ISSUE BRIEF

FINANCING DEVELOPMENT IN TIMES OF CHANGE

Malaysia's economy has been transformed since 1970 from one based primarily on the export of raw materials (rubber and tin) to one that is among the strongest, most diversified and modern in Southeast Asia. In 2019, the country's gross national income per capita was $27,534[1] (in constant 2017 dollars), up from $13,927 in 2009 (SDG 8.5). Its economic achievements have helped to fuel social developments over the years. Malaysia's 2019 Human Development Index[2] score (0.810) puts the country in 62nd place out of the 189 countries included in the index. The high overall score means that the country is categorised as having 'high human development', well above the average for East Asia and the Pacific (0.747). In the ASEAN region, Malaysia's score is third highest with only Brunei (0.838) and Singapore (0.938) exceeding it.

However, broad challenges remain in terms of reducing inequalities which are still high, particularly when comparing rural with urban communities. There is work to be done to ensure that the whole population has healthy nutrition intake and general food security, to address the prevalence of non-communicable diseases, to manage urbanisation and protect the country's natural resources, biodiversity and to adapt to the challenges being brought about by climate change. Child malnutrition, as manifested by stunting in children aged under 5, was 21.8% in 2019, an increase from 17.7% in 2017, while the incidence of tuberculosis is rather high at 75.0 per 100,000 population (latest data 2018).[3]

The average unemployment rate over the last ten years was 3.2% or around 500,000 unemployed. Recently, as a result of COVID-19, unemployment numbers spiked to 5.3% or 820,000, in the month of May 2020, the highest since 1989 (Figure 1). A consistent trend being observed is that the youth unemployment rate (ages 15 – 24) is often three times higher than the national rate (Figure 2). For example, Q1 2020 youth unemployment is 12.1% compared to 4.8% for the total population.

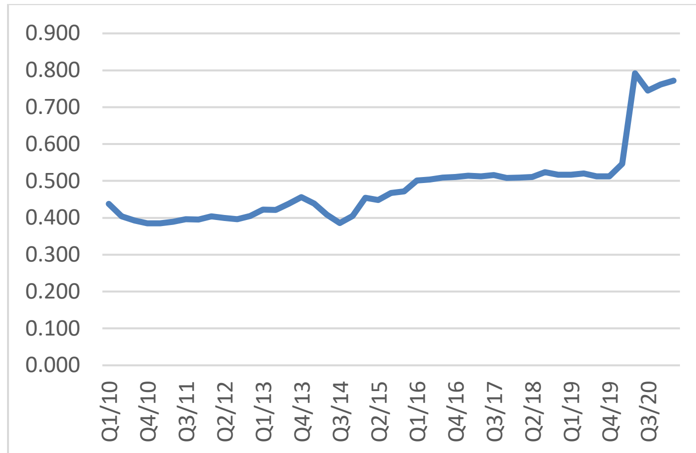

Figure 1. Malaysia: unemployment (million persons)
Source: Department of Statistics, Malaysia (2021)

Government funding for education, particularly higher education, is becoming unsustainable and the situation is being exacerbated by the high rate of student loan defaulters, especially among the B40s. It is also unsurprising that the majority of the population in this group (B40) is also experiencing problems with house affordability. House prices have increased at a compounded annual growth rate of 9.1% since 2009 and there has hardly been any significant improvement in housing affordability between 2002 and 2016. The median multiple[4] for Malaysia hovered between 4.0 and 5.0 from 2002 to 2016, exceeding the 3.0 threshold for housing affordability. The country's overall housing affordability worsened significantly between 2012 and 2014, increasing from 4.0 in 2012 to 5.1 in 2014.[5]

Malaysia's population pyramid is slowly shifting with fewer young people and an increasing proportion of middle-aged individuals and older people. The dependency ratio per 100 people of young people has decreased to 33.1 (Q1:2021) from 40.4 in 2010, but

1 Another calculation method, the Atlas method (current US$), puts Malaysia's GNI at $11,230, retrieved from https://data.worldbank.org/country/malaysia

2 The Human Development Index Statistical Update, 2020.

3 Sustainable Development Goals Indicators 2019, Department of Statistics, Malaysia.

4 The median multiple is used to indicate the affordability of housing in any given community. It is the ratio of the median house price by the median gross (before tax) annual household income.

5 Rethinking Housing Between State, Market and Society: A Special Report for the Formulation of the National Housing Policy (2018-20205), Malaysia, 2019.

