2 Malaysia

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I. Introduction

Malaysia, formerly known as Federation of Malaya before being replaced by its current name in 1963 by the amendment of the Constitution, is located in the South-East Asia. It has total area of 329,750 sq kilometres (comprises of 328,550 square kilometres of land and 1,200 square kilometres of water) and consists of two region; namely Peninsula Malaysia (also known as West Malaysia) and East Malaysia. Some 850 square kilometres of the South China Sea separate these two regions. Apart from having 13 states, Malaysia also has three federal territories; Kuala Lumpur (upon becoming the capital city), Labuan when it was granted the offshore status and Putrajaya, which is the new administrative city of the Federal Government.

It shares land boundaries with Brunei, Indonesia and Thailand. Other neighbours include Philippine and Singapore which is connected physically by a causeway and a highway bridge across the narrow Strait of Tebrau. Besides being strategically located along Strait of Malacca, Malaysia also offers some brilliant sceneries, spectacular wildlife and excellent beaches especially those in Tioman Island which is rated among the best 10 beaches in the world.

The oldest known evidence of human habitation in Malaysia is a skull from Niah Caves in Sarawak dating from 35,000 BC. About 2,500 years BC, a group much more advanced from the Negrito aborigines, then the inhabitants of Peninsula Malaysia, migrated from China. Called the Proto-Malays (the predecessors of the Malays now) their advances into the Peninsula forced the Negritos into the hills and jungles.

The colonisation of Malaysia began when the Portuguese in their search of new trade routes from Europe to India and Far East conquered Malacca in 1511. In 1641, the Dutch defeated Portuguese and took control of Malacca. Then the British took the first step in colonising Malaysia by acquiring Penang Island in 1786 and ruled Malaysia ever since, except for a brief period of 1942-1944 when Malaysia felt under Japanese occupation during World War II, until 1957 when Malaysia gained its independent.

Among those colonial powers, it was the British, which arguably made the most impacts on the Malaysian economy and social life and shaped the country to what it is today. Under their rule, capitalist economies enterprises were introduced and with them the necessary infrastructures. They encouraged the entry of foreign labour, especially from China and India. Their divide and rule policy kept the immigrants workers apart from each other’s and from the indigenous populations. The local Malays were confined to the rural areas engaged mainly in peasant farming. The Indian were mainly employed as wage labour in the plantation and in the construction sectors, especially building roads and railways. The Chinese on the other hand worked in the mines and involved themselves in trade and commerce in the urban areas.

Today with a population of about 21.5 million people that is composed of 58% Malay and other indigenous, 27% Chinese, 8% Indian and 7% others; it is the Chinese, through their control of business and trade, who have the largest share of economic wealth. The Malay, being the majority are given by the Constitution permanent spots in the Government (representing political power), their language (Bahasa Malaysia) becomes national language and their religion (Islam) becomes national religion. Ironically even the Indians which consists of only 8% of the population are richer than Malays.

Malaysia practises Parliamentary Democracy with Constitutional Monarchy and His Royal Highness is the Paramount Ruler. One of the conditions of Parliamentary Democracy is the division of the administrative power into three parts, which are Legislative, Judiciary, and

Administrative or Executive. Malaysia is also a country that practises a system of Democracy based on the Federation system. In accordance to this, all the 13 states which have agreed to the concept of the formation of the country of Malaysia has surrendered part of its power, such as financial, defence, education, foreign affairs and others, as stated in the Malaysian Constitution, which is administered by the Central Government.

II. Overview of Macroeconomic Activity and Fiscal Position

The Malaysian economic policy framework is based upon the New Economic Policy (NEP), which was launched in 1974. The political and economic objectives of the NEP are to reduce poverty by increasing income levels for all Malaysians and to restructure the Malaysian society in order to erase all racial identification in economic terms. In other words, the NEP calls for a financial redistribution from the minority of wealthy non-Bumiputra (native Malaysians also known as "Princes of the Soil") racial groups to the Bumiputras. The goal is to achieve corporate equity of 30% Bumiputra, 30% foreign and 40% other-Malaysians. This goal can only be facilitated with an expanding economy, so that no racial group should suffer from economic or social deprivation. Other specific economic goals include; maintain high sustainable growth, low unemployment rates and ensure the stability of economic factors such as inflation.

The National Development Policy (NDP) replaced the NEP when it expired in 1990. This new policy can be considered an add-on document to the NEP, the objectives of which were not achieved in 1990. Furthermore, it provides a framework towards Dr. Mahathir's new vision 2020 plan symbolizing "the way forward" policy towards a "developed" nation in 2020. Former Prime Minister Mahathir believes raising workforce quality and developing expertise in sophisticated industries are decisive elements in the country's road to economic success and development.

Until mid-1997, Malaysia enjoyed three decades of relatively uninterrupted economic growth and increasing diversification from an early reliance on tin, rubber and palm oil into manufacturing and, more recently, information technology. Sound macroeconomic policies and a favourable international environment contributed to overall prosperity. Since July 1997, however, Malaysia has been buffeted by the regional economic and financial downturn that erupted with the Thai financial crisis. By mid-1998 Malaysia was in recession. Real GDP contracted by 2.8% in the first quarter, 6.8% in the second quarter, and 8.6% in the third quarter, year-on-year. From the outset of the crisis in July 1997 to the end of August 1998, the Kuala Lumpur stock exchange lost 73% of its capitalization, while the RM (Malaysia's currency) depreciated roughly 67% against the U.S. Dollar.

Despite entering the crisis with relatively stronger fundamentals than its neighbours, investor concerns have grown over excessive commercial property investment, high levels of domestic corporate debt, government-funded mega projects, the lack of transparent policies regarding support for troubled firms, and continued trade and investment restrictions.

To deal with increasing stresses on Malaysia's banking sector, the government established DANAHARTA, also known as the Asset Management Corporation, to purchase or manage nonperforming loans, and DANAMODAL, a special purpose vehicle to inject funds into banks in need of recapitalization. Bankruptcies have risen, and several major Malaysian corporations, burdened with heavy debt loads, sought court protection from creditors. The government has also created a Corporate Debt Restructuring Committee to provide a framework for creditors to resolve liquidity problems of viable businesses and reduce the number of companies seeking bankruptcy protection.

The government plays a strong pro-active economic role. This role includes: investor, economic planner, approver of investment projects, approver of public and private procurement decisions, author and implementer of policies and programs to bolster the economic status of the Malay and indigenous communities (commonly referred to as Bumiputra), and decision maker over privatization contracts. The government holds equity stakes (generally minority shares) in a wide range of domestic companies -- usually large players in key sectors -- and can exert considerable influence over their operations. The government has said it will consider granting assistance to troubled corporations based on three criteria: national interest, strategic interest, and equity considerations under Bumiputra policies.

The Eighth Malaysia Plan, covering the period 2001-2005, is the first phase in the implementation of the Third Outline Perspective Plan (OPP3), 2001-2010. The OPP3, which embodies the National Vision Policy (NVP), will chart the development of the nation in the first decade of the 21st century. The Eighth Plan incorporates the strategies, programmes and projects designed to achieve the NVP objectives of sustainable growth and strengthen economic resilience as well as create a united and equitable society.

Although fiscal policy has been expansionary since 1998, Malaysia still enjoys fiscal flexibility, and the continued expansionary budget in 2002 would not create risks in the economy. This is because the federal government debt is expected to be contained at a manageable and sustainable level. Debt servicing of the federal government is also low, with interest payments accounting for about 16% of operating expenditure. The level of expenditure would be managed by taking into consideration the need to stimulate economic activities, maintain a surplus position in the current account, avoid excessive reliance on external borrowings, and avoid crowding out the private sector in terms of borrowings from the domestic financial system.

Expenditure allocation would continue to focus on programmes and projects that would have higher multiplier effects on domestic activity and raise the long-term productivity of the economy. In addition, the annual budget contained both tax and non-tax fiscal incentives focused on expanding domestic demand while strengthening the nation’s competitiveness and resilience. Apart from promoting new sources of growth, allocation is also aimed at developing skilled manpower and technological competence, and expediting the restructuring of the financial and corporate sectors.

Regarding tax policy, the government continued with its tax reform programmes aimed at improving tax buoyancy and tax collection. Emoluments constitute the largest component of operating expenditure. As for development expenditure, education, transport infrastructure and trade and industry are the biggest components.

A. Macroeconomic Activity

1. International Environment

a) Trade Balance

In 2000, the large current account surplus provided a buffer to the outflows for repayment of debts and overseas investments by Malaysians thereby generating a surplus in the basic balance (current and long-term capital accounts). The Government stepped up efforts to ensure that the fiscal stimulus package was implemented fully. Measures were taken to accelerate the implementation using the Turnkey, Design and Build Concept and simplification of guarantee procedures. The Government has instituted several oversight measures to ensure prompt disbursements and timely completion. These include creating a Late Payments Unit to handle late payment grievances faced by suppliers and contractors, allowing greater flexibility of Government agencies in handling project management and payments and forming a special squad to ensure timely implementation of projects. As a result of these measures, the Government disbursed RM27.9 billion of the RM28.3 billion in development expenditure earmarked for spending in 2000.

An important development was that fiscal policies were effective in reviving consumer and investor confidence while maintaining the strength in the balance of payments. By focusing Government expenditure on projects with high domestic linkages, the Government sector did not contribute to the lower current account surplus in the balance of payments. The lower surplus (10% of GNP in 2000 from 17.1% in 1999) was due mainly to higher private sector activities seen in higher imports for the manufacturing sector and higher services payments.

The overall balance of payments turned around to a surplus position in 2001. The improvement was due to lower outflows in the financial account. The current account surplus narrowed in 2001, but nevertheless the surplus remained large at RM27.4 billion or equivalent to 8.9% of GNP. This reflected a moderate decline in the trade account and improvement in the income and services accounts. The impact of the global slowdown on exports has been significant as exports of both manufactured goods and commodities declined during the year. At the same time, demand for imports of intermediate inputs used in the production of exports also declined. This contained the decline in the trade surplus. Given the lower export earnings during the year, repatriation of profits and dividends was also lower in 2001, resulting in an improvement in the income account. The services deficit also declined, reflecting not only lower payments related to export activities but also the marked improvement in the travel account surplus.

Overall, the improved macroeconomic fundamentals reduced the risks that inflationary pressure would emerge over the medium term or that a significant misalignment in the exchange rate would occur. While Malaysia has pursued an expansionary fiscal stance for four consecutive years, the Federal Government debt was contained at 43.8% of GDP. The high domestic savings rate gave the flexibility to finance the deficit mainly from non-inflationary domestic sources of growth. The ample liquidity in the system, supported by strong surpluses in the balance of payments, allowed domestic financing of the deficit without crowding out the private sector.

Table 1. Balance of Payment

			ITEM	**Year**			
				1999	**2000**	**2001**	**2002**
A.	*Goods and Services*			75,348	68,474	61,488	62,948
	1	*Goods*		86,049	79,144	69,854	68,914
	2	*Services*		-10,701	-10,670	-8,366	-5,666
		2.1	*Transportation*	-8,464	-11,736	-11,352	-11,542
		2.2	*Travel*	6,135	11,158	16,148	17,102
		2.3	*Other Services*	-8,395	-10,030	-13,187	-11,242
		2.4	*Government Transactions n.i.e*	23	-62	25	-284
B.	Income			-20,886	-28,909	-25,623	-25,061
	1	Compensation of Employees		-611	-975	-1,014	-1,179
	2	Investment Income		-20,275	-27,934	-24,609	-23,882
C.	Current Transfer			-6,567	-7,313	-8,178	-10,566
D.	**Balance on Current Account (A+B+C)**			**47,895**	**32,252**	**27,687**	**27,321**
E.	Capital Account			0	0	0	0
	1	Capital Transfer		0	0	0	0
		Non-produced Non-financial Assets		0	0	0	0
F.	Financial Account			-25,152	-23,848	-14,791	-11,941
	1	Direct Investment		9,397	6,694	1,091	4,935
	2	Portfolio Investment		-4,392	-9,395	-2,466	-6,506
	3	Other Investment		-30,157	-21,147	-13,416	-10,370
G.	Errors & Omissions			-4,924	-12,107	-9,234	-1,189
H.	**Overall Balance (D+E+F+G)**			**17,819**	**-3,703**	**3,662**	**14,191**
I.	Reserves Assets			-17,819	3,703	-3,662	-14,191
	1	IMF Resources		0	0	0	0
	2	Net Change in Bank Negara Malaysia's External Reserves [Increase (-) / Decrease (+)]		-17,819	3,703	-3,662	-14,191

Source: Central Bank of Malaysia

The overall balance of payments strengthened further to record a larger surplus in 2002. The improvement reflects the sustained strong current account surplus and larger long-term capital inflows into Malaysia while short-term outflows by the private sector declined. The current account surplus narrowed marginally but remained large at RM27.4 billion or equivalent to 8.1% of GNP. While the services and income accounts improved, the outflow of current transfers was larger during the year. The strong recovery in exports led to continuing large surplus in the trade account. At the same time, profits and dividends accruing to Malaysian companies investing abroad turned around to record net inflows, leading to an improvement in the income account. In the services sector, cumulative effects of policies to develop the sector resulted in a significant narrowing of the services account deficit to RM6 billion or 1.8% of GNP.

b) Current Account

The current account surplus in 2002 remained large at RM27.4 billion or equivalent to 8.1% of GNP in 2002, despite the higher growth in imports in line with the pick up in domestic demand. The recovery in export growth emanated from stronger demand for electronics exports and a significant improvement in the terms of trade for commodity exports.

