

ISSUE 06 - APRIL 2019

# DEVELOPMENT DIGEST

FEATURED WORK FROM THE  
WORLD BANK GROUP GLOBAL KNOWLEDGE  
& RESEARCH HUB IN MALAYSIA

## The Potential of Human Endeavor



**WORLD BANK GROUP**  
Global Knowledge & Research Hub  
in Malaysia

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## ABOUT DEVELOPMENT DIGEST

The Development Digest is a half-yearly publication that features key works from teams based at the World Bank Group Global Knowledge and Research Hub (the Hub) in Malaysia.

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# DEVELOPMENT DIGEST: ISSUE 06

The Potential of Human Endeavor

**The World Bank Group Global Knowledge and Research Hub in Malaysia brings to you its sixth edition of the Development Digest**, a semi-annual publication featuring frontier research on selected economic and development topics from the Hub.

On March 28, 2019, we celebrated three years of partnership with Malaysia. Since its inception, the Hub has produced a myriad of knowledge products that serve to share Malaysia's development experience with the world and offer new insights as the country forges ahead at the frontier of development, very closely approaching high-income and developed nation status. Beyond that, our research has bridged new audiences both in academia and policy-making on a global scale.

We begin this issue with a note from the Executive Director and Dean of the Board at the World Bank Group, Merza Hussain Hasan, who reflects on the Hub within the grander





scheme of how the Bank, as an institution, has evolved over the decades. Further, we explore how human capital can unlock meaningful growth for all Malaysians. Then, we explore the regional issues plaguing the economy, discussing the potential of slowing growth for East Asia and Pacific.

We also touch on Malaysia's growth, including its performance in the latest Doing Business rankings, the country's public sector performance, and how taxation can deliver its digital economy ambitions. Other articles include informality, how Islamic social finance can further the Sustainable Development Goals (SDGs), oral democracy, the productivity gap between female and male-managed private firms in Malaysia, fiscal policy and making sense of Malaysia's current account balance. Finally, we highlight the winner of this year's Sundaran Memorial Prize for Young Malaysian Researchers.

# Achieving Milestones



During recent meetings in Putrajaya, I could not help but draw a connection between two important narratives.

The first relates to human capital and the early investments in health and education required for children to succeed and prosper as adults in a rapidly evolving world. This agenda is one of the World Bank's global priorities following the launch of its Human Capital Project in October 2018. As part of this new initiative, an index was constructed capturing progress achieved by all countries in the areas of child survival, school learning, and health status outcomes. The initiative also produced a global ranking of countries based on scores derived from the index.

One of the indicators of health status outcomes in the index is stunted growth among children. Its underlying causes include poor nutrition, chronic infection, and weak psych-social stimulation – and it can have significant long-term effects on the cognitive development of children. When assessing the influence of nutrition on a child's well-being, experts agree that the first 1,000 days are a crucial milestone. What happens in those early years can critically shape a child's ability to grow, learn, work, and succeed over the course of his or her life.

Malaysia's human capital outcomes, particularly those related to stunting (i.e. stunted growth in children) and childhood learning, are weaker than expected for its level of income and development ambition. One out of every five Malaysian children suffers from stunting, and student performance scores are well-below those of its aspirational peers in the region.

The second narrative relates to our Hub in Malaysia that crossed its own milestone of 1,000 days earlier this year. Opened in March 2015, the Hub in its initial phase of operation has served as a platform for disseminating cutting-edge innovations, for promoting original economic research with global impact, for strengthening the country's economic research eco-system, and for supporting Malaysia's development priorities and plans for achieving high-income and developed country status.

Some of its noteworthy 'development results' include important innovations in the areas of financial sector development, the digital economy, and global economic research. Teams from the Hub supported Malaysia in leading the development of the global green *sukuk* market with the first-ever issuance of a green Islamic bond. They also supported efforts to boost the efficiency of migrant remittance services within ASEAN (enhancing financial inclusion) and



focused on pushing the frontier of policy and research innovations in numerous areas including Green Finance, alternative financing models, digital taxation, long-term growth modeling, firm productivity, and the ease of doing business.

These results during the Hub's initial phase of operation are a function of the close development partnership with the government of Malaysia – and other partners in the country consisting of academic institutions, youth associations, civil society organizations, the private sector, and member of the media. This visible track record of delivering results together positions our partnership to grow and thrive over the coming years.

Two areas of collaboration that are well-poised for growth are South-South knowledge exchanges and the production of high-quality economic research. The Hub is continuously brokering the exchange of knowledge and development experiences between Malaysia and less-developed countries – and demand for these exchanges continues with an upward trajectory. In terms of conducting and promoting research, the Hub has made an early mark as a pioneering think tank and economic center of excellence. A recently-organized international conference entitled 'Globalization: Contents and Discontents' is one such example in which the Hub convened a gathering to world class-researchers from around the globe including Malaysia to share and discuss research findings related to economic globalization.

The development partnership between Malaysia and the World Bank, as recently operationalized by the Hub, has made significant strides forward. It reflects the country's development aspirations and serves as an important platform for the World Bank Group's efforts to promote global development solutions. For these reasons, we are immensely proud of this relationship and look forward to deepening our collaboration.

We also look forward to working with Malaysia to improve its human development outcomes – particularly those of its children in the first three years of life. As international nutritional research and our collaboration with Malaysia have shown that achieving early milestones is an essential enabler for continuity and longer-term development.

In conclusion, I am thrilled that we are releasing the sixth edition of the Development Digest, a half-yearly publication that features the work of our teams in collaboration with various partners. After three years of delivery, it is perhaps safe to say that our development partnership with Malaysia has crossed an important milestone. Happy reading!



**Mara Warwick**

Country Director for Brunei, Malaysia, Philippines and Thailand.

BOX 1

# World Bank East Asia and Pacific VP Highlights Strength of Ties with Malaysia



Photo courtesy of Ministry of Finance Malaysia.

In December, the World Bank Vice President for East Asia and Pacific Victoria Kwakwa arrived in Kuala Lumpur for an official four-day visit to the country. During her visit, she highlighted the progress achieved by Malaysia as an upper-middle-income country; and identified ways in which the World Bank could strengthen its support of Malaysia's efforts to reach high-income and developed country status.

During this visit, Victoria met Prime Minister YAB Tun Dr. Mahathir Mohamad, Finance Minister YB Lim Guan Eng, and Bank Negara Malaysia Governor Datuk Nor Shamsiah Mohd Yunus. They discussed the close partnership between the country and the World Bank Group, and how the Hub in Kuala Lumpur can further strengthen this partnership.

"Malaysia is well on its way to cross the threshold into high-income and developed country status over the coming years. Its economy is well-diversified and rests on solid foundations; and is primed to take the country to the next level. We welcome the government's efforts, as part of this process, to strengthen institutions, develop human capital, and protect the vulnerable within society. The World Bank Group stands ready to support Malaysia during this important transition process," Victoria said.



Photo courtesy of Ministry of Finance Malaysia.

The World Bank senior official and her delegation also met Malaysia's Deputy Yang di-Pertuan Agong Sultan Nazrin Muizzuddin Shah, with whom they exchanged ideas about development trends in Malaysia and the wider region. These trends include the rising significance of the digital economy, and the importance of education and skills development for future competitiveness in all countries of the region.

As part of her program, Victoria visited the state of Penang and met with local state, civil society, and private sector representatives to discuss the state's 2035 development vision. During the brief visit, she met with Think City to discuss urban regeneration efforts and toured some of Penang's cultural heritage sites. Back in Kuala Lumpur, she also engaged with 40 young Malaysian leaders from the Perdana Fellows program who are embedded in different ministries and government institutions (see Box 2).

In time with Victoria's visit, the World Bank also launched in Kuala Lumpur its 2018 Regional Flagship Report, *A Resurgent Asia – Navigating a Changing World*. The report is co-authored by the World Bank's Chief Economist for the East Asia and Pacific Mr. Sudhir Shetty, and highlights the rising development challenges facing countries in East Asia and how they can navigate these in the years ahead. These ideas can be found in his contribution to this edition of the Digest on page 26.

Victoria was joined by Mara Warwick, World Bank Country Director for Brunei, Malaysia, Philippines and Thailand, Firas Raad, Country Manager for Malaysia, and Alejandro Cedeno, Communications Manager for East Asia and Pacific.

BOX 2

# A Dialogue with the Perdana Fellows

Tengku Dewi Ahdiyana



When we talk about development, we adopt a top-down view of how it should work. For the youth however, we tend to see things differently. From where we stand, we see the paths to take for a future we want to live in – one where everyone has a place as our country develops. We see policies affecting lives everyday – ours and those around us - and we want to contribute. All we need is to be heard.

Towards this end, 33 youth leaders from the Perdana Fellowship Programme met with the World Bank Group Global Knowledge and Research Hub, in conjunction with the visit of Victoria Kwakwa, Vice President for East Asia and Pacific. We spoke about key themes in multilateralism, youth empowerment and how the world can better live in the digital age it has been thrust into.

Here's what some of our Perdana Fellows had to say from the sharing session with Victoria Kwakwa. We begin with Perdana Fellow at the Prime Minister's Department of Unity and Social Wellbeing, **Tengku Dewi Ahdiyana**:



*“Our lively exchange with Victoria, Mara Warwick, Country Director for Brunei, Malaysia, Philippines and Thailand and Firas Raad, Country Manager for Malaysia was thought provoking and inspiring. What began as a discussion about youth and multilateralism quickly evolved into a conversation about youth empowerment and leadership to help meet the challenges of the world today.*

*“The expression of ‘youth as the disruptive generation’ stimulated the discussion further as we spoke about the challenges facing the Malaysian youth in moving*



The Perdana Fellowship Program is a prestigious program established by the Ministry of Youth and Sports in 2013 to provide young Malaysians a first-hand experience in matters of national governance. Under this program, Perdana Fellows are placed under the purview of various ministers to assist in the highest form of governance.

*forward and our role as global citizens. Today's youth have the privilege to grow up in more prosperous conditions. We grew up with better access to education and healthcare and now, access to better jobs. But sometimes, this may be something we take for granted. Many of us aren't aware of the hardships faced by past generations. This affects how we see the world today and is a point of difference from our parents' time."*

*"However, the sharing of knowledge and experiences will bridge the generational gap to enhance and strengthen the ability of a society in pursuing a progressive development. We entered the meeting with the World Bank with good expectations and left with hope and confidence that together, we can make the world a better place!"*

For Perdana Fellow at the Ministry of Communications and Multimedia, **Amirah Fazira Azemin**, how digital technology is changing the world was a key takeaway point for her:



*"The digital revolution has brought about digital disruption. But this also has the effect of augmenting the way we do things – a topic we discussed quite extensively with Victoria, Mara and Firas."*

*"We are the generation who has the advantage of better access to information and tools. We are more acquainted with various sources of information and this, I believe, is a key trait that can help us navigate careers and in the future, find solutions to the world's biggest problems."*

*"Having said that, there must be a room for us to practice and expand our abilities. What we do with our youth today will have impacts for the future of entire nations."*

Perdana Fellow at the Ministry of Foreign Affairs, **Leeroy Ting Kah Sing**, raised his hopes for the future of multilateralism:



*"We are all inhabitants of a global village. Southeast Asia has a vibrant, youthful population. There is potential in every young person to be an agent of change. Youth can make good use of our knowledge, skills and enthusiasm irrespective of their field of expertise."*

*"When we joined the Perdana Fellows, we came in with the intention of wanting to serve the country. This was a great start. But after gaining exposure and learning from the fellowship, my horizons have been broadened. We can use the very same skillset to contribute to a larger regional and global agenda. I am thinking ASEAN and the SDGs!"*

*"Youth engagement and contribution are essential in making international cooperation sustainable and forward-looking. Working together is a key principle of multilateralism in the journey for peace and social inclusion."*

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**TENGGU DEWI AHDIYANA** was Perdana Fellow to the Minister in the Prime Minister's Department of Unity and Social Wellbeing.





# The Force of Ideas

Merza Hussain Hasan

**Nearly 75 years ago in Bretton Woods, New Hampshire, a group of nations met to discuss the establishment of a global system of cooperation for supporting the economic recovery of countries affected by the Second World War.** The outcome of these deliberations resulted in the creation of the International Bank for Reconstruction and Development (IBRD) and the International Monetary Fund, as well as an immediate post-war focus on financing the reconstruction of war-torn countries, particularly in Europe. The first few loans issued by the IBRD were to France, the Netherlands, and Denmark.

In the ensuing decades, the IBRD witnessed two important transitions: (i) a gradual shift in emphasis from financing ‘reconstruction’ to financing ‘development’ as countries began to phase-out their reconstruction efforts; and (ii) the formation of an expanded ‘World Bank Group’ with the establishment of the International Finance Corporation, the International Development Association, the International Center for the Settlement of Investment Disputes, and the Multilateral Investment Guarantee Agency. A third transition which emerged in the 1990s and 2000s was the greater emphasis on sharing global ‘knowledge’ alongside the long-standing agenda of extending concessional ‘financing’ to support the development priorities of countries around the world.

**This evolution towards adopting a ‘knowledge’ agenda reflected the changing requirements of governments, as a greater number of countries in recent decades successfully climbed up the income ladder and were no longer in need of development financing.**

Some of these shareholding countries that moved beyond borrowing status developed a new type of institutional relationship with the IBRD; one focused on the generation and dissemination of innovative policy solutions for the benefit of other countries striving to reduce poverty, increase shared prosperity, and navigate the challenges posed by disruptive technologies.