For more information: registry.my@undp.org
United Nations Development Programme, Malaysia Country Office
Level 10, Menara PjH, No. 2, Jalan Tun Abdul Razak, Precinct 2, 62100 Putrajaya, Malaysia.

July 2021

the dependency ratio of older people has gone up to 10.38 (Q1:2021) from 7.3 in 2010.[6] The implications of an ageing society have not been fully mapped out in the national and sub-national development plans. As populations grow older, increases in old-age dependency ratios are indicators of added pressures that social security and public health systems have to withstand.

How can the country finance solutions to the problems outlined above? While public finance is and will remain the key source of funding for the country's sustainable development goals (SDG) priorities and COVID-19 recovery plans, with the current tight fiscal space and uncertain external environment, the country will need to seek opportunities to build a more integrated approach to public and private financing of national development priorities. As the country reaches the end of the 'Vision 2020' era and embarks on a new 'Shared Prosperity 2030' era, it is an opportune moment to assess the financing trends and risks that can influence Malaysia's development finance capabilities. Achieving the SDGs demands both significant increases in capacity and knowledge regarding development finance flows as well as a willingness to explore new funding sources to complement traditional ones.

Financing Sustainable Development – The Journey So Far

The Government has committed to formally incorporating the SDGs into its 5-year development plans, starting with the 11th Malaysia Plan (11MP). The 11MP, which was officially launched on 21 May 2015, has been identified as a critical roll-out plan from 2016 to 2020 to realise Malaysia's aspiration to become an advanced nation. The 5-year plan, based on the theme "Anchoring Growth on People", emphasises several strategic thrusts to position Malaysia as a developed nation in terms of all dimensions – economically, politically, socially, spiritually, psychologically and culturally – by the year 2020.

A total of RM260 billion was allocated between 2016 and 2020[7] to finance all of the development expenditure planned in the 11MP. Demand for financing is mainly driven by development gaps in infrastructure, as well as the transport and energy sectors. Based on the mid-term review covering 2016 to 2017, up to 23.3% of the allocation was targeted at strengthening the infrastructure to support economic expansion; another 22.5% was allocated to improvement of the *rakyat's* wellbeing. The rest of the allocation was targeted at enhancing inclusiveness to move towards an equitable society (17.1%), re-engineering economic growth for greater prosperity (13%), accelerating human capital development for an advanced nation (11.7%), transforming public service for productivity (7.5%) and pursuing green growth for sustainability and resilience (4.9%). Given changes in the fiscal condition of the government during the period (i.e. lower government revenue due, in part, to volatile global crude oil prices and the abolition of Goods and Services Tax (GST) in 2018. As a consequence, the total development expenditure for the 11MP were eventually revised downwards to RM220 billion.[8]

The COVID-19 pandemic changed the course of public expenditure in an unprecedented way. The government undertook an expansive COVID-19 socioeconomic policy response to support businesses and livelihoods, and the economy in general. This included 7 packages to date (ESP, PRIHATIN, PRIHATIN SME+, PENJANA and KITA PRIHATIN, PERMAI, PEMERKASA, PEMERKASA+). Primarily adopted to provide economic relief during the Movement Control Order (MCO) period, these packages collectively stands RM380 billion ($ 92.6 billion) in gross value, with a direct fiscal stimulus of more than MYR77 billion ($18.8 billion)).[9] The packages supplement the national Budget 2021 valued at RM322 billion or $78.5 billion). This funding measures will likely make a considerable difference to social and economic conditions.

Challenges in Financing Development

Composition of development financing flows for Malaysia has evolved and changed in recent years, as a result of various internal and external influences. Theoretically, development financing sources can be divided into four categories, namely domestic public sources, international public sources, private domestic investment, and private international investment. This typology greatly assists in understanding the issues, current trends and potential capability of each funding source to support future sustainable development.

Challenge 1: Domestic public finance not keeping pace with economic growth

Domestic public finance refers to government resources that originate domestically, covering government revenue (excluding any grants received, to avoid double counting with international resources) and government borrowing from domestic sources (i.e. domestic financing). The overall government revenue volume as a percentage of GDP was 15.5% in 2020, compared to 22.3% in 2009 (Figure 2). Tax buoyancy, which is the ratio of percentage growth in tax revenues to growth in nominal GDP for a given year, has also declined from 57.8% in 2018 to 52.4% in 2020. A low tax buoyancy implies that although the country's GDP is growing, tax revenue is not growing at the same pace.