The surplus in the goods account was more than sufficient to offset the deficits in the services and income accounts and also net outflows in the current transfers account. The decline in the services deficit reflected sustained improvement in the travel account surplus and lower payments for contract and professional charges. The income account deficit improved, reflecting the turnaround in profits and dividends accruing to Malaysian companies investing abroad. Meanwhile, profits and dividends accruing to foreign investors remained large, in line with the higher export earnings.

A factor contributing to the marginal narrowing of the current account surplus was a larger net outflow of current transfers of RM10.4 billion (-RM8.2 billion in 2001). This arose largely from the one-off remittance by illegal foreign workers returning to their country under the Amnesty Program from 22 March to 31 July 2002.

c) Exchange Rate

The monetary framework in 2002 continued to operate under a pegged exchange rate regime. The ringgit remained fixed at RM3.80=US$1, an arrangement that has been in place since September 1998. The exchange rate regime continued to provide an environment of certainty and stability to facilitate planning, investment and pricing decisions to support economic activities. Under the current environment of volatile international financial markets, the exchange rate peg reduced efficiency losses and other costs associated with exchange rate uncertainty, thereby benefiting trade and investments. The stable exchange rate amidst low interest rates also created a conducive environment for the rapid and effective restructuring of the banking system and the corporate sector.

The peg continues to be supported by strong macroeconomic fundamentals. The risk of misalignment is minimal as the exchange rate continues to be supported by low inflation, strong current account surplus, a high level of international reserves, low external debt and a strong banking system.

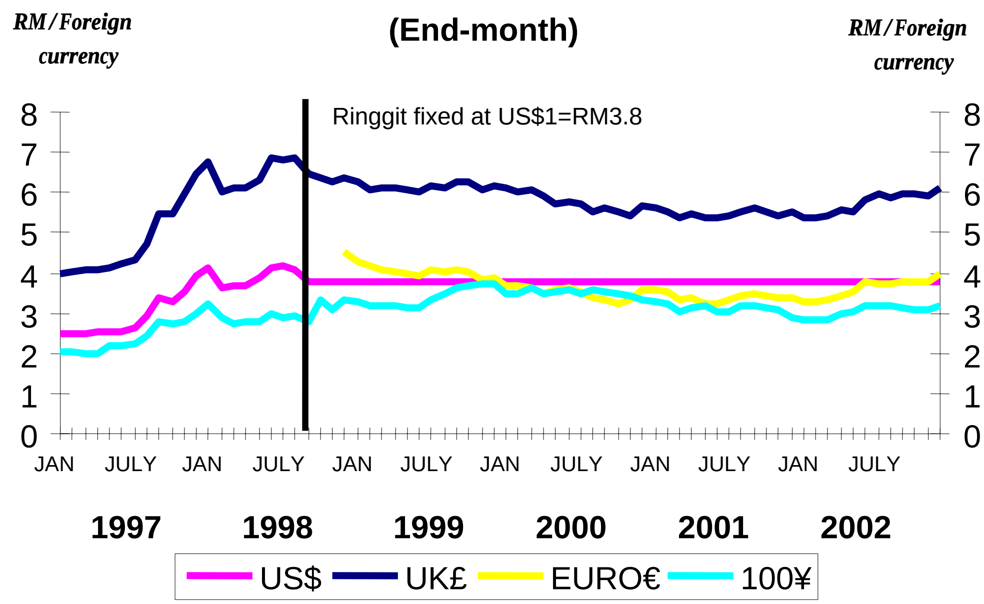
Bilateral exchange rates with other currencies are determined through cross rates based on the movements of the US dollar against these currencies in the foreign exchange markets. The appreciation of the US dollar in 2001 continued into early 2002 as it strengthened further against major currencies on market optimism over better economic growth prospects for the US relative to Japan and the euro area.

In tandem with the movements of the US dollar in the foreign exchange markets, the ringgit depreciated against the euro (-15.4%), the Japanese yen (-9.6%) and the pound sterling (-9.5%). However, given that a large proportion of Malaysia’s external transactions are denominated in US dollars, the Malaysian economy was reasonably insulated from the high volatility in currency movements during the year. The stability accorded by the ringgit peg reduced the element of uncertainty in the decision making process of manufacturers and service providers, thereby facilitating trade and investment.

On the regional front, the ringgit depreciated against most regional currencies in the range of 2.4% - 14.1% in 2002. The exception was the Philippine peso, against which the ringgit appreciated by 3.1%. In addition to the weak US dollar, regional currencies were influenced to some extent by market optimism over the growth prospects of regional economies, a steadier yen, as well as country-specific developments. While several regional currencies were adversely affected by heightened security concerns in the immediate aftermath of the bomb blasts in Bali and Zamboanga in October, the impact, however, was only temporary.

In terms of its trade-weighted nominal effective exchange rate (NEER), the ringgit depreciated by 4.0% during the year 2002, in line with the depreciation of the US dollar against most of the currencies in Malaysia's trade-weighted basket. Since September 1998 when the ringgit was pegged to the dollar, the ringgit NEER has remained stable depreciating by only 1.1%. The small depreciation implies that the ringgit remains fairly valued. The currency continues to be supported by Malaysia's strong macroeconomic fundamentals, namely the low inflation, low external debt levels, strong external balance, higher reserves levels and strong banking sector.

Figure 1. Exchange Rate of the RM against Major Currencies



Source: Bank Negara Malaysia

d) Foreign Direct Investment

Foreign direct investment (FDI) flows to Malaysia increased significantly and mainly comprised retained earnings following the stronger performance of multinational companies in the electronics industry. There were also some new equity investments, which were channelled mainly into the services, oil and gas and manufacturing sectors. The shift in the overall pattern of FDI inflows to services continued to be evident in 2002. These new investments are in diverse fields such as the retail industry, financial services, telecommunications and software development. The key distinguishing feature of these new investments is that while they are small in dollar value, they enhance productivity and competitiveness, thereby generating higher value added and growth.

Outward investment by Malaysian companies also increased, led by some large companies in the oil and gas, manufacturing and utilities sectors. An emerging feature is that overseas investments are now in larger projects in utilities and plantations, compared with previous years when they were concentrated in holding and trading companies.

While enhancing domestic sources of growth is critical to the establishment of a broader economic base and the strengthening of resilience, FDI will continue to play an important role. FDI not only contributes directly to investment and growth but also helps the Malaysian economy absorb new technology and processes to speed the transition up the value chain. The Government's sustained policy to make Malaysia attractive to different types of FDI reflects the recognition of this dual role. Since the mid-1990s, the Government has given more weight to FDI proposals that encompass high skill, high value-added projects. The flexible and focused approach to attracting FDI is best exemplified by the pre-packaged incentive scheme, under which investors are able to apply for a number of incentives customised to suit their requirements while furthering the Government's objective in raising the quality of investments. This scheme is complemented by various other incentives to encourage foreign investors to locate other complementary activities, especially high value-added activities such as regional training centres, research and development, operational headquarters and international purchasing offices, in Malaysia. These operations provide support services not only to the manufacturing operations in Malaysia but also regionally and have a positive spill-over impact on the services sector. Similarly, companies in the services sector, most notably in finance and insurance, and telecommunications and information technology, have moved backroom operations and other support services to Malaysia.

Table 2. Foreign Direct Investment

	Net Foreign Direct Investment RM (Millions)	Net Foreign Direct Investment as % of GDI
2002	1,298.68	5.60 %
2001	287.13	1.36 %
2000	1,761.66	7.19 %
1999	2,321.40	13.10 %
1998	2,187.92	11.38 %
1997	5,557.59	12.75 %

Source: Bank Negara Malaysia & Department of Statistics of Malaysia

e) Borrowing and Aid from Abroad

Malaysia continued to maintain a prudent external debt management strategy to ensure that the nation's external debt is low and its debt profile is biased towards a longer maturity structure. The relatively low level of external debt is the result of the active debt management by the authorities in accordance with international guidelines on prudential safeguards to ensure the country's sustained capacity to meet the challenges associated with external shocks. The prudential safeguards include conscious efforts to reduce risk exposure to global interest rate shocks, adverse exchange rate movements and shifts in investor sentiment. The core rationale of these safeguards is to ensure the diversification of the external borrowing by the public and private sectors in terms of currencies, debt instruments and creditors in order to spread risks, achieve a longer maturity profile and gain wider access to international capital markets.

Furthermore, debt-servicing capacity over the medium term, especially by the private sector, is ensured through a guideline requiring external loans to be utilised to finance productive activities that will generate foreign exchange revenue to service the debt. The management of the nation's debt has been adequately supported by an efficient debt monitoring system which has enabled the authorities to monitor the overall changes in the debt level, the structure of the debt as well as the debt servicing obligation of both the public and private sectors. Malaysia's external debt position in 2002 remained within prudential limits. Notwithstanding the increase in total external debt outstanding by RM11.5 billion or 6.6% to RM185.3 billion (US$48.8 billion) at the end of 2002, the ratio of external debt to GNP and external debt to exports of goods and services remained stable at 55.1% and 44.2% respectively.

The increase in total external debt reflected mainly higher market loans by the Federal Government and the revaluation loss arising from the weakening of the US dollar. The overall debt service ratio (excluding prepayments) remained low at 6% in 2002. The share of short-term debt to total debt continued to be low, accounting for 17% of total external debt, compared with the end-1997 level of 25.3%. The ratio of short-term debt to international reserves continued to be one of the lowest in the region, accounting for only 24% of reserves (end-1997:73.2%). In addition, about two-thirds of the medium and long-term debt have remaining maturity of more than three years. The outstanding medium and long-term external debt increased by RM4.1 billion or 2.8% to RM153.8 billion (US$40.5 billion) as at the end of 2002. The increase was due largely to an exchange revaluation loss of RM3.7 billion resulting from the depreciation of ringgit, particularly against the yen and euro. During the year, the public sector, comprising the Federal Government and NFPEs, recorded a lower net drawdown of RM4.7 billion (2001: RM7.2 billion), as the marginally larger net drawdown of external borrowing by the Federal Government was offset partially by the net repayment by the NFPEs. This net inflow was further offset by net repayment of RM4.2 billion by the private sector.

In 2002, short-term external debt (maturity of one year or less) rose by RM7.4 billion to RM31.6 billion (US$8.3 billion), reflecting largely the increase in external borrowing by the banking sector. Much of these borrowings occurred in the fourth quarter, when commercial banks took advantage of arbitraging opportunities as interest rate differentials widened in favour of Malaysia. The increase in short term transactions is transitional and will be reversed upon maturity. Meanwhile, short-term borrowings by the non-bank private sector, comprising mainly revolving credits and inter-company loans, declined in 2002. In particular, there was a large repayment of RM3.1 billion during the second quarter for bridging loans acquired in the fourth quarter of 2001 to finance the acquisition of controlling interests in a telecommunication company from non-resident partners.

Table 3. External Debt

	External debt outstanding								*External debt service ratio*[5]	
		Medium and long-term debt[1]				*Short-term debt*[2]				
End period	*Total*	*Federal Government*	*NFPEs*[3]	*Private sector*[4]	*Sub-total*	*Banking sector*	*Non-bank sector*	*Sub-total*	*Total*	*Federal Government*
	RM million								%	
1997	170,757	12,952	52,467	62,081	127,500	32,276	10,981	43,257	5.1	0.5
1998	169,956	14,924	51,220	67,991	134,136	20,339	15,481	35,820	6.5	0.9
1999	162,133	18,369	57,021	64,315	139,706	12,661	9,766	22,427	7.5	0.5
2000	161,091	18,821	59,566	65,078	143,465	9,271	8,355	17,626	6.5	2.6
2001	174,358	24,328	67,415	58,419	150,162	11,926	12,270	24,195	8.4	0.7
2002	186,601	36,283	64,330	53,799	154,412	21,894	10,295	32,189	6.4	1.0

1 Medium and long-term debt refers to debt with tenure of more than one year. Quarterly figures are preliminary.
2 Short-term debt refers to debt with tenure of one year and below.
3 Includes both guaranteed and non-guaranteed debt of Non-Financial Public Enterprises. Up to 1982, the non-guaranteed debt of the NFPEs were classified under private sector. Malaysian Airline System Berhad has been reclassified as an NFPE instead of private sector in 2001.
4 Up to 1982, includes the non-guaranteed debt of the NFPEs.
5 Measures the principal repayment (excluding prepayment) and the interest payment of the external debt as a proportion of gross export of goods and services.
Data on the annual total debt service ratio for the period prior to 1980 and quarterly debt service ratio for the period prior to 1981 are not available.
Source: Treasury and Bank Negara Malaysia

The currency composition of the medium and long-term debt continued to be largely denominated in United States dollars, with a share of 77% of debt outstanding as at end-2002. The share of yen denominated debt stabilised at 15% while that of the euro increased marginally to 4%. The remaining 4% of the debt was denominated in other international currencies, including the pound sterling, Swiss franc and Singapore dollar. The currency composition of external debt generally corresponds closely with the currency composition of the nation's external earnings, thus, providing a natural hedge against currency risks.

