Foreword

This first OECD Investment Policy Review of Malaysia *presents an assessment of the investment climate in Malaysia, including the institutional and legislative framework for investment. Undertaken in partnership with the Secretariat of the Association of Southeast Asian Nations (ASEAN) it illustrates the growing ties between the OECD and Malaysia, and Southeast Asia as a region.*

The Review *uses the Policy Framework for Investment to chart the investment-related reforms undertaken in Malaysia that have contributed to its economic success. It describes the major role foreign direct investment has played in the growth and diversification of the economy, within an outward-oriented development strategy. Today, Malaysia is a net outward investor, with its companies increasingly becoming regional and global players. The* Review *also highlights ways to address inter-related challenges Malaysia faces in further opening up the economy and in making its regulations more efficient as the country strives to attain developed country status by 2020.*

The Review *is based on a background report that facilitated a review by the OECD Investment Committee of Malaysia's investment policies in December 2012. The Malaysian delegation was led by the Secretary General of the Ministry of International Trade and Industry, Dr. Rebecca Fatima Sta Maria. An early draft of the report was also discussed at a stakeholders' workshop organised by the Government of Malaysia in October 2012 in Kuala Lumpur, with the participation of a wide range of government agencies, the private sector, civil society and OECD delegations.*

The Review *has been prepared by the Investment Division of the OECD Directorate for Financial and Enterprise Affairs. The team comprised Stephen Thomsen, Mike Pfister, Fernando Mistura, Hélène François, Cristina Tébar Less, Dambudzo Muzenda and Mi-Hyun Bang. Secretariat inputs were received from the Financial and Corporate Affairs Divisions. The* Review *was supported by the ASEAN-Australia-New Zealand Free Trade Agreement Economic Cooperation Support Programme (AECSP) and by the Government of Japan.*

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Preface by Dato' Sri Mustapa Mohamed, Minister of International Trade and Industry, Malaysia

Malaysia is an open economy with trade accounting 174.3% of the GDP in 2012. As a result Malaysia is highly-exposed to developments in the global economy. Given the current global scenario, strengthening domestic demand would continue to be the key focus in driving growth.

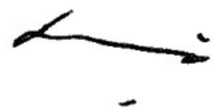
Our aim is to ensure that the development and growth of the economy contribute to improvements in the lives of all Malaysians and provide a sustainable environment for the future. It's against this backdrop that Malaysia continues to undertake reforms and reinvent itself in the pursuit of moving from a middle income economy to an advanced nation status by 2020 by attaining a per capita income of US 15 000, while maintaining the principles of sustainability and inclusiveness.

In pursuit of the transformation agenda, we will focus on:

- Promoting investments both domestic and foreign in high value added activities and niche areas;
- Liberalizing the services sector and promoting the development of key sectors in order to enhance its contribution to the economy;
- Creating an environment for innovation, research and development;
- Reducing regulatory barriers in order to improve the environment for businesses;
- Enhancing entrepreneurial skills and promoting the development of SMEs;
- Attracting skilled talent from abroad to sustain growth of a knowledge-based and innovative economy; and
- Promoting regional growth and inclusiveness.

Going forward, creating strong, sustainable and balanced growth would be underpinned by productivity improvements and innovation, enabling the transition into a higher value-added and higher income economy. Malaysia will also leverage on new opportunities in the changing global landscape, as exports remain key to the Malaysian economy. Towards this end, Malaysia will promote investment in key strategic sectors to ensure it is positioned strategically to take advantage of opportunities in new export markets, the global supply chain as well in capitalising on global and regional growth centres.

In this light, the co-operation with the OECD in undertaking the first *Investment Policy Review of Malaysia* is a timely initiative to support the government in achieving its objectives.



Dato' Sri Mustapa Mohamed
Minister of International Trade and Industry, Malaysia

Preface by Angel Gurría, Secretary-General, OECD

Malaysia's economic performance during the last half century has been impressive. From an agricultural economy in the 1950s, the country has now built global competitiveness in high-end manufacturing and is pushing out its technology frontier, an immediate goal of its national vision. This performance is the result of a sustained commitment to improving the business climate. Malaysia is attracting record levels of foreign investment and its companies are becoming increasingly global. The country is also shaping the regional dialogue on numerous policy fronts, from corporate governance to science and technology. These have brought Malaysia closer to the OECD policy community, with co-operation progressing beyond investment policy to areas such as competition, anti-corruption, regulatory reform, global value chains and innovation.

This first *OECD Investment Policy Review of Malaysia* supports the government in its ambitious reform path towards strong growth and greater prosperity. While the *Review* describes Malaysian efforts to make investment policies more open, transparent and non-discriminatory, it also recognises the important steps taken in tackling challenges linked to corporate governance and in promoting responsible business conduct and green investment.

Malaysia has stepped up its liberalisation of foreign investment and has strengthened its institutions for investor protection and corporate governance. Responsible business and environmental sustainability are also high on the agenda. The *Review* highlights areas where the investment policy framework could be improved to help the country reach its goal of becoming a developed economy by 2020. Liberalisation in sectors such as services should be maintained to create more space for private investment to grow, while mechanisms to measure the impact of FDI in achieving development targets should be strengthened to better inform its investment promotion strategy. Aligning with international initiatives that promote responsible business conduct would also cement the steps already under way to instil a responsible business culture.

This *Review* is the result of close co-operation between the Government of Malaysia and the OECD. It is also an integral part of the deepening partnership between the OECD and the Southeast Asian investment policy community. While the OECD provided technical inputs from its various Committees, the Government of Malaysia provided invaluable substantive contributions as well as driving a cross-agency process that also involved the private sector and civil society. Above all, this report offers a repository of Malaysian experiences for the benefit of other countries, including members of both the OECD and of the Association of Southeast Asian Nations (ASEAN). It also paves the way for Malaysia and the OECD to intensify their co-operation.