**The creation of the World Bank Group Global Knowledge and Research Hub in Malaysia in 2015 is a clear expression of this evolving World Bank agenda.**

After Malaysia transitioned to upper-middle-income nation status in the 2000s, it expressed an interest in forging an innovative development partnership with the World Bank to help share its own development experiences, produce cutting-edge policy innovations, conduct original economic research with global impact, and promote South-South knowledge exchanges. Another dimension of this partnership is to support Malaysia’s own development priorities as it continues its own journey toward high-income nation status - and connecting its economy regionally and globally.

This World Bank Group agenda for engaging upper-middle-income (UMICs) and high-income countries (HICs) was recently endorsed by the World Bank Board as reflected in the agreed Forward Look and the commitments of the General Capital Increase (GCI) package. The GCI reaffirmed that ‘strong, yet selective engagement in the mid-to-upper income range of clients



Former President of the World Bank, Robert S. Macnamara with former Prime Minister of Malaysia, Tun Abdul Razak in 1978.

is necessary to address a still-often significant agenda on the Goals, increasingly sophisticated financing challenges, knowledge generation and sharing, advancing global public good issues, and strengthening World Bank Group financial sustainability’.

In line with this corporate strategy, the Hub in Malaysia has made good on its promise to deliver results since its establishment around three years ago. Among its noteworthy results include contributions to innovations in the areas of financial services, the digital economy, and global economic research. These contributions have resulted in the launching of the global ‘green *sukuk*’ market (with the first-ever issuance of a green Islamic bond in Malaysia), the spread of digital enhancements to migrant remittance services, and important innovations in the areas of digital taxation, Fintech, alternative financing models, and long-term economic growth modeling.

Against this background, I am delighted that the ‘Malaysia Hub’ will be coming to Washington DC during the 2019 Spring Meetings and hosting an event under the title: ‘Lessons from the Development Frontier: a Malaysia Hub Event’. This event will consist of two-high level panels focused on sustainable finance and digital economy, and will bring together Ministers and policymakers from Malaysia and countries around the world to share experiences and development perspectives on these important topics.

Good ideas in action are a great force for development and constitute a critical part of our institution’s global mandate in the years ahead. I look forward to seeing the future contributions of our development partnership with Malaysia as operationalized by our Hub in Kuala Lumpur.

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**MERZA HUSSAIN HASAN** is the Dean for the World Bank’s Executive Board and an Executive Director.



# The Potential of Human Endeavor

Firas Raad

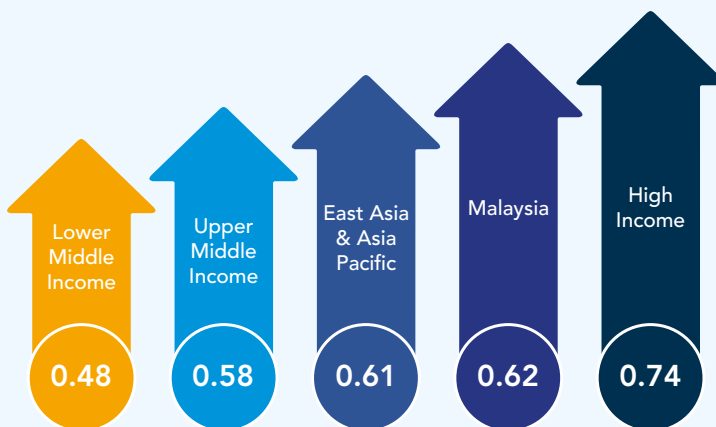
**Making greater gains in human capital accumulation will be critically important for the quality of Malaysia's transition into high-income and developed country status when it crosses the threshold into the ranks of high-income countries.** In this article, Firas Raad, Country Manager for Malaysia, World Bank Group Global Knowledge and Research Hub, discusses unleashing more broadly the rivers of innovation and productivity in Malaysia by improving the quality of education.



Over several millennia, human endeavor has propelled civilizations forward with astonishing ingenuity. From the invention of the wheel to the creation of the printing press, clocks, light bulbs, steam engines, vaccines, telephones, airplanes, and the personal computer, a combination of curiosity and need generated solutions to advance the human condition. The scientific, agricultural, and industrial revolutions of the modern age, spanning the past 400 years, improved living conditions and boosted economic prosperity for a vast number of people in the world. The dawn of a Fourth Industrial Revolution (4IR) – driven by current advances in artificial intelligence (AI), robotics, and cloud-computing – holds out the promise of a new wave of ‘development dividends’ for economies and societies.

Yet, technological progress can also be powerfully disruptive and lead to sizeable unintended consequences. The second industrial revolution from 1870-1914 drove an immense expansion in the production of electricity, petroleum, and steel – but also carried with it significant social and environmental costs. These adverse effects are captured poignantly by Charlie Chaplin in his movie, *Modern Times*, which highlights the alienation felt by American workers in the age of mechanization and mass industrialization. The rapid expansion of the global fossil fuel industry in subsequent decades also contributed to the warming of our planet with significant consequences for the future of countries around the world. Along with this profound challenge of climate change, the advent of new and disruptive technologies is transforming the nature of work, and will likely affect large categories of existing jobs while creating new ones at the same time.

Figure 1. Malaysia’s Human Capital Index (HCI)



Malaysia’s HCI score at 0.62 indicates that children in Malaysia will be only 62% as productive as they could be in adulthood





Less than two generations ago, the global community came together in the 1980s and examined some of the adverse effects of modern development on human societies. A United Nations (UN) Independent Commission on International Humanitarian Issues (ICIHI) produced a report on Winning the Human Race and focused on questions related to famine, refugees, modern conflict, desertification, and deforestation. The United Nations Development Programme (UNDP) later launched its Human Development Index in 1990 to highlight the importance of human progress alongside economic progress. Similarly, the World Bank focused its attention on this topic with a series of World Development Reports (WDRs) in the 1990s related to human development, notably the 1993 WDR on Investing in Health, and the creation of the Human Development Network within its organizational structure in 1997.

Three decades later and following the launch of UN's Sustainable Development Goals for the period 2015-2030, the world's development community is highlighting the urgency of accelerating progress, particularly in areas related to human capital. The participants of the earlier ICIHI efforts convened a conference in 2017 entitled 'Winning Back the Human Race' and emphasized the importance of making greater strides in addressing the most pressing human development concerns. The World Bank's 2018 WDR on 'Learning to Realize Education's Promise' focused on the immense challenges confronting many educational systems around the world. A high-level meeting during the 2018 United Nations General Assembly Week (UNGA) noted that greater efforts were required to reduce the spread of non-communicable diseases (NCDs) in countries of all income levels. Lastly, in the area of climate change, the UN Intergovernmental Panel on Climate Change (IPCC) issued a report last fall calling for unprecedented changes in national policies to avoid the devastating results of extreme climate conditions.

As part of this effort, the World Bank launched a new global Human Capital Index (HCI) during its annual meetings in October 2018. The initiative was motivated by remaining concerns over unfulfilled human capital around the world. About 60 percent of primary school children in developing countries are not learning up to minimum proficiency standards.

## **Almost a quarter of children worldwide are stunted, and half of the world's population do not have access to essential health services.**

In his remarks during the annual meetings, World Bank President Jim Yong Kim emphasized that the new HCI 'draws a direct line between better health and education outcomes, and future economic growth... and paints a very clear picture for leaders of how much more productive their workers could be with full health, a complete education and the skills needed in the future'.

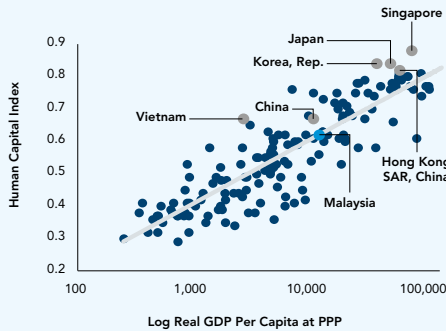
The HCI is part of the World Bank's new Human Capital Project, which aims to motivate greater investments in education, health, and social protection. It produces a composite indicator for all countries of the world and captures, at a national level, the human capital that a child

**Figure 2. Malaysia’s HCI score in comparison to regional peers and the corresponding learning gap**

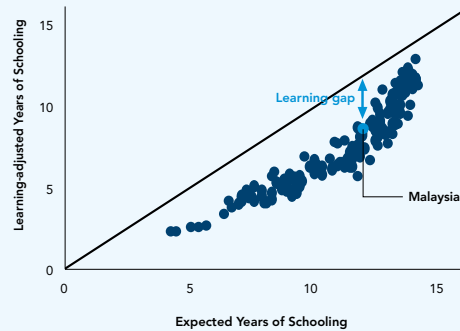
The HCI for Malaysia is lower than that of aspirational peers...

...and the shortfall is especially pronounced in terms of educational attainment, with an average learning gap of 3.1 years

HCI vs. GDP per Capita, Selected EAP Countries, 2017



Expected Years of Schooling vs. Learning-Adjusted Years of Schooling



Source: World Bank Human Capital Index.

born today can expect to attain given the prevailing state of education and health services in his or her country. It consists of three sub-indicators: (i) childhood survival as reflected by the under-five mortality rate; (ii) the quality of education as reflected by years of schooling adjusted for learning; and (iii) health status as captured by childhood stunting and adult survival rates. The HCI also ties the composite indicator to potential forgone labor market earnings due to gaps in human capital outcomes. As with the format of its Doing Business report, the World Bank produced a global ranking of countries based on their individual HCI scores.

Four of the top five highest performers in the global HCI are from East Asia – which is a tribute to the remarkable education gains made by some countries of the region. The top five performers globally, in descending order, are Singapore, Japan, the Republic of Korea, Hong Kong SAR China, and Finland. The following five countries are Ireland, Australia, Canada, the Netherlands, and Sweden. In the global ranking, Malaysia is 55th and its performance exceeds the average performance for countries in the East Asia and Pacific region and for upper-middle-income countries around the world. Yet it trails behind the performance of high-income countries and its aspirational peers in the region.

While Malaysia performs well, on average, in relation to child survival and adult health status, it can do better with respect to learning outcomes and childhood stunting. Malaysia has

**Figure 3. Stunting rates in Malaysia**

Source: World Bank Human Capital Index.

an average learning gap of 3.1 years, meaning the cumulative learning experience of school children is on average three years shorter than the highest performing benchmark, and its performance in international learning assessments such as TIMSS1 and PISA2 is well below the performance of the high-income countries in East Asia. In terms of addressing childhood stunting, Malaysia's performance is slightly better than the regional average but significantly weaker than the performance of high-income countries. One of five Malaysian children, according to national data, has stunted growth – and hence will face greater challenges in his or her physical and cognitive development.

Making greater gains in human capital accumulation will be critically important for the quality of Malaysia's transition into high-income and developed country status. According to World Bank estimates, Malaysia will cross the threshold into the ranks of high-income countries by 2024. This transition can be boosted with greater investments in tackling childhood stunting and boosting learning outcomes. Improving the quality of education outcomes – through better pre-school services, stronger in-school assessments, greater emphasis on math and science, and a general alignment of all efforts to ensure better childhood learning from kindergarten (KG) grade 12 – will better position Malaysian youth to compete in a global marketplace that will be dominated by automation, digital services, AI, and 4IR.



What is important for Malaysia is also important for the world. Every country will have to navigate the opportunities and challenges of this new digital age, and work towards mitigating the most severe consequences of global climate change. In its 2019 WDR on ‘The Changing Nature of Work’, the World Bank argues that ‘work is constantly reshaped by technological progress... as firms adopt new ways of production, markets expand, and societies evolve’. Ultimately, ‘technology brings opportunity, paving the way to create new jobs, increase productivity and deliver effective public services’. As to the global climate change agenda, the recent COP24 gathering in Katowice, Poland, re-energized countries’ commitments towards reducing carbon emissions and heading off greater climate disruptions to our planet’s biodiversity and global ecosystem.

Human endeavor, mirroring the patterns of the past, holds great potential for global development over the coming decades. But the ‘capital’ upon which it rests needs to be strengthened and widened to unleash more broadly the rivers of innovation and productivity in every country. Such progress will better position our societies to race ahead with technological progress – and not fall behind in its wake – and to better contend with the existential challenges posed by our warming planet.

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**FIRAS RAAD** is Country Manager for Malaysia, World Bank Group Global Knowledge and Research Hub.

## BOX 3

# How Can Malaysia Realize the Potential of its Human Capital?

Richard Record and Harsha Aturupane



Anyone who visits Malaysia will quickly come to realize that Malaysians are blessed with enormous talent, ranging from the myriad of entrepreneurs creating new businesses online to those active in the creative industries including music, culture, and sports. But there is also still a widespread sense that Malaysia is not making the most of its human capital, with concerns that despite large investments in education and health, the returns are not as high as they should be, and that a large share of Malaysians are still being left behind.

As Malaysia looks towards becoming a high-income and developed nation – particularly one where development progress is measured in much more than just GDP – ensuring that human capital is effectively nurtured, developed, and protected will be critical. With the advent of digital and disruptive technologies changing the nature of work, this challenge is becoming ever more central to Malaysia's future development progress. This puts an increasing premium on high-order cognitive skills, such as complex problem-solving, socio-behavioral skills, reasoning, and self-efficacy. Building these skills effectively will require a transformation in the way that Malaysia invests in its human capital.

Human capital – the knowledge, skills, and health that people accumulate over their lives – has been a key factor behind the sustained economic growth and poverty reduction rates of many countries over the past half century, especially in East Asia. Education, health, and social protection all play vital and complementary roles in the development of human capital.