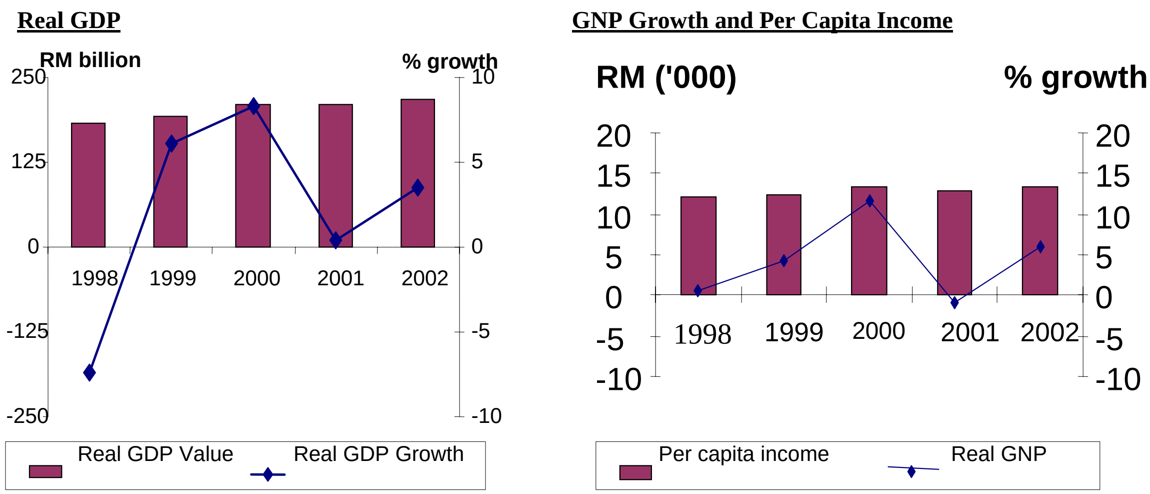
2. Domestic Environment

a) Economic Growth (GDP & GNP)

Recovery of the Malaysian economy gained momentum in 2002 amidst a more challenging external environment. Real economic growth turned positive in the first quarter and strengthened to 5.6% in the fourth quarter. For the year as a whole, real gross domestic product (GDP) expanded by 4.2% compared with 0.4% in 2001. Economic growth was broad based, driven by strong domestic demand and reinforced by improved export performance. While public expenditure was strongly supportive of economic activity, growth was reinforced by sustained strength in consumer spending and external demand. Low interest rates, improved access to financing and the significant improvement in commodity prices provided strong stimuli for private sector expenditure to grow.

During the years of high growth in the early 1990s, actual output tracked closely its potential. With the sharp contraction experienced after the Asian crisis, the output gap has widened significantly in 1998 but as the economy recovered, the gap narrowed. In 2001, the output gap widened to 6.2% as real output growth was marginal. However, with the stronger pickup in economic activity compared to the growth in potential output in 2002, the output gap narrowed. Bank Negara Malaysia's latest estimates of potential output indicated that the output gap narrowed to 5.1% of potential GDP in 2002 (2001: 6.2%) as actual GDP grew more rapidly (4.2%) than potential GDP (3%). The moderate increase in potential growth rate was due to the slow increase in capital investments (0.2%) as investors remained cautious given global uncertainties in 2002 and the continued excess capacity in selected sectors of the economy.

Figure 2. GDP & GNP



Source: Bank Negara Malaysia

The estimated short-run elasticity of capital is slightly higher than the short-run elasticity of labour, implying that changes in capital have had a slightly greater impact on output and returns to capital have improved, even in the short-run. Firms have therefore, managed to increase output without increasing capital investments significantly. This could possibly reflect that capital investments, which were mainly channelled into the upgrading of firms' technological capabilities, could have had an immediate impact on output.

Table 4. Gross Domestic Product by Kind of Economic Activity in Constant 1987 Prices

(RM million)

	1999	2000	2001	2002p	2003f
Agriculture	17,596	17,943	18,269	18,330	18,613
Mining and quarrying	15,344	15,641	15,892	16,603	17,354
Manufacturing	56,841	67,717	63,536	66,126	69,400
Construction	6,926	6,996	7,159	7,325	7,467
Services	106,293	112,372	118,764	124,083	129,545
Less: Imputed bank service charges	14,896	15,873	17,902	18,644	19,556
Plus: Import duties	5,319	4,742	4,762	5,519	6,379
GDP at purchasers' prices1	193,422	209,538	210,480	219,342	229,202

1 Total may not necessarily add up due to rounding.
p Preliminary
f Forecast
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The long-run elasticity of capital, which is estimated to be 0.49, is slightly higher than its short-run counterpart, in line with previous findings. The higher returns to capital imply more efficient utilisation of capital. Efficiency as measured by the ratio of output to capital has increased at a faster rate compared to the ratio of output to the number of employees. Past supportive infrastructure investments, which have long gestation periods, have begun to show positive returns as they have expanded the productive capacity of the economy and alleviated bottlenecks. In the longer term, with the implementation of the Knowledge-based Economy Master Plan, potential output growth would be further increased.

b) Inflation Rate

Inflation rate remained subdued in 2002. The headline inflation, as measured by the annual change in the Consumer Price Index (CPI), was slightly higher at 1.8% in 2002 (2001: 1.4%) but core inflation, a measure of demand-related price pressures, moderated from 1% in 2001 to 0.4% in 2002. Despite the stronger expansion in domestic demand, the excess capacity in several sectors in the domestic economy and low import prices dampened price pressures during the year.

The marginal increase in headline inflation during the year reflected the one-off price adjustments mainly for the transport and communication sub-group. These one-off price adjustments accounted for 10.9% of the CPI basket and contributed to 1.4 %age points to the headline inflation in 2002. Except for higher import duties for cigarettes and tobacco, the one-off price adjustments for the transport and communication sector; and petroleum related products reflected the move towards a more market-based pricing mechanism. Overall, these changes were:

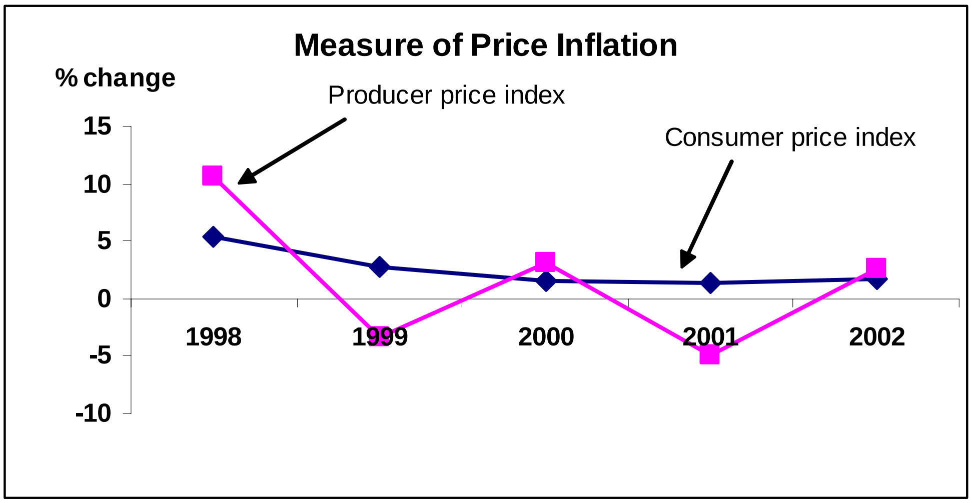
1] An increase in toll charges by 10%, effective from 1 January 2002;
2] Higher domestic telephone charges following a new structure for telephone tariff, implemented with effect from 1 March 2002;
3] Increase in retail petrol-pump prices by 10 sen from end of October 2001, a further increase of 2 sen from 1 May 2002 and 1 sen from 1 November 2002; and
4] Increase in diesel and LPG prices by 2 sen from 1 May 2002, followed by another increase of 2 sen from 1 November 2002.

The adjustments of these input prices during a period of excess capacity in several sectors had minimum pass-through effect on other goods and services and hence, contained the effect of increases in other consumer products. The upward adjustments in the prices of retail petrol and its related products, and telephone charges reflected higher crude petroleum prices and the change in market conditions of higher production costs. A positive outcome of the increase in domestic telephone charges has been the improvement in the quality of telephone services and an expansion of internet services to the rural areas.

An analysis of the changes in the prices of goods and services showed that the headline inflation rate reflected mainly larger price increases for services (2.9%), particularly transport and communication services. Prices in the goods sector increased at a slower pace of 0.5%. Prices for non-durable goods moderated as growth in prices of food taken at home softened to 0.2% in 2002 (0.4% in 2001) on the back of favourable weather conditions. Prices for durable and semi-durable goods were lower during the year, brought about by the decline in the prices charged for goods produced locally, which recorded a price increase of 5.7% during the year (2001: -6.1%) and accounted for 79.3% of the total PPI basket. This reflected higher prices for commodity-related products following the sharp increase in prices of crude palm oil, crude petroleum and rubber during the year. Excluding these commodity-related products, producer prices remained relatively stable, increasing only by 0.1%.

Meanwhile, prices for goods paid by importers were also stable during the year, as excess global capacities and competition for markets eroded the pricing powers of producers.

Figure 3. Inflation: Annual Rate of Change



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

c) Consumption

Domestic demand conditions strengthened significantly in 2002, sustained by the continued expansion in overall public sector spending and a marked increase in private consumption. Despite greater uncertainties prevailing in the external environment in the second half of the year, consumer confidence remained high throughout the year.

Higher disposable incomes and the positive impact of the fiscal stimulus and low interest rates were reinforced by a stronger export performance and the sharp improvement in commodity prices. As domestic economic recovery gained strength, private investment turned around from five consecutive quarters of decline to record a modest recovery in the second half of the year. Overall, growth in aggregate domestic demand (excluding stocks) strengthened to 4.3% from 2.8% in 2001.

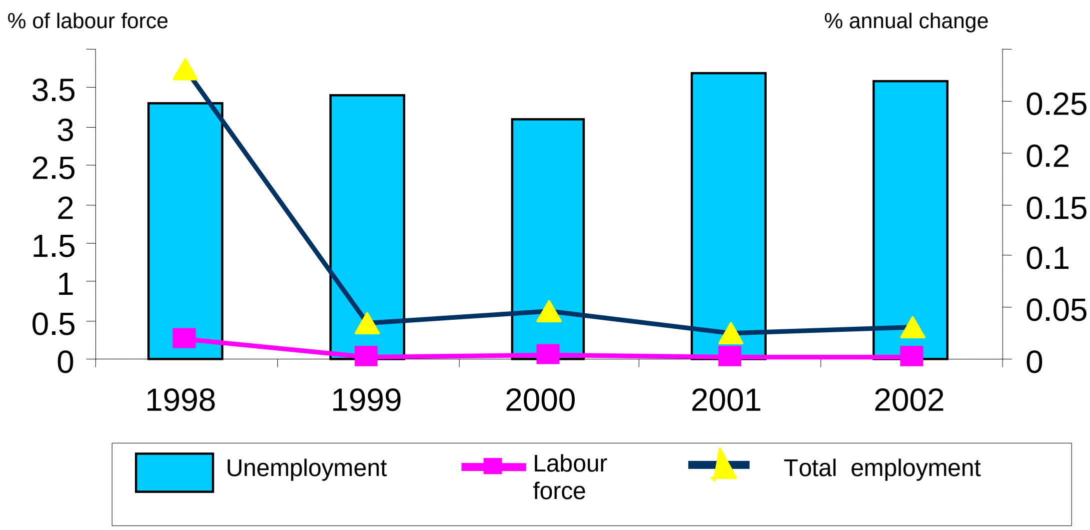
d) Employment

The potential for sustained economic growth can be expected to continue to generate employment opportunities in the major sectors of the economy, led by the services and manufacturing sectors. The unemployment rate is estimated to be about 3.4%. Initiatives undertaken by the Government in recent years have aimed to increase the quality of labour to meet changing demands of employers and to reduce the skills mismatch in the domestic labour market.

For the most part, the trends in the labour market mirrored that of the improving economic conditions. As the recovery gained momentum, the unemployment rate fell to 3.5% at the end of 2002. The decline in unemployment was due to both a significant decline in retrenchments as well as higher demand for labour. However, with excess capacity still affecting selected sectors, the pick-up in economic activity has not exerted undue pressure on wages. The latest indicators showed that increases in wage rates moderated while productivity improved in 2002.

In addition to implementing fiscal measures to support economic activity, non-fiscal measures were also formulated to complement private sector initiatives and enhance confidence. The focus of these policies was to ensure that employment and income prospects remained sound. In this regard, several concrete steps were taken to match job seekers with job vacancies and improve the mobility of workers. Nationwide job fairs and retraining programmes were held throughout the year. A major development during the year 2002 was the commencement of operations of the Electronic Labour Exchange (ELX). The ELX, which started operating in May 2002, was designed to effectively match job seekers with vacancies over larger geographical areas. As at end-2002, 11,000 job seekers had registered with the ELX while 720 employers had advertised 2,040 vacancies on it.

Figure 4. Output and Employment



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Labour market conditions remained favourable in 2002 to support the recovery in economic activity. The latest estimates showed that the total labour force and employment expanded moderately by 3.1% to 10.2 million persons and 3.2% to 9.8 million workers, respectively. Consequently, the unemployment rate declined from 3.6% to 3.5%, and remained close to the full employment level. The improved labour market conditions during the year were also reflected in the significant decline in the number of retrenched workers and higher demand for labour. Measures were taken in 2002 to improve the quality of labour and to address concerns of mismatch of skills with labour demand. Human resource development remained a priority area in continued reforms to strengthen the Malaysian economy.

In order to alleviate the shortage of workers in certain sectors, the Government approved the recruitment of 545,725 new foreign workers (2001: 258,578). In total, the number of registered foreign workers increased by 111% to 1,057,156 in 2002. The majority of foreign workers were engaged in the manufacturing, agriculture, domestic services and construction sectors. While the recruitment of Indonesians accounted for the largest proportion (71.4%) of total registered foreign workers, the recruitment of workers from Thailand increased significantly to 23,660 in 2002 (2001: 2,240), with the majority being absorbed by the construction sector.