Angel Gurría
Secretary-General
OECD

Acronyms and abbreviations

AANZFTA	ASEAN-Australia-New Zealand Free Trade Agreement
ACCA	Association of Chartered Certified Accountants
ACIA	ASEAN Comprehensive Investment Agreement
AGM	Annual general meeting
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BCSRM	Business Council for Sustainability and Responsibility Malaysia
BIT	Bilateral investment agreement
BLESS	Business Licensing Electronic Support System
BNM	Bank Negara Malaysia
CAGR	Compound annual growth rate
CDM	Clean Development Mechanism
CER	Certified Emission Reduction
CGC	Corporate Governance Consultative Committee
CLRC	Corporate Law Reform Council
CMP	Capital Market Master Plan
CMSA	Capital Markets and Services Act
DGTU	Director General of Trade Unions
DNA	Designated national authority
DOE	Department of Energy
EIA	Environmental impact assessment
EPA	Economic partnership agreement
EPF	Employees Provident Fund
EPI	Environmental Performance Index
EPU	Economic Planning Unit
ETP	Economic Transformation Programme
FDI	Foreign direct investment
FET	Fair and equitable treatment
FIC	Foreign Investment Committee
FPS	Full protection and security
FSMP	Financial Sector Master Plan
FTA	Free trade agreement
GBI	Green Building Index

GDP	Gross domestic product
GLC	Government Linked Company
GLCTP	GLC Transformation Programme
GLIC	Government Linked Investment Company
GreenPASS	Green Performance Assessment System
GTFS	Green Technology Financing Scheme
GTP	Government Transformation Programme
ICA	Industrial Coordination Act
ICSID	International Centre for Settlement of Investment Disputes
IFRS	International Financial Reporting Standards
IGA	Investment guarantee agreement
IIAs	International investment agreements
ILO	International Labour Organization
IMF	International Monetary Fund
IMP	Industrial Master Plan
IP	Intellectual property
IPA	Investment promotion agency
IPO	Initial public offering
IPP	Independent power producers
IRB	Inland Revenue Board
ISDS	Investor-state dispute settlement
ITA	Investment tax allowance
JMEPA	Japan-Malaysia Economic Partnership Agreement
KeTTHA	Ministry of Energy, Green Technology and Water
KLIA	Kuala Lumpur International Airport
KLRCA	Kuala Lumpur Regional Centre for Arbitration
KPI	Key performance indicators
M&A	Mergers and acquisitions
MACS	Malaysia Airports Consultancy Services Sdn Bhd
MAFTA	Malaysia-Australia Free Trade Agreement
MAHB	Malaysia Airport Holdings Bhd
MaSRA	Malaysian Sustainability Reporting Awards
MATRADE	Malaysian External Trade Corporation
MCMC	Malaysian Communications and Multimedia Commission
MDTCC	Ministry of Domestic Trade, Cooperatives and Consumerism
MFN	Most-favoured nation
MICECA	Malaysia-India Economic Cooperation Agreement
MIDA	Malaysian Investment Development Authority
MIGHT	Malaysian Industry-Government Group for High Technology
MITI	Ministry of International Trade and Industry
MNE	Multinational enterprise

MOF	Ministry of Finance
MoHR	Ministry of Human Resources
MP	Malaysia Plan
MPC	Malaysia Productivity Corporation
MRT	MY Rapid Transit
MSC	Multimedia Super Corridor
MSWG	Minority Shareholders Watch Group
MyIPO	Intellectual Property Corporation of Malaysia
NAFTA	North American Free Trade Area
NEAC	National Economic Advisory Council
NEM	New Economic Model
NEP	New Economic Policy
NKEA	National Key Economic Areas
NLC	National Land Code
NT	National treatment
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
OFDI	Outward foreign direct investment
PAAB	Water Asset Management Company
PCG	Putrajaya Committee for GLC Transformation
PDC	Penang Development Corporation
PEMANDU	Performance Management and Delivery Unit
PEMUDAH	Special Task Force to Facilitate Business
PFI	Policy Framework for Investment
PIA	Promotion of Investments Act
PPA	Power purchasing agreements
PPP	Public-private partnership
PSDC	Penang Skills Development Centre
PSP	Private sector participation
PTIA	Preferential trade and investment agreements
R&D&C	Research and development and commercialisation
RBC	Responsible business conduct
SCM	Securities Commission of Malaysia
SEDA	Sustainable Energy Development Authority
SME	Small and medium-sized enterprise
SPAN	National Water Services Commission
SREPP	Small Renewable Energy Power Programme
SSM	Companies Commission of Malaysia
TEVT	Technical Education and Vocational Training
TFP	Total factor productivity
TPP	Trans-Pacific Partnership Agreement

TNB	Tenaga Nasional Berhad
TRIMS	Trade-related investment measures
TRIPS	Trade-related aspects of intellectual property rights
UAE	United Arab Emirates
UNCITRAL	United Nations Commission on International Trade Law
UNFCCC	United Nations Framework Convention on Climate Change
USAID	United States Agency for International Development
USTR	United States Trade Representative
VDP	Vendor Development Programme
WBCSD	World Business Council for Sustainable Development
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

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Executive summary

Malaysia stands out as one of the economic success stories in Asia over the past few decades. From a plantation economy at the time of independence, with rubber and tin representing one half of GDP, Malaysia has become a diversified, open economy. Poverty, which was widespread at the time, is now virtually eradicated, except in certain pockets of the country. GDP per capita is now seven times as high as it was in 1980 (in purchasing power terms) and Malaysia has become one of the countries the most integrated into the global economy through trade. The distribution of income among ethnic groups has also improved dramatically since the 1960s. Malaysia is now the second richest economy within the Association of Southeast Asian Nations (ASEAN) after Singapore.

Malaysia has set itself the goal of becoming a high-income economy by 2020. This will require annual growth of private investment of 10.9% or RM 148 billion. Recognising that there are challenges in meeting this goal, the New Economic Model (NEM), inaugurated in 2009, compiled well over 100 different recommendations. A new Performance Management and Delivery Unit was created to ensure that reforms are implemented. Strategic initiatives include the Economic Transformation Programme to stimulate private investment and the Government Transformation Programme to make the government leaner and more consultative, with measurable targets in the form of National Key Result Areas and Strategic Reform Initiatives.

The government has begun since 2009 to liberalise rules for foreign investors in service sub-sectors. Many of these sectors play a key role in the competitiveness of all sectors and of all firms, including small and medium-sized enterprises. Recognising the contribution of services to competitiveness, the government has announced that it will continue to liberalise the rules for the services sector, for both domestic and foreign firms.