The World Bank's new Human Capital Index is a cross-country metric designed to forecast a country's human capital by tracking the trajectory, from birth to adulthood, of a child born today. In the latest edition of the Malaysia Economic Monitor, we investigate how Malaysia fared using this method. We found that overall, Malaysia scores 0.62, meaning that children in Malaysia will be 62 percent as productive as they could be in adulthood compared to optimal health and education outcomes. Overall, Malaysia ranks 55th out of 157 countries, and while performance is good in some components of the index, it remains poor in others. Relative to other countries, Malaysia does well in child survival, expected years of schooling, and overall health conditions. However, there is significant room for improvement in the areas of child nutrition and learning outcomes.

Looking to the future, how can Malaysia continue to improve its human capital and boost productivity? In our report, we identify three priority areas:

- To enhance learning outcomes, a key measure would be to provide universal access to high-quality early childhood care and education to ensure that children are “ready for school”. International evidence has shown that the quality of early childhood and preschool education programs are directly linked to better development of children's cognitive and social skills. Improvements to learning assessment systems could also improve outcomes. Similarly, international evidence shows that the quality of an education system can only be accurately determined by an effective framework for assessment, including classroom-based, national, and international comparative assessments. When implemented correctly, this type of continual assessment can have a major impact on student learning.
- Nutritional outcomes must be improved to overcome childhood stunting as a constraint on learning and human capital development. Child stunting in Malaysia is higher than that of other countries at similar levels of income. There is overwhelming international evidence that malnutrition in a child's early years of life is associated with significant negative consequences for health, cognition, and productivity throughout the course of their life. Further work is needed to better understand why poor nutrition remains a problem in Malaysia, across all states, ethnicities, and income strata.
- Protecting human capital from the impact of shocks through social welfare programs is of key importance. Rigorous evidence from around the world demonstrates the positive role that social protection programs can play by providing vulnerable households with the income support to fight poverty for human capital development. Malaysia's current social protection system could be both expanded and reformed to integrate a mixture of mandates and incentives, thereby helping households to invest in human capital.

Accelerating human capital development will be critical for enabling Malaysia's successful transition to a high-income and developed nation. With human capital, the country can boost productivity to ensure that it stays well on its development path and that no Malaysian gets left behind in the process of growth.

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# East Asia Must Clear Hurdles to Sustain Growth

Sudhir Shetty and Andrew Mason

**In the past half-century, East Asia has made extraordinary progress in sustaining economic growth and improving living standards.** Some of the region's developing economies are now middle-income countries and have collectively grown more than three-fold. Some of the economies that moved up from low- to middle-income status in the past quarter-century can realistically aspire to high-income status in the space of the next generation.

**The region's sustained growth means more than 1 billion of its people moved out of extreme poverty and, as a result, nearly two-thirds of developing East Asia's population can now be considered economically secure or middle-income earners.**

Yet developing East Asia's resurgence remains work in progress. Changes in global and national circumstances mean the region's transition to high-income status will depend on how well the economies are able to adapt their development models to these changing circumstances.

### **Past models may not work in the future**

A newly published World Bank study, **A Resurgent East Asia**, looks at the prospects for developing East Asia. Its central message is that the model that has worked so well so far will not necessarily work the same way going forward.

East Asia's remarkable success has been built on a development model that combines outward-oriented growth, human capital development, and sound economic governance. While this model still has a lot to offer, the region's economies will need to adapt it to produce results in these changing circumstances.

Many factors are increasing the urgency for such adaptation. Slowing global trade, rapidly changing technologies and the rising expectations of the people who are joining the middle-income group are among the main forces at work. In turn, these changes imply challenges of slowing productivity growth, risks to inclusion, and rising demands on state institutions.

**Slowing global trade means the economies will need to look for other ways to spur productivity growth.**

Technological change, while it provides opportunities for productivity growth, could deepen existing inequalities among workers depending on the extent to which they have the requisite skills. And, as East Asia has become more affluent and middle-class, its political economy challenges, such as those of building broad coalitions for policy reforms, have become more complex, even as the people demand more and better public services.



## Competitiveness key to progress

So, how could developing East Asian economies adapt their development policies to sustain their transformations and make the transition to high income? While many of the answers will necessarily be economy-specific, the combination of policy reforms will need to focus on promoting economic competitiveness, building skills, fostering inclusion, strengthening state institutions, and financing the transition to high income.

To boost competitiveness, the focus should now be more on service sector reforms, deeper trade agreements, broader innovation policies, and improved access to finance for small and medium-sized enterprises. Emerging priorities on skills include developing higher-order cognitive and socio-emotional skills, supporting systems for continuous skills development, and enhancing people's digital and technical capabilities. To foster inclusion, strengthening employment services, linking unemployment benefit schemes to economic transitions, and improving access to digital technologies will all be important.

And strengthening state institutions will require more emphasis on mechanisms to solicit people's opinions and participation, greater government transparency, and stronger systems of checks and balances. Besides, financing the transition to high-income status will require measures to expand the tax base and limit tax competition.

**These emerging policy priorities will need to be complemented by foundational policies – reforms that the economies are already pursuing – that remain critical to sustaining development.**

In boosting competitiveness, for instance, this means continuing to emphasize regulatory reforms. And to develop skills, finding ways of improving learning outcomes in schools remains important.

### **Policymakers must act now to sustain progress**

Unless policymakers act decisively on these fronts, the risk is that the region's progress could stall. We can't forget that the developing East Asian economies are still much less affluent and productive than their high-income counterparts.

China's per capita income, for instance, is still only about a fifth of the average in high-income economies. When the Republic of Korea achieved high-income status in 2001, for instance, its labor productivity was two and a half times higher and its human capital a third higher than those of China today.

In sum, the current challenges and uncertainties don't leave room for complacency in developing East Asia. In development, as in other things, past success does not guarantee future success. Economies that are content to rest on their laurels, despite rapidly changing global, regional, and national contexts, risk forgoing the opportunities for sustained progress and falling victim to new challenges. We hope policymakers across developing East Asia will consider the implications of the changing times and devise their economic development policies accordingly.

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# Malaysia Doing Business 2019: Tougher at the Top

Maksym Iavorskyi

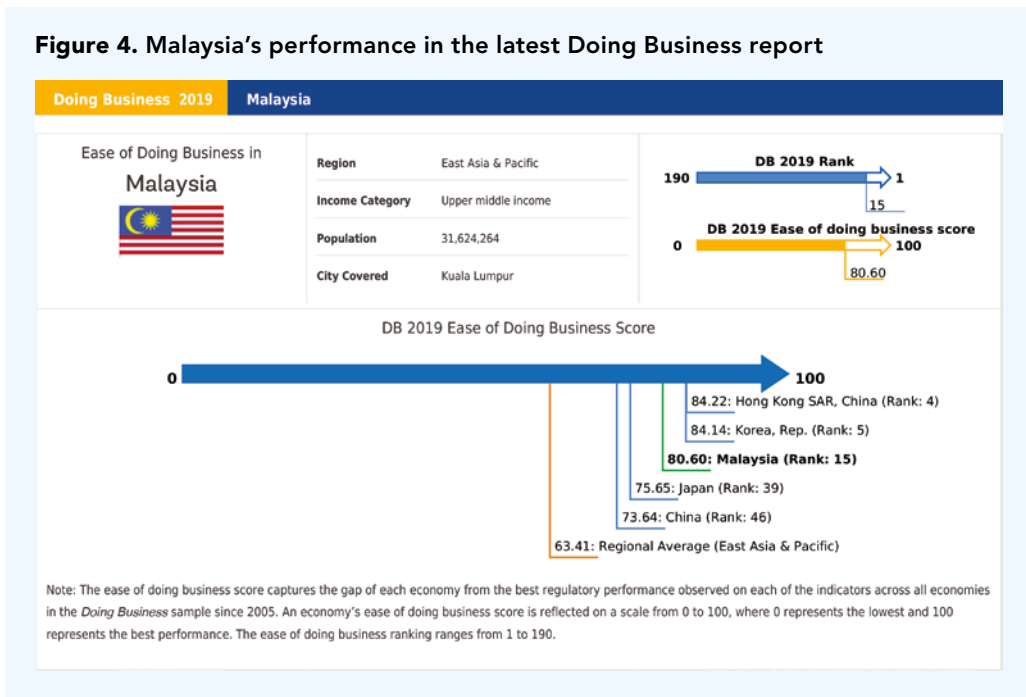
**Competition amongst the world's economies to provide the best business environment possible is no walk in the park.** Even top-tier countries in the World Bank's Doing Business index are not immune to this challenge.

In the latest edition of the World Bank Group's **Doing Business 2019: Training for Reform** report, there was a peak in reform activity with 128 economies undertaking a record total of 314 business reforms. The numbers show that countries must sustain their best possible pace of reforms in order to stay competitive. Malaysia has done just that.

**With a record of six business reforms carried out in the past year, Malaysia made a significant jump to a global rank of 15th in the Ease of Doing Business global rankings.**

Now a top global performer in the rankings, Malaysia’s business reforms demonstrate the country’s commitment to improving its business climate, thus sending important signals to the global business community and further encouraging local entrepreneurs to launch their businesses and create jobs in Malaysia.

**Figure 4. Malaysia’s performance in the latest Doing Business report**



We look back at the six reforms that have contributed to a breakthrough year for the country:

- Starting a business was made easier and faster by introducing an online registration system for Sales and Service Tax (SST), reducing the time it usually takes to start a business by 10 days.
- The process of obtaining a building permit was streamlined, reducing the time for a business to complete all required procedures to build a warehouse by 24 days.
- Getting electricity was made easier by eliminating site visits for new commercial electricity connections, reducing the length of this process by seven days.
- Property transfers were made simpler by implementing an online single-window platform to carry out property searches.
- Trading across borders was made more accessible by introducing electronic forms and

enhancing risk-based inspection systems. Importing and exporting was also made easier by improving the infrastructure and port operation system at Port Klang. As a result, the time usually taken to complete border compliance requirements was significantly reduced.

- Resolving insolvency was made easier by introducing reorganization procedures for commercial entities as an alternative to liquidation.

**As a result of this increased reform activity, the country now takes a place as a regional leader in certain indicators. Notably, Malaysia ranked:**

- As the third global performer in the dealing with construction permits indicator with only Hong Kong SAR, China and Taiwan, China ahead.
- Fourth globally for the getting electricity indicator. As such, the cost for businesses to obtain a commercial electricity connection in Malaysia is only 26 percent of income per capita, whereas the regional average is 625 percent.

For local entrepreneurs, this marks an encouraging move in the right direction towards creating a conducive business environment for further growth. The big question is – moving into 2020, can Malaysia sustain this overall reform momentum?

**This remarkable breakthrough year only means that the country must continue to work to accelerate efforts to improve its business climate.**

**It is important for Malaysia to improve areas where entrepreneurs still experience obstacles. Some key challenges for the country include:**

- In the area of starting a business, it is still relatively cumbersome for local entrepreneurs to do so.
- Despite reforms in how businesses pay taxes in the earlier years, the total tax and contributions rate in Malaysia at 39.2 percent is higher than the regional average of 33.5 percent. Additionally, it takes on average 188 hours per year for businesses to prepare, file, and pay taxes, which is still significantly longer than other regional comparators like Hong Kong SAR, China.

As Malaysia gears up towards becoming a high-income economy, focusing on these challenges are key as it can help foster more conducive business environments, level up the dynamics of the country's economic development, and narrow the gap with high-income economies.

This is an enormous task for governments across the globe to cultivate an enabling environment for continued growth and development. With sound and efficient business regulations these can be extremely beneficial for entrepreneurship ecosystems and a thriving private sector.

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# Improving Public Sector Performance Through Innovation and Inter-Agency Coordination

Bernard Myers

**Bureaucracy, politics, lack of IT, corruption, low motivation – these are just some of the excuses we often hear around the world for why public sector services and agencies do not work as effectively as they should.** Citizens in developing countries and emerging markets have often grown accustomed to poor quality in service delivery or a lack of services altogether. The real reasons behind the performance failures and the corresponding lack of corrective measures is not always obvious. This most likely involves some combination of the factors above, and others.

For public officials in charge of managing public institutions, improving public sector performance can look like a daunting task. Where to begin? Is it really possible to overcome a system of inefficiency and ineffectiveness that has persisted for many years? Can one really break through the obstacles that stand in the way of success? And finally, can the public sector really improve the quality of services it delivers?

The Hub in Malaysia has been at the center of generating insights into these questions. Recently, the Hub issued the first edition of a new global report series on **Improving Public Sector Performance**. The report draws on the Bank's network of governance specialists across the globe to curate 15 inspiring stories of how reformers are finding new and innovative ways to drive breakthroughs in public sector performance.

The report shows that innovation does not always require state-of-the-art or high-cost technology. On the contrary, many of the innovations use technology in only a supporting capacity. Across a diverse set of low- and middle-income countries, the Bank's team found five common drivers of success in public sector management reforms:

- **Leadership**
- **Incentives (either individual or institutional)**
- **Institutional capacity building**
- **Transparency**
- **Technology**

There are no silver bullets to transforming public sector performance. In each of the success stories, three to five of these drivers were clearly present.

**Political leadership is almost always an essential catalyst to embark upon a reform path and to navigate the forces that resist change. But institutions and individuals can also be motivated to act when given the right incentives to care about performance.**

Institutional capacity building helps assure sustainability of reforms. Transparency about performance (individual and corporate) can also be a powerful driver to help motivate change and to hold key actors accountable. Finally, technology can be an enabler to increasing capacity, streamlining processes, and creating much-needed transparency.



This inaugural report aims to inspire public sector practitioners to see what is possible – even in challenging environments – and to encourage innovative ways to tackle long-standing problems in performance. It shows countries addressing challenges in different function domains: civil service management, public financial management, policy management in the center of government, last-mile service delivery, and even justice services.

