclusion of 'avoided deforestation' in carbon market mechanisms. More simply, payment in return for the active preservation of existing forests. REDD+ is the extra consideration in reducing greenhouse emissions given to sustainable forest management and afforestation/reforestation in developing countries, beyond deforestation and forest degradation. This would be a viable possibility in being implemented for the states of Sabah and Sarawak.

VCU (Voluntary Carbon Unit)

The name of carbon offset credits specifically verified to the Voluntary Carbon Standard, one of the leading independent standards established to demonstrate integrity in project-based emission reductions in the unregulated voluntary carbon market. This is especially suitable for an intra-community mechanism – e.g. RSPO carbon certification with price shadowing CER. This can be applied to the whole nation.

VERs (Verified Emission Reductions)

The general name given to carbon offset credits in the voluntary carbon market. These are tradable credits for greenhouse emission reductions generated to meet voluntary demand for carbon credits by organisations and individuals wanting to offset their own emissions.

CER (Certified Emission Reduction)

A credit generated under Kyoto's Clean Development Mechanism (CDM) for the reduction of emissions of greenhouse gases equal to one tonne of CO2-equivalent. They are designed to be used by industrialised countries to count toward their Kyoto targets but can also be used by EU companies and governments as offsets against their emissions under the EU Emissions Trading Scheme.

UN data shows Malaysia's carbon emissions in 2006 stood at 187 million tones or 7.2 tonnes from each Malaysian.

Although that figure is far less than neighbouring Indonesia, which is the world's third largest emitter with 2.3 billion tonnes or 10 tonnes per capita, according to Indonesian government data, Malaysia has stated that all nations must contribute.

APPENDIX

2

Managing adjustments – Aligning old expectations to the new reality

Appendix 2: Managing adjustments–Aligning old expectations to the new reality

The NEM paves the way for more opportunities for advancement across the spectrum of society especially the private sector. More flexible labour markets and better use of foreign workers should lead to more robust growth in wages for the bottom 40% while also increasing demand for the services of the highly skilled. Efforts to address weaknesses in rural education as well as strengthening the quality of tertiary education through greater accountability and competition will provide a broader range of Malaysians with the skills needed for more competitive markets and the potential rewards that active participation brings.

Nevertheless, the path forward also requires major adjustments producing both winners and losers. Losers will be those firms whose viability depended on subsidised commodities, notably energy and privileged access to controlled imports or contracts. These firms and individuals will have to cope with the new market realities and many companies will either have to restructure or be phased out. Workers in these firms may need to find other positions and in the process retool their skills to become more employable. Moreover rapid growth is often spatially unbalanced with some regions benefiting more than others – increasing pressures for social services to rectify differing regional needs.

Globalisation also has increased the stakes for each country to have efficient labour markets. Rapid technological progress, trade in goods, mobility of labour, and international sourcing of services have combined to create new openings for economic players and a more integrated global market for labour. The impact is tempered by differences in skills, technology, and know-how available to workers. Although globalisation widens the breadth of export markets and improves access to a wider range of cheaper imported products (thereby boosting productivity and average living standards), it can also impose adjustment costs on certain groups within countries, primarily by influencing wages and job security, and triggering the need for retraining from the upheaval of moving between jobs.

To cushion these adjustment costs, some phasing of the reforms may be advisable, but experience has shown that reforms which are carried out too slowly are often ineffective or even reversed. Thus it is far better to have in place social protection systems which can cushion adjustment costs but in ways which do not impede requisite reforms. Moreover by allowing firms and households to seek higher but often riskier economic returns and reducing the need for precautionary savings, such programmes help spur a more dynamic economy. The general objective is to build a more competitive but also more compassionate society. And with a well structured social safety net, economic reforms become politically more acceptable, thus improving the chances of effecting real change.

Building a stronger social safety net is now urgent

Malaysia's social protection system as in many Asian countries is still evolving. While it is relatively well-developed there are major gaps and inefficiencies. Poverty is less widespread but there remain selective vulnerable groups and pockets of intractable poverty. Inequality remains a pressing issue. Despite substantial subsidies available to the population, the disadvantaged are still not getting access relative to other groups. Safeguards are needed to protect individuals from catastrophic outcomes and soften income shocks for the most vulnerable. Some have suggested that a formal minimum wage might be helpful to cushion workers against such shocks or downturns. The NEAC strongly believes this would be a wrong approach and in fact could exacerbate the situation by reducing competitiveness and reducing employment opportunities.

Malaysian labour laws are skewed towards protecting workers at the expense of employers, who face obstacles in hiring and firing. The absence of a formal safety net forces the government to put in place regulations to protect workers but in ways that impede firm-level competitiveness. As a consequence even as the country enjoys low unemployment, the fact is that many workers are under-employed which leads to the implicit acceptance of low factor productivity. The government must be prepared to tolerate initially a moderate degree of frictional unemployment and coordinate with stakeholders to encourage re-skilling and up-skilling of workers to improve labour productivity.

Existing weaknesses in the social safety net need to be addressed

The social safety net in Malaysia comprises a broad array of programmes implemented—at least in part—to protect the poor and otherwise vulnerable groups from persistent or transitory poverty. Expenditures on these programmes are classified largely under three categories. The bulk goes for subsidies for energy and food products, with smaller allocations for social assistance and "incentive programmes". In total, these amounted to 4.6% of GDP in 2008, and an estimated 3.5% in 2009. Compared with other middle/high income countries, these are large amounts in relation to GDP and if restructured would allow the government to use available public resources more effectively.