Table 5. Labour Market Indicators

	1997	1998	1999	2000	2001	2002
Job Seekers[1]	**23,762**	**33,345**	**31,830**	**27,820**	**34,200**	**32,305**
No. of job vacancies (by categories)[2]	**64,463**	**74,610**	**108,318**	**123,484**	**131,459**	**162,787**
Professional, technical & related workers	3,779	3,362	3,339	4,055	3,942	6,597
Administrative & managerial workers	537	767	1,042	976	1,078	1,978
Clerical & related workers	12,300	6,454	6,961	10,948	8,914	9,660
Sales workers	1,681	2,171	1,740	2,074	2,974	3,062
Service workers	2,325	3,036	2,526	2,848	3,575	4,151
Agriculture, Animal Husbandry, Forestry						34,424
workers, Fishermen & Hunters	947	2,637	17,188	27,031	23,084	-
Production operator	42,894	56,183	75,522	75,552	87,892	102,915
Retrenchment (No. of workers)[3]	18,863	**83,865**	**37,357**	**25,244**	**38,116**	**26,457**

1 The number of job vacancies could have been under-reported as it is not compulsory for firms to report vacancies to the Manpower Department.

2 Since 1 February 1998, it is mandatory for employers to inform the Director General of the Labour Department at least one month before any retrenchment exercise is undertaken.

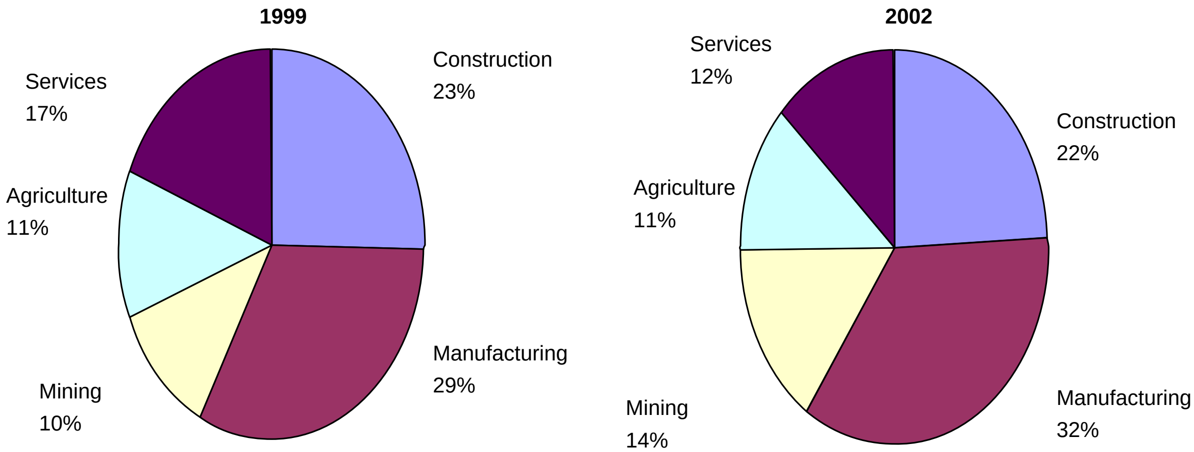
Source: Department of Statistics; Ministry of Human Resources; Manpower Department

e) Investment

Public investment expenditure grew moderately by 4.6%. The Federal Government's development expenditure was channelled mainly towards education and training to enhance human resource development and longer-term productive capacity-building projects, and includes infrastructure and information and communication technology, to facilitate the move towards a knowledge-based economy. Higher outlays were also expended on rural development, health services, low-cost public housing projects and housing for essential personnel.

All the major sectors of the economy, with the exception of the manufacturing sector, registered moderate increases in capital spending. This trend in part reflected concerted efforts taken by the Government aimed at developing new domestic sources of growth, mainly in the services sector, including tourism, high value added knowledge-based and resource-based economic activities, and agriculture. Consequently, there has been a noticeable shift in the pattern of investment, with new investment increasingly being channelled towards the new promoted areas in the services sector. This included higher value added and knowledge–based foreign investment in the services sector as evidenced by the setting up of operational headquarters, regional sectors of the economy and slower-than-expected recovery in world growth. Nevertheless, investment activities recovered in the second half of the year, supported by on-going electrical and electronics projects and petrochemical projects and capacity expansion in industries operating at higher capacity levels such as transport equipment and basic metal products industries.

Figure 5. Private Investment by Sector (% of share)



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The foreign share of total investment applications and approvals, both for new activities and expansion by existing concerns, remained high as investors took advantage of the relative robustness in the Asian economies, including Malaysia. Foreign investors accounted for 78.6% of total approved reinvestments during the year. The value of foreign investments approved in the manufacturing sector in 2002 amounted to RM11.2 billion and accounted for 68% of total approved investments. The top five sources of foreign investments during the year 2002 were Germany, the United States, Singapore, the Netherlands and Japan, which together accounted for 86.6% of the total foreign investment approved.

f) Capital Formation

Private capital formation turned around to post moderate growth in the second half of 2002 as several industries in the manufacturing sector, such as electronics, chemical products and transport equipment, operated at high rates of capacity utilisation in response to stronger external demand. Reinforcing this development were new investments in high value-added services such as telecommunications and information technology. Malaysia also benefited from some diversion of foreign investment flows, particularly through outsourcing activities and the relocation of design and product development operations by some foreign companies in the electronics industry.

Despite increasing uncertainties in the global and regional environment, underlying growth prospects for Malaysia remain reasonable with sustained domestic demand and the expansion in intra-regional trade providing a floor to growth. Gross fixed capital formation, which rose 9.8 per cent in the fourth quarter of 2002, is also an encouraging indicator of near-term growth prospects.

Table 6. Gross Capital Formation

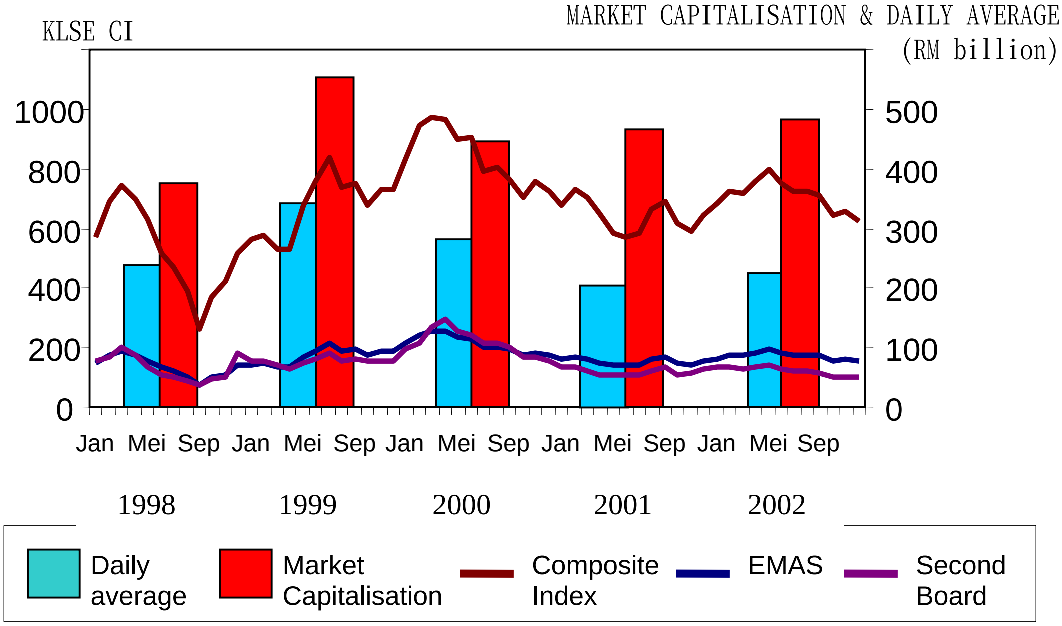
	1999	2000	2001	2002
Public gross domestic capital formation	34,466	43,627	48,817	51,142
Private gross domestic capital formation	32,851	49,100	30,867	37,026
Gross domestic capital formation	67,317	92,727	79,684	88,168
(as % of GNP)	24.1	29.6	25.8	26.2

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

g) Stock Exchange

The securities industry in Malaysia effectively began in the late 19th century as an extension of the presence of British companies in the rubber and tin industries. In 1964, Stock Exchange of Malaysia formed. With the secession of Singapore from Malaysia, the common stock exchange continued to function but as the Stock Exchange of Malaysia and Singapore (SEMS). In 1973, with the termination of currency interchangeability between Malaysia and Singapore, the SEMS was separated into The Kuala Lumpur Stock Exchange Bhd. (KLSEB) and The Stock Exchange of Singapore (SES). Malaysian companies continued to be listed on SES and vice-versa. A new company limited by guarantee, The Kuala Lumpur Stock Exchange (KLSE) took over operations of KLSEB as the stock exchange in 1973.

Figure 6. KLSE - Composite Index and Market Capitalization



Source: KLSE

Companies are listed either on the Main Board or the Second Board of the KLSE, and are classified into a range of diverse sectors reflecting their core businesses. With the increasing emphasis on corporate governance, the KLSE, too, is moving towards implementing a disclosure-based system in order to inculcate higher standards of disclosure and accountability by listed companies. This move is largely aimed at improving the transparency of public listed companies and to ensure that small investors are better protected.

Compared with major regional bourses, the KLSE fared better than Hong Kong, Singapore, Korea and Taiwan markets. Despite the decline in the KLSE CI, market capitalisation increased by 3.6% to RM481.6 billion due to two very large initial public offerings. For the year as a whole, trading volume increased to 55.6 billion units valued at RM117 billion (49.7 billion units valued at RM85 billion in 2001).

h) Money Supply

The improved economic activity was also reflected in the growth of all monetary aggregates, M1, M2 and M3 expanded at stronger rate of 10.3%, 5.8% and 6.7% respectively at end-2002. Consistent with the higher expansion in output, M3 rose by RM31.6 billion in 2002. The main impetus for monetary expansion came from the increase in financing of private sector activity

(RM26.2 billion during the year). Higher financing of the private sector, reflected both higher bank lending and higher holdings of private securities held by the banking institutions.

Table 7. Money Supply: Annual Change and Growth Rates

	M3[5]													
	Total		M2[3]										Deposits with other banking institutions[4]	
			Total		M1[1]						Narrow quasi-money[2]			
					Total		Currency		Demand deposits					
	RM m	%	RM m	%	RM m	%	RM m	%	RM m	%	RM m	%	RM m	%
1998	10,650	2.7	4,255	1.5	9,230	-14.6	3,188	14.9	6,043	14.4	13,485	5.9	6,395	6.5
1999	33,131	8.3	40,666	13.7	19,313	35.7	6,534	35.8	12,778	35.6	21,354	8.8	7,535	7.2
2000	21,906	5	17,564	5.2	4,769	6.5	2,517	10.2	7,287	15	12,795	4.9	4,342	4.5
2001	13,022	2.9	7,810	2.2	2,512	3.2	-115	-0.5	2,627	4.7	5,298	1.9	5,213	5.1
2002	31,608	6.7	21,030	5.8	8,343	10.3	1,749	7.9	6,595	11.3	12,687	4.5	10,578	9.9

[1] *Currency in circulation and demand deposits of the private sector.*
[2] *Comprising savings and fixed deposits, negotiable instruments of deposits (NIDs), repos and foreign currency deposits of the private sector placed with commercial banks and Islamic banks.*
[3] *M1 plus narrow quasi-money.*
[4] *Comprising fixed deposits and repos of the private sector placed with finance companies, merchant banks and discount houses. Also includes saving deposits with finance companies, NIDs with finance companies and merchant banks, foreign currency deposits placed with merchant banks and call deposits with discount houses. Excludes interplacement among the banking institutions.*
[5] *M2 plus deposits placed with other banking institutions.*
Source: Bank Negara Malaysia

At the same time, the Government and external operations also contributed to M3 growth. In the case of M1, the stronger growth reflected higher demand for transaction balances. Both currency in circulation (RM1.8 billion) and demand deposits (RM6.7 billion) increased significantly, in line with the higher consumption spending and higher current account balances maintained by businesses following the improved business activity.

As at April 2003, the annual growth rates of broad monetary aggregates, M2 and M3, were sustained at 5.7% and 6.5% respectively (5.7% and 6.8% respectively at end- March). M1 growth moderated to 6.4% (8.4% at end March) largely on account of the decline in demand deposits of domestic business enterprises. During the month, the growth in M3 emanated mainly from the expansionary Government and external operations, as well as the sustained increase in bank lending activities. These expansionary effects were partially offset by the liquidity operations of BNM.

B. Fiscal Position

1. Government Expenditure & Public Borrowing

In the management of public finances, the Government remains committed to fiscal prudence to preserve long-term fiscal sustainability and flexibility. In this respect, growth in operating expenditure was kept within reasonable bounds, resulting in sustained large current account surplus of RM14.8 billion. Operating expenditure was higher in 2002 arising largely from salary and pension adjustments for civil servants as well as grants and transfers to government agencies, including state governments, for development and maintenance purposes. Higher development expenditure than initially budgeted reflected larger allocation for education and training as well as for infrastructure and industrial development. Concurrently, the Government adopted measures to mitigate increases in expenditure, including a progressive reduction in the subsidy for petrol and petroleum products.

Recognising the need to promote skills development and the nation's orientation towards a knowledge based economy, the thrust of the spending was on human resource development.