Foreign investment has also been facilitated by the removal of the Guidelines of the Foreign Investment Committee which initially governed all foreign acquisitions in Malaysia but is now restricted to certain investments in property. Intellectual property (IP) is recognised, under the Economic Transformation Programme, as a pillar for transforming the economy. IP rights have been strengthened through the National IP Policy, the creation of IP courts and awareness raising programmes, but investors still complain of weak enforcement of IP rights.

Malaysia has a good track record in investment promotion. The Malaysian Investment Development Authority has been tasked as the lead agency to coordinate activities of all investment promotion agencies to ensure consistency at different levels of government. After-care service is being given greater emphasis by MIDA to facilitate investment. Overall, investment promotion is being geared towards capital- and knowledge-intensive projects, offering high value-added and high technology.

Weak corporate governance is widely recognised as one of the causes of the Asian financial crisis, and Malaysia has done much to improve standards in this area. The Malaysian Code on Corporate Governance was issued in 2012 and new institutions have been created. For GLCs, the government launched the GLC Transformation Programme to improve the performance of GLCs. Corporate governance reforms have included some responsible business conduct initiatives where Malaysia has made laudable progress in many areas, including high-level political endorsement, while co-ordination and oversight remain difficult.

These many and varied reforms are already starting to affect investor perceptions, and foreign direct investment reached an historic high in 2011 in absolute terms. Domestic investment has also shown some improvement. At the same time, private investment has never fully recovered to the levels in real terms seen before the Asian financial crisis in 1997. This Review documents the reforms that Malaysia has undertaken over time and examines areas where further reforms could address remaining shortcomings in the investment environment and place the Malaysian economy of its trajectory towards developed country status by 2020.

Key recommendations

Liberalisation of service sectors

- Consider accelerating and broadening the programme for opening up services to greater foreign competition.
- Boost regional and international financial integration to deepen Malaysia's capital market and to contribute to the growth of related services industries.
- Transcribe the existing degree of openness of the investment regime in international commitments.

Intellectual property rights

- Strengthen the IPR regime, particularly at the border, and continue to build the capacity of the IP courts.

Investment promotion and facilitation

- Enhance the Malaysian Investment Development Authority's (MIDA) role as the government's interface with the private sector.
- Expand Key Performance Indicators to include the impact of investment on Malaysia's economy.
- Undertake a cost-benefit analysis of investment incentives and publish the results.
- Promote better co-operation between business and institutes of higher learning to address skills shortages.

Corporate governance

- Continue the momentum of corporate governance reforms.

Responsible business conduct

- Improve stakeholder consultative mechanisms for RBC.
- Further align Malaysia with international principles concerning RBC.

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Assessment and recommendations

This review assesses the investment climate in Malaysia, including both the institutional and legislative framework for investment and also a broad range of policies in other areas. It documents the reforms implemented by successive government administrations to improve the investment climate, describes the remaining challenges faced by Malaysia in moving towards becoming a high-income economy and discusses what further measures might help to revive both foreign and domestic investment. A good investment climate concerns more than just the rules and regulations faced by investors; it results from complementary policies across almost all of government. Equally importantly, a good investment climate is not static; it requires that governments and firms become more nimble in order to respond to new challenges and opportunities as they arise.

The investment climate in Malaysia is examined using the *Policy Framework for Investment* (PFI) (Box 1), focusing on the following policy areas: investment; investment promotion and facilitation; corporate governance; responsible business conduct; infrastructure and financial sector development; and policies to channel investment into activities which promote green growth.

Through this review, conducted in close collaboration with the government of Malaysia, the OECD can provide an objective assessment of progress in Malaysia and the reform challenges that remain. It can share the experience of how OECD member countries and many emerging economies have tackled the same problems, and it can help to benchmark Malaysia's performance against these countries. It can also explain to an international audience the reform measures that are currently being undertaken and their likely impact on the investment climate. At the same time, the government can also use the PFI assessment exercise to help build consensus and capacity within government and to foster a whole-of-government approach to investment climate reform.

Progress and policy challenges

Malaysia was an early leader in export-led development...

Malaysia stands out as one of the economic success stories in Asia over the past few decades. From a plantation economy at the time of independence, with rubber and tin representing one half of GDP, Malaysia has become a diversified, open economy. Poverty, which was widespread at the time, is now virtually eradicated, except in certain pockets of the country. GDP per capita is now seven times as high as it was in 1980 in purchasing power terms and Malaysia has become one of the countries the most integrated into the global economy through trade. The distribution of income among ethnic groups has also improved dramatically since the 1960s. Malaysia is now the second richest economy within the Association of Southeast Asian Nations (ASEAN) after Singapore.

Foreign firms have played a major role in the process of growth and diversification and foreign investment has been a key part of the outward-oriented development strategies of successive governments. As an early mover in terms of export-led development, Malaysia has traditionally received significant amounts of foreign investment relative to the small size of its economy. Foreign investors are prominent in many parts of the manufacturing sector, including in the electronics sector, which has been the driving force behind exports and where foreign investors represent 82% of the capital in approved projects in 2012.

Box 1. **The Policy Framework for Investment**

The *Policy Framework for Investment* (PFI) helps governments to mobilise private investment in support of sustainable development, thus contributing to the prosperity of countries and their citizens and to the fight against poverty. The *Framework* was developed at the OECD by representatives of 60 OECD and non-OECD governments in association with business, labour, civil society and other international organisations and endorsed by OECD ministers. It offers a list of key questions to be examined by any government seeking to create a favourable investment climate.

The *Framework* is a flexible instrument that allows countries to evaluate their progress and to identify priorities for action in ten policy areas: *i*) investment, *ii*) investment promotion and facilitation, *iii*) trade, *iv*) competition, *v*) tax, *vi*) corporate governance, *vii*) promoting responsible business conduct, *viii*) human resource development, *ix*) infrastructure and financial sector development, and *x*) public governance. Three principles apply throughout the *Framework*: policy coherence, transparency in policy formulation and implementation, and regular evaluation of the impact of existing and proposed policies.