An evaluation of the current social safety net raises a number of issues that need to be addressed:

- The portion of social spending targeting poor households is quite limited;
- Targeting criteria should be refined to achieve more equitable and consistent outcomes;
- The structure of systems and programmes differs across agencies and needs to be made more consistent.

Although all households spend a substantial proportion of their budgets on energy and subsidised food items, the benefits of these subsidies accrue disproportionately to higher-income households. This reflects the general inequality in the distribution of household expenditure on subsidised products, where the bottom quintile accounts for just over 9% of aggregate consumption and the top quintile for almost 40%.

Currently, there is a general lack of understanding about modern social protection mechanisms and inconsistent approaches across agencies. Fragmentation and the resulting dilution of other social assistance programme budgets increase the probability of targeting errors, both of exclusion and inclusion. Implementing agencies, such as the Ministries for Women, Regional Development, and Housing, have differing views about objectives and structure and this is causing misconceptions. Some policy makers worry about creating an entitlement culture- forgetting that the current poorly targeted system is already producing perverse incentives. Others do not differentiate between social protection and basic core social services such as education and health. Yet others do not see how related programmes such as pensions and training services or new programmes such as unemployment insurance schemes might complement or enhance the effectiveness of the overall response capacity. Thus there is a need for a clear vision on what would be a suitable comprehensive social safety net across agencies.

Reform principles and options

The social protection system in Malaysia needs to be looked at from different angles: risk coping (“Are assistance schemes well designed?”); risk mitigation (“Are insurance schemes sufficiently widespread in coverage?); and risk prevention (are labour markets efficient and core social services effective?)”.

Currently the bulk of social safety net resources are being spent on risk coping programmes in the form of energy and food subsidies. The economic case for eliminating price subsidies for energy products is compelling and the Government is currently considering various options. To the extent that protecting the poor is a goal of the policy—there are more efficient ways to achieve this objective. However, lack of political support and effective offsetting mechanisms can be serious impediments to reform. Consequently, reduction in energy subsidies should be gradual, accompanied by credible assistance for the poorest during the transition.

More generally to overcome obstacles to subsidy reform, social assistance programmes will have to be more efficiently structured. An important step in the government's reform effort should be to catalog all existing social assistance programmes to identify their policy objectives, eligibility criteria, benefit structure, administrative costs, and target beneficiaries. To improve targeting, proxy measures of a household's consumption per capita could be constructed to create better means-test benefits. Other measures could be implemented to avoid the current vertical inequity in the system by gradually rather than sharply phasing out eligibility and reducing horizontal inequity by restructuring certain benefits to make them less lumpy.

The system needs to be better targeted, expanded in some aspects but reduced in others. There are errors of exclusion - some groups are falling through the net (foreign workers, their children, the urban and rural poor) and some problems with the e-Kasih approach in terms of targeting. There are also errors of inclusion largely because of poor targeting. Moreover, the overall system can be streamlined to improve efficiency and generate savings that would help fund expanded programmes.

A related concern is that the Employment Provident Fund only covers about half of the workforce leaving many low income workers out of the formal pension system. And while there is generally free or low cost health services available, a large portion of total health expenditures are out of the pocket payments putting those who may be displaced in the adjustment process particularly vulnerable.

Regarding risk mitigation programmes, Malaysia needs to protect workers, but not jobs. This is where social protection systems, such as unemployment insurance come in. Currently Malaysia's labour market mobility is severely constrained by difficulties of hiring and firing (e.g. large severance payments as well as barriers to redundancy). Reducing these restrictions will improve the productivity of firms (by allowing them to condition wage increases on productivity improvements). The burden of cushioning labour should be shifted more from firms to the state but the private sector also has a role to play. Options which are suitable for low and middle income countries become obsolete in moving to high income conditions. Here the Government needs to access knowledge on design options and conduct simulation analysis for the determination of parameters and financial implications; and of course explore international experience in general.

In practice, there is no magic formula for the appropriate division of adjustment costs (e.g. training, health expenses, unemployment benefits and pensions) between the government – employers – workers. In many developed countries, the proportion of medical costs borne by employers are lower than that of developing countries such as Malaysia, where most companies in the private sector provide medical consultation and treatment as well as hospitalisation benefits to their staff. The Malaysian Employers Federation (2007) reported that the staff's medical expenses were fully borne by the more than half of the respondent companies, while others paid medical expenses subject to an upper limit for medical consultation and hospitalisation benefits. In summary, although firms compete by selling their goods and services in the international market, some firms are disadvantaged due to the additional costs borne, and as such are not actually competing on a level playing field.

Making labour markets more efficient is part of the solution

Pressures on the social safety net are reduced if the labour market functions well:

- In an efficient labour market, workers are likely to find jobs quickly that match their skills. At the same time, upward movements in wages must not outstrip labour productivity otherwise no firm could survive.
- Labour markets also need to minimise the costs of job loss and associated risks. The international experience is that an effective unemployment insurance can provide a short-term solution and usually does a better job than strict reliance on severance payments.

Left on their own, it is often difficult for jobseekers to identify good career opportunities and for employers to identify appropriate workers. As such government interventions via active labour market policies are important to minimise information asymmetries and labour market inefficiencies. Such policies consist mainly of training for new or restructured positions; targeted subsidies for job creation; better labour market information systems and improved employment services. Nonetheless, it is also recognised that such programmes have drawbacks, such as reducing incentives to swiftly seek re-employment or providing training which is not geared to real market needs. Thus strict monitoring and evaluation systems also need to be in place.