If public sector institutions are going to perform better and be more responsive to citizen demands, they also need to find effective ways to tame what The Economist traditionally called “Leviathan.”

**As size and complexity of government functions grow with each generation, ministries and agencies risk becoming more disconnected from citizens, as well as increasingly disconnected from each other.**

Government departments and agencies are naturally prone to function in silos, and it requires concerted effort to mitigate against duplication of effort, hoarding of information, or working at cross-purposes. The Bank’s report spans the globe to examine why some the approaches to inter-agency and policy coordination are working, and why others are not.

Malaysia sits at an important juncture in its development history. Despite a history of rapid economic growth over the past decades, Malaysia is positioned to do better over the next decade in creating a nation of shared prosperity and social well-being. Experiences from around the world show that public officials are not giving up but are forging new ways to enhance public sector performance. The Malaysian experience should be part of that future tapestry of transforming public sector performance.

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# Taxing the Digital Economy in Malaysia: How do We Balance Growth with Sustainability?

Richard Record and Jonathan Leigh-Pemberton

**Malaysia wants the digital economy to play a central role in the next chapter of the country's development – that much is clear.** However, what may be less clear is why taxation should be part of the policy mix that will help deliver the country's digital economy ambitions. This is important because taxes raise the cost of doing business rather than reducing it.

The fact is that many of the key enablers for growth of the digital economy are going to require public investment, and this will require funding. Overcoming the human capital constraints in the country, as described in a new World Bank report, is just one example of that.

**As the economy becomes increasingly digitized,  
the tax system will need to reflect that change.**

But taxation can do more than just fund necessary investments – it can also help ensure that digital entrepreneurs in Malaysia are operating on a level playing field. Like other businesses in Malaysia, digital entrepreneurs will have to account for sales taxes on the goods and services they provide to their customers.

During our recent conference on ‘Public Policy in a Digital World’ we found that 72 percent of people on Facebook in Malaysia are currently linked to a small business outside the country. At the moment, those businesses are not required to pay sales taxes here – which gives them an edge over domestic suppliers. We also learned that 87 million Facebook users outside Malaysia are connected to businesses in the country. Increasingly, Malaysian businesses selling online to foreign customers will find they have to account for taxes on consumption levied in the countries where their customers are based. In February, Singapore announced that it would be applying its sales tax to imported digital services – a step many other countries are already taking. This reflects an international consensus that taxes on consumption should also apply to goods and services supplied across borders. With a well-established model in place, this means that Malaysia has an opportunity to follow suit in order to secure sales taxes from foreign suppliers. This would also remove the incentive for consumers to favor foreign suppliers over their domestic competitors.



Our report on **Malaysia's Digital Economy** delves further into this, and discusses how Malaysia might also approach the taxation of profits generated from cross-border activity within the digital economy. This is an important issue as the digitization of the world economy has made international sales much easier to achieve, including for SMEs. Aspects of how digital businesses operate across borders raise some novel issues for the designers of income taxes.

For example, policymakers around the world are wrestling with the fact that a digital business can have a sizeable presence in a local market, and yet have no physical footprint there at all – no local staff, no offices, and no equipment. This is often described as having “scale without mass”. If that business is making significant profits because of its virtual presence in an economy – through advertising or through the sale of data – some of its profits could also be taxable in that economy. Some governments take the view that this is particularly true of businesses that rely on their users to create the content that attracts other users to their platform. The equal treatment of domestic and foreign businesses is also part of the debate about how best to tax the profits of international digital businesses. The report discusses developments internationally in the field and sets out options that Malaysia can consider as it develops a tax policy that supports growth in its domestic digital economy.

**To put it simply, good tax policies can play an important role in delivering the results that Malaysia has set for itself when it comes to the digital economy.**

The report provides a framework for thinking about these different options. This framework could serve as the foundation for a balanced approach that is fair and clear, and which also fosters growth that is both rapid and sustainable.

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# Informality: Why is it So Widespread and How Can it be Reduced?

Norman Loayza

**In a typical developing country, about 70 percent of workers and 30 percent of production are informal.** Informality is a cause and a consequence of the lack of economic and institutional development. It implies productive inefficiency and a culture of evasion and noncompliance. Informality, however, exists because it offers the advantages of flexibility and employment in economies with low labor productivity and an excessive regulatory burden. Under these conditions, if there were no informality, there would be greater unemployment, poverty, conflict, and crime. A well-conceived formalization strategy should seek to make formality more attractive. As the causes of informality are complex and interrelated, the reforms to reduce it must include all relevant areas. A formalization strategy should consist of making labor markets flexible, reforming social protection, increasing labor productivity, making the regulatory framework and the justice system efficient, and rationalizing the tax system.



“Informality” is a term used to describe the set of firms, workers, and activities that operate outside the legal and regulatory framework or outside the modern economy. It is more prevalent in smaller firms, more marginal locations, more rudimentary activities, and among less educated people.

It is a problem because it implies that a large number of people and a considerable share of economic activity do not fully benefit from appropriate technologies and efficient production methods, access to essential public services such as police and judicial protection, and the possibility of sharing and mitigating risks such as old age, illness, and unemployment. Informality is also a problem because informal firms, workers, and activities contribute insufficiently to the State and the generation of public goods.

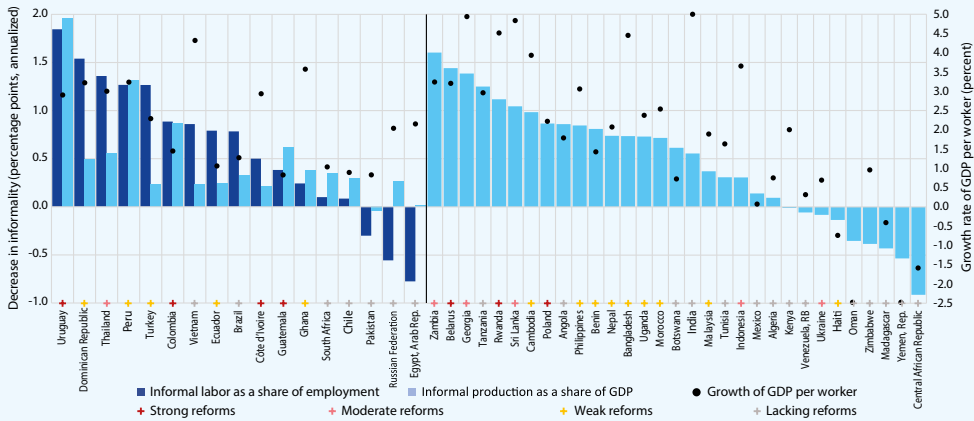
**Informality, however, exists because it offers several economic advantages in economies constrained by low labor and business productivity, as well as by a State that does not offer efficient services but imposes an excessive regulatory and tax burden.**

## **The Prevalence of Informality**

The informal economy is commonly defined and measured in relation to two areas: employment and production. In the first area, a key measure is the percentage of employment that is not subject to or does not comply with labor legislation, does not pay income taxes, or performs subsistence activities. In the second area, a key measure of the size of the informal economy is the percentage of the country’s production that is generated informally.

Informality is widespread in developing countries. It is one of the most important characteristics of their labor and production markets. Informal labor is highest in Sub-Saharan Africa and South Asia; considerably high in East Asia and Pacific, Latin America and the Caribbean, and Middle-East and North Africa; lower in Eastern Europe and Central Asia; and lowest in the rich countries of the OECD. Informal production as a share of GDP is also substantial in developing countries, though lower than in terms of employment, a reflection of the informal sector’s lower productivity. However, while persistent over time, in many countries, informality is declining (see Figure 5).

**Figure 5. Decrease in Informality in Relation to Economic Growth and Formalization Reforms, circa 2005-2015**



**Source:** Author's calculation based on ILOSTAT (2018), TURKSTAT (2018), and Medina and Schneider (2018) for informal labor and production; World Bank World Development (2018) for growth of GDP per worker; Kim and Loayza (2018) for market flexibility and governance; World Bank ASPIRE Indicators (2018) for social protection; and World Bank Doing Business (2018) for taxes.

**Note:** Reforms are measured using indicators in the areas of market flexibility, social protection, governance, and taxation. Considering the period 2005–15, progress of at least 10 percent in three or four areas is labeled “Strong”; in two areas, “Moderate”; in one area, “Weak”; and in no area, “Lacking.” Growth rates are truncated at –2.5 percent and 5 percent.

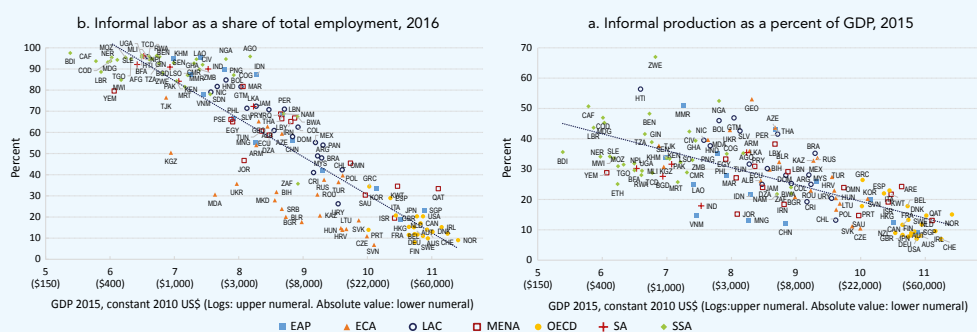
## The Causes of Informality

There are two main schools of thought about the causes of informality, both of which are correct. The first considers that informality is a symptom of underdevelopment; i.e. low productivity of workers and firms, mostly due to structural factors. Accordingly, policies to reduce informality should be aimed at increasing labor and business productivity.

The second school of thought considers that informality is the result of bad governance. Thus, informality is the response of the private sector to an overly-regulated economy and an inefficient State. As such, policies should focus on improving the regulatory environment and public services.

**Lack of economic development, and low productivity in particular, and poor governance are both relevant, in proportions that vary from country to country.**

One way to appreciate that both lack of economic development and poor governance can be responsible for the high level of informality in a country is to consider the international relationship between informality and per capita income.

**Figure 6. Informal Labor and Informal Production versus GDP per capita**


**Source:** For panel a, ILO (2018); Loayza and Meza-Cuadra (2018); for panel b, Medina and Schneider (2018).

**Note:** Data labels use the International Organization for Standardization (ISO) country codes. OECD includes high-income countries that have been members of OECD for more than 40 years. Other regions include East Asia and Pacific (EAP), Europe and Central Asia (ECA), Middle East and North Africa (MENA), Latin America and Caribbean (LAC), South Asia (SA), and Sub-Saharan Africa (SSA).

The comparison shows that less economically developed countries tend to exhibit larger informality. However, some countries have a significantly higher level of informality than their level of GDP per capita would predict. This suggests that informality is not only driven by economic development, but also by other factors arguably connected to the quality of government and regulatory environment.

## Objectives of a Formalization Strategy

In principle, formalization should achieve the following goals:

1. **Increase the productivity of workers, businesses, and the economy in general.** The transition from informality to formality can represent a substantial efficiency gain as firms grow in scale and diversity. Moreover, an expansion of the tax base can imply larger and more stable resources for funding public infrastructure and services.
2. **Reduce the vulnerability to systemic and idiosyncratic risks.** The reforms that bring about formalization can increase the ability of the national economy, firms, and workers to adjust to the changing conditions of the world economy, to recover from adverse shocks, and to avoid unnecessary risks to health and safety. The combination of market flexibility with broad and effective social protection encourages formalization and decreases vulnerability.
3. **Promote a culture of respect for law and order.** Improving the legal and regulatory systems can help economic agents change their perspective and behavior with respect to laws and regulations, as well as the institutions responsible for enforcing them. If economic agents see these institutions as reasonable and fair, they will perceive a clear personal and social benefit in respecting them.

## Guiding Principles of a Formalization Strategy

The principles underlying formalization reforms consider the fundamental causes and most relevant consequences of informality, the prevalence and size of the informal economy, and the objectives to be achieved through formalization:

1. **Reduce informality, but not at all costs or in any possible way.** An indiscriminate reduction of informality can lead to unemployment, poverty, and the social evils they bring, from criminality to social conflict. Informality can and should be improved, without losing the benefits it has brought to economic activity and people's welfare.
2. **Make formality attractive, rather than only penalize informality.** The strategy should seek to increase the benefits of formality and reduce its costs, as well as discourage informality; i.e. a series of "carrots" alongside "sticks" can be adopted, depending on the characteristics of a country's informal sector. Enforcement of rules and regulations is important only to the extent that they are economically and socially sensible.
3. **Formalize labor and economic activity, not necessarily all firms.** Most microenterprises in heavily-informal economies are inefficient, gradually exiting the market as development proceeds. Formalization should be sought through the generation of employment and



production mainly in emerging, medium, and large firms, as these enterprises can generate greater growth in productivity and greater diversification of risks.

4. **Implement a comprehensive, not a piecemeal, formalization strategy.** To succeed, a formalization strategy must include well-integrated reforms that address the complexity and particularity of informality in each country. The benefit of implementing a comprehensive formalization strategy can be greater than the sum of the isolated effects of its components. Integration of reforms may be necessary not only for these technical reasons but also for political economy considerations.

## **Reform Components of a Formalization Strategy**

The main reform components of a formalization strategy seek to confront the two main causes of informality – lack of development and poor governance – and to make formality attractive in a comprehensive yet realistic way.