Box 1. **The Policy Framework for Investment** *(cont.)*

By encouraging a structured process for formulating and implementing policies at all levels of government, the *Framework* can be used in various ways and for various purposes by different constituencies, including for self-evaluation and reform design by governments and for peer reviews in regional or multilateral discussions. A Toolkit was created to offer practical guidance on how to implement the PFI.

The PFI recognises that creating a good investment climate involves the interaction of governments, firms and other stakeholders, and concerns both output and factor markets. Too often, governments focus narrowly on the costs of doing business or on investment promotion without paying sufficient attention to the bigger picture. Creating a good business climate requires efforts by government to: expand market opportunities for new entrants; improve public service delivery and policy effectiveness, in part through public consultations; improve the availability and quality of inputs and the efficiency of capital and labour markets; facilitate access to imported inputs, whether through trade policy reform or through targeted import exemptions; foster innovation and technology transfer by making markets more competitive and by protecting intellectual property rights; and encourage firms to play their part through voluntary codes of corporate governance and responsible business conduct, and through training of local employees and linkages with local suppliers.

The objective of a good investment climate is not just to increase investment but also to improve the flexibility of the economy to respond to new opportunities as they arise – allowing productive firms to expand and uncompetitive ones (including state-owned enterprises) to close. The government also needs to be nimble: responsive to the needs of firms and other stakeholders through systematic public consultation and able to change course quickly when a given policy fails to meet its objectives. It should also create a champion for reform within the government itself. Most importantly, it needs to ensure that the investment climate supports sustainable and inclusive development.

The PFI was created in response to this complexity, fostering a flexible, whole-of-government approach which recognises that investment climate improvements require not just policy reform but also changes in the way governments go about their business.

For more information on the *Policy Framework for Investment* and its User's Toolkit, see: *www.oecd.org/daf/investment/pfi and www.oecd.org/investment/pfitoolkit*.

… but has had difficulty sustaining momentum over time

In spite of this enviable performance when seen in a long-term perspective, the Malaysian economy is nevertheless confronting numerous inter-related challenges commonly associated with a middle income trap. The symptoms of this trap are easy to find. Growth, which averaged over 9% in the decade leading up to the Asian financial crisis in 1997-98 has been only 5% since 2000. Net exports as a share of GDP have also declined steadily since 2000. Private investment, which was running at 30% of GDP in the early 1990s, has been only 12% of GDP since 2000, although it grew 22% in 2012, the highest rate of expansion since 2004. Foreign direct investment (FDI) has continued to rise in absolute terms but has declined significantly both as a share of GDP and as a share of total FDI in ASEAN since the pre-crisis 1990s – it is now below the share of Malaysia in ASEAN GDP. A large share of FDI inflows involves reinvested earnings of existing foreign affiliates which suggests that, while established foreign investors are not fleeing the country, there are fewer new arrivals compared to earlier decades.

The government attributes this decline in relative FDI flows in part to a shift towards more knowledge-intensive investment, in line with its promotional efforts and with Malaysia's evolving competitive advantages. Malaysia also continues to rank highly in many investment climate indices, and private investment has picked up recently. These factors, and the numerous policy initiatives described below which are beginning to bear fruit, militate against painting too bleak a picture based on historical trends. But at the same time, achieving developed country status by 2020 will require a significant increase in investment compared to the previous decade.

Investors complain that skills shortages are the top obstacle to doing business (World Bank 2009), at the same time as an estimated half a million Malaysians – up to half with university degrees – now live and work outside the country, and the number of foreign expatriates in Malaysia is declining. Low-skilled, low-wage immigrants from the rest of Southeast Asia sustain the low value-added export model which Malaysia is slowly trying to abandon. In promising sectors, the lack of specialised knowledge in fields such as renewable energy and green technology has slowed the pace of growth and held back financing for projects. Investors also complain of diminishing English proficiency. Labour market dynamics are not covered in this Review, except in relation to skills development and linkages with multinational enterprises.

The government is aware of the challenges and has begun to address them

The Malaysian government is keenly aware of these challenges and has set itself an ambitious goal of becoming a high-income economy by 2020 which will require a doubling of private investment as a share of GDP between 2010 and 2020. Initiatives have proliferated to achieve these objectives, most notably the New Economic Model (NEM) developed by the National Economic Advisory Council (NEAC) which was inaugurated by the prime minister in 2009. Strategic initiatives include the Economic Transformation Programme to stimulate private investment and the Government Transformation Programme to make the government leaner and more consultative, with measurable targets in the form of National Key Result Areas and Strategic Reform Initiatives. There are well over 100 different recommendations outlined in the NEM, with a new Performance Management and Delivery Unit created to ensure that reforms are implemented.

In almost all of the areas covered by this Review, the government has undertaken policy reforms and created or revamped institutions to ensure that the reforms deliver results. A Special Task Force to Facilitate Business (PEMUDAH) was created in 2007, comprising public officials and corporate leaders to simplify business operations and thereby successfully to improve Malaysia's ranking in the World Bank's *Doing Business* report. The Malaysia Productivity Corporation is spearheading a comprehensive review of business regulations to improve processes and procedures. The investment promotion agency was renamed the Malaysian Investment (formerly Industrial) Development Authority (MIDA) to reflect its wider remit to promote services as well as manufacturing. The Putrajaya Committee on GLCs (Government-Linked Companies) High Performance was created to lead the GLC Transformation Programme. A new *Malaysian Code of Corporate Governance* was promulgated in 2012 and a *Competition Act* in 2010. In the financial sector, the government has a Financial Sector Blueprint for 2011-20 and a Capital Market Master Plan 2, following on from earlier Financial Sector and Capital Market Master Plans. Malaysia's National Green Technology Policy (2009), the Renewable Energy Policy and Action Plan (2010), and the creation of the Ministry of Energy, Green Technology and Water are all designed to address environmental concerns.

Reforms in Malaysia have traditionally been gradual and pragmatic

In contrast to many other countries in the region, Malaysia has often taken a long-term approach to reform: sectoral reforms are planned over a long period and outlined in Master Plans; the NEAC was created to prepare the diagnosis and policy recommendations and to present the case for wide ranging reforms through seminars, dialogues and briefings, including with state governments; the private sector and other stakeholders are involved in key commissions such as the NEAC and PEMUDAH, as well as on the board of MIDA; and public consultations have been an integral part of the process, although investors have nevertheless complained that consultations are sometimes perfunctory and with selective participation. A gradualist approach allows for consultations with stakeholders, provides opportunity for feedback and mid-course corrections, and allows domestic firms time to adjust but, at the same time, requires a firm political commitment to carry through with the reforms to avoid backtracking.