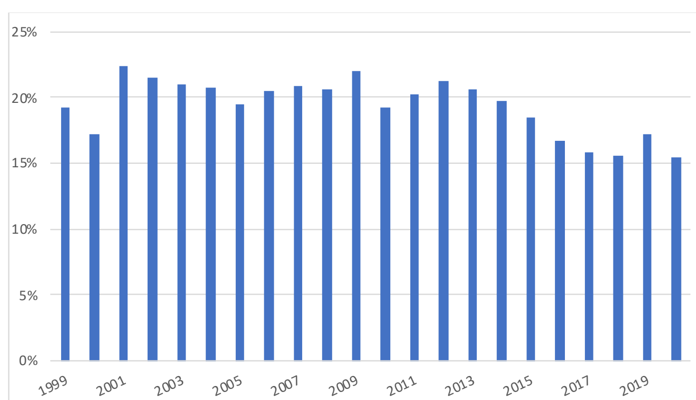

Figure 2. Ratio of government revenue to GDP (% of GDP)
Source: Ministry of Finance, Malaysia (2021)

6 Demographic Statistics, First Quarter 2021, Department of Statistics Malaysia.
7 Economic Report 2016/2017, Ministry of Finance Malaysia.
8 11th Malaysia Plan Mid-term Review.
9 Ministry of Finance Malaysia and author's calculations.

In terms of revenue composition, direct tax makes up more than half of government revenue, on average (Figure 3). Growth in other revenue sources, in particular indirect taxes, remains sluggish and small, only temporarily boosted during the implementation of the GST system between 2015 and 2018 (Figure 4). Share of petroleum dividend and royalty as a non-tax revenue component has been relatively high in the years following the Great Financial Crisis (2008–2011), though they fell significantly due to global oil market slump beginning 2014. Despite a brief spike in 2019 (RM83.9 billion), petroleum-related revenue is expected to decline from RM50 billion in 2020 to RM37.8 billion in 2021.[10] Share of petroleum-related revenue to total government revenue fell from 22% in 2010 to 17.4% in 2020, both due to the weak global market for oil and the conscious effort of the government to reduce dependency on oil revenues.

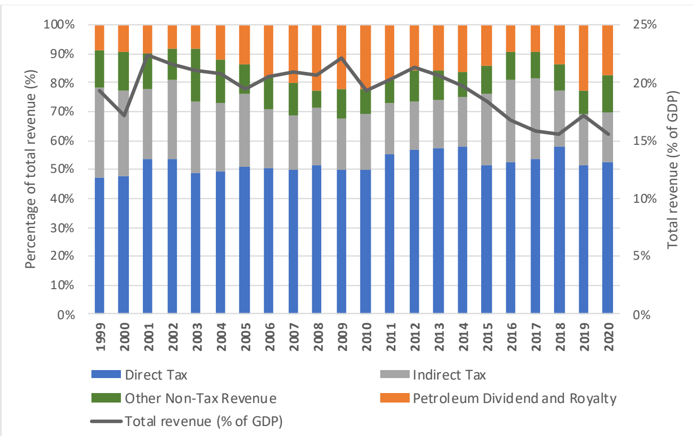

Figure 3. Components of government revenue
Source: Ministry of Finance, Malaysia (2021)

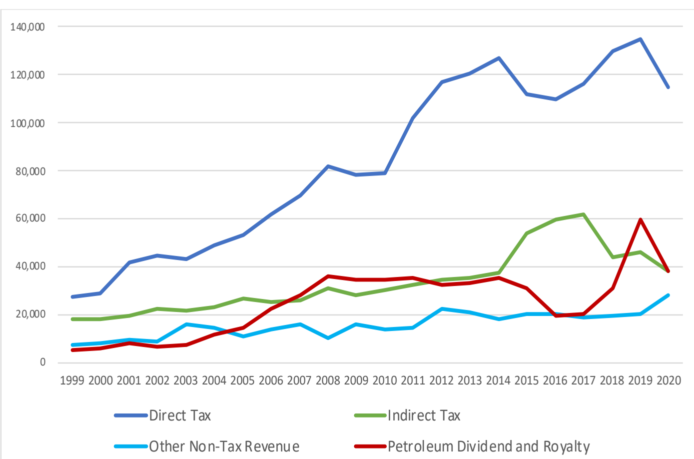

Figure 4.Value of government revenue by component (RM million)
Source: Ministry of Finance, Malaysia (2021)