Dealing with the possibility of increasing unemployment during down turns is a special concern with political implications. The unemployment rate has been relatively low at about 3-4% of the total labour force over the past decade (concentrated among those with primary and secondary education). Nonetheless, the share of unemployed graduates compared to non-graduates has risen sharply. Total graduate unemployed has increased an annual average of 15% in recent years, to account for about 18% of total unemployed persons compared with less than 5% a decade ago.

With increased competition and restructuring, unemployment is likely to rise in the future. Currently, there is no formal unemployment insurance system since severance payments are seen as providing the needed support.

However, such views fail to realise that as Malaysia approaches developed country status, appropriately designed unemployment insurance schemes provide significant advantages in terms of pooling risks and providing a channel for shifting some of the burden from firms to shared pooling schemes with government, thus facilitating firm level competitiveness, especially for SMEs and relatively new companies. It is also far easier to link unemployment insurance schemes (compared to firm specific severance payments) to other social programmes to provide extra assistance for retrenched workers who also happen to be specially disadvantaged.

To deal with severe unemployment situations, options could include for example some form of partial wage loss insurance with benefits kicking in only upon reemployment, thereby giving people stronger incentives to find a new job. Benefits would be determined as a share of the difference between previous and current wages and paid out only for a fixed period of time. This would encourage individuals to get hired quickly – even at a lower wage – rather than holding out for higher salaries.

As discussed earlier, Malaysian firms indicate that difficulty in hiring local and expatriate foreign workers and skill shortages are the reasons for why they are understaffed. Firms also face considerable uncertainty regarding the length of time required to complete bureaucratic procedures (e.g. licenses from land offices and import permits). In some cases, bankruptcy and new startups are part of the solution and if so, a regulatory environment that minimises the costs of entry and exit is critical. For example, current bankruptcy laws are outdated and do not easily offer entrepreneurs a second chance.

In sum, Malaysia’s labour market is failing to convey information on the type, quantity and quality of skills needed, making it difficult for the country to produce the right skills and hampering the countries’ progression to higher value added industries and services. Indirectly, these policies also put additional stress on the social safety net system.

Training programmes can help but need to be linked to market demand

During adjustment periods, revamped training programmes are often helpful in enhancing employability in a shifting labour market. Compared with other regional countries, Malaysia ranks high in giving priority to training by large companies for specific needs relevant to the job scope and specifications, especially when there is a technology upgrade involved. But firms have no incentive to provide their workers with general skills because this increases the likelihood that the worker will leave the firm. This has been found to be a key factor in causing very low training incidences among small and medium enterprises (SMEs) in the manufacturing sector.

Specific to Malaysia, there will continue to be a need to bring in substantial numbers of semi-skilled foreign workers but locals can be protected from some of the negative implications through training schemes that would help them shift from one industry to another as the economy moves up the value chain. Hence, training needs to be emphasised during periods of significant economic adjustment. Ongoing programmes in the Human Resource Development Fund (HRDF), which supports training for companies in the manufacturing and services should be evaluated for how they can be more supportive of emerging needs.

Is a special transformation fund needed?

Financing costs for augmented social safety nets and related needs will be significant in the coming years, especially for new initiatives, such as unemployment insurance or revamped welfare programmes. Some options can be designed with built-in partial or full cost recovery mechanisms – firm or employee contributions for insurance or training schemes for example. But these funding mechanisms will not be enough for a wider range of envisaged activities to deal with adjustment costs.

Thus is a special transformation fund needed to cover the additional but often temporary costs involved? Malaysia's fiscal situation will be tight in the coming years as the stimulus programme is phased out and budgetary deficits as a share of GDP scaled back to more sustainable levels. Within a tighter fiscal envelope, a transformation fund designed more like a special "holding account" to support the cushioning of adjustment costs would provide tangible recognition of the government's intent to foster more inclusive outcomes. This holding account or fund would initially be the recipient of the potentially large savings from cutting back wasteful subsidies such as those for energy and food products and rationalizing of other public expenditure programmes.

But these resources could be used more effectively if for implementation they are channeled into specific programmes (e.g. retraining or targeted assistance programmes) rather than being administered from a general fund supporting a collection of activities. Experience has shown that efficiency and implementation is enhanced if resources are administered by agencies with specific core responsibilities than left in a larger fund for which mandates and oversight expertise are likely to be diffuse, difficult to monitor and prone to rent-seeking requests. Thus while a special fund makes sense to signal the Government's intentions, the fund should be operated as a holding account for reallocating to specific programmes for implementation with adequate centralised oversight to ensure that accountability is identified and efficiencies realised.

APPENDIX

3

Targeted actions needed for promoting micro-enterprises and SMEs

Appendix 3: Targeted actions needed for promoting micro-enterprises and SMEs

Actions to re-energise the private sector must be accompanied by programmes to build up the bottom segments of the domestic private sector based on needs and merit. Some common problems faced by these segments, and the possible approaches to tackling the problems, can be found in Table I.

Both informal businesses and micro-enterprises are at the bottom of the economic pyramid and likely constitute enterprises, existing and potential, that reside among the bottom 40% of income earners. These segments include the rural population and also those who migrate from the rural to the urban environment seeking to better their lives. It also includes the wide range of women in the rural and urban areas who seek work opportunities. These are motivated individuals who, but for the lack of knowing how, wish to better their lot in life.