1. **Make the labor market more flexible.** In an economy with a large and growing workforce, it is essential that the labor market has the capacity to generate enough formal employment opportunities. Companies must be able to determine their workforce without major restrictions on hiring and firing. Likewise, the wage and non-salary costs that firms face must correspond to the productivity of workers and market conditions.
2. **Reform social protection.** Labor flexibility can be politically and socially viable only if it is accompanied by labor reinsertion systems and encompassing social protection aimed at the worker, regardless of employment status. Social protection reform can not only help in achieving its primary objectives but also contribute to formalization of workers and enterprises. It must be based on the following principles: it should benefit people regardless of employment status; target the most vulnerable; be fiscally viable; and not discourage self-sufficiency.
3. **Increase labor productivity.** At the individual level, labor productivity depends on the technical and social skills acquired at home and school. Educational reform is badly needed to transform schooling into learning. For workers already in the labor force, retraining is necessary to sustain and improve their productivity. At the firm level, labor productivity depends on the quality of management, the usefulness of capital investment, and the capacity to adopt and develop new technologies, processes, and products. Finally, at the economy-wide level, labor productivity is also determined by the quality of public infrastructure and government institutions, as well as competition in and access to global markets.
4. **Make the regulatory framework and the justice system more efficient.** The regulatory framework should promote business development, market competition, and the protection of workers and consumers. Likewise, a proper justice system can make formality not only



attractive but also feasible. What is needed is a consistent and agile justice system that lays the rules for property and use of the territory, resolves commercial and labor disputes effectively, enforces contractual agreements fairly, and protects citizens from crime and predatory behavior.

5. **Rationalize the tax system.** A poorly-designed tax system can represent a barrier to investment and growth and can induce evasion and informality. To promote formalization, the tax system should tend toward simplicity, gradual increases in the tax cost with the size of the firm, and reduction of marginal tax rates. The tax enforcement agency must be made more efficient through the use of information technologies and address not only formally registered firms but also informal activity.

## **Concluding remarks**

The specific measures that are needed for a concrete plan must be country-specific. For each reform component, a diagnosis of the country's current situation is required, possibly contrasting it with other countries; and specific reforms to address the main weaknesses should be formulated.

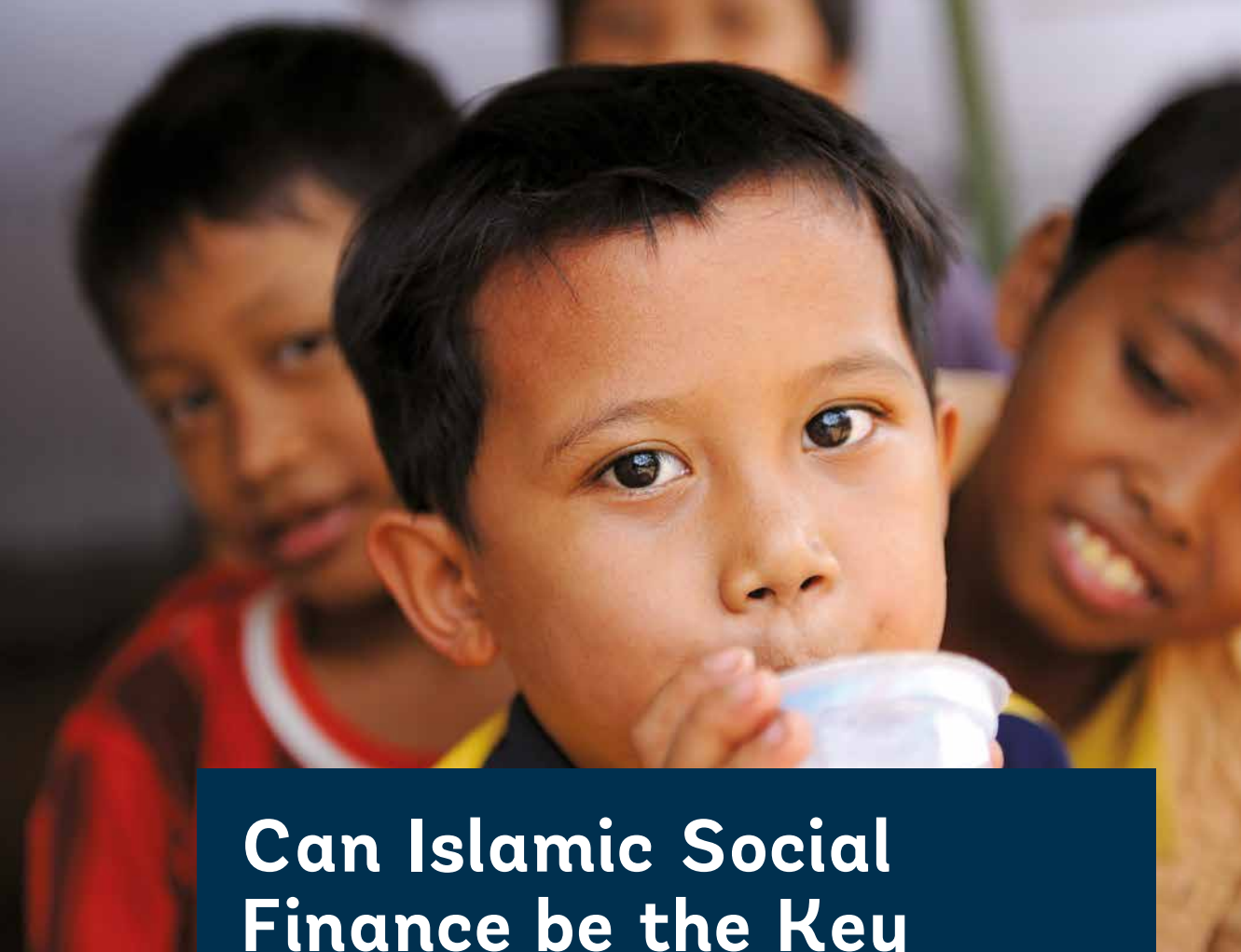
These reforms would consist of a combination of measures that vary in terms of their economic cost, technical complexity, and political difficulty. In addition to specific and well-grounded measures, for implementation to succeed, a formalization plan should explicitly state the costs and difficulty (procedural, budgetary, and political) of each reform; a timeline for their realization and potential effects; and the entities responsible for their execution, monitoring, and evaluation.

Formalizing the economy without losing the advantages of flexibility and employment is a task of epic proportions. It is, nonetheless, feasible provided policymakers possess sufficient expertise and, above all, political will. The long-term benefits of formalization for growth and prosperity can be vast and enduring.

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For the full report of *Informality: Why Is It So Widespread and How Can It Be Reduced?*, visit <http://bit.ly/RPBinformalitymy>

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# Can Islamic Social Finance be the Key to End Poverty and Hunger?

Ahmad Hafiz Abdul Aziz and Wei Zhang

As the world works toward achieving the Sustainable Development Goals, Islamic social finance provides new options to help mobilize these efforts, especially with regard to ending poverty and hunger.

In 2015, countries around the world adopted a set of goals to end poverty, protect the planet, and ensure prosperity for all as part of a new sustainable development agenda. Formulated on the principle that no one gets left behind, the Sustainable Development Goals (SDGs) has defined the world's priorities and aspirations for 2030.

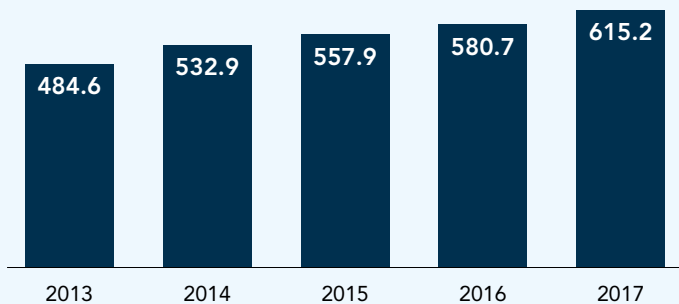
But to mobilize these efforts, we need to effectively uplift groups at the bottom where poverty plays a main obstacle. Although poverty levels have fallen dramatically since 2000, there are still 783 million people living below the international poverty line of \$1.90 a day. We may need more creative and effective solutions to end poverty. In the recent 4th Annual Symposium on Islamic Finance in Kuala Lumpur, we discussed how Islamic social finance might just be the key to alleviating poverty and hunger.

What we found was that Islamic social finance tools like *waqf* (Islamic endowment) and *zakat* (an obligatory contribution or poor due payable by all Muslims having wealth above *nisab* which is the threshold or exemption limit) can effectively support the SDGs if they are properly developed, managed and utilized with transparency, accountability and efficiency. Some of our key takeaways include:

**Islamic social finance tools such as *waqf* and *zakat* can be leveraged to bridge financing gaps**, and can also be used to create social safety nets. A clear example can be seen in Indonesia where a *zakat* fund of \$350,000.00 was used to finance the construction of a Micro Hydro Power Plant in Jambi, thus providing electricity for households, schools and clinics, benefiting at least 4,448 people directly and many more businesses and services indirectly.

Here in Malaysia, the *zakat* fund could be leveraged to alleviate urban child poverty and provide food to the poor. The key findings from the UNICEF report on Children Without, a study of urban child poverty in low-cost flats in the city showed how poverty impairs the access of children living in low-cost flats to early education and makes them more vulnerable to malnourishment. With 99.7% of children in low-cost flats living in relative poverty and

**Figure 7. Collection of Zakat in the Federal Territory, Malaysia (RM Million)**



Source: Annual Report 2017 Federal Territory Islamic Religious Council

another 7% in absolute poverty, this could have long-term impacts on the B40. At the moment, the majority of *zakat* is spent on redistribution to eligible recipients including poor and needy.

**Building affordable houses on *waqf* land for the bottom 40%** was recently mooted by the Malaysian federal government. Previously Saudi Arabia, Singapore and the state of Selangor in Malaysia allowed the development of *waqf* land by way of leasehold basis for commercial properties. This method uses the *waqf*'s principle of perpetuity, meaning that there is no transfer of ownership involved. This same method could be applied for affordable housing development in Malaysia to aid the B40 further.

**Harnessing financial technology (FinTech)** through blockchain technology (BCT) to monitor operations can provide more efficiency and transparency for Islamic social finance institutions. This could eliminate asymmetric information, fraud, and distrust between counterparties. BCT also reduces the ambiguity in the operations and business models of counterparty transactions and creates positive ripple effects throughout the entire supply chain.

**To address the issues associated with the distribution of Islamic social funds, a social smart card is a powerful tool** that can make it more effective. The Social Family Card in Egypt, Orphans and Vulnerable Children (OVC) Card and Hunger Safety Net Program in Kenya are among the examples of how the card can be used to facilitate cashless transactions, leverage citizen involvement in the banking/government sector and reduce fraudulent activities associated with cash handling.

**Blockchain technology has also been employed in the fight against hunger** such as the Building Blocks (BB) project led by the UN World Food Program (WFP) for Syrian Refugees camps in Jordan. The BB has benefitted more than 100,000 refugees to redeem WFP-provided assistance. With BB, the WFP has a full, in-house record of every transaction that occurs at that retailer, ensuring greater security and privacy for the Syrian refugees. It also allows for improved reconciliation and significant reduction of transaction fees. The BB has integrated UNHCR's existing biometric authentication technology that allows refugees to identify themselves with the blink of an eye.

These findings allow us to look at Islamic social finance as an option for policymakers to consider in efforts to achieve the SDGs. With technology playing a key role in implementation, this makes it more targeted and effective – an important move that we must take to lift people at the bottom of society from poverty, and end world hunger to ensure that no one is left behind.

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The 4th Annual Symposium on Islamic Finance was held on December 12-13, co-organized by the World Bank Group Global Knowledge and Research Hub in Malaysia, the Islamic Development Bank (IsDB) and the International Centre for Education in Islamic Finance (INCEIF).

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# Oral Democracy

Vijayendra Rao and Paromita Sanyal

**The challenges of electoral democracy are becoming increasingly visible worldwide.** Elite capture, corruption, and patronage are serious concerns, and the legitimacy of some elections has come under critical scrutiny. This has led to a revival of the idea of direct democracy – giving power directly to groups of people to make collective decisions.



Direct democracy is organized around the principle of deliberative decision-making which holds that the interests of diverse citizens can be represented by a process of discussion, debate, and dialogue that builds consensus. In the developing world, deliberative and participatory institutions have come into widespread use and have become centrally important. These institutions for citizen engagement have been viewed as a way to wrest power from elites and to hold them accountable, to harness the power of collective action, and to improve the efficiency and adaptability of development interventions.

But we know very little about how deliberation works in the real world. There is a large literature in political theory on democratic deliberation which sees it as ideally rooted in equality, rationality, and the free exchange and thoughtful argumentation of ideas. But these preconditions do not exist in most of the developing world, where communities are more likely characterized by low literacy, and high and persistent inequality in income, gender, and political power.

Our new book, **Oral Democracy: Deliberation in Rural India** sheds light on how real-world deliberation works in poor and unequal settings. It is an analysis of discourse within the largest deliberative institution in human history – the *gram sabha* (village meeting) in rural India, which affects the lives of 800 million people living in two million villages. These are constitutionally mandated open assemblies that constitute an integral part of a system of decentralized and participatory local government in India. They are ideal for understanding how institutionalized deliberation works at a very large scale.

We have analyzed and interpreted discussions in 300 *gram sabhas* from four South Indian states that were sampled within the framework of a natural experiment. Indian states were reorganized to make them linguistically homogenous in 1956, and we match villages that were “mistakes” – who speak the same language, and are a few kilometers away from each other, but located across different states. Linguists tell us that discourse should be similar between such “linguistic communities” that are marked by similarities in language, culture, social structure and geography. So, differences that we observe across these matched villages can be attributed to policy differences across states implemented after 1956. This design allows us to tease out the extent to which state policy influences the nature of discourse.