In summary, domestic public finance trends are vulnerable to external conditions which affect mineral-based revenue, while internal factors, such as corporate profitability and labour market conditions, largely affect direct and indirect tax collection. The government is aware of the need to continue to strengthen and maximise its tax revenue collection and enhance its buoyancy via tax reform initiatives. These include efforts to broaden the revenue base, tap the informal sector, curtail under-reporting and under-declaring practices, reduce tax leakages as well as to enhance tax administration through effective data management and integration with relevant agencies.

Challenge 2: Untapped domestic private finance sources

Domestic private finance refers to investment by the domestic private sector in the country. There was weak investment performance at the beginning of the 11MP period, which can be attributed to global economic headwinds exacerbated by the slump in oil and commodity prices, as well as the rise of the US dollar (Figure 5). Investments in the primary sector registered a decrease of 96.2% from RM14.4 billion in 2014 to RM3.8 billion in 2019, largely due to a drop in investments in oil and gas exploration activities. A brief surge in 2016 was linked to two major projects which were approved that year, namely the PETRONAS Refinery and Petrochemical Corporation's (PRPC's) project in Johor and LNG9's project in Sarawak, which totalled RM35.3 billion. In 2019, the percentage of investments recorded by the Malaysian Investment Development Authority (MIDA) was equal to 8.3% of the country's GDP, far below the 15% reached in the 2013-2014 period.

One bright spot has been financing through the bond market. The domestic capital market constitutes a key source of financing for the private sector. Business demand for funding from the capital markets also remained consistent. New bond and *sukuk* issuances totalled RM366.67 billion in 2020, although this represented a slight decrease by 0.05% from RM 384.85 billion in 2019.[11] However, for a leading market in sukuk (by asset size), the number of issuances as part of impact investment towards realising SDG-aligned outcomes is still very low. As of June 2020, a total of 12 green *Sukuk*, two social bonds and three sustainable bonds were issued in Malaysia, with a total issuance value of $2,090 million.[12] This large untapped source of funding for the SDGs is the reason why there is a relatively small portfolio of pure green bonds. In terms of returns, the returns on green bonds and *sukuk* are, on average, higher by 2% than a normal portfolio of typical bonds.[13]

10 2021 Fiscal Outlook and Federal Government Revenue Estimates, Ministry of Finance Malaysia.

11 Security Commission Malaysia Annual Report 2020, SC, retrieved from https://www.sc.com.my/api/documentms/download.ashx?id=e1c7eb21-53db-4f02-a8f8-55dc09f9ffff.

12 Sustainable Finance: State of Market in Malaysia, retrieved from https://www.msfi.com.my/sustainable-finance-state-of-market-in-malaysia/, accessed 6 June 2021.

13 Green bonds gain traction in Malaysia, retrieved from https://news.cgtn.com/news/2020-11-17/Green-bonds-gain-traction-in-Malaysia-VuQeF0tESk/index.html, accessed 6 June 2021.

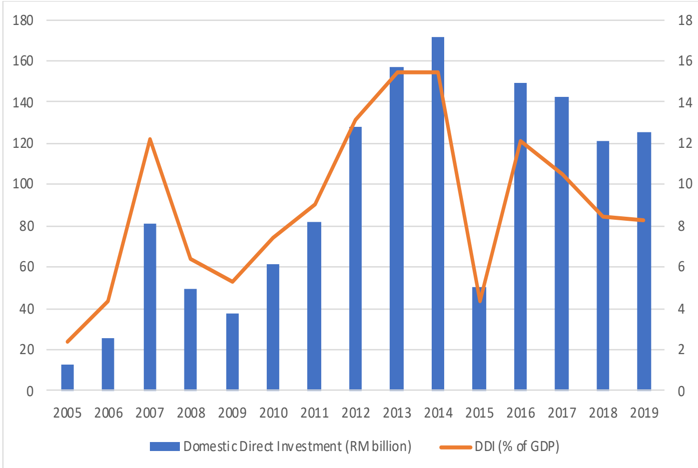

Figure 5. Domestic direct investment (RM billions) and as a percentage of GDP
Source: Malaysian Investment Development Authority (MIDA) and author's calculations