Consequently, the share of the education sector in total development spending has increased to account for a larger share of 34.6% (17.1% in 1999). The projects were mainly for the construction of single-session school system, smart schools, community colleges, new colleges and universities. In addition, emphasis was given for upgrading of educational infrastructure and support facilities, including provision of facilities for science and computer education and curriculum development. To provide loans for higher learning, the allocation for the Higher Education Fund was increased by RM500 million to RM1.8 billion.

In the economic services sector, capital outlays for the transport sector absorbed the largest share of the development expenditure (15%). Higher expenditure was spent mainly on air, port and road transportation to develop a more efficient and effective integrated transportation system linking air, rail, land and marine transportation networks. Outlays on trade and industry were focused on the provision of infrastructure facilities, industrial research and development, development of small and medium enterprises and promotion of tourism. Reflecting the Government's commitment to upgrade the standard of living in the rural area, expenditure on agriculture and rural development remained high, with higher investment to improve rural roads, water supply and electrification programmes.

Spending for defence and internal security was also higher, mainly for modernisation programme of the armed forces and police. On the other hand, general administration expenditure was substantially lower, largely on account of the gradual completion of the new Government administrative centre in Putrajaya.

In September 2002, the government announced the two-year Budget preparation to ensure the smooth implementation of development projects. This is aimed at giving implementing agencies lead time to plan and carry out projects. Implementing agencies can proceed with preliminary works, such as acquisition of sites, environmental impact assessment, soil investigation and design. For this purpose, an allocation of RM985 million is provided to various ministries to commence preliminary works this year and undertake physical implementation in 2004. To accelerate the implementation of Government projects, the state governments were urged to also play their role in simplifying and expediting the acquisition process of project sites. Local authorities should also expedite the approval of design plans and licences.

Table 8. Components of Federal Government Operating Expenditure

(RM Million)

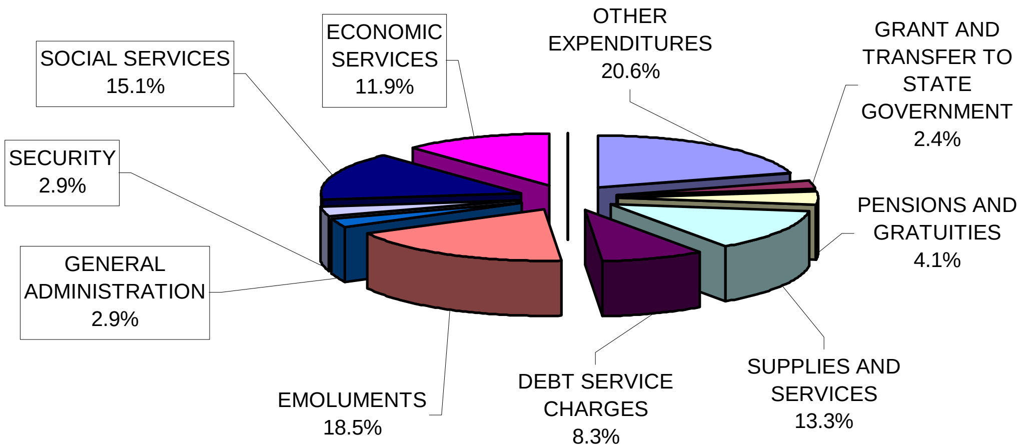
Components	1999	2000	2001	2002[1]	2003[2]
Emoluments	14,436	16,357	17,443	20,242	19,727
Pension & Gratuities	3,792	4,187	4,711	5,134	4,408
Debt Service Charges	7,941	9,055	9,634	9,670	8,868
Supplies & Services	6,074	7,360	10,704	11,269	14,253
Grants & Transfer to State Governments	1,513	2,077	2,012	2,539	2,534
Subsidies	1,136	4,824	4,450	3,677	3,936
Others	11,807	12,687	14,803	16,168	18,011
Total	46,699	56,547	63,757	68,699	71,737

[1] *Estimated Actual*
[2] *Revised Estimate*
Source : Ministry of Finance, Malaysia

Of the total gross borrowings of RM28.5 billion raised in 2002, 63% was raised from the domestic market. The continued high national savings rate and ample liquidity in the banking system allowed funding requirements of the Government to be met without "crowding out" private sector access to financing. In an environment of declining interest rates in the domestic money market, new issues of MGS were raised at lower coupon rates ranging from 3.07 to 4.053%. The low interest rate environment reduced significantly the cost of debt issuance and contained the increase in the Government's future debt servicing burden. Apart from meeting financing requirements, the domestic borrowing programme was also aimed at providing a reflective benchmark yield curve to facilitate the development of the domestic ringgit bond market.

The issuance of government securities in the domestic market amounted to RM18 billion. During the year, the Federal Government floated five issues of Malaysian Government Securities (MGS) totalling RM15 billion, by way of open tender through principal dealers, as well as via private placements. A sole issue of the Government Investment Issues (GII) amounting to RM3 billion was also raised. As part of the strategy to develop the domestic bond market, the Government continued to issue securities on a regular basis and with maturities ranging from 3, 5 and 10-years to meet the demands of the market and to generate a benchmark yield curve. The Government also reopened three of its existing MGS issues to increase their respective sizes. The strategy was to develop the secondary market by enhancing market liquidity. The issuance of Treasury bills (TB) was only to meet rollover of maturing bills.

Figure 7. The Federal Government Budget (2003)



Source: Department of Information Services

The bulk of the new MGS issuance was absorbed by the provident, pension and insurance funds, which continued to be the dominant holders, holding 77% of the outstanding MGS. In terms of ownership structure for GII and TB, the banking sector was the main holder, followed by insurance companies. While the Government continued to rely on domestic sources to meet its financing requirements, the Government also tapped the international capital markets for benchmarking purposes, to take advantage of low costs, and diversify and make inroads into the broader international financial markets in terms of financing based on Islamic principles. Given the favourable external market conditions, the Government raised two external borrowings. In March, the Government reopened Malaysia's US$ Global Bond due 2011 by US$750 million (RM2.9 billion) at a much lower rate of 6.80%, 90 basis points lower than the initial issue of 7.70%.

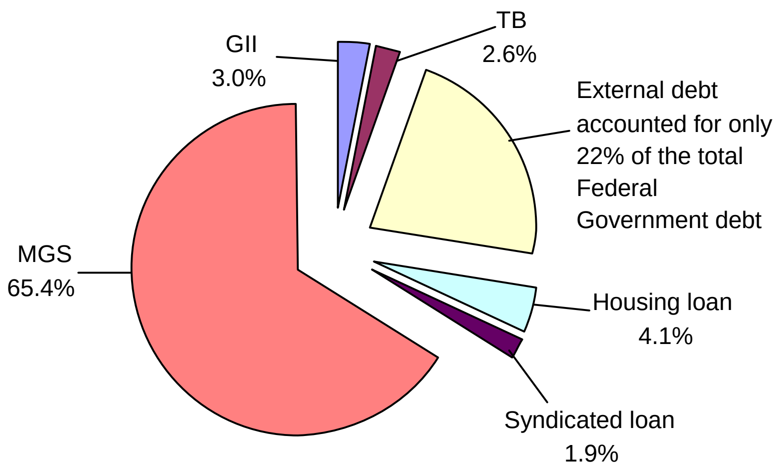
Other sources of external borrowing comprised mainly the draw down of project loans from bilateral sources, especially from Japan under the New Miyazawa Initiative and from multilateral sources such as the World Bank and the International Development Bank. The Government signed a ¥68 billion project loan (RM1.6 billion) in February 2002 with the Japan Bank for International Cooperation. The loan was for the financing of high technology ventures and would be drawn down over several years. After taking into account the exchange rate revaluation loss arising from the strengthening of the yen and euro against the ringgit, as well as assumption of debt incurred by public enterprises and privatised entities, the ratio of external debt of the Federal Government to GDP increased to 10% from 7% in 2001. Nevertheless, external debt of the

Federal Government remained low, accounting for 19.6% of the nation's external debt. Notwithstanding the increase in external debt in 2002, the bulk of the outstanding debt of the Federal Government was raised from domestic sources (78%).

Total outstanding debt of the Federal Government increased moderately by 13.2% to RM165 billion or 45.6% of GDP. Lower net domestic borrowings led to a decline in the proportion of the domestic debt outstanding, from 36.3% of GDP as at end-2001 to 35.6% of GDP as at end-2002. Overall, the Government's debt servicing capacity continued to remain within prudent levels. Debt servicing as a proportion of the operating expenditure and revenue remained low at 14.1% and 11.6% respectively in 2002. External debt service ratio of the Federal Government also remained low at 1%. Active debt management also reduced bunching of repayments, with about 60% of the debt having remaining maturity of more than three years. The bulk of the loans are also at fixed interest rates, reducing exposure to any significant increase in interest rates.

Figure 8: Federal Government Outstanding Debt as at end-2002 (% share)

Domestic Debt



Source: Bank Negara Malaysia

Table 9. Federal Government Development Expenditure: A Functional Classification [1,2]

RM million

Period	Total	*Economic services*							*Social services*					General admin.[4]
		Defence and security	*Sub-total*	*Agriculture and rural develop.*	*Trade and industry*	*Transport*	*Public utilities*	*Others*[3]	*Sub-total*	*Education*	*Health*	*Housing*	*Social and community services*	
1980	7,470	1,222	4,856	1,147	1,567	1,031	665	446	1,173	558	80	295	240	219
1981	11,358	1,839	6,908	1,481	3,170	1,272	748	237	2,437	791	118	1,231	297	174
1982	11,485	2,065	5,908	1,487	1,138	1,970	856	457	3,286	1,082	150	1,658	396	226
1983	9,670	1,722	5,803	1,156	1,299	1,650	1,027	671	1,965	983	156	552	274	180
1984	8,407	1,005	5,061	1,122	689	1,193	1,132	925	2,223	1,009	125	908	181	118
1985	7,142	627	4,251	1,190	531	1,126	789	615	2,139	868	112	976	183	125
1986	7,559	384	4,509	1,147	504	1,397	683	778	2,546	1,064	118	1,047	317	120
1987	4,741	333	3,164	919	629	955	650	11	1,033	810	53	79	91	211
1988	5,231	360	3,564	991	838	1,065	656	14	1,189	865	69	58	197	118
1989	7,696	842	4,630	1,140	956	1,506	993	35	1,981	1,242	218	182	339	243
1990	10,689	1,061	6,701	1,298	2,726	1,845	798	34	2,617	1,634	461	43	479	310
1991	9,565	2,211	4,684	1,126	969	1,897	681	11	2,426	1,285	572	66	503	244
1992	9,688	2,173	4,504	1,098	648	1,896	834	28	2,653	1,205	602	94	752	358
1993	10,124	2,258	5,265	1,276	660	2,678	610	41	2,220	1,117	425	167	511	381
1994	11,277	2,360	5,289	1,342	961	2,158	790	38	3,285	2,010	354	359	562	343
1995	14,051	2,888	6,440	1,360	1,218	3,151	654	57	3,513	2,044	388	403	678	1,210
1996	14,628	2,438	7,693	1,182	1,212	4,530	733	36	3,984	2,091	459	501	933	513
1997	15,750	2,314	7,501	1,105	1,285	3,578	1,496	37	4,919	2,521	449	735	1,214	1,016
1998	18,103	1,380	9,243	960	3,227	3,062	1,968	26	5,783	2,915	716	1,030	1,122	1,697
1999	22,614	3,122	8,969	1,088	2,798	2,893	1,850	340	6,936	3,865	836	1,081	1,154	3,587
2000	27,941	2,332	11,639	1,183	3,667	4,863	1,517	408	11,076	7,099	1,272	1,194	1,511	2,894
2001	35,235	3,287	12,724	1,394	4,829	5,042	1,092	367	15,385	10,363	1,570	1,269	2,183	3,839
2002[5]	35,977	4,333	12,433	1,364	3,474	5,401	1,808	387	18,043	12,436	1,503	1,808	2,296	1,168

1 Quarterly figures are preliminary.
2 Include Federal Government loans to state governments, statutory authorities and public corporations with substantial Government participation.
3 Include communications, feasibility studies and mineral resources.
4 Include s public services, statistics, Royal Customs and Excise, Inland Revenue Departments and Ministry of Foreign Affairs.
5 Preliminary.
Numbers may not add up dto total ue to rounding. Source: Accountant General Department

2. Aggregate Tax Revenue

Federal Government revenue increased by 5% to RM83.5 billion in 2002. The increase in revenue emanated entirely from tax sources. Tax revenue rose by 8.7% to account for a higher share of total revenue (80%). Collection from non-tax revenue was lower, attributable mainly to lower receipts of investment income and petroleum royalties.

Table 10. Federal Government Revenue (RM million)

	1999	2001	2001	2002
Tax revenue	45,346	47,173	61,492	66,860
% of GDP	15.1	13.9	18.4	18.5
Direct taxes	27,246	29,156	42,097	44,351
Income taxes	25,159	27,016	40,135	42,237
Companies	15,742	13,905	20,770	24,642
Petroleum	2,856	6,010	9,858	7,636
Individuals	6,419	7,015	9,436	9,889
Co-operatives	142	87	70	69
Real property gains tax	287	247	227	319
Stamp duties	1,566	1,799	1,650	1,732
Others	234	94	85	63
Indirect taxes	18,100	18,017	19,395	22,509
Export duties	670	1,032	867	803
Import duties	4,720	3,599	3,193	3,668
Excise duties	4,723	3,803	4,130	4,745
Sales tax	4,488	5,968	7,356	9,243
Service tax	1,459	1,701	1,927	2,214
Others	2,040	1,914	1,922	1,836
Non-tax revenue and receipts	13,329	14,691	18,075	16,655
Total revenue	58,675	61,864	79,567	83,515
% of GDP	19.5	18.2	23.8	23.1

Source: Bank Negara Malaysia

The higher tax revenue collection was due to the broad overall expansion in economic activities and concerted efforts made by the Government to broaden the tax base, strengthen the efficiency of tax collection, improve compliance and pursue stricter enforcement. On balance, the proportion of total revenue to GDP was sustained at a high level of 23.1% (23.8% a year ago). Of significance, the larger tax collection in 2002 was achieved amidst further reductions in income tax rates and import duties announced in the 2002 Budget and lower contribution from petroleum-based revenue. Crude oil prices were lower in 2001, the income tax base for 2002.