Our book takes readers deep into the heart of Indian democracy. Within the chapters readers will encounter citizens talking to the state – conversing and arguing with public officials and demanding accountability about village infrastructure and services, expressing their needs and demands, pleading for attention, critiquing the local government, and even directing sarcasm and scorn at elected leaders and public officials. Immersed in these state-citizen deliberations are two of our most important findings, one regarding the role of the state and the other concerning the necessity of literacy for a vibrant deliberative democracy.

We find that the quality of deliberation can be substantially influenced by state policy.

## States that prioritize citizen participation in local government have substantially better deliberative quality than states that de-emphasize local decentralization.

For instance, citizens exercise pressure for public accountability much more forcefully in states that play an active role in sharing information and mandating the presence of public officials from line departments. States that adopt a system of selecting government subsidy recipients through the *gram sabha* significantly improve the volume and quality of public deliberations.

By comparing nearby villages within a state, on the same side of the border but with different levels of literacy, we find that illiteracy does not hamper political discourse as much as it makes it haphazard. It is akin to a blindfold that denies people, who might otherwise have intrinsic oratory skills, from understanding the facts, the issues, and the politics of the *gram sabha* in a manner that allows them to be coherent participants in the discussion.

## As literacy increases, the discourse tends to become less noisy and far more knowledgeable on budgets and local government procedures, and citizens have more information about the various kinds of benefits that they can apply for.

But higher literacy does not always translate to a more effective *gram sabha*. The reason for this is state policy. States that have neglected local government show no difference in deliberative quality between less and more literate villages. This is because in such states citizens are what we call “passive petitioners” talking to an unresponsive government.

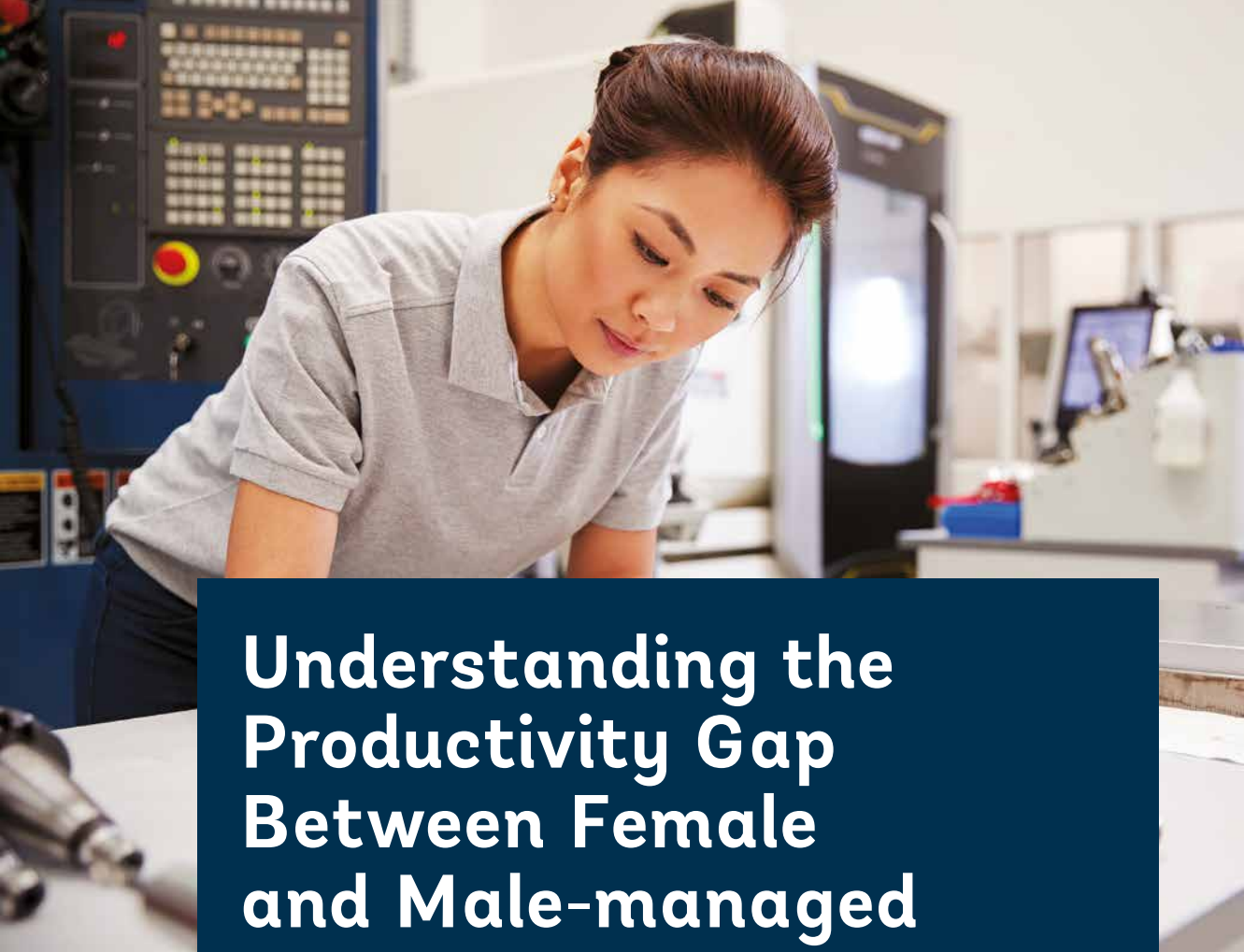
The voices of the poor are often not heard. Governmental systems devised to assist the poor focus on top-down poverty identification through definitions, biometrics, surveys, and measurements, over which people have little say. And programs to assist the poor are administered through opaque and difficult to navigate bureaucracies. *Gram sabhas* have the potential to change that by facilitating what we have termed “oral democracy”, a political system powered by citizens’ voices, where direct verbal engagement is the modality and narratives are the main currency.

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The article was first published on the World Bank’s *Let’s Talk Development* blog. To access the blog, visit [http://bit.ly/oraldemocracy\\_my](http://bit.ly/oraldemocracy_my)

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# Understanding the Productivity Gap Between Female and Male-managed Private Firms

Asif Islam, Amparo Palacios Lopez and Mohammad Amin

**Using firm-level survey data from World Bank's Enterprise Surveys for 128 developing countries, the difference in labor productivity between firms with a female versus male top manager has been analyzed.** Female-managed firms have 11 percent lower labor productivity than their male counterparts. Using the Oaxaca-Blinder decomposition technique, several factors that contribute to the narrowing and widening of the productivity gap between female-managed and male-managed firms have been highlighted. Factors such as firm-size, sector of activity, foreign ownership, protection against crime, having a generator, and age of the firm seem to make a significant contribution to the productivity gap.

There is a productivity gap between female-managed and male-managed or owned firms (henceforth, productivity gap), which is important for several reasons. First, women constitute about half of the world's population; hence, their contribution as top managers can have significant impact on the economies. Second, there is a lingering concern that much of the increase in women's employment over the last few decades is in low-paying and vulnerable jobs. Thus, women's performance in high-paying and influential positions as top managers of formal private firms is important for their occupational attainment.

A recent study focusing on the productivity gap in developing countries used data from a sample of over 46,000 private firms across 128 countries (mostly developing) collected by the World Bank's Enterprise Surveys. Throughout, a female-managed firm is defined as one where the main decision maker or the top manager is a female; a male-managed firm is likewise defined. Productivity is defined as annual sales of a firm (in 2009 constant USD) divided by the total of workers employed at the end of the year (that is, labor productivity).

The results indicate that productivity is approximately 11 percent lower among female-managed firms than among male-managed firms.

**The productivity gap remains large and statistically significant even after accounting for firm characteristics such as size, industry, exporting status, age of the firm, etc.**

It is also robust to country-specific characteristics such as size and development. The productivity gap is large and statistically significant for firms of all sizes, whether small (5-19 employees), medium (20-99 employees) or large (100+ employees); a similar result holds for manufacturing and other services sectors. In the retail sector, however, the productivity gap becomes statistically insignificant.

To understand the gap, a statistical tool known as the Oaxaca-Blinder decomposition is used. A decomposition analysis allows for the study of the contributions of various factors to the productivity gap. However, the decomposition cannot establish whether the relationships are causal. To this end, the productivity gap is decomposed into an endowment effect and a structural effect. The endowment effect refers to the attributes or incidence of certain factors experienced by the firm, whereas the structural effect refers to the returns to these attributes or factors.

## **Endowment effects**

Female-managed firms are about two years younger than male-managed firms, and this leads to the widening of the productivity gap by 8 percent. Female-managed firms are much smaller



than male-managed firms (26 versus 45 employees). Regressions analysis indicates that firm size is inversely related to labor productivity. This smaller size of female-managed firms contributes to a 22 percent narrowing of the productivity gap.

Foreign ownership has a positive relationship with labor productivity. On average, 9 percent of female-managed firms have foreign ownership, in contrast to 12 percent of male-managed firms. The lower foreign ownership in female-managed firms contributes to a 12 percent widening of the labor productivity gap. This is the second biggest contributor in terms of endowments that increase the gap. Similarly, the proportion of female-managed firms with their own websites is slightly lower than the corresponding proportion of male-managed firms. This contributes to an 8 percent widening of the labor productivity gap between female-managed and male-managed firms.

The ability of a firm to protect itself against crime and to buffer the effects of power outages are important ways to safeguard firm productivity.

Female-managed firms are less likely to pay for security, which is associated with widening of the productivity gap by 6 percent. The implication is that female-managed firms are unable to pay for security services or may view such payments as ineffective in reducing crime, a likely factor in lowering their productivity. Female-managed firms are also less likely to use generators which is associated with a 13 percent widening of the productivity gap.

Female-managed firms are more likely to be in the retail sector than male-managed firms. This is associated with a large narrowing of the productivity gap by 55 percent, given that labor productivity is higher in the retail sector relative to other sectors.



## Structural effects

The only statistically-significant structural contribution to the gender gap is the sector of the firm. Female-managed firms achieve higher returns in the retail sector than male-managed firms, and this leads to a 34 percent narrowing of the productivity gap. Female-managed firms are hence not only disproportionately represented in the retail sector, but also achieve higher returns than male-managed firms in the sector. Female-managed firms are also able to take advantage of being in service sectors (other than retail), which contributes to a 72 percent narrowing of the labor productivity gap. Thus, the service sector (retail plus other services) contributes to narrowing the productivity gap by 106 percent via the structural effect.

## The next step forward

It is important to note that these results essentially focus on a few firm characteristics as factors that drive the productivity gap. However, much of the productivity gap seems to be driven by country-specific factors (country fixed effects) and other factors not accounted for. Understanding these sources of productivity gap remains an important task for future research.

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For the full report of *The Labor Productivity Gap Between Female And Male-Managed Firms In The Formal Private Sector*, visit <http://bit.ly/FMproductivitygap>

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An illustration featuring a blue background with a world map and a network of white lines. Various financial symbols are scattered across the scene: a green one-dollar bill, a white one-dollar bill, a blue 100 Euro bill, and several gold coins with dollar signs. Hands are shown interacting with these elements: one hand points at a coin, another holds a coin, and a third is near a laptop keyboard. There are also some charts and documents floating in the air.

# Fiscal Space: Concept, Measurement, and Policy Implications

Ayhan Kose, Franziska Ohnsorge and Naotaka Sugawara

**Effective fiscal policy depends on the amount of budget resources available to raise spending or lower taxes without jeopardizing fiscal sustainability, or ‘fiscal space’.** Fiscal space can be broadly grouped into four dimensions: government debt sustainability, balance sheet composition, external and private sector debt, and market perception of sovereign risk. Since the global financial crisis (GFC), fiscal space in emerging market and developing economies has narrowed. This makes these economies more vulnerable to sudden spikes in financing costs and limits their ability to counteract adverse shocks. Both policy measures and institutional mechanisms are critical in improving fiscal space.

## Defining fiscal space

Governments in emerging market and developing economies (EMDEs) are likely to face rising costs of financing deficits and rolling over debt, as interest rates increase and global financing conditions tighten. Countries with large external liabilities could even suffer sharp movements in capital flows and exchange rates. This would generate financial stability risks and dampen output growth.

In many EMDEs, public sector vulnerabilities to spikes in financing cost have risen since the global financial crisis. On average, public debt levels have increased and sovereign credit quality has deteriorated. This may limit the budgetary resources available for governments to stimulate activity and strengthen safety nets. At the same time, it may restrict governments' fiscal space.

Debt service capacity is a critical component of fiscal space. Its multiple dimensions include financing needs related to budget positions and debt rollover, access to liquid markets, resilience to changes in market valuations of debt, and the coverage of contingent liabilities. While loss of market access and vulnerability to changes in valuation can severely constrain debt service capacity in the short run, persistent deficits and growing contingent liabilities can erode it in the medium to long run.

A higher share of nonresident holdings of government debt may imply liquidity risk as well as currency risk in the event of losses of confidence among foreign investors. A high share of foreign-currency debt could raise exchange rate risk, while a high share of short-term debt could raise rollover risks. Debt principal coming due at maturity often constitutes an important portion of an economy's upcoming financing needs, and a bunching of maturities can constrain fiscal space. External and private sector debt could be a source of contingent liabilities. Market participants' perceptions of sovereign risk reflect and, in turn, influence an economy's ability to tap markets and service its obligations.

**Given this, fiscal space can function as an essential instrument of macroeconomic risk management.**

## Measuring fiscal space

No database had systematically brought together different aspects of fiscal space until the release of the cross-country database by Kose et al. (2017). This periodically-updated database covers 41 advanced economies and 159 EMDEs, and focuses on the most extensively discussed and relevant measures of debt service capacity. In order to ensure data quality, consistency, and comparability across countries, most series are obtained from cross-country sources.