Challenge 3: Unstable international private finance flows

International private finance includes foreign direct investment (FDI), portfolio equity, private borrowing from international sources and remittances. International portfolio investment is typically the most unstable type of international private finance. At the height of the COVID-19 pandemic, Malaysia's net FDI inflows registered at RM13.9 billion; a decline from RM31.7 billion achieved in 2019. Total gross FDI inflow into Malaysia remained strong at RM139.9 billion in 2020 compared to RM138.8 billion in 2019, indicating an increase of 0.8%.[14] This is despite the MCO and Recovery Movement Control Order (RMCO) in the second and third quarters of last year, respectively. However, there were massive FDI outflows in the second and third quarters of 2020, to some extent contributed to by MNCs in Malaysia repatriating higher amounts of their profits for loan repayments and retaining earnings to help boost their global profit margins.

The role of remittances in financing development is also very small; as in most years, Malaysia's net remittance inflow is negative. The volume of remittances Malaysia's foreign workers send abroad far outweighs the amount of income repatriated into the country. Hence, relatively speaking, remittances have a very small direct social impact compared to countries such as Nepal and Bangladesh, where families of migrant workers are able to depend on money sent from abroad to finance home and educational improvements.

Challenge 4: Changing nature of international public finance

International public finance played a major role in supporting economic development in the early years after the country gained independence, when domestic resources were extremely limited. Official development grants not only helped to bridge the capital gap but were usually packaged in a way that incorporated skills/capacity building and integrated social development programmes for poverty eradication purposes. With a headline target of attaining high-income country status, Malaysia is preparing for changes in the accessibility of external support such as Official Development Assistance (ODA).[15] Today ODA represents a relatively small source of finance in Malaysia, relative to its impact for regional neighbours. ODA per Gross National Income (GNI) dollar currently stands at 0.0017%.[16] The country will no longer be eligible for ODA funding once it graduates into the high-income category. In recent years, the nature of assistance received has also been of a more technical and knowledge-based format rather than monetary.

Challenge 5: Prospects for public borrowing

Public borrowing refers to lending from bilateral and multilateral institutions and private entities received or guaranteed by the state. New fiscal challenges have emerged; the government's 2021 fiscal deficit is anticipated to widen from 5.4%, as estimated in the Budget 2021 announcement in October, to 6% of GDP. This is due to the roll out of new COVID-19 stimulus packages in January, March and May, lower GDP estimates and weak global crude oil prices. The statutory limit for outstanding federal government debt via Malaysian Government Securities (MGS), Malaysian Government Investment Issues (MGII) and Malaysian Treasury Bills (MTB) has temporarily been increased to 60% of GDP. As at the end of May 2021, statutory debt stood at 58.5% of GDP.[17] The focus of the agenda is mainly to ensure productive public expenditure to help protect the well-being of *rakyat* and propel the business and domestic economy. Federal government direct domestic borrowings remain the primary source of funding. Almost all the country's financing operations, including the financing of stimulus packages, are raised via domestic sources, and this minimises foreign exchange risk exposure (Figure 6).

Since 2018, the government began to publish more comprehensive debt and liabilities reporting. This is in line with efforts to transition to accrual accounting standards as well as statistical reporting under the International Public Sector Accounting Standards (IPSAS) and Public Sector Debt Statistics produced by the International Monetary Fund (IMF). The debt and liability exposure is composed of the federal government debt and other financial obligations such as committed guarantees and other liabilities, including the estimated cash commitments of the government. Figure 6 shows the breakdown of stock of federal government debt (domestic and external) in contrast to indirect government liabilities in the form of debt guarantees.[18]

---

14 Malaysia Investment Performance Report 2020, Malaysian Investment Development Authority (MIDA).
15 World Bank, https://data.worldbank.org/indicator/DT.ODA.ODAT.GI.ZS
16 OECD, ODA Receipts and Selected Indicators for Developing Countries and Territories, 2019.
17 Ministry of Finance Malaysia, "Economic Outlook 2019: Section 4 Debt Management", retrieved from http://www.treasury.gov.my/pdf/budget/budget_info/2019/revenue/section4.pdf
18 2021 Fiscal Outlook and Federal Government Revenue Estimates, Ministry of Finance Malaysia.