While there are some 30 government programmes to help the micro-enterprises and SME segments, the effectiveness of the outreach for the bottom 40% of the economic pyramid is wanting and requires greater awareness of their needs and facilitation to bring them to the table of opportunities.

While not exactly at the bottom of the economic pyramid, SMEs – accounting for 35% of GDP, 57% of total employment, and 20% of exports – should be given more support and assistance as well. Many SME operations remain low-tech and exhibit low growth rates – due to lack of capital, lack of entrepreneurial skills and management capacity, and high illiteracy rates.

Table I: A closer look at the bottom/ middle segments of the domestic private sector

Segments	Current situation	Possible approach
Informal	• Off the radar screen and not registered • Unaware of aid schemes • Low business skills	• Engage and provide advice on business opportunities • Training, education and support network
■ Rural	• Lack capital & financial ability • Subsistence farmers; Small holdings • Migrating to urban poverty	• Access to loans/ grants • Assistance in business development • Job training and resettlement
■ Women	• Financially stressed • Marginalised • Lack of child care • Unaware of opportunities	• Microfinancing • Empowerment and mentoring networks • Child Care Centres • Exposure and access to information
Micro	• High illiteracy rate • Use rudimentary technology • Low skills • Motivated but unaware of opportunities • Bottom 40% income group • No business acumen	• Facilitation and counseling in business development • Microfinancing • Education, especially with regard to management and planning skills
Small	• Need for incubation • Lack access to financing • Lack entrepreneurial skills • Poor management/marketing skills • Low networking presence • Poor ICT usage	• Provide office space • Skills development, including financial training • Credit guarantee schemes • Schemes to help raise productivity through upgrading • Linkages and exposure to opportunities with local firms and MNCs through effective networking
Medium	• Need training • Need capacity building • Not fully exploiting ICT • Poor growth strategies • Lack financing • Low technology • Low networking	• Skills training • Build inter-firm linkages, especially with large firms, to provide opportunities for market and product expansion • Encourage adoption of ICT applications • Encourage more technology, innovation and R&D

APPENDIX

4

Leveraging 40 years of manufacturing experience to bridge into high value added niche areas

Appendix 4: Leveraging 40 years of manufacturing experience to bridge into high value added niche areas

Summary

The manufacturing sector has been at the center of Malaysia's growth and transformation story since the 1970s. The sector was unequivocally the driving force in the country's transition to middle-income status. However manufacturing performance has stalled over time and the sector seems at odds with the objective of 'moving up on the value chain.'

While there have been recent encouraging signs of upgrading and clambering up the technological and value-added ladders at the firm level, it is not clear if change is coming fast enough and in the scale that can trigger large externalities. This situation has prompted questions on the role of the manufacturing sector in the NEM.

The NEAC believes that some segments of the manufacturing sector, the E&E industry specifically, where Malaysia has achieved world-class performance, can and should play a major role in driving the next transition, i.e. propelling Malaysia into high income status. However, this is only possible if there is a sustained effort and far-sighted public policies to support the private sector's capacity for innovation.

Of utmost importance is the alleviation of serious structural constraints that are holding back firms with a demonstrated innovation potential in their efforts to increase productivity and produce higher value-added goods and services in Malaysia.

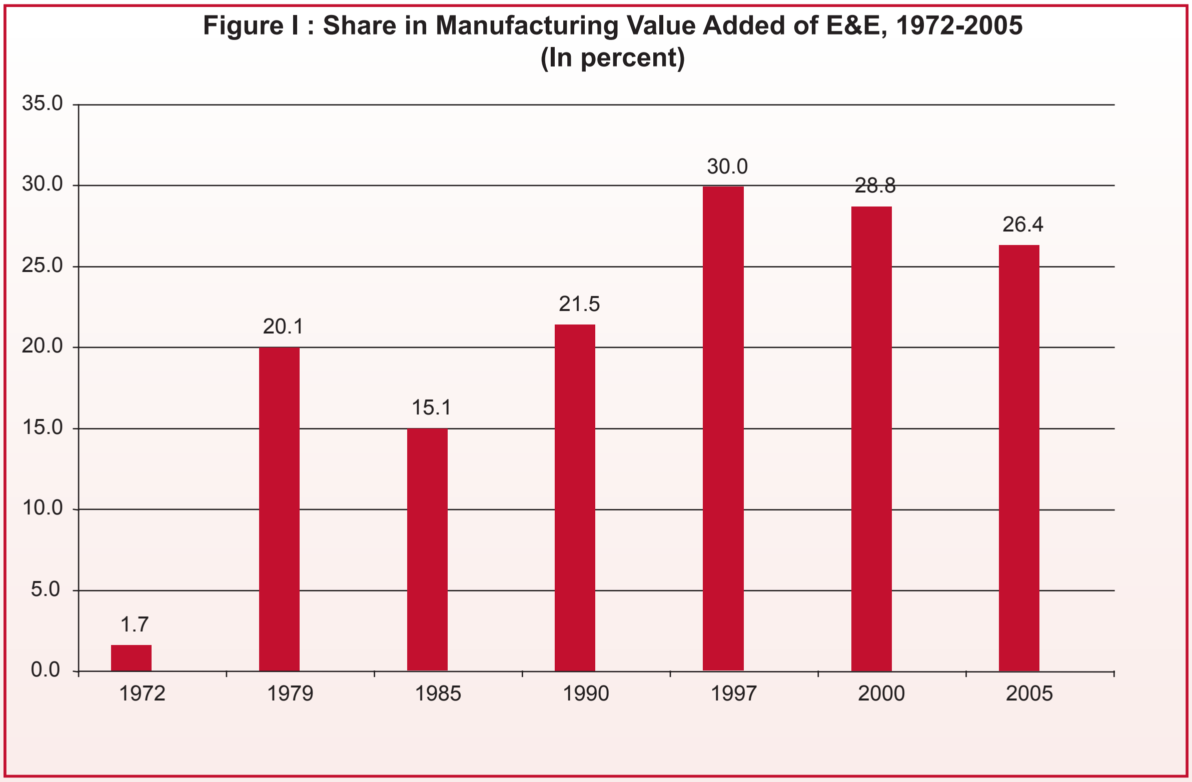
The NEM while resolutely geared towards the future will also avoid the risk of 'premature exit' which may happen if industries that could have served as basis for the country's specialisation process are abandoned.