The database covers the four dimensions of fiscal space with 28 indicators: 12 indicators for government debt sustainability; six indicators for the balance sheet composition; eight for external and private sector debt; and two for market perception.

**Government debt sustainability** captures the longer-term capacity of the government to finance its obligations. Indicators include general government debt, fiscal balances, and sustainability gaps. Sustainability gaps are measures that compare a country's fiscal balance with the balance that stabilizes government debt at a target level under different assumptions of output growth and long-term interest rates.

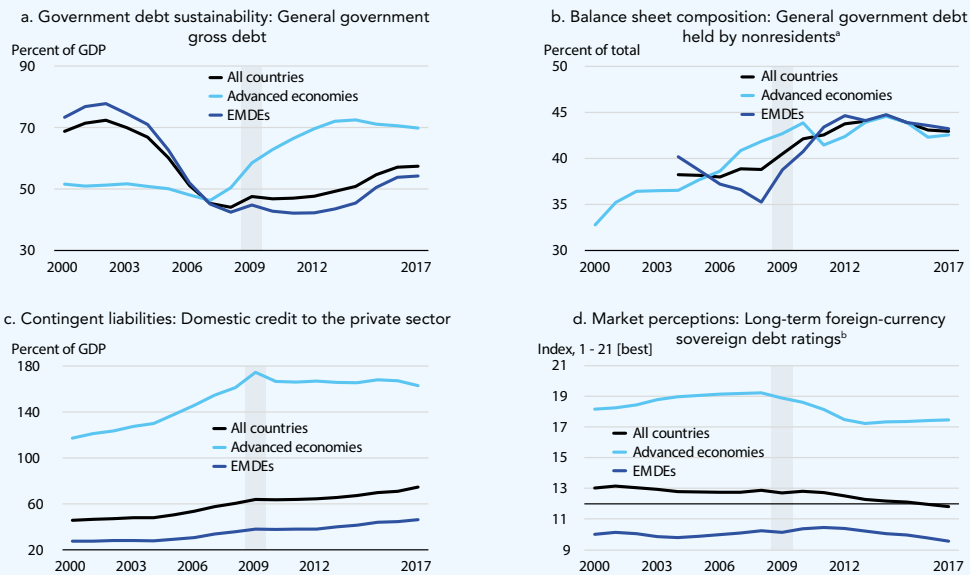
**Balance sheet composition** – such as by sources of funding, currency structure, and maturity profile – determines exposures to the risks of a sudden change in financial market conditions. Indicators in this category include the average maturity of sovereign debt, as well as the share of government debt denominated in foreign currency, held by nonresidents, held on concessional terms, or maturing in 12 months or less.

**Contingent liabilities** may eventually arise from private sector debt, both domestic and external, if explicitly or implicitly guaranteed by governments. These guarantees would force governments to assume private liabilities in the event of the failure of the borrower. The costs associated with such interventions would rise with the overall size of private sector obligations, and maturity or currency mismatches. To capture these risks, the database includes total external debt, private external debt, short-term external debt, external debt in foreign currency, and domestic credit to the private sector.

**Market perception** of sovereign risks reflects an economy's ability to tap markets and service its obligations, and measures investor sentiment about sovereign credit risks and borrowing costs in the market. Indicators in this group include the five-year sovereign credit default swap (CDS) spread and foreign-currency long-term sovereign debt ratings by major international rating agencies.



**Figure 8. Four measures of fiscal space since 2000**



Source: Kose et al. 2017.

Note: Simple averages. The year of global recession (2009) is shaded in gray. One representative indicator from each of the four dimension of fiscal space in Kose et al. (2017) is chosen, partly because of the data availability. However, the overall trend is shared by other indicators in each of four dimensions of fiscal space. Kose et al. (2017) present further details. EMDEs = emerging market and developing economies.

a. Data are not presented in some years because the sample size is smaller than in the other years.

b. The sovereign debt ratings are converted to a numerical scale ranging from 1 to 21 (higher, better rating). The horizontal line at an index value of 12 is the border between investment grade (above the line) and non-investment grade (below the line).

## The evolution of fiscal space over time

Fiscal space improved during 2000-07, but has shrunk around the world since the global financial crisis. The improving trend before the crisis was widely shared; however, after the crisis, debt sustainability indicators, including government debt and fiscal sustainability gaps, have deteriorated in at least three-quarters of countries in the world. External and private debt stocks have also increased in more than half of all countries, and perceptions of market participants on sovereign credit risks have worsened.

Since 2011, fiscal space has shrunk in EMDEs. Partly as a result of steep revenue losses in commodity-exporting EMDEs, sustainability gaps and fiscal deficits widened to 3% to 5% of GDP in 2016, on average, with some improvements in 2017. Government debt has risen to 54% of GDP, on average, in 2017. It now exceeds 2000 levels in more than one-third of EMDEs.

External and private sector debt have increased from 2007 levels in the majority of EMDEs. A rapid increase in private sector credit, especially for corporates, since the global financial



crisis has been accompanied by weaker solvency and profitability. Reflecting deteriorating debt sustainability, balance sheet risks and credit ratings of EMDEs have somewhat worsened on average.

## Fiscal space improvement

**Policy measures** to shore up fiscal sustainability have become a priority as fiscal space has deteriorated since the global financial crisis.

Fiscal sustainability could be improved by increasing revenue collection and spending efficiency. Measures to strengthen revenue collection could include broadening tax bases to remove loopholes for higher-income households or profitable corporates. In countries with high levels of informality, taxing the informal sector could help raise revenues directly, as well as indirectly, by encouraging informal firms to join the formal sector with better growth prospects. In EMDEs, reforms to broaden revenue bases and strengthen tax administration can generate revenue gains.

On the spending side, governments can consider shifting the reallocation of expenditures toward more growth-enhancing or better-targeted ones, such as investment or means-tested income support. Increases in the spending composition of infrastructure and education projects could have long-term gains in the economy. Pension reforms could also support fiscal credibility and generate long-term fiscal gains with limited short-term impact on growth.

**Meanwhile, credible and well-designed institutional mechanisms can help support fiscal discipline and strengthen fiscal space.**

These include fiscal rules, stabilization funds, and medium-term expenditure frameworks.

**Fiscal rules** impose numerical constraints on budgetary aggregates – debt, overall balance, expenditures, or revenues. Rules often allow for flexibility in meeting budget targets by taking into account temporary cyclical deviations or structural adjustments. They have become increasingly popular in EMDEs, especially since the global financial crisis. Implementation of balanced budget rules can be improved by a well-designed framework, a simple enforcement structure without any off-budget government guarantees, flexibility, transparency, and support by surveillance arrangements.

**Stabilization funds** set aside receipts from natural resource revenues during favorable times, which are released to cushion potential revenue shortfalls and mitigate government expenditure shocks. Many stabilization funds are integrated with the budget, with clear rules to guide the accumulation and withdrawal of fund resources. The effective use of stabilization funds requires government commitment to fiscal discipline and macroeconomic management. Proper

designs and strong institutional environments that support their operations are crucial factors for their success.

Medium-term expenditure frameworks are intended to establish or improve credibility in the budgetary process. The frameworks seek to ensure a transparent budgetary process, where government agencies allocate public resources based on strategic priorities. Robust implementation is closely related to linkages with broader economic and social policy objectives and the forecasting capability based on reliable data.

## **Concluding remarks**

Given tightening global financing conditions, EMDEs need to maintain the necessary fiscal space to counteract cyclical downturns or unexpected shocks as natural disasters and heightened risks of violence. Fiscal space is a complex and multi-dimensional concept, and therefore, needs to be captured from different directions.

Fiscal space has been shrinking in EMDEs since the global financial crisis. Strengthening fiscal space requires well-designed policy frameworks with clear and broad objectives and, most importantly, strong commitments of policymakers in each country.

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For the full report of *Fiscal Space: Concept, Measurement, and Policy Implications*, visit <http://bit.ly/RPBfp>

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# Good or Bad? Making Sense of the Current Account Balance

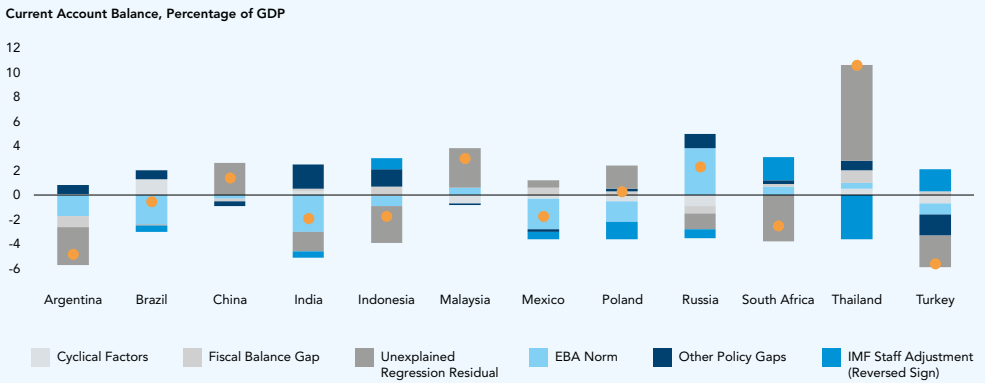
Sharmila Devadas and Norman Loayza

**On the surface, a current account surplus seems to have many more positive implications than a current account deficit, with the latter raising greater fears of illiquidity and insolvency than the former.** However, depending on what drives the balance, a deficit may not necessarily be a bad thing. Similarly, a surplus does not necessarily imply that all is well in an economy, despite its suggestion of a stronger net foreign assets (NFA) position. In addition, whether in deficit or surplus, the current account balance may not in itself be sufficient to indicate near-term financial vulnerabilities. What matters for macroeconomic stability is that the external position (including the current account and gross foreign flows and stocks) is sustainable, without the risk of drastic disruptions or the need for sharp policy adjustments in response to domestic or external shocks.

The underlying drivers of current account balances include economic and demographic characteristics that imply a benchmark for normal balances. Other drivers include the institutional environment and government policies that may mitigate or exacerbate a departure from the benchmark. A current account deficit may be an optimal response, given a country's fundamentals that cut across its level of income and stage of development, demographics, trade, and financial characteristics. Some of these may signal strength, indicating the potential for future increases in output. For example, at an early stage of an economy's development, higher average output growth or productivity, faster population growth (resulting in a higher youth dependency ratio), low terms-of-trade volatility, and financial deepening are associated with higher deficits. A deficit may also be an optimal response to cyclical conditions, particularly conditions characterized by a positive output gap and a negative terms-of-trade shock. On the other hand, in terms of policy settings, a deficit that coincides with relatively large budget deficits, exchange rate overvaluation (which may be due to interventions that prevent the exchange rate from serving as an effective shock absorber), and excessive credit growth imply the risk of over-consumption and over-investment.



**Figure 9. Decomposing the sources of current account balances**



Source: Authors' illustration based on data from IMF (2018). See IMF (2018) for further details on the External Balance Assessment (EBA).

EBA model-based gap = Policy gaps + Unexplained regression residual  
 = Actual current account deficit - Cyclical factors - EBA norm

EBA norm comprises fundamentals and desirable policies. Fundamentals include productivity and expected growth, demographics, initial NFA, oil and natural gas net exports, and institutional/political environment.

Cyclical factors = output gap and commodity terms of trade gap.

Policy gaps = the differences between actual and desirable policies. Fiscal balance gap = the difference between current cyclically adjusted fiscal balance and one desirable in the future at full employment.

Other policy gaps are for public expenditure on health (versus benchmark), foreign exchange intervention (against 0, or non-zero if deemed necessary to reach reserves adequacy), the private credit-to-GDP ratio (deviation from detrended value), and capital controls (against cross-country average or own level, whichever is lower).

IMF staff adjustment = outside-the-model adjustments for special factors such as high mortality risk (South Africa) and high political uncertainty (Thailand). A negative (positive) value implies a negative (positive) EBA model-based gap.

The results of the IMF's External Balance Assessment (EBA) provide a basis to determine the level of excesses in current account balances and their source.<sup>1</sup> However, the explanatory power of the regression model works better for some countries than others. For some deficit countries (e.g. Brazil, India, and Mexico), estimated norms established a deficit that was in excess of their actual deficit, given their lower income, higher growth potential, and faster population growth, thus resulting in no overall excesses. Though Malaysia's current account surplus has narrowed since 2010 to 3 percent of GDP in 2017, much of the surplus cannot be adequately explained by the EBA model, potentially reflecting country-specific factors that contribute to relatively high savings and low levels of investment. In terms of identified policy gaps, the low level of public healthcare spending explained a small portion of the excess saving and current account surplus. Product market regulations, which could hinder investment, also accounted for some of the unexplained gap. The model also did not explain much of Thailand's current account surplus, which stood at 10.6 percent of GDP. An excessively tight fiscal stance and high level of foreign exchange intervention contributed to identified policy gaps, with the IMF assessment finding that the unexplained gap was partially related to political uncertainty and

<sup>1</sup> The model-based estimation of excessive current account balances is provided by the sum of policy gaps, which is a normative assessment of actual policies against desirable policies, and an unexplained gap (regression residuals) after accounting for current account 'norms' (reflecting fundamentals, the institutional environment, and policies set at desirable levels) and cyclical factors.



a temporary tourism boom. Both factors would have led to higher savings. Consistent with assessed current account excess surpluses, both Malaysia and Thailand showed some signs that their real effective exchange rates were undervalued, despite the fact that these exchange rates had appreciated in 2017.