Many of the reforms described above are recent, and it will take time to see their full impact on the investment climate. The proposed and enacted reforms appear to move in the right direction, and inflows of foreign investment are at record levels in nominal terms. The question nevertheless remains of whether the measures go far enough to reverse fully the decline in private investment in Malaysia and its relative under-performance in attracting FDI inflows. Many other countries in the region are embarking on their own reform agenda at the same time as Malaysia, and growing regional integration makes comparisons with neighbouring countries all the more pertinent.

Reducing socio-economic imbalances has been central to Malaysian development strategies for four decades…

The cornerstone of Malaysian policies since the ethnic riots in 1969 has been the New Economic Policy (NEP), an affirmative action policy in favour of the *bumiputera* (ethnic Malay, indigenous people, as well as ethnic groups in Sabah and Sarawak) to redress socio-economic imbalances in the country. These various measures have traditionally implied a much stronger involvement of the government in resource allocation, production and trade. As a first step in the 1970s, the government took over several major foreign-owned corporations in the mining and plantation sectors through mergers and stock market purchases with the aim of transferring ownership eventually to the *bumiputera*. At the same time, the Foreign Investment Committee (FIC) was created to screen incoming investments and to limit foreign equity to 30% for domestic-market oriented projects and for acquisitions of Malaysian firms. Partly as a result of these policies, the foreign portion of share capital declined from 62% in 1969 to 25% by the late 1980s, while the *bumiputera* share rose from 1.5% to 19% over the same period (OECD 1999).

These redistributive policies are widely acknowledged to have contributed to social peace but are increasingly coming under criticism, including within the government itself, for their unintended side effects. It has inadvertently given rise to rent-seeking and patronage.

... but redistributive policies are evolving

As a result, after four decades, the redistributive policies are being retooled to focus more directly on the poor. The first exemptions from equity rules were given to exporters and pioneer industries in the 1980s, and this was temporarily extended to almost all manufacturing sectors during the Asian financial crisis and then made permanent in 2003. Companies located in the Multimedia Super Corridor also received exemptions. The biggest step came in 2009 with the abolishment of the FIC and thus the removal of the FIC Guidelines governing foreign equity limits. The purchase of properties valued at RM 20 million and above that will result in a dilution of *bumiputera* interest nevertheless require the approval of the Economic Planning Unit, Prime Minister's Department. From now on, equity limits will be set by the sectoral regulator, allowing greater flexibility to liberalise certain key sectors. The only remaining equity restriction is subsumed within the public spread requirement under Bursa Malaysia listing rules, implying a minimum *bumiputera* shareholding in a company listed in Malaysia of 12.5%. The new requirement does not apply to foreign companies seeking a listing on Bursa Malaysia where no equity conditions remain.

The recent alleviation of FIC Guidelines is not only a potentially strong signal to investors but may also enhance the scope for further reforms in the future. At the same time, the government remains committed to the goal of redistribution and maintains many measures in support of the *bumiputera*: preferential access to education, housing, jobs, business licences, public sector contracts, government grants, bank credit and share capital (WTO, 2009).

These reforms and proposals enunciated in the NEM and elsewhere represent a significant departure from longstanding policy approaches which have characterised the Malaysian economy for the past four decades. At a time when the *status quo* is being called into question in almost all policy areas, further targeted reforms could provide the critical mass necessary to revive investor confidence and restore the Malaysian economy to its historic growth trajectory before the Asian financial crisis. The following section focuses on the prospects for accelerating the pace of liberalisation of key service sectors.

Malaysia still maintains restrictions on foreign investment in many services...

A country's investment climate cannot be captured in a single indicator, whether on the costs of doing business or a measure of statutory restrictions on FDI. Many different policies and practices impinge on investment decisions, and the way – and whether – policies are implemented is arguably as important as the policies themselves. Quantitative indicators have nevertheless proven highly effective in drawing attention to the burdens of business regulation, identifying priorities for reform and communicating success and progress. Benchmarking Malaysia's performance in liberalising its investment regime compared to regional peers and to the average for OECD member countries provides a useful external assessment of how Malaysia performs in this area and the results accord well with the relative performance of Malaysia in attracting FDI over time. Just as Malaysia gauges its performance in attracting investment against its peers, so too should it assess how it compares with its peers in terms of restrictions on market access and operational constraints faced by foreign established firms.

The OECD *FDI Regulatory Restrictiveness Index* provides a measure of statutory restrictions on foreign investment across countries. It includes neither the degree to which those measures are actually implemented, nor all other policy areas that might impinge upon foreign investment, but it is a useful benchmark of one key aspect of the investment climate. It is also found to be one of the factors shaping FDI patterns in cross-country studies. The *FDI Index* estimates that Malaysia is now one of the most open in East Asia in terms of statutory restrictions on FDI (based on a sample of nine countries in Asia and the Pacific for which the *Index* currently exists), but a wide gap still exists relative to the levels of restrictiveness found on average in OECD member countries. An historical series based on the *Index* suggests that, while Malaysia may well have been a relatively open economy in terms of statutory restrictions prior to the Asian financial crisis, the more rapid liberalisation of other countries in the region after 1997 may have diverted some investment away from Malaysia.

In terms of foreign investment in specific sectors, Malaysia remains relatively restrictive in distribution and communications, not only compared to OECD countries but also relative to the average for India, China and Indonesia. In financial services, Malaysia has fewer restrictions than China or India, for example, but the level of restrictiveness is still higher than the average of OECD countries. Business services were also "unusually restrictive" according to the NEM before the recent reforms announced in October 2011. If the reforms in this sector are fully carried out, Malaysia will have the same level of statutory restrictions in business services as OECD member countries, on average. Previously it had been more restrictive than both the OECD average and score for individual Asian countries.