The Malaysian E&E industry: A brief history and importance to the Malaysian economy

The E&E industry is the most well-organised and largest industry in the country, making Malaysia the largest exporter of semi conductor components to the United States. The E&E industry of Malaysia was begun by Japanese foreign capital in 1965 seeking to supply the domestic market with final consumer goods. Matsushita Electric opened operations in Shah Alam. The Penang government launched Penang Electronics in 1970 to symbolically promote electronics manufacturing operations which attracted firms such as Japanese owned Clarion followed by National Semiconductor from the United States. The Malaysian government attracted these firms to tax-free export-processing zones in the country to create employment opportunities. Earlier export-oriented initiatives following the Investment Incentives Act (IIA) of 1968 and the launching of the New Economic Policy in 1971 (Malaysia, 1971) did not prove successful until the Free Trade Zones (FTZ) was enacted in 1971 (see Rasiah et al, 2009)[1].

The E&E industry became Malaysia's leading manufacturing employment and export generators by 1980. By 2005, the E&E industry contributed about 64.1% of total exports and provided jobs to over 800,000 people in 2005 (MITI 2006). The contribution of the E&E industry in manufacturing employment and value added also rose in the period 1972-1979 and in 1985-97 before showing a trend fall in 2000-2005 (Figure I). The E&E value added rose to 30% of total manufacturing value added by 1997, as shown in the figure below, but declined to 26% in 2005.

Figure I: Share in manufacturing value added of E&E, 1972-2005 (In percent)



[1] Rajah Rasiah, Hamdan Majeed and G.N. Gopalan (2009), Background Report to Positioning Penang; A World Bank-Khazanah National Berhad collaborative study.

The E&E industry growth has staggered since the dot.com bubble burst. Labour productivity declined between 2000 and 2005, and manufacturing total factor productivity (TFP) growth has been flat over the past seven years (see Zeufack, 2009)[2]. The industry seems to have reached a point of saturation and its survival depends critically on its capacity to climb up the technological ladder.

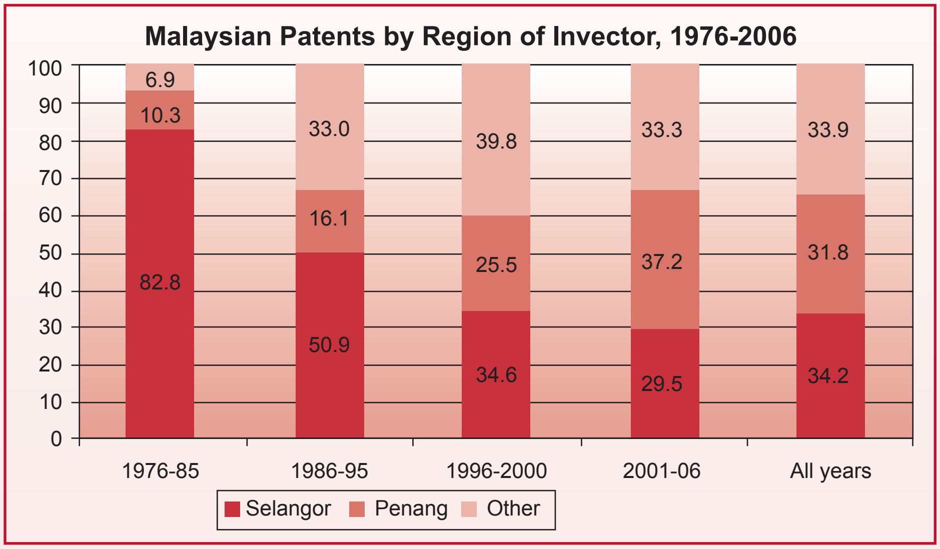
There is anecdotal evidence that a nucleus of E&E firms are upgrading and clambering up the technological and value-added ladders

The good news is that there is some evidence that a nucleus of firms, mostly MNCs, are indeed upgrading and moving up the value-added ladder in the E&E industry. OSRAM Malaysia manufacturing capability outside of its headquarters in Germany is based in Malaysia. In addition, the group's R&D hub for Asia is located in Penang. Intel runs one of its three Global IC Design Centres in Malaysia which designed and developed the innovative Atom Chip, which is the core of the Netbook revolution. Malaysia also hosts ASIC's design company, Altera, which is the group's largest offshore R&D Centre, involved in designing next generation FGPA chips.