Even if drivers of current account balances can be identified, they remain insufficiently informative about the immediate risks to financial stability. Financial liabilities that are more stable (such as foreign direct investment (FDI)), that foster greater automatic risk sharing (such as equity), or that correspond to investors with a longer time horizon limits the fallout from a negative domestic shock and reduces the probability of contagion from an external shock (Forbes 2013). For instance, while Argentina and Turkey were identified as having large excess current account deficits with some policy gaps, both have been especially vulnerable in recent times given the high share of short-term foreign liabilities in their net international investment positions (NIIPs) (IMF 2018). The balance sheets of different sectors also matter. Aggregate NFA may hide imbalances across different sectors. For example, despite previously having current account surpluses, the Republic of Korea was badly affected during the global financial crisis. Banks and corporates with high levels of external debt and negative net positions were hit by large financial outflows and sharp exchange rate depreciation. More than half of Malaysia's external debt is of medium-to-long-term maturities, limiting rollover risk. Foreign-currency denominated debt, which accounts for two-thirds of external debt, is mainly held by banks and corporations and is subject to the Central Bank of Malaysia's prudential requirements and external debt approval framework respectively. Banks also have substantial external assets that can be drawn upon to meet their short-term external debt obligations.

Perceived vulnerabilities are undoubtedly greater for deficit countries. Deficits are used to proxy reliance on foreign borrowing and exposure to shifts in sentiment, especially when foreign exchange reserves are relatively low. Sound policies and institutional features can go a long way to attracting and sustaining a healthy demand for domestic assets.

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## BOX 4

# Malaysia's New Policy Priorities - Highlights from the Mid-term Review of the 11th Malaysia Plan

Malaysia Country Team



On October 18, 2018, the government tabled the Mid-term Review of the 11th Malaysia Plan (11MP) with this review outlining updated policy directions for the remaining two years of the plan. The report consists of two distinct parts: Part I, which reviews the performance of the Plan's six strategic thrusts in 2016 and 2017 under the previous government; and Part II, which outlines the government's new policy directions in six pillars. These newly defined pillars and the order in which they are prioritized reflects the priorities of the government: (i) reforming governance towards greater transparency and enhancing efficiency of public service; (ii) enhancing inclusive development and wellbeing; (iii) pursuing balanced regional development; (iv) empowering human capital; (v) enhancing environmental sustainability through green growth; and (vi) strengthening economic growth.

Overall, the updated policy framework outlined in Part II covers most of the key policy areas and highlights the institutional reforms that will be required to facilitate the fulfilment of Malaysia's aspirations to achieve sustainable and equitable growth. The updated policy framework continues to emphasize some of the themes of the earlier 11MP, including the emphasis on inclusive wellbeing, human capital development, and green growth. The key difference in the updated framework is the inclusion of pillars on governance reforms and on balancing regional development.

The inclusion of the new pillar on "Reforming governance towards greater transparency and enhancing efficiency of public service" signals the government's commitment and political will to reform the public sector. In the context of concerns regarding Malaysia's public finance management and widespread public dissatisfaction with public service delivery and

political systems, the prominent inclusion of this pillar communicates the government's strong commitment to addressing these concerns and its awareness of the challenges that currently impede reform. Under this pillar, reforms are categorized into four priority areas that aim to improve governance at all levels; to elevate integrity and accountability; to enforce prudent public finance management; and to enhance public service delivery.

Another newly included pillar is "Pursuing balanced regional development", which signals the government's commitment to reducing developmental imbalances across states and between urban and rural areas. Although the earlier 11MP outlined measures to further develop the regional economic corridors, this new pillar contains more comprehensive measures to better spread socioeconomic benefits across states and to promote equitable growth, particularly in less-developed states such as Sarawak, Sabah, Kedah, Kelantan, Terengganu, and Perlis. The inclusion of this pillar is encouraging, signaling the government's commitment to establishing stronger linkages between urban and rural areas and between leading and lagging regions, which will help to boost inclusive economic growth and development across Malaysia.

In addition, the review has an updated framework on "Empowering human capital." This pillar on human capital remains a high priority for the government, as it is crucial for Malaysia's transition to an inclusive, high-income economy. This updated pillar places emphasis in fostering stronger linkages with industry and academia, enhancing access to quality education and skills training, reforming the labor market and improving labor efficiency and productivity. Skilled individuals contribute significantly to economic growth through direct channels, such as technology and design innovations, but also indirectly, through coordination and guidance of the actions of others. The transition to a developed economy requires systematic investment in human capital. Recent research shows that human capital is a necessary pre-condition to make other investments work, and that the marginal returns from investment in human capital are 40 percent higher than investment in R&D.

On the whole, the review is comprehensive in scope, providing useful insights into the government's future social and economic policy directions. It also contains a candid assessment of the limitations of past policy design and implementation. However, by its nature, the document focuses on higher-level, broad strategic measures, rather than defining specific implementation details. This is understandable, given the short time frame that the new government had to develop the review. The prioritization of policies and programs under each of the pillars and more detailed information to guide ministries and agencies are likely to be formulated in the coming months, as the government determines more specifically the implementation of the Plan's reform measures.

In addition, some of the more ambitious reforms and strategies outlined in the review may require more time for completion, beyond the remaining period of the 2018-2020 plan. Given this possible outcome, it would be useful to formulate an assessment of the implementation capacity and risks, and to commit to the conduct of an interim review to signal the government's commitment towards the achievement of the reforms outlined under the new pillars. The use of intermediate outcome indicators or milestones could also enable the public to better understand and anticipate how the Plan's targets will be achieved at various stages of implementation and to hold institutions to account.

**TABLE 1**  
**New priorities and emphases for 2018-2020, selected highlights**

<p><b>PILLAR 1</b>  <b>Reforming Governance Towards Greater Transparency and Enhancing Efficiency of Public Services</b></p>	<ul style="list-style-type: none"> <li>• Enforcement of a two-term limit for the positions of Prime Minister, Chief Minister, and Menteri Besar to prevent the abuse of power.</li> <li>• Review and streamlining of the role of state-owned enterprises and monopoly entities to promote market efficiency and healthy competition.</li> <li>• Decentralization of some functions, including public transport, social services, and environmental protection to empower state governments.</li> <li>• Lowering of the voting age limit to 18 years and the introduction of a legislation on political financing.</li> <li>• Transformation of the MACC into a full independent body, accompanied by a review of the MACC Act 2009, the Witness Protection Act 2009, and the Whistleblower Protection Act 2010 to strengthen anti-corruption legislation.</li> </ul>
<p><b>PILLAR 2</b>  <b>Enhancing Inclusive Development and Wellbeing</b></p>	<ul style="list-style-type: none"> <li>• A target of 200,000 units of affordable houses set to be built through promotion of greater private sector participation, and the establishment of a National Affordable Housing Council to coordinate the management of public affordable housing.</li> <li>• Formulation of a national health policy aimed at increasing human capital capacity and healthcare facilities.</li> <li>• Construction of a new cancer center in the northern region, and a national center for disease control and prevention in Negeri Sembilan to detect, prevent, and overcome disease threats.</li> <li>• Formulation of an action plan to increase public awareness on mental health.</li> </ul>
<p><b>PILLAR 3</b>  <b>Pursuing Balanced Regional Development</b></p>	<ul style="list-style-type: none"> <li>• Building and upgrading of 1,500 kilometers of rural roads.</li> <li>• Expansion of access to clean and treated water supply for 60,000 additional homes, and extension of electricity supply to 41,160 additional homes.</li> <li>• Construction of 300 new telecommunication towers and upgrading of 1,000 existing towers to widen coverage and improve broadband quality.</li> <li>• Provision of a fair share of oil and gas revenues to Sabah and Sarawak in accordance with prevailing laws, and the establishment of a Special Cabinet Committee to review and monitor the proper implementation of the Malaysia Agreement 1963.</li> </ul>
<p><b>PILLAR 4</b>  <b>Empowering Human Capital</b></p>	<ul style="list-style-type: none"> <li>• Standardization of the monthly minimum wage at RM1,050 (subsequently adjusted to RM1,100) nationwide, effective January 1, 2019.</li> <li>• Review of labor laws and implementation of a comprehensive Employment Insurance System to enhance workers' rights.</li> <li>• Review of both the Malaysia Education Blueprints, and replacement of the Universities and University Colleges Act 1971 with an improved legislation towards ensuring academic liberty as well as freedom of speech and association.</li> </ul>
<p><b>PILLAR 5</b>  <b>Enhancing Environmental Sustainability Through Green Growth</b></p>	<ul style="list-style-type: none"> <li>• Increased gazettement of terrestrial, inland water, coastal, and marine protected areas.</li> <li>• Increased contribution of renewable energy in electricity generation to reduce dependency on fossil fuels.</li> <li>• Integration of disaster risk reduction measures into planning and development to strengthen disaster risk management capability.</li> <li>• Development of an integrated system for weather and flood forecasting as well as early warning for floods to increase disaster preparedness.</li> </ul>
<p><b>PILLAR 6</b>  <b>Strengthening Economic Growth</b></p>	<ul style="list-style-type: none"> <li>• New target to increase SMEs' contribution to GDP to 41 percent by 2020.</li> <li>• Formulation of a national policy framework for the Fourth Industrial Revolution to promote innovation, creativity, and competitiveness.</li> <li>• Upgrading of existing plants and construction of new plants to improve water supply services to states with low reserve margins.</li> <li>• Construction of new power plants to be undertaken through competitive bidding.</li> </ul>

Source: Mid-Term Review of the 11th Malaysia Plan (2016-2020)

A woman with glasses and a dark blazer over a white shirt is smiling and holding a silver award. The award is a circular plaque with an ornate, floral-patterned border. The center of the plaque features the World Bank Group logo and the text "Sundaran Memorial Prize Malaysia Researchers". Behind her is a blue and white banner with the World Bank Group logo and the text "WORLD BANK GROUP".

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## The Sundaran Memorial Prize for Young Malaysian Researchers 2018-19

To promote high quality and relevant research, the World Bank Development Research Group based in Kuala Lumpur awards a prize for the best academic paper on economics and related social sciences by an early-career Malaysian national. The Sundaran Memorial Prize for Young Malaysian Researchers 2018-19 was awarded to Dr. Wong Woan Foong for her paper "The Round Trip Effect: Endogenous Transport Costs and International Trade." Dr. Wong's paper found that once transport costs are recognized to change according to market conditions, exports and imports become closely linked through cost-related spillovers. Hence, protectionist policies can backfire, increasing rather than balancing a trade deficit.



The Sundaran Memorial Prize is named after the late Dr. Sundaran, who was Director of National Strategy of the Malaysian Ministry of Finance. He was also a former Executive Director of the Board of the World Bank Group, whose efforts, vision, and support fundamentally contributed to make the World Bank Knowledge and Research Hub in Malaysia a reality.

Open to all Malaysian nationals younger than 40 years of age who are working on their doctoral studies or have received their doctorate degree within the last five years, the prize's winners have demonstrated excellence in research, while addressing in clear and compelling ways a key development policy issue. The first award was conferred in 2016 to Boon Hwa Tng (Bank Negara Malaysia), with Dr. Wong Woan Foong being the second winner. The jury for the 2018-19 prize was composed of Norman Loayza and Vijayendra Rao, lead economists in the Development Research Group of the World Bank.

## About Dr. Wong Woan Foong

Dr. Wong Woan Foong is Assistant Professor of Economics at the University of Oregon. She specializes in international trade, particularly the factors that impede and facilitate trade flows. Her current research focuses on the role that container transportation plays in influencing international trade, the economics of the rules and regulations of preferential trade agreements as embodied in the World Trade Organization, and the impact of resource misallocation on trade liberalization outcomes.

Dr. Wong completed her dual Bachelor's degrees in Economics and Music Composition at Oberlin College and Conservatory of Music, as well as earned her Master's and Ph.D. degrees in Economics from the University of Wisconsin-Madison. Prior to graduate school, she was a Research Analyst at the Peterson Institute for International Economics.

**Dr. Wong's work is on understanding how trade costs are affected by transportation, especially in the mechanics of international trade and the interdependencies this creates.**

As a policymaker looking to impose tariffs, there are many potential spillovers that should be considered.

Dr. Wong had presented her paper during a seminar at the Hub in Malaysia a few years ago. According to her, lecturing at the University of Oregon has been a good avenue to open discussions with students on her research agenda and to get them interested in pursuing research as a whole.

## Research Findings

Using cutting-edge economic theory and applying econometrics on a novel data set, Dr. Wong studied the implications of transport costs for international trade outcomes and policies.

**The initial insight of Dr. Wong's paper was that transport costs are not only determined by distance or infrastructure, but also by the relative demands of traded goods across countries and by the strategies of transport carriers.**

One of these strategies is that carriers often make round trips between a few destinations. When goods are moved from the US to China, for example, the ship carrying these goods ended up going back-and-forth between the two countries. Being endogenously determined and driven by round trips, transport costs can then affect the outcome of demand and supply shocks on exports and imports. Moreover, they can also influence the outcome of trade policy, as they create interesting interdependencies between countries in ways not normally thought of.

Dr. Wong presented a theoretical model that matched key features on transport costs and trade outcomes in the data. One of her predictions was that the round-trip effect mitigates shocks on a country's trade and generates spillovers from exports to imports, and vice versa. Dr. Wong then used her model to study the effect of trade policies, with insightful policy implications.

While tariffs are not normally seen as the most efficient way of dealing with international trade, this round-trip effect is another channel of consideration for policymakers. The paper showed that an increase in import tariffs (introduced to purportedly protect national producers and revert a trade deficit) can be counterproductive – although imports would be reduced, exports could go down even more because of a proportionally larger rise in export transport costs. The paper then provides one more reason to avoid trade protectionism.



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