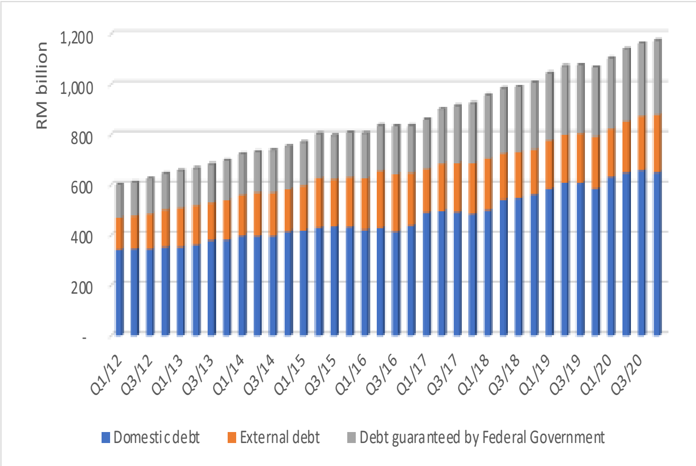

Figure 6. Stock of federal government debt and liabilities exposure as at the end of every quarter
Source: Bank Negara Malaysia (2021)

However, on the positive side, the government has plenty of reason to leverage on investors' vote of confidence in Malaysia's strong economic fundamentals and solid prospects for growth. On 22 September 2020, the federal government completed the issuance of *Sukuk Prihatin*, with a maturity period of two years, at an annual coupon rate of 2%. This issuance provides the platform for retailers and corporations to contribute to financing government measures to mitigate the COVID-19 crisis. The *Sukuk* was oversubscribed by 1.3 times at RM666.4 million ($163.4 million), from the initial offering of RM500 million ($121 million)[19]. Proceeds from the issuance will be channelled into the national COVID-19 Fund, which was established to finance economic stimulus packages and the recovery plan.

Malaysia's maiden Sustainability *Sukuk* is the world's first US Dollar Sustainability *Sukuk* issued by a sovereign, whereby proceeds will be used for eligible social and green projects aligned to the United Nations' SDG Agenda. This *Sukuk* is also unique as its underlying assets are sustainable assets, being vouchers representing travel entitlement on Malaysia's Light Rail Transit, Mass Rapid Transit and KL Monorail networks. The addition of a new avenue of public financing via the *sukuk* further underlines the government's already low liquidity risk. At the 22 April 2021 launch, the government issued two tranches of its first sovereign international sustainability *sukuk*, comprising US$800 million (RM3.3 billion) 10-year trust certificates and US$500 million 30-year trust certificates. The *sukuk* was oversubscribed by 6.4 times.[20] The success was hailed as further evidence of Malaysia's ability to access deep into domestic and international capital markets. Its ability to attract high-quality investor demand across multiple geographies reinforces the fact that there is a healthy investor appetite for sustainable forms of financing.

The Way Forward

The financing landscape in Malaysia has undergone considerable changes over the years. Domestic public revenue is declining as a percentage of GDP and the government is right to wish to avoid larger development funding gaps. Private domestic sources of funds have largely been dominated by private sector borrowing via the bond market, whereas MIDA statistics show an erratic trend in terms of domestic direct investment volumes over the past 10 years. International public resources, such as the ODA, are almost non-existent moving forward, but the space to increase funding through public sector borrowing, through sovereign *sukuk* and bonds, remains promising.

The gap between public resources and the funding targets for under-served SDG targets requires that systematic and efficient revenue mobilisation modality is implemented, whilst at the same time, new alternative and innovative sources of funding are explored. Achieving the SDGs in the next development plan will require investments and services from a wide range of public and private actors. To achieve this, the government would do well to design an integrated financing strategy that sets out a framework for mobilising the necessary scale of, and outcomes from, the required resources. In addition, while COVID-19 recovery expenditure may be the focus in the medium term, in the long run, the government should actively pursue fiscal consolidation efforts, including through improvements in spending efficiency, reprioritising programmes and mega projects, reductions in discretionary expenses and the rationalisation of public sector administrative expenditure.

Malaysia has always relied on a wide-range of generous tax incentives to promote domestic and foreign investment, e.g. pioneer status, which allows up to 70% reductions in corporate income tax for five years and investment tax allowances on up to 60% of capital expenditure. While these incentives are necessary to compete in terms of attracting investment flows into the country, they also incur a significant cost to the government in terms of foregone revenue, which highlights the issues of tax competition, base erosion and profit-shifting (BEPS) and indicates the need for tax coordination. This is, thus, a good opportunity to revisit these "tax expenditures", which are not reported publicly and are not subject to the same degree of scrutiny or management as direct expenditure outlays on the budget. As a whole, introducing a system that allows tax expenditure by the government to be tracked and published would facilitate more active management of government spending and also help to ensure that, for instance, incentive schemes are contributing effectively towards national priorities.