Some segments of manufacturing, in the E&E industry for example, are 'World Class'and could serve as a bridge to higher value-added activities

Malaysia has built up over the years, an impressive suite of companies from amongst the leading companies in the world. Today, 50 percent of the world's microchips shipment is produced in the Penang E&E Cluster. Also in the same cluster is Motorola's largest facility for R&D which is fully responsible for the development and manufacturing of all Motorola

Figure II



2 Albert Zeufack and G. N. Gopalan (2009), Background Report to Positioning Penang; A World Bank-Khazanah National Berhad collaborative study.

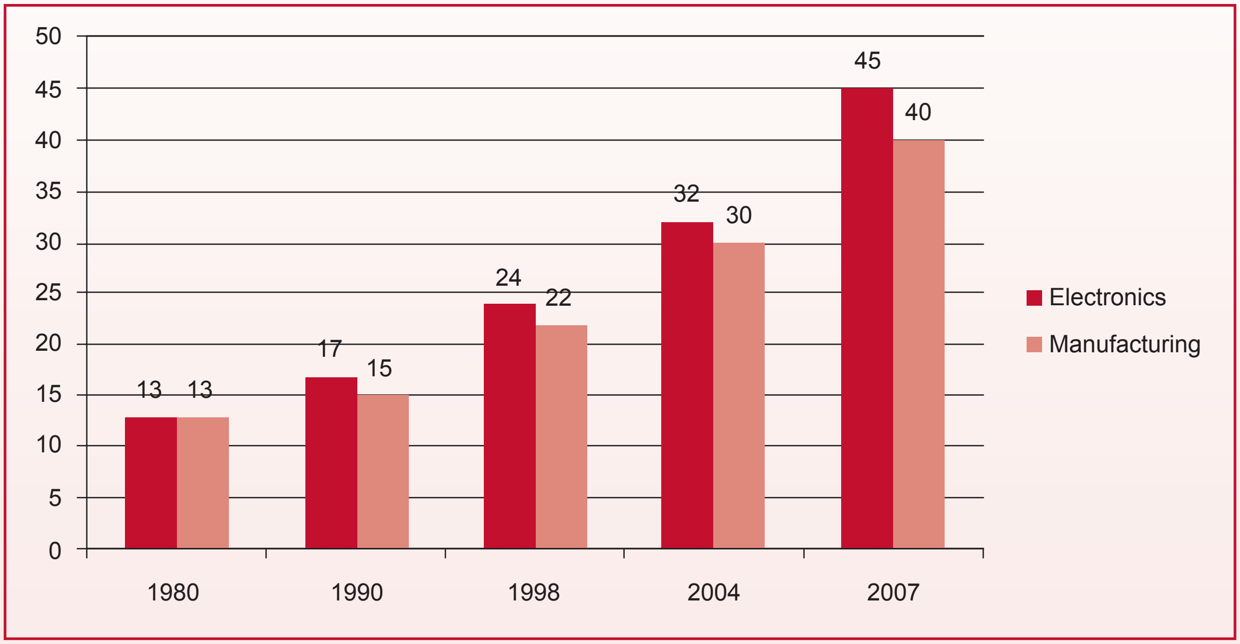
2-way communication devices, accounting for more than 50 percent of the global market share.

It is interesting to note that the E&E industry has become the first driver of innovation in Malaysia. However, innovation remains driven by MNCs. About three quarters of patents generated in the Penang industrial cluster are owned by foreign MNCs in the electronics sector (Figure II).

Along the way, there has been skills' upgrading among the nucleus of innovators. Figure III below shows skills intensity has increased significantly in the E&E industry in the Penang Cluster from 13% in 1980 to 45% in 2007. As an illustration of this transition, 94 percent of Altera's current total employees are engineers, and 60 percent of its worldwide engineering talent is in Malaysia. A subsequent survey of some of the leading electronics companies in Penang confirmed this trend. This change in the workforce composition is a reflection of the burgeoning change taking place in the electronics industry, shifting from high volume manufacturing to more technology content related activities.

A final reason why E&E is key to the transition to higher income is that the presence of a strong manufacturing E&E base, while being a neither necessary nor sufficient condition[3], can be helpful to the development of higher value services. Services such as Business Processing Outsourcing (BPO), Information Technology Outsourcing (ITO), Shared Services and Outsourcing (SSO), warehousing tend to be manufacturing-related and thrive well around E&E clusters.

Figure III: Skills intensity manufacturing and electronics, Penang Cluster (1980-2007)



[3] India for example has skipped the manufacturing stage

For example:

- Intel Malaysia started as an assembly operation but is now responsible for the group's global shared services.
- AMD now have its global shared services and design centre in Malaysia
- Agilent conducts activities like R&D to supply chain management in Malaysia, accounting for more than 60 percent of the group's turnover.
- Dell Penang supplies 95 percent of laptop computers to North America and boasts efficient delivery of less than 4 days after order. It also supplies all computers to its ASEAN, Indian and Australian markets.

But the transition is not happening fast enough and in the scale that can trigger large externalities

While it is comforting that technological and skills upgrading are starting to take place in the E&E industry, it is fair to admit that change is not coming fast enough and in the scale that can trigger large externalities and to catalyze the whole industry. The number of firms involved in the high end activities of R&D, chip design and product design and wafer fabrication are very few in number.

In addition, the Malaysian E&E industry is still lagging far behind in "Linkages" such as technology transfer of local suppliers, and cooperative efforts between firms and other institutions on technology research and development (R&D). Additional efforts to integrate the more technologically-advanced foreign-owned establishments into the economy can help accelerate knowledge spillovers in the local economy.