Foreign investors are present to varying degrees in all of these sectors but nevertheless face restrictions on mergers with local firms, as well as operational restrictions. The most notable restriction is on foreign equity limits: 30% in domestic banks, 70% in insurance companies and investment banks, as well as a 30% *bumiputera* requirement in retail. In telecommunications, equity limits are being raised to 70%, except for a 30% limit in Telekom Malaysia.

Beyond equity limits, the activities of foreign affiliates are circumscribed in other ways, such as limits on the number of branch offices for foreign banks operating in Malaysia and on floor space and minimum capital requirements in the distribution sector. Foreign investors in both banking and distribution are also required to incorporate locally.[1] Entry barriers for both foreign and domestic potential investors have also arisen at times through a freeze on new licences, as occurred in the conventional banking sector between the early 1980s and 2009 and in the Islamic banking sector between the early 1980s and 2003, and as was initially announced for distribution from 2004 to 2009.

... but progressive liberalisation has begun

The Third Industrial Master Plan for 2006-20, followed by the Tenth Malaysia Plan and the NEM are in favour of liberalising the service sector. Since 2009, Malaysia has made great strides to open up the service sector to foreign investment and once again has begun to offer a more attractive environment for investors. In addition to the elimination of the FDI Guidelines described above, the government liberalised 27 service sub-sectors in 2009 and a further 17 sub-sectors in 2012. In Malaysia's conventional and Islamic financial sectors, gradual and progressive liberalisation has been implemented over the years. Moving forward, under the new Financial Sector Blueprint 2011-20, the approach to financial sector liberalisation will shift from setting hard quantitative limits on equity participation and on the number of licences towards facilitating greater foreign participation in the financial sector based on prudential criteria and where it is deemed to be in the best interest of Malaysia. Moving forward, greater flexibility will also be accorded to financial institutions to establish branch and non-branch electronic terminals.

Many of these reforms have not yet been fully transcribed in Malaysia's growing web of free trade agreements (FTAs). For example, the Malaysia-Australia FTA, which was concluded in March 2012 and entered into force on 1 January 2013, incorporates certain recent liberalisation measures in the schedule of specific commitments, such as in telecommunications and financial services, but Malaysia still reserves the right to screen any acquisition over an aggregate 30% of equity. The text states that approval is normally granted but may be denied where the proposed investment conflicts with the interest of the state. The Malaysian list of reservations to the ASEAN Comprehensive Investment Agreement states that national treatment may not apply in the issuance of a licence or permit, including both numerical limitations and the non-issuance of licences.

In financial services, equity restrictions generally reflect existing national regulations, but no commitment is made for the issuance of licences to allow new foreign-owned commercial banks. However, banking licences for international Islamic banks and international takaful operators have been granted in 2008 under FTAs, namely Malaysia-Pakistan as well as the ASEAN Framework Agreement on Services Fourth Package of Financial Services Commitments. Liberalisation of business services, which is only scheduled to occur in 2012, is not yet reflected in the commitments. A key milestone will be under the ASEAN Framework Agreement in Services which calls for allowing 70% ASEAN equity ownership by 2015.

Government-linked companies are prominent in many services

Going beyond restrictions on foreign investment, many service sectors are characterised by a strong presence of GLCs. On a broad basis including entities in which the government has controlling and minority stakes, GLCs account for 43% of total assets in agriculture and forestry, principally in oil palm plantations, 67% in telecommunications, 50% in distribution, 56% in the banking sector and 88% in utilities (Menon, 2012), where GLCs operate in roads, airports, air transport, water, power and telecommunications. Estimates of the market share of GLCs in these sectors are often even higher. On an effective controlling interest basis, state participation via government funds in private companies is lower but often not negligible. For instance, in the case of the banking sector, several government-linked investment companies currently hold equity stakes of more than 30% in four out of eight domestic banking groups, representing a share of 23% of total assets of the banking sector on an effective interest basis.

According to the NEM, while GLCs have historically been tasked with providing public goods and services, maintaining government control in strategic sectors and engineering socioeconomic change through wealth redistribution, investors now feel that GLCs have ventured beyond their mandates and are now competing directly with private businesses, hence crowding out private investments (NEAC, 2010b). The degree of government ownership is less an issue, in itself, than the productivity of many GLCs. The NEM reports that "sectors in which government companies dominate have shown the lowest rates of growth of productivity in recent years" (NEAC, 2010b, p. 18). Several studies have found that GLCs have often underperformed relative to other public listed companies in the past.[2]

Aware of the impact that the performance of GLCs has on the competitiveness of the Malaysian economy, the government has undertaken various initiatives to bring GLC governance closer to private sector corporate governance standards. Most notable is the GLC Transformation Programme, launched in 2004 and which introduced key performance indicators, performance-linked compensation and changes in the composition of boards. Partly as a result, and in spite of a more challenging economic environment in 2008, the 20 most important GLCs reported aggregate earnings that were 53% higher than in 2004.

Under the present institutional set up, various entities are responsible for managing public savings and investment on behalf of the members/ contributors, but only the Minister of Finance Incorporated (MOF Inc.) invests on behalf of the government. The rest of the government-linked investment companies (GLICs) invest for the benefits of their contributors, unit holders and depositors. The government basically ensures that the public money is properly invested by these entities and avoids interfering with the investment strategies/decisions of these institutions. Many investments are solely to provide return to the members/contributors/unit holders and are not aimed at contributing to the government's revenue collection.

While governance of GLCs has improved, it is important to ensure they face competitive pressures in each sector in which they operate. Significantly, the mandate of the new Competition Commission covers both private firms and GLCs. The Commission will require high-level political support to implement this mandate and to ensure that equity rules do not constitute barriers to entry. It is also important that other means be found to fulfil the socio-economic policy objectives that GLCs are currently tasked with undertaking.

Key recommendations

Liberalisation of service sectors

- The government should continue the progressive liberalisation of service sub-sectors and consider accelerating and broadening the programme

The government opened 27 service sub-sectors in 2009 and another 18 in 2012 and is examining the need for complementary measures to accompany further liberalisation. Through the Malaysia Productivity Corporation, it is also modernising its business regulations which will contribute to the ease of doing business for all investors. These steps will contribute to enhancing the competitiveness of the Malaysian economy, but obstacles to foreign investment remain in certain services and the prominent role of GLCs in some sectors adds to the uncertainty about market opportunities for new entrants, whether domestic or foreign.