III. Tax Structure: Institutions and The Reality

Taxation is one of the economic tools that the government employs to regulate the economy. The major objectives of implementing tax policies are to encourage economic growth through the granting of fiscal incentives and to finance the various development programmes. The Malaysian Treasury is responsible for all policies relating to taxation. Meanwhile it is the responsibility of Inland Revenue Board of Malaysia (IRB) for the enforcement of the following legislations, which are related to direct taxation; Income Tax Act 1967 (ITA 1967), Petroleum (Income Tax) Act 1967, Promotion of Investments Act 1986, Real Property Gains Tax Act 1976, Stamp Act 1949 and Labuan Offshore Business Activity Tax Act 1990. The Royal and Custom Excise Department on the other hand is responsible for the enforcement of legislation relating to indirect taxation.

Of course, there are other types of taxes such as entertainment tax, gaming tax, etc. However, these are not Federal taxes and are administered by the relevant State Authority. Nevertheless, there are also departments other than the IRB or the Royal and Custom Excise Department that administer Federal taxes such as Road Transport Department Malaysia, which is one of the departments under the Ministry of Transport. It is responsible for providing counter services in matters pertaining to vehicles and driving licences, and enforcing the Road Transport Act 1987 (among other things is collecting road tax) to ensure competent drivers and safe vehicles.

a. Tax Administration – direct tax

As mentioned earlier, direct taxation is under the administration of IRB. The IRB came into existence when the Inland Revenue Department was revamped into a statutory body in 1 March 1996 under the Inland Revenue Board of Malaysia Act 1995. The care and management of the IRB is in the hands of the Director General of Inland Revenue (DGIR) who is appointed by the Minister of Finance. With effect from 1 August 1997, the amendment in the IRB Act 1995 provided that the chief executive officer (CEO) of the IRB will be appointed as the DGIR. Four Deputy Director Generals (DDG) assist the DGIR/CEO in administrating the Act.

The IRB has a vision to be recognized as the foremost tax administration in the region and the best government agency in the country by creating a just, transparent and respectable tax management system. Other visions of the IRB are that their management is always sensitive to the welfare of its employees, provides career advancement opportunities for each employee and recognizes individual excellence and their officers and staff members are committed towards achieving excellence in work and efficiency in service to clients. Only then can the public have a high degree of confidence in the fairness of the country's tax system.

b. Income Tax System

A person resident in Malaysia is assessable to income tax on income accruing in or derived from Malaysia or received in Malaysia. The exception to this rule is when a resident person carries on banking, insurance or air/sea transport operations. In such cases, the person carrying on such operations is assessable to tax on worldwide income. Another exception to this rule is that a non-resident person is not taxed on income arising from sources outside Malaysia that is brought into Malaysia.

The ITA 1967 sets out the main classes of income upon which income tax is chargeable. These are:-

(a) gains or profits from a business, for whatever period of time carried on;
(b) gains or profits from an employment;
(c) dividends, interest or discount;
(d) rents, royalties or premium;

(e) pensions, annuities or other periodical payments not falling under any of the foregoing paragraphs; and
(f) gains or profits not falling under any of the foregoing paragraphs.

In addition, under section 4A of the ITA 1967 tax is also chargeable on special classes of income on amounts paid in consideration of services rendered by the person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from, such person, amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme or rent or other payments made under any agreement or arrangement for the use of any moveable property.

Malaysian implemented the “current year assessment” (CYA) system with effect from the years 2000. It means that the chargeable income of a person for a YA is ascertained by reference to the income for the basis year (defined as the calendar year by the ITA 1967) coinciding that YA. In order to relieve the burden on taxpayers from payment of income tax for 2 years in one year, in the year the CYA system was implemented, income tax on the 1999 income was waived. In other words, in the year 2000 no tax was charged on income for the basis period 1999. Tax that was paid in year 2000 was based on income derived in the year 2000 only.

Recognising that business organisations may have accounting year-ends that do not end on 31 December, the ITA 1967 allows the accounting year-end to be the basis period for income derived from a business source. Income Tax (Amendment) Act 2002 which seeks to introduce the SAS from YA 2004 for groups of taxpayers other than companies provides that the basis period for individual which have business income and for partnerships shall be the calendar year. With this amendment, all individuals and partnerships income is taxable on a calendar year basis.

As a concession for companies, the IRB also accepts a computation in a situation whereby a company, whose financial year ends on a day other than the 31st of December, submits a computation in which adjusted income **(refer to Appendix A1 chart of “computation of tax payable/refundable”)** from non-business sources is calculated by reference to the same basis period as the basis period for the business source.

c. Residence Status

Under the ITA 1967, a company (or a body of persons) carrying on a business or businesses is resident in Malaysia if, at any time in the basis YA, the management or control of its business or any one of its business is exercised in Malaysia. Any other company, i.e. a company not carrying on a business, is resident in Malaysia in the basis year if at any time in that basis year the management and control of its affairs are exercised in Malaysia.

For individuals, residence status is determined by the duration of stay in Malaysia in a basis year. Generally, duration of stay for 182 or more days qualifies for resident status. Even though a person’s liability to income tax is not dependent on his residence status, however, it can influence the extent of his tax liability. For companies, a resident company will be taxed on income received in Malaysia from outside Malaysia in addition of being taxed in respect of any profits or gains accrued in or derived in Malaysia. A non-resident company is exempted from Malaysian tax on remittance received in Malaysia. As for individuals, only a resident will be eligible for personal reliefs, liable to income tax at graduated rates, taxable for any income received in Malaysia from outside Malaysia, taxable for any income from short-term employment of 60 days or less, taxable for any interest income derived from deposits placed with licensed banks. The provision of Malaysia’s double taxation agreements will only apply to Malaysian residents. As such, double tax relief is available only to Malaysian residents.

d. Collection and Assessment

Generally, tax shall be paid within 30 days from the date of the Notice of Assessment notwithstanding any appeal or disagreement with the tax assessed. In certain circumstances, an extension of the 30-day period may be permitted; for example, where the taxpayer is away from the country. There are cases where the Director General may require payment within 7 days of the issue of the notice, for example, where a person has a non-resident employer and is likely to leave Malaysia at short notice. In addition to the above direct method of collecting tax, there are also other methods of payment of tax by deduction or instalments.

1. Companies

As mentioned earlier, the SAS has been implemented for companies beginning from YA 2001. Under this system, companies are required to furnish estimate of tax, make instalment payment, determine tax payable and file Return Form C to the IRB.

An estimate of tax payable must be furnished in a prescribed form not later than 30 days before the beginning of the basis period for a YA. For a new company, the estimate of tax payable must be furnished within 3 months from the date of commencement of operation. As part of a service to taxpayer, this prescribed form will be issued to all companies registered with IRB. In the event that companies did not receive the form, these forms are also available at all IRB branches and also at IRB's website. Upon completion of this form, it should be sent back to the Processing Centre.

The estimate of tax payable for a year of assessment should not be less than the revised estimate of tax to be paid for the immediate preceding year of assessment or the original estimate in the case where no revised estimate has been submitted. A company that has furnished its estimate of tax according to the basis provided and within the time stipulated can revise its estimate of tax payable. This revision can be made in the 6th month of the basis period by using the form CP 204A and submitting it to the above mentioned address. No confirmation on the revised instalment scheme (Form CP 206) will be issued beginning from YA 2002. Therefore, companies can continue to make payment according to the revised estimate submitted.

A company must notify IRB if there is a change in its accounting date by using the form CP 204B. This form must be sent to the Processing Centre.

The estimated tax payable must be paid in equal monthly instalments commencing from the second month in the basis period. For a new company monthly instalments must commence from the sixth month in the basis period. These monthly instalments must be paid on or before 10th day of each month. With effect from YA 2002, IRB will not issue notice of instalments scheme (Form CP 205) for companies that have complied with the provision in furnishing tax estimates. Therefore, companies can carry on to make instalments payment according to the estimate submitted.

Penalty in the form of increased in tax will be imposed if:

1] A company fails to fully pay up the instalments payment within the stipulated time. A 10% increase in tax will be imposed on the payment outstanding within the stipulated time.

2] A company that underestimates very much its estimate of tax. The formula for imposition of penalty is a follows:

Increased in Tax = [AT-ET] - (30% **x** AT)] **x** 10%

Where: AT: Actual Tax Payable

ET: Revised estimate or original estimate (if no revised estimate is furnished)

All payments of tax must be accompanied with the Remittance slips (Form CP 207) sent to the companies. Payment can be made at the IRB payment counters, by post (cheques/bank draft) and at any of the Bumiputra-Commerce Bank Bhd./Public Bank Bhd./Public Finance Bhd. branches in Malaysia. For payment by cheque, all cheques must be crossed and made payable to: "The Director General Of Inland Revenue". The name of the company, the tax reference number and the address must be written on the reverse side of the cheque. If there is any credit balance in the company's account with the IRB, the taxpayers has to contact the Collections Branch if he wish to use the credit balance for payment of tax.

Beginning with the YA 2001, companies are required to determine their tax payable and declare in the prescribed form (Return Form C) to be furnished to IRB. Explanatory notes together with a guide on how to compute the tax payable are provided to assist companies in furnishing the tax return.

Return Form C must be completed and furnished to IRB within 6 months after the close of its accounting period. Return Form C must be sent back to the IRB's Processing Centre.

Notice of assessment will not be issued to companies that have complied with the furnishing of a complete Return Form C within the stipulated time. The Director General is deemed to have made an assessment on the day the Return Form was furnished and the Return is deemed to be a notice of assessment.

Upon determining the actual tax payable for a year of assessment, the balance of tax i.e. the actual tax payable less instalment payment (if any) must be paid not later than the last day of the 6th month after the closing of the accounting period. Remittance slips (Form CP 207) attached to the Return Form C must be used when making payments.

If balance of tax payable is not paid up within the stipulated time, a 10% increase in tax will be imposed on the outstanding balance without further notice. If there is still balance outstanding after 60 days from the stipulated date for payment, a 5% increase in tax will be imposed on the outstanding balance.

a) Statement of Section 108 Income Tax Act 1967

The income tax chargeable on a resident company is credited into a tax account which can be utilized to frank payment of dividends to shareholders. Income tax paid by a company is imputed to the shareholders by means of imputation credits attached to dividends. Where the franking of payment of dividends exceeds the tax credit available in the tax account, the deficit becomes a debt due which is payable by the company upon requisition. The imputation system does not apply to a non-resident company and such companies are not subject to dividend franking.

A new section 108 has been introduced with effect from the YA 2001 where the definition of Compared Aggregate is changed from the basis of Tax Chargeable to Tax Paid. Companies resident in Malaysia (including Singapore companies that pay Malaysian income tax) are required to submit to the IRB a statement in a prescribed form. In line with these changes a new Form R and the Explanatory Notes have been prepared for companies. Where the company fails to submit this form by the due date and upon conviction may be penalized and the amount of penalty ranges from RM200 to RM2000.

The Form R has to be submitted within 6 months from the date of the close of the accounts. Send it to the IRB's Processing Centre.

Where the Compared Total exceeds the Compared Aggregate the excess is debt due to the Government and is payable within 6 months from the close of the accounts. If the excess is not paid by the due date, the amount unpaid will be increased by 10%.

b) Tax Rate

The tax rate for companies is 28%. Effective from YA 2003, the rate of 20% is levied on the first RM100,000 of chargeable income for companies with a paid up capital of RM2.5 million and below at the beginning of the basis period for a year of assessment.
The rate for foreign fund management companies (provision of fund management services to foreign investors is 10%.

2. Other Taxpayers

For other types of taxpayers, the SAS will only apply to them from YA 2004. Currently, the Official Assessment is still in force for them. For them, tax shall be paid within 30 days from the date of the Notice of Assessment notwithstanding any appeal or disagreement with the tax assessed. An increase of 10% tax will be imposed upon failure to pay the tax within 30 days from the date of Notice of Assessment issued. If tax is not paid for the next 60 days from the date of imposition of 10% increase in tax, a further increase of 5% will be imposed on the outstanding tax after the expiration of the 60 days.