The need to avoid 'premature exit', a common mistake of countries 'caught in the middle income trap'

Malaysia is strategically located and should leverage its geography and excellent infrastructure to benefit from regional growth. Malaysia could position itself to attract more activity in design, research and development, custom manufacturing, logistics delivery, support services and order generation as multinational companies become more wary of property rights violations in China or simply as the second pole in a China +1 Asian strategy of multinationals in the manufacturing sector. Malaysia should aggressively leverage its over 30 years of manufacturing experience in precision engineering, automation, and manufacturing management to bridge into niche areas such as medical devices, electronics devices for the renewable energy industry, devices and sensors for high performance agriculture, nano-electronics and other specialized electronics and services.

The NEAC draws attention to the risks of exiting prematurely from the E&E industry. Michael Spence's Growth Commission report (2008) points to this interesting fact. Trapped MICs tend to make two common mistakes: either they cling on too long to past successful policies or they exit prematurely from the industries that could have served as basis for their specialisation process.

The E&E industry's upgrading and transition hinge on significant structural constraints

Technological upgrading has many determinants and is unlikely to take place especially when there are severe structural constraints. Chief among the constraints facing Malaysia E&E is the compelling evidence of skills deficiency. Malaysia underperforms on key skills indicators compared to countries in the same income bracket.

Despite spending more on education than most countries in ASEAN, the quality of skills produced by the Malaysian education system does not seem to match the demand from the labor market. The incidence of vacancies for professionals in manufacturing has increased from 26 percent in 2002 to 27 percent in 2007, much higher than the levels observed in neighboring countries. Furthermore, it takes longer in Malaysia than in most other countries to fill vacancies for professionals or skilled production workers. This skills mis-match has two implications.

Talent supply mismatch- First, the number of unemployed graduates has been increasing steadily while at the same time, firms face more difficulties finding the skills they need. It takes on average 5 weeks to fill a vacancy for a skilled technician in manufacturing in Malaysia, one of the longest time in Southeast Asia. Therefore, there is ample evidence that Malaysia is skills-constrained and the prevalence of graduate unemployment, instead of invalidating this argument is its manifestation.

Skills constraints have devastating consequences on firms' productivity. The World Bank estimates that firms in selected industries in Malaysia may be losing up to 15% of their output to skills constraints. In 2007, around 19% of employers surveyed cited skills mis-match as a major constraint to doing business in manufacturing.

Paradoxically, inflexible and bureaucratic immigration policies prevent Malaysia from attracting and retaining the needed talent. In addition, the rate of Malaysian talent attrition

Table I: Malaysia needs affordable and faster Broadband

	Singapore	Philippines	Thailand	Vietnam	Malaysia	Korea
Fastest Bandwidth/ Cost	100Mbps/ $84.68	3Mbps/ $62.10	8Mbps/ $58.30	3Mbps/ $50.55	**4Mbps/ $76.00**	100Mbps/ $25.00
Lowest Bandwidth/ Cost	3Mbps/ $19.04	1Mbps/ $20.60	1Mbps/ $17.28	1.5Mbps/ $14.00	**400Kbps/ $14.00**	20Mbps/ $20.00
Cost/Mbps Low/Hi (US$)	$2.70- $10.20	$15.50- $20.70	$5.80- $17.28	$9.30- $16.85	**$19.00- $35.00**	$0.25- $1.15

has been increasing lately and the diasporas is not returning. This dynamics can only further delay Malaysia's transition to high income status.

Regulatory and infrastructure bottlenecks- Findings from firm surveys suggest that the proportion of firms ranking electricity and telecommunications as a major business obstacle remains high in Malaysia. In addition, the need for broadband bandwidth and speed at affordable price is a severe constraint to E&E upgrading and expansion of high value-added services.

As shown in the Table I, the fastest bandwidth in Malaysia is five times slower and more than three times more expensive than the lowest bandwidth in Korea.

Regulatory bottlenecks both for entry and exit for new firms are also preventing the transition in the E&E industry. It takes longer to create or close a business in Malaysia than its main competitors and the time to register property is among the longest in the world. Red tape is also prevalent including in the management of different grants and incentive schemes. The multiplicity of institutions, with different requirements and milestones, make it particularly cumbersome for firms to avail of the incentives and there is no single window monitoring device which keeps track of the activities of the targeted industries. Urgent and decisive action needs to be taken to alleviate these infrastructure and regulatory constraints as well as issues related to public safety.

Social perceptions- The perception of crime, theft and disorder has worsened as a major obstacle to business in all regions. In order to cope with the lack of security, firms spent around 3% of their sales in Malaysia on security-related charges, more than any other neighboring country and more than they spend on R&D. Similarly, while Malaysia has made great strides in improving the investment climate, business regulations can be further streamlined.

The need for sustained effort and far-sighted public policies to support the private sector's capacity for innovation

Policymakers in Malaysia must focus on fostering the environment that promotes and enables the development of firm-level technological capabilities. In so doing, it is important to realize that firm-level technological capability building is an incremental and cumulative process (World Bank, 2009). Therefore, enterprises cannot instantaneously develop the capabilities needed to handle new technologies; nor can they make jumps into completely new areas of competence. Instead, they proceed in an incremental manner, building on past investments in technological capabilities and moving from simple to more complex activities. Therefore, education and training play crucial roles in the development of firm-level technological capabilities. Also, firms rarely acquire capabilities in isolation. Economies of scale from agglomeration are key to innovation. It is therefore important not to spread economic activity, but to facilitate clustering and linkages between economic agents, both private and public, local and foreign. For this to happen, the budget and respective development plans need to have a geographical focus, and systematically avoid sector silos.