Opening the service sector to greater private – including foreign – involvement is not an end in itself. An efficient and competitive services sector, particularly backbone services, will raise the performance of firms throughout the economy, including in the manufacturing sector. Several studies of other countries' experience cited in Box 2.2 suggest a link between restrictions on foreign entry in the service sector and total factor productivity in the manufacturing sector.

For instance, Malaysia has intensified liberalisation of the financial sector since 2009, but remaining restrictions on FDI are relatively high compared to the OECD average. The increase in foreign equity limits of investment banks and stock broking institutions undertaken in 2009 is likely to contribute to on-going consolidation in those sectors, but further easing of the remaining restrictions in commercial banks could also be considered. As the Economic Transformation Programme states, "many of our [Malaysian] commercial banks are significantly smaller than regional powerhouses". While foreign and domestic banks do not necessarily focus on the same market segments, foreign-owned commercial banks seem to have been on average more efficient and profitable than domestic commercial banks for most of the past decade. However financial reforms and capacity building efforts undertaken under the Financial Sector Master Plan (FSMP) have substantially strengthened and improved domestic banks' competitiveness and financial performance, narrowing the gap with foreign institutions. Notwithstanding, enhancing existing measures to increase competition in this sector can contribute to further strengthening Malaysia's banking competitiveness *vis-à-vis* large regional players and to improve investment levels in the country.

In addition, the growing integration of the regional market offers an opportunity for Malaysia to become a regional hub for many services. While the government has geared investment incentives towards fulfilling its regional aspirations, the regulatory environment and the degree to which investors will be able to compete on a level playing field will count for more than tax allowances in bringing Malaysia's regional strategy to fruition.

- Regional and international financial integration can help deepen Malaysia's capital market and contribute to the growth of related services industries

Malaysia's equity market remains one the most developed in the region, but market capitalisation as a share of GDP has been rather stable since the Asian crisis, facing greater competition from regional financial centres. Liquidity levels are also relatively low, diminishing Bursa Malaysia's attractiveness to worldwide investors and hindering the development of related service industries. The corporate debt securities market, though rather well developed by regional and international standards with relatively high liquidity levels compared to regional bond markets, has seen its liquidity decline substantially since 2004. A slight recovery has taken place since 2008 but liquidity remains shallow in relation to the public market. Further regional and international integration could contribute to enhance Malaysia's capital market competitiveness by broadening the issuer and investor base, while raising its capacity to support the level of investments required for transitioning to a developed economy by 2020.

Efforts to enhance the efficiency and competitiveness of Malaysia's capital market are already underway with the implementation of key initiatives contained in the Capital Market Master Plan 2 (CMP2) launched in

2011. Efforts to boost regional integration have been undertaken by the Securities Commission and Bursa Malaysia and are expected to provide greater market access to regional players and maximise the growth potential of Malaysia's capital market. Initiatives to facilitate intermediation and increase liquidity, as well as to maximise scale through internationalisation, are also taken into account in the CMP2.

- Commitments in international agreements should transcribe the existing degree of openness

Malaysia has a complex web of international investment agreements, including both bilateral investment treaties and free trade agreements with an investment chapter. Such agreements include those signed as part of ASEAN, with external partners and among ASEAN member states. Malaysia is now also negotiating the Trans-Pacific Partnership Agreement with the United States and others. Within ASEAN, the ASEAN Comprehensive Investment Agreement, which includes commitments in manufacturing and related services, has been ratified. Although liberalisation commitments are often included in the FTAs and regional agreements, these commitments do not always appear to match the existing level of openness in Malaysia.

Intellectual property rights

- Strengthen the intellectual property rights regime

Malaysia has gradually moved towards an enabling regulatory environment for investors, including a sound legal and regulatory framework for intellectual property (IP) rights, but investors have complained about weak enforcement of IP rights. Although Malaysia has made significant and widely acknowledged progress in combating piracy and counterfeiting activities, the government should further intensify its efforts in terms of border enforcement measures and in training customs officials. To achieve a higher level of enforcement at the border, greater involvement of customs authorities in prohibition measures is required. The creation of a dedicated IP court is a laudable step towards a more efficient enforcement system that will further develop judges' capacity and experience in IP-related matters. The government has also made great efforts to allow IP rights to be used as collateral for loans from financial institutions, and provides training to local companies to carry out due diligence on intellectual property.

Investment promotion and facilitation

- Enhance MIDA's role as the government's interface with the private sector

The Malaysian Investment Development Authority (MIDA) is internationally recognised as an effective investment promotion agency, particularly for investors at the establishment phase. It has significant experience with investment promotion in the manufacturing sector and is increasing its role in promoting services. In 2009, at the time of the first liberalisation moves in the service sector, the government created the National Committee for Approval of Investments in the Services Sector under MIDA.

In a context of reform and proliferating initiatives to improve the business climate, the private sector needs an accessible and responsive interlocutor in the government. In particular, MIDA's after-care services for established investors could be enhanced. This function becomes even more important in light of the government's aim to increase re-investment and expansion by established investor. MIDA's activities also extend to providing the private sector with a channel to give feedback on reform initiatives and measures to further improve the business climate. Enhancing MIDA's policy advocacy role and capacity would help it to engage better with the private sector.

As Malaysia's central IPA, MIDA should set the direction for other states and corridor IPAs to synergise efforts towards common objectives. In working with other key enablers in attracting investment, overlapping tasks and duplication of efforts can be avoided.

- Expand KPIs to include the impact of investment on Malaysia's economy

To support the government's objective to move the economy further up the value chain by producing more sophisticated and high-end technology products, MIDA may consider adjusting its KPIs. The indicators could go beyond target investment volumes and include an evaluation of the impact of investment. Evaluation measures could cover consultative stakeholder processes and technology transfer from foreign investors to Malaysian companies.

Such indicators can be difficult to develop as the necessary data and the capacity may not be available. One way to address this gap, while also increasing the credibility of the KPIs, is to have external parties create and monitor KPIs. KPIs could also be expanded to include measures beyond MIDA's mandate to include areas under the Ministry of International Trade and Industry's overall responsibility and which aim to increase the developmental effects of investment and to better inform policy making.