Section 107B Income Tax Act 1967 provides for compulsory payment of tax by instalments covering all taxpayers other than individual taxpayers who are already paying under the deduction scheme for employees. All taxpayers included in this scheme will be issued Notices of Instalments Payment (Form CP200) at the beginning of each year. Taxpayers are advised to contact the relevant Collection Branch if they fail to receive CP 200 by end of February of each year.
Persons with business income included under this scheme are required to pay 6 bi-monthly instalments in the months of March, May, July, September, November of the relevant year and January of the following year. Each instalments payment must be accompanied by a Remittance Slip (CP203). The due date for each payment is the 1st day of the relevant month. An increase of 10% on that instalments payment will be imposed upon failure to pay the tax instalments within 30 days of the stated date. If there is any difference to be settled upon the issue of Notice of Assessment, the said difference is required to be settled within 30 days from the date of issue of the Notice of assessment.
Application for variation of the Notice of Instalments payment must be submitted not later than 30th June of the relevant year. Request for changes will only be granted in respect of the amount of each instalments; changes in due dates will not be granted. If a request for variation of instalments payments has been approved, and, where actual tax payable exceeds total instalments payments and the difference is more than 30% of the actual tax payable , then, an increase of 10% of the difference will be imposed without further notice being served.
Persons who are taxable and have never received any income tax Return Form before, must notify their chargeability to the nearest IRB office and request for an income tax Return Form. If they already have an income tax file but have not received an income tax Return Form by the 31st. March in the year, they must immediately write in to the IRB office (i.e. the office which issued the last return form) for a Return Form for the relevant year. A foreigner employed in this country, must give notice of his/her chargeability to the nearest IRB office within 2 months of his/her arrival in Malaysia.

a) Filing of Tax Returns

A Return Form received by a taxpayer must be completed and submitted together with the necessary documents, within 30 days from the date indicated on the tax Return Form. For general issues (late February) of return forms to those taxpayers who already have income tax file, normally the filing dateline is 31 May each year. The completed tax return should be sent to the address of the IRB office indicated on the return form.

For easier administration, the IRB office should be informed of any change in the taxpayer address within 3 months from the date of change.

b) Tax Rates
Resident individuals are taxed at progressive rate with 8 tax brackets. The highest bracket is income above RM250,000 which is taxable at 28% maximum rate. These rates are also applicable for executor of deceased person domiciled inside Malaysia at the time of death.

Table 11. Individual Income Tax Rates

Chargeable Income Brackets (RM)	Tax Rates (%)
1 - 2,500	0
2,501 -5,000	1
5,001 -20,000	3
20,001 -35,000	7
35,001 -50,000	13
50,001 -70,000	19
70,001 -100,000	24
100,001 -250,000	27
Above 250,000	28

Source: Income Tax Act 1967

Resident individuals also enjoy tax rebate as follow:-

Single resident individuals/wife assessed separately	RM350
Married resident individual (combined assessment)	RM750
Purchase of personal computer (claimable once every 5 years)	RM400
Levy/fee paid by foreign workers	actual amount
Zakat/tithe/alms (eligible for Muslims only)	actual amount

The rates for trustee of a trust body and executor for deceased person domiciled outside Malaysia at the time of death is 28%. Cooperatives are taxed at progressive rate with 10 tax brackets. The maximum rate of 30% is applicable for taxable income above RM500,000. A tax exempt period of five years from the date of registration will be allowed for cooperatives. After the five years, co-operatives having members' fund of RM750,000 or less shall continue to be tax exempt.

Table 12. Cooperative Income Tax Rates

Chargeable Income Brackets (RM)	Tax Rates (%)
1 - 20,000	0
20,001 - 30,000	3
30,001 - 40,000	6
40,001 - 50,000	9
50,001 - 75,000	12
75,001 - 100,000	16
100,001 - 150,000	20
150,001 - 250,000	23
250,001 - 500,000	26
Above 500,000	28

Source: Income Tax Act 1967

3. Deduction Scheme For Employees

Effective from 1 January 1995, a new system of tax recovery known as Schedular Tax Deduction (STD) was introduced. Employers are required to make deductions from their employees remuneration every month in accordance with a Schedule as prescribed by the Income Tax (Deduction from Remuneration) Rules 1994 ["the Rules"]. Every employer shall pay to the Director General, not later than the 10th. day of every calendar month, the total amount of tax deducted or that should have been deducted by him from remuneration of employees during the preceding calendar month. Such payments must be remitted together with Form CP 39 or a return setting out the names, identity card numbers or if none, passport numbers, and tax reference numbers of those employees from whose remuneration he has or should have made deductions.

Failure to comply with any of the Rules will render an employer liable to prosecution and, if convicted, be liable to a fine not exceeding RM1,000 or imprisonment for a term not exceeding 6 months or to both. (Refer to Rule 17). "Failure To Comply" includes not remitting the appropriate tax deductions to the IRB, not remitting the tax deductions by the 10th day of the following month and not deducting and remitting the correct amount. The tax deductions do not belong to the employer and therefore, under no circumstances may an employer delay remitting the tax deductions to the IRB.

4. Real Property Gains Tax

Generally, there is no tax on capital income in Malaysia, with the exception of those capital incomes which fall under the Real Property Gains Tax. Under this Act, real property gains tax is imposed on the chargeable gains arising from the disposal of any land situated in Malaysia or any interest, option or other right in or over such land or the disposal of shares in a 'real property company'.

Every person whether resident or non-resident in Malaysia is chargeable in respect of any chargeable gain he has made on the disposal of a chargeable asset. Where a chargeable asset is sold with the result that a gain arises (the selling price is higher than the acquisition price), such a gain is referred to as a chargeable gain Should a loss arises, the loss is referred to as allowable loss. An allowable loss (except for a few cases of losses in disposal of shares) which cannot be wholly relieved may be carried forward for set-off against future gains.

A gain made on the disposal of a private residence by individuals who are either citizens of Malaysia or who are permanents residents of Malaysia will be exempt from property gains tax upon application from taxpayers. Malaysian wives of individuals who are non-citizens and non-permanent residents are also exempt on disposal of one private residence owned by the wife.

The acquirer (or his solicitor) is required to retain the whole of the selling price or 5% of the total values of the consideration whichever is the lower, until he receives clearance (CKHT 4/CKHT 5) from the IRB.

Table 13. Rates of Real Property Gains Tax

CATEGORY OF DISPOSAL	COMPANY	INDIVIDUALS & OTHER PERSON
Disposal within 2 years	30%	30%
Disposal in the 3rd year	20%	20%
Disposal in the 4th year	15%	15%
Disposal in the 5th year	5%	5%
Disposal in the 6th and subsequent years	5%	Nil

Source: Income Tax Act 1967

An individual who is not a citizen and not a permanent resident is subject to the following rates :

Table 14. Rates of Real Property Gains Tax (non-citizen & non-permanent resident)

CATEGORY OF DISPOSAL	RATE OF TAX (%)
Disposal within 5 years after the date of acquisition	30
Disposal in the 6th and subsequent years after the date of acquisition	5

Source: Income Tax Act 1967

5. Stamp Duty

The Assessment and collection of Stamp Duties is sanctioned by statutory law now described as the Stamp Act 1949. Under the Act, the instrument is adjudicated whereby the purpose is so that an application to determine the amount of duty chargeable on any executed instrument can be made to the Collector. For this purpose the Collector may require that the instruments be furnished together with an affidavit or other evidence. The Collector may refuse such application until the required instrument and evidence have been furnished accordingly. The purpose of adjudication is to protect the parties to the contract in respect of the admissibility of the instrument as evidence in court during a civil proceeding. An instrument which is not duly stamped is not admissible in court as evidence. The fee payable for adjudication of an instrument is RM10.

6. International Tax

The Malaysian government promotes foreign investments. Malaysia does not discriminate against investors from any country. In order to encourage foreign investments, Malaysia offers many incentives and advantages to the people from the 46 countries (including limited agreement with USA, Argentina and Saudi Arabia) with a double taxation agreement (DTA) with Malaysia. Basically, DTA is an agreement seeking to avoid double taxation by defining the taxing rights of each country with regard to cross-border flows of income and providing for tax credits or exemptions to eliminate double taxation .

The objectives of a Malaysian DTA are as follows :

a) to create a favourable climate for both inbound and outbound investments;

b) to make Malaysia's special tax incentives fully effective for taxpayers of capital exporting countries;

c) to obtain a more effective relief from double taxation compared to relief gained under unilateral measures; and

d) to prevent evasion and avoidance of tax.

Like many other countries in the developed as well as the developing world, Malaysia too cannot absolve herself from the need to facilitate her trade and investments with the outside world through international tax treaty network with other countries. The increased pace of industrialisation coupled with increased foreign direct investment in the country necessitated tax treaty arrangements with other countries to provide investors with certainty and guarantees in the area of taxation.

e. indirect taxation

The responsibility to administer indirect taxation in Malaysia lies with the Royal Customs and Excise Department. The various types of indirect taxes are such as customs duties, excise duty, sales tax and service tax.

1. Sales Tax

Sales Tax in Malaysia is a single-stage ad valorem imposed on all goods except those classified as exempt. Depending on the goods, they are taxed at 5% (food, timber, building materials), 10% (all other goods) or 15% (beer, wine, liquor and cigarettes).

All exports are exempt from sales tax. The following goods are also exempt from sales tax:

a) Live animals, fish, seafood, and certain essential food items such as milk, eggs, meat, vegetables, fruits breads and so on;
b) Photographic equipment and films;
c) Medical and educational equipment such as sports equipment, books and stationary;
d) Motorcycles and bicycles for adult use, including parts and accessories;
e) Machinery for textile industry, food preparation industry, paper and printing industry, construction industry, metal industry and so on;
f) Helicopters, aircrafts, ships and other vessels;
g) Naturally occurring mineral substances and chemicals etc; and
h) Primary commodities such as cocoa, rubber and their related products.

2. Service Tax

Service tax is a consumption tax levied on a prescribed value of goods or services provided. The Island of Langkawi (a promoted tourist resort and port) and Labuan is exempt from service tax. The rate of service tax is 5 %.

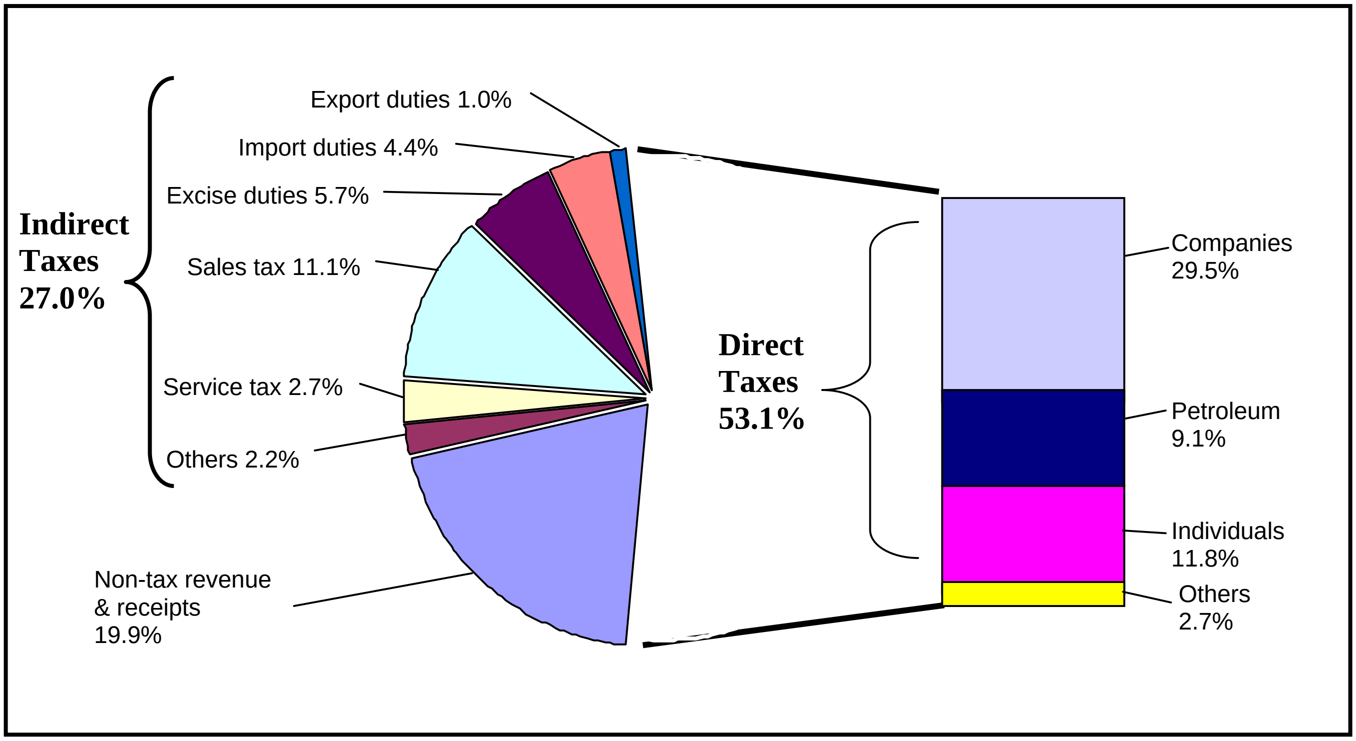
The prescribed establishment at the time the services or goods are provided or sold collects the service tax. Prescribed establishments are as follows:

a) Hotels, nightclubs, health centers, public pubs;
b) Insurance companies and firms providing telecommunications or parking services;
c) Restaurants, private clubs and advertising firms with a turnover of not less than RM500,000;
d) Accounting, architectural, legal, surveying and architectural firms, private hospitals, estate agent firms, consulting firms, dentists and veterinary doctors with annual turnover of not less than RM 300,000; and
e) Forwarding agents, motor vehicle services and repair centers, security guards with annual turnover of less than RM 150,000

3. Excise Tax

Excise tax is imposed on a selected range of goods manufactured in Malaysia. The rate of excise tax depends on the goods involved and varies from RM 0.02 per liter on soft drinks to 65% on motorcars. Other goods such as tobacco, sugar and sugar confectionaries, beer and stout, toys and games are also subject to excise tax.