Specific policy recommendations to accelerate and scale up the E&E transition to higher value-added

Specific policies could be implemented to accelerate and scale-up the move of the E&E industry up the value chain. The capacity and capability built up over the last 40 years in the field of electronics manufacturing and related activities need to be nurtured and further developed aggressively. Firms, including MNCs and Malaysian domestic ones, that either are willing to employ or have introduced new business activities, should be supported. This action would accelerate the growth of an ecosystem which will not only bring in new technologies and activities, but help to develop a new breed of technopreneurs. Provided the right incentives, this new ecosystem would flourish through outsourcing opportunities and the use of new products to create the next generation of applications and devices. The presence of a nucleus of innovative firms in Malaysia represents an opportunity which can be tapped in order to proliferate innovation and creativity.

The NEAC has identified four key areas of intervention: Talent, the R&D Ecosystem, Infrastructure, and Institutions and Incentives.

These four thrusts must be aligned and implemented simultaneously for optimum impact in order to create the right environment for the transformation into the innovation-led economy.

Pushing Ahead: The 4 Major Thrusts

Talent	R&D Ecosystem	Infrastructure	Institution/ Incentive
Welcome talent Attract diaspare Develop & retain talent	Nurture technopreenurship Establish high and research centre (CEE) R&D grants scheme which connects foreign-local	Globally competitive ICT infrastructure Seamicess physical connectivity Sustainable and liveable city	One Stop Centre Re-visit incentive packages Adapting an “Asset Light’ approach

Thrust 1: Talent

Proposed Solutions	Key Measures For Action	Remarks
Allow **flexibility for entry, exit and residence** for highly skilled professionals and domain experts with clear deliverables.	• Introduce a fast-track procedure for work permits for high-tech/ skills businesses and Universities	• Follow the H1 Visa system in the US to attract talent
	• Review and shorten the process of delivering the Permanent Resident status for foreign talent	• Singapore is a model to retain foreign talent
Attract diasporas as principal source of talent	• Establish a Non-Profit organisation to foster links with the diasporas • Match the capabilities to the right economic opportunities	• Enterprise Ireland / Singapore International could be models to emulate
Bridge the skills and knowledge gap to meet industry requirement	• Establish a 'finishing school' programme • Introduce electives into graduate programmes in niche areas	• Formalize and strengthen current programmes aimed at employability

Thrust 2: R&D Ecosystem

Proposed Solutions	Key Measures for Action	Remarks
• **Promote technopreneurship** and high risk ventures in targeted sectors by lowering cost of entry & exit	• Review & adapt bankruptcy laws to support high risk ventures in innovation-based businesses, allowing more risk-taking and eliminating the stigma of failure in these targeted areas • Explore partnerships with global venture capital firms	• Explore best practices in the developed world similar to Chapter 11 for innovation ventures
• **Revise R&D grants/ incentives** under a single window • Simplify grants system to accelerate disbursement • Establish **condition-based grants** system to encourage foreign-local collaboration	• Conduct an independent study to streamline R&D grants / incentives	• The focus of the awards should be on predetermined outcome of local companies • The awarding of grants must be supported by a clear set of deliverables on the part of the recipient
• Establish **high end research centre** to nurture & retain talent, attract global talent • Provide a **suitable work environment** for the diasporas	• Establish CEE as a pilot center in collaboration with global research centres like IIT with free access to foreign talent and flexible mechanism to involve the diasporas	• ITRI (Taiwan), Cambridge Science Park, A*Star (Singapore), R&D labs in Bay Area. CEE is a hybrid learning from these four models

Thrust 3: Infrastructure

Proposed Solutions	Key Measures For Action	Remarks
• **Enhance virtual connectivity** with high speed data and voice connection • Increase bandwidth and virtual connectivity to enhance connectivity to tech hubs	• Establish globally competitive ICT infrastructure	• Ensure seamless connectivity both virtually and physically • Upgrade Penang's logistical capabilities such as warehouses and airport so that the export infrastructure would better support the E&E sector
• **Improve physical connectivity** through 'frequency of air / port connection'	• Establish flights to regional cities and enhance port / rail connectivity	
• Create a **viable and vibrant urban centre** • Focus on establishing Penang as leader on sustainability and liveability	• Improve security for both the living and business environment • Enhance the George Town Conurbation • Redevelop the waterfront and ensure seamlessness like Hong Kong-Kowloon	• Adopt a city strategy to reinvent Penang as a leader for sustainability

Thrust 4: Institution and Incentives

Proposed Solutions	Key Measures For Action	Remarks
• Set up '**One Stop Agency**' to handle all matters relating to the E&E industry	• Reduce the regulatory burden • Abolish the system of Approved Permits and replace it with a short negative list • Introduce a 'single-window' system to manage all matters	• Benchmark against EDB (Singapore) and IDA (Ireland)
• **Re-visit incentive framework** and packages to strengthen the competitive position of companies globally	• Adopt proactive approach to retain and grow companies • Link incentive packages to impact and outcomes	
• Adopt an '**Asset Light**' approach to unlock asset value	• Appoint a trust company to manage the 'Asset Light' approach on a selective basis	• The unlocking of asset value must be supported by a clear set of deliverables on the part of the recipient

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