Developing an explicit and measurable presentation of SDG targets in budget allocations and reports (and in other elements of the budget cycle) would be a logical step along with other steps

[19] Two-year RM500m Prihatin sukuk launched with 2% annual profit rate, retrieved from https://www.theedgemarkets.com/article/twoyear-rm500m-prihatin-sukuk-launched-2-annual-profit-rate, accessed 6 June 2021.

[20] Strong demand for Malaysia's international sukuk shows investor interest in sustainability finance, says Moody's, retrieved from https://www.theedgemarkets.com/article/strong-demand-malaysias-international-sukuk-shows-investor-interest-sustainability-finance, accessed 6 June 2021.

such as improving an SDG monitoring framework that spans public and private contributions, and inclusion of the most relevant SDG targets in national plans. In the long-term, deeper reforms can take place, that transform the budgeting process from an input or agency-based to budgeting that considers interrelated and comprehensive Agenda-2030 achievement goals.

UNDP's Support: Development Finance Assessment

Thematic priorities in SDGs such as climate and environmental issues, equality, gender equality and inclusivity, job creation, health and social protection, among others, are still unaddressed in many national contexts. Building forward better, within the context of rapid changes across the financing landscape due to COVID-19, means that the need for an integrated approach to financing is greater now than it has ever been. The Addis Ababa Action Agenda (AAAA), which outlines a framework for financing the 2030 Agenda, highlighted the wide range of resources that would need to be mobilised, and the many ways in which public and private financing would need to become more inclusive, more sustainable, and more resilient.

At the heart of national efforts to finance the 2030 Agenda is the adoption of national integrated frameworks to support a country's own sustainable development strategies. Integrated National Financing Framework (INFF) help governments and their partners to strengthen the alignment between public and private investments with longer-term sustainable development objectives, build greater coherence across the governance of public and private financing policies, and promote greater collaboration among actors in each area of financing. The Inter-Agency Task Force on Financing for Development (IATF) has developed guidance on the concept and building blocks of an INFF: (i) assessments and diagnostics; (ii) financing strategy; (iii) monitoring and review; and (iv) governance and coordination.

The Development Finance Assessment[21] is a tool to help countries shape the inception phase in the process of operationalising an INFF. It offers a mechanism that can form the backbone of this phase, assessing and building consensus on the key issues that need to be considered, while drawing in the findings and recommendations for a next generation of financing strategies that can be articulated in an INFF Roadmap. The DFA offers a unique country-owned, government-led process for determining the steps which will be taken to operationalise an INFF in the national context. It responds to the demand expressed by countries for support in building a holistic analysis of the context and existing development finance structures and identifying ways forward.

Under the guidance of a government-led national oversight team, DFA dialogues bring together government officials, private sector, and other stakeholders aimed to build a broad constituency for reforms and leverage the innovations and collaboration. Research at the core of a DFA draws together information from a wide range of existing sources and assessments. This includes government policy research, as well as assessments and diagnostics from national research institutes and other national initiatives. It draws from a range of assessments by IFIs and development partners, such as Public expenditure and financial accountability (PEFA) and Public investment management (PIMA) assessments, SDG costing and International Monetary Fund (IMF) macroeconomic financial frameworks. It captures analysis and information from private sector initiatives in areas such as Environmental, Social, and Corporate Governance (ESG) reporting, SDG Impact Standards, and insurance risk modelling.

Author & Contact Information:
Haniza Khalid, Senior Development Economist, UNDP Malaysia, Singapore, Brunei Darussalam.
Email: haniza.khalid@undp.org

Acknowledgement
The author thanks Dr. Maya Puspa Abd. Rahman (International Islamic University) for her comments on the manuscript; and Umi Zakiah Norazman for her assistance in data collection.


Photo by Julia Lee from Pexels

[21] The Development Finance Assessment approach was originally developed as part of the Asia-Pacific Development Effectiveness Facility (now the Asia-Pacific SDG Financing Facility, APFIN), and continues to benefit from close engagement with the APFIN leadership and network.