Figure 9. Composition of Federal Government Revenue, 2002 (% share)
Total Revenue: RM83.5 billion



Source: Bank Negara Malaysia

IV. Malaysia – Specific Fiscal Issue

A. Domestic Private Investment Activities Lacking Dynamism

For decades, our economic growth has been overly reliant on external sector developments, FDI and international trade. Growth must be domestic-driven and generated by own resources as well as greater domestic investment activities. Malaysians must be prepared to venture and undertake risks, even in challenging areas. Domestic-driven growth demands a rapid transformation of the economy. Only this will ensure that our sources of growth will be diversified. To accelerate structural transformation, several long-term strategic plans have been formulated. The Third Outline Perspective Plan (OPP3) sets out the growth direction for the first decade of the new millennium. Malaysia is in the midst of implementing the strategies and programmes of the first phase of OPP3, that is the Eighth Malaysia Plan. Several sectoral master plans have also been prepared, including the Financial Sector Master Plan aimed at establishing a competitive, resilient and dynamic financial system and the Capital Market Master Plan for the comprehensive development of the capital market. The Government has recently launched the Knowledge-Based Economy Master Plan based on knowledge, creativity and innovation to generate stronger economic growth without overly depending on capital and labour.

We are trying to emulate China and Korea in formulating industrial sector strategies. China has been successful in producing high quality consumer products at competitive prices and has been able to penetrate and gain a footing in the international market. Korea, on the other hand, adopted a strategy to import foreign technology and developed it further to become a successful producer. It has established a name in heavy industries, producing world-class quality products. Currently, Kia is a well-known brand in the automotive industry while Samsung, in electronics. Korea has also successfully developed small an medium-scale industries to support the industrial sector using high technology.

B. Private Sector Remains Sluggish

Since the financial crisis, the public sector has been the catalyst of economic growth. The Government has implemented expansionary fiscal policies for five consecutive years since 1998. As a result, total public investment increased from nearly RM32 billion in 1997 to RM49 billion in 2001. In contrast, private investment declined sharply from RM90 billion to RM34.5 billion. In terms of contribution to GDP, public sector expenditure increased from 24 percent to 31 percent, while that of the private sector declined significantly from 83 percent to 59 percent during the same period.

The Government cannot continuously implement expansionary fiscal policies. Although revenue is rising, the increase in Government expenditure has been higher, especially following the implementation of the fiscal stimulus package in 2001. As a result, its financial position continued to be in deficit during the period. Although borrowings are at a manageable level, and are largely sourced domestically, the Government is concerned that rising fiscal deficits will further increase borrowings beyond prudent levels. The Government must avoid borrowing continuously from external sources, which if not contained, can lead to instability and eventually, threaten the nation's sovereignty.

The private sector must now resume its role as the main driver of economic growth. The Government is confident that the private sector is capable of increasing investments to levels achieved during the decade from 1988 to 1997, with an average annual growth of 21 percent. The Government undertook various measures to revitalise the private sector, including corporate and financial sector restructuring. The problem of non- performing loans (NPLs) was addressed with Danamodal injecting a sum of RM7.6 billion into ten financial institutions and Danaharta acquiring NPLs of nearly RM48 billion. As a result, the NPL ratio of the banking system was reduced to 8 percent in August 2002. Meanwhile, the Corporate Debt Restructuring Committee restructured corporate debts totalling RM54 billion or 92 percent of total cases received.

The Government had also provided various tax and non-tax incentives to banking institutions to encourage mergers. To ensure private investors have easy access to financing sources at reasonable costs, the Government not only established new funds but also increased the size of existing funds. The number of existing funds exceeds 40 with a value of nearly RM15 billion. The Government has sacrificed billions of ringgit in revenue losses through the reduction of corporate tax, exemptions and tax reliefs. This enabled the private sector to have additional resources for investments. Despite the many incentives provided by the Government, the response of domestic investors has been lukewarm. The private sector must be aggressive and venture into new frontiers. They should not take the easy route to reap immediate gains. Obviously, they prefer activities in the construction sector. Despite the large property overhang, property developers continue to compete to build commercial buildings and residential properties, although high-rise buildings remain empty, houses without occupants and shop-houses abandoned. Financial institutions on the other hand, are reluctant to extend loans, insist on collaterals and impose high service charges even on interest-free funds provided by the Government.

The Government's affirmative policy has provided many opportunities to Bumiputras. It cannot be denied that since the implementation of the New Economic Policy and the National Development Policy, many Bumiputras have benefited, particularly those who are diligent and possess positive attitudes. However, there are some who regard this policy as their special rights, making them complacent and overly dependent. In addition, they are inclined to seek the easy way out, impatient and are risk-averse as well as solely dependent on Government contracts and projects. They also have the habit of selling off what is given and keep asking for more, thereby defeating the objectives of the New Economic Policy.

They must discard this dependency syndrome. They must also realise that the support from the Government will not be there in perpetuity. As such, they should not be overly dependent on the Government but be self-reliant instead.

C. Global Competition Becoming Increasingly Challenging

In an environment of weak global economic recovery and greater competition from globalisation as well as rapid technological advancements, the nation's resilience must be enhanced. Negotiations at the WTO level have broadened to encompass investment issues in new areas, including finance as well as information and communications technology. The boundaries of free trade are expanding with China's entry into WTO and the implementation of AFTA. The emergence of new bilateral free trade and investment areas can undermine regional efforts and demands us to become more competitive.

Malaysian must not be complacent with their current level of competitiveness as other countries are also striving to strengthen their position. The private sector must, therefore, adopt global competitiveness as their primary business strategy. Malaysians must penetrate the markets of West Asia, Central Asia, Eastern Europe and South Asia, including India, Pakistan and Sri Lanka. China has a huge market that can provide opportunities for our products. In this respect, the Government and the private sector will collaborate to establish new exhibition centres overseas.

V. Conclusion: Where We Stand and Where We Go

In view of the above challenges, a new approach is taken focusing on domestic business and industrial activities to generate higher growth. The shift that Malaysia has taken from agriculture to manufacturing has succeeded in increasing per capita income from 300 US dollars when Malaysia achieved independence to 4,000 US dollars today. By enhancing the value added of our products, GDP and consequently, per capita income will also increase.

Most analysts are now forecasting the economies of industrialised countries, especially the US and Japan to remain fragile. Such an outlook would certainly have an adverse impact on other economies, especially developing countries.

The Malaysian economy has recovered from the Asian financial crisis with a strong growth of 8.3 percent in 2000. However, in the subsequent year, the growth momentum was again affected by the global economic slowdown, following the weakening of confidence arising from weak corporate governance and the September 11 incident in the US. To mitigate the adverse impact of the external slowdown, the Government took timely actions by implementing pro-growth policies and strategies through the Pre-emptive Stimulus Package. This has successfully prevented the economy from sliding into a recession, unlike some economies in the region. In fact, Malaysia's economic recovery continued to strengthen strongly in 2002, registering a growth of 4.2 percent.

To further sustain economic growth and ensure an efficient, resilient and competitive capital market, the Government had on 11 March this year, announced 10 new measures to stimulate and strengthen the capital market. To further reinforce these measures and ensure our economic fundamentals remain strong in the medium and long-term, the Government once again undertakes immediate initiatives to formulate policies and strategic pro-growth measures under the Package of New Strategies.

The Package which focuses on 4 main strategies and comprises 90 measures, aims at generating economic activities by mobilising domestic sources of growth as well as reducing our dependence on the external sector, as follows:

STRATEGY I: promoting private investment

STRATEGY II: strengthening the nation's competitiveness

STRATEGY III: developing new sources of growth

STRATEGY IV: enhancing the effectiveness of the delivery system

The outbreak of SARS has severely affected businesses, especially in the tourism and related sectors, arising from a significant decline in tourist arrivals. As such, the Government has also included in the Package, specific measures to assist the affected industries as well as improve the general health of the people.

The Package of New Strategies to stimulate economic growth will result in a loss of Government revenue amounting to RM800 million a year, from the provision of incentives and tax exemptions. This Package will require Federal Government budgetary allocation of RM1.7 billion. In addition, BNM will provide RM2 billion while Development Financial Institutions, such as BPM, BSN, Bank Pembangunan dan Infrastruktur Malaysia Bhd (BPIMB) and Bank Industri will provide RM3.6 billion.

The Government is confident that this Package will further strengthen the nation's economic fundamentals that will ensure more sustainable growth in the medium and long-term. In addition, the measures to develop new sources of domestic growth will contribute significantly to our efforts in reducing the nation's dependence on the external sector.

Meanwhile, GDP is estimated to grow between 6 and 6.5 percent. The impetus for growth emanates from domestic economic activities. The services sector is expected to be the largest contributor to the increase in GDP, while the manufacturing sector is expected to record the highest growth. On the demand side, private sector expenditure is expected to recover strongly with private investment increasing by 16.5 percent and consumption by 10 percent. The public sector will continue to play a supportive role towards growth of the private sector. Public investment is estimated to increase marginally by 2.4 percent while public consumption by 10.1 percent.

In line with the Government's intention to strengthen the financial position of the Federal Government, the overall deficit is estimated to further narrow to 3.9 percent of GDP, compared with 4.7 percent this year. The better performance is the result of higher Government revenue which is expected to grow by almost 8 percent compared with 5 percent this year. By continuing to maintain its accommodative monetary policy will further strengthen domestic economic activities. In an environment of low inflation, we have the flexibility to maintain low interest rates to encourage increased bank lending to support economic growth. This policy will be maintained, with the Government always having the flexibility to manage macroeconomic policies even in a less encouraging external environment.

Malaysian economic fundamentals will further strengthen. Total reserves is 5.1 times the short-term foreign liabilities and able to finance 5.6 months of retained imports. Foreign trade balance continues to record a surplus for 57 consecutive months since November 1997. The gross national savings rate is maintained at a high level of about 33% of GNP. The banking system remains strong with the risk-weighted capital ratio at 13.1%, exceeding the 8% international standard. Short-term foreign debt liabilities remain low at 7.6 % of GDP, while the debt service ratio remains at a low level of 5.8.

In line with the strong economic growth, the purchasing power of the Malaysians are also expected to be higher with per capita income increasing by 5.5% to RM14,100, compared with RM13,400 in 2002. In terms of purchasing power parity, our per capita income will increase by 5.4% to 8,800 US dollars, compared with 8,400 US dollars in 2002. The unemployment rate continues to decline to 3.4%, which is still within the level of full employment. The unemployment rate takes into account approximately 700 thousand foreign workers working in the country. The incidence of poverty has been reduced from 8.7% in 1995 to less than 6% in 2002.

Strong economic fundamentals will ensure that higher growth can be achieved and sustained in the long- term. To ensure the economy continues to achieve sustainable growth and withstand external shocks, policies and strategies to generate domestic growth will be further strengthened. Efforts to diversify sources of domestic growth will be intensified to reduce our dependence on the external sector. Currently, the manufacturing sector is not only the main source of growth, accounting for one-third of GDP but also contributing almost 90% of the nation's exports. The contribution of other sectors to GDP must be also be increased.

The nation has enjoyed the fruits of independence for nearly five decades. The progress achieved is the result of peace, solidarity and staunch support of the people for the Government and effective development policies. Malaysia’s success was, however, affected by the regional financial crisis and the September 11 incident which had worsened global economic recovery. We had managed to survive the crisis and are now on a stronger foundation. However, the increasingly challenging domestic and external environment demands sacrifices and courage to undertake a shift in our macroeconomic management policies.

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Appendix 1:
Illustration of Individual Tax Computation for year of assessment 2003

		RM	RM
Gross business income			500,000
Less:	Allowable Deductions (Sections 33, 34, 34A, 34B, 35, 39)		(100,000)
	Adjusted Income		400,000
Add:	Balancing charge/agriculture charge/forest charge (Schedule 3)		-
			400,000
Less:	Capital allowance – current year and brought forward balance (Schedule 3) including balancing allowance/forest allowance/agriculture allowance		(50,000)
	Statutory Income (Section 42)		350,000
Add:	Statutory income from other business		-
			350,000
Less:	Business losses brought forward		-
			350,000
Add:	Statutory income from non-business sources:-		
	Employment;	100,000	
	Dividends (Tax credit: RM2,800)	10,000	
	Rents, royalties or premium;	-	
	Pensions, annuities or other periodical payments; and	-	
	Gains or profits not falling under any of the above.	-	
	Recoveries of prospecting expenditure (Schedule 4)	-	110,000
	Aggregate Income (Section 43)		460,000
Less:	Business Losses for the Current Year	-	
	Prospecting Expenses (Schedule 4)	-	
	Capital Expenditure on Approved Agricultural Project (Schedule 4A)	-	
	Gifts of Money to the Government/Approved Institutions	(5,000)	
	Gifts of Money to Libraries	-	
	Gifts of Artefacts, Manuscripts or Paintings	-	
	Gifts of Money or Contribution in Kind	-	
	Gifts of Money or Medical Equipment	-	
	Gifts of Painting	-	(5,000)
	Total Income (Section 44)		455,000
Less:	Reliefs (for resident individuals only)	8,000	
	Employment Provident Fund & Life Insurance (maximum: RM5,000)	5,000	13,000
	Chargeable Income		**442,000**
	Chargeable Income X Tax Rates = **Total Income Tax**		108,735
Less:	Rebate (for individuals only)		-
	Tithe or Fitrah (for Muslim individuals only)		-
	Purchase of Personal Computer (for individuals only- once in 5 years)		-
	Fee (for individuals only)		-
	Total Tax Charged		108,735
Add:	Penalty For Late Submission Of Return Form		-
			108,735
Less:	Double Taxation Relief (Section 132/133)	-	
	Relief On Tax Deducted On Dividend (Section 110)	2,800	2,800
	TOTAL TAX PAYABLE/REPAYMENT		**105,935**