- Undertake a cost-benefit analysis of investment incentives

Malaysia has been promoting international investment through investment tax allowances and tax holidays for decades, primarily for exporters and pioneer industries. Despite the efficiency with which MIDA disburses incentives, they could be more targeted and should be subject to adequate public review and reappraisal. A review of investment incentives in ASEAN in 2004 noted that the list of promoted activities and products eligible for "pioneer" status (and hence tax allowances) compiled by MIDA ran to 21 pages.[3] The same point could be made today: the National Key Economic Areas established under the Economic Transformation Programme seem to cover broad areas of the economy.

Incentives offered to investors have become less generous over time but remain pervasive. According to the WTO, no estimates have been made available of total tax revenue forgone as a result of these incentives. One estimate of forgone revenue in the 1980s amounted to 1.7% of GDP. Almost all countries offer incentives in one form or another to attract foreign investment or to channel investment into priority activities or geographical areas. There is also pressure to offer incentives so as to compete with other countries in attracting mobile investment. It is difficult to assess whether an investment would have occurred in the absence of such incentives, but both investor surveys and econometric studies suggest that their importance is marginal in most cases.

Authorities offering incentives to attract investment must periodically evaluate their relevance, appropriateness and economic benefits against their budgetary and other costs, including the long-term impact on resource allocation. To assist governments in this task, the OECD has created a *Checklist for Foreign Direct Investment Incentive Policies* which serves as a tool to assess the costs and benefits of using incentives to attract FDI, to provide operational criteria for avoiding wasteful effects and to identify the potential pitfalls and risks of excessive reliance on incentive-based strategies.

- Improve co-operation between business and institutes of higher learning to address skills shortages

A major challenge facing the government is the need to ensure that skill programmes continue to meet the changing demands of the labour market. Improvements could include closer collaboration between industry and institutes of higher learning on R&D and curriculum development. Such collaboration can contribute to closer alignment of training provisions and industry demands. Malaysia should aim at replicating some of its world-class models in this regard, such as the Penang Skills Development Centre, in other parts of the country. To support the effectiveness of this triangle of co-operation (government, training institutions, industry), training institutions and universities need to be have greater flexibility in curriculum development.

Corporate governance

- Continue the momentum of corporate governance reforms

Good corporate governance of state-owned enterprises is becoming a reform priority in many countries. The OECD *Guidelines on the Corporate Governance of State-Owned Enterprises* provide an internationally agreed benchmark to help governments assess and improve the way they exercise their ownership functions in state owned enterprises. The *Guidelines* build on a wealth of concrete experience from a large number of OECD and non-OECD countries around the world and offer concrete advice on corporate governance challenges that need to be addressed when the state is a corporate owner.

Responsible business conduct

- Improve stakeholder consultative mechanisms for RBC

Stakeholder engagement by companies often takes the form of testimonials, rather than genuine engagement. More engagement with critical stakeholders is recommended and more structured stakeholder engagement processes and consultations are needed to demonstrate openness and responsiveness to concerns.

- Malaysia should further align itself with international principles concerning RBC

Through both private and government initiatives, Malaysia has undertaken measures to promote RBC, as an extension of efforts to foster a strong corporate governance culture. The past few years have seen a number of policy and institutional advances, in particular in environmental protection and the promotion of green investment. All publicly listed companies in Malaysia are obliged to disclose their RBC activities as stipulated in the Bursa listing requirements. If there are no RBC reports, a statement to that effect is required, thus acting as a form of moral suasion.

Challenges remain in terms of consultative processes when developing policies and in the area of labour relations, where Malaysia faces some gaps in reaching more advanced standards. Another area that deserves some scrutiny is overall co-ordination of RBC related initiatives. No designated ministry within the government has the mandate for such a function, which can hamper the development of a coherent RBC framework.

Participating in international initiatives would support the government in taking advantage of global experience on RBC and its implementation. The government should increase its efforts to align itself with the standards and principles upheld in multilaterally backed instruments, including the OECD *Guidelines for Multinational Enterprises*. Adherence to the Guidelines would help ensure that foreign multinational enterprises operating in Malaysia contribute fully to meeting societal expectations concerning their conduct. Adherence would also send a strong signal to the rest of the world that Malaysian firms, including many GLCs, are acting responsibly as they expand rapidly in Southeast Asia, Africa, and beyond. The Malaysian government would also be better able to share its own experience in promoting RBC with peers in 44 other countries that have already adhered. The creation of a national contact point as part of adherence would also serve as a focal point for RBC initiatives within government and provide best offices for settling disputes between investors and local communities.

Conclusion

Malaysia is confronting many challenges as it strives towards high-income status, but these challenges need to be kept in perspective. Malaysia has improved its *Doing Business* rankings from 23 in 2011 to 12 in 2013, and its attractiveness as a location for investment has increased, according to surveys. FDI inflows are also at record levels in nominal terms. It is a performance that many other countries aspire to emulate. Over several decades, Malaysia has developed a good record in attracting and retaining investment and it is located in a dynamic and rapidly integrating region which will continue to retain the attention of investors.

There is nevertheless a clear recognition within government and society at large that the *status quo* is no longer tenable, and in the same pragmatic way that Malaysia has approached challenges in the past, it has begun to address its underperformance relative to both some of its peers and to its own historic record. The fact that the Malaysian government has agreed to undertake this first OECD *Investment Policy Review* attests to the government's willingness to learn from the experience of other countries, including OECD members, as it undertakes reforms to reinvigorate its investment climate.

This review builds on the accumulated experience of *Investment Policy Reviews* undertaken in all regions of the world and of countries at different levels of development to focus on certain key recommendations for the Malaysian government. The individual policy chapters cover each area in more detail and include further suggestions where policies or approaches could be modified or expanded.

Notes

1. According to Bank Negara Malaysia, the local incorporation requirement was put in place to ensure adequate capital is dedicated to safeguard the sustainability and continuity of locally-incorporated foreign banks' operations in Malaysia as well as to constitute a separate board structure in Malaysia with direct statutory responsibilities for the Malaysian operations. The requirement also provides an important safeguard to minimise the effects of cross-border contagion.
2. Najid and Rahman (2011), Mohamad and Said (2010) and Chun-Teck Lye (2011).
3. Thomsen (2004).

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