Report No. 20371-MA

Malaysia
Malaysia Public Expenditures
Managing the Crisis; Challenging the Future

May 22, 2000

Poverty Reduction and Economic Management Sector Unit
East Asia and Pacific Region

Document of the World Bank

CURRENCY EQUIVALENTS
(as of May 2000)
Currency Unit = Ringgit (RM)
RM 1 = US$3.8
US$ 1 = RM 0.26

MALAYSIA - FISCAL YEAR
January 1 - December 31

ABBREVIATIONS AND ACRONYMS

EPF	-	Employment Provident Fund
EPU	-	Economic Planning Unit
IDC	-	Infrastructure Development Corporation
IDF	-	Infrastructure Development Fund
ISO	-	Independent System Operator
MAMPU	-	Malaysian Administrative Modernization and Management Planning Unit
MBS	-	Modified Budgeting System
MOH	-	Ministry of Health
MTA	-	Metropolitan Transportation Authority
NEP	-	New Economic Policy
NERP	-	National Economic Recovery Plan
NGO	-	Non-Governmental Organization
NHI	-	National Heart Institute
NDP	-	National Development Policy
OECD	-	Organization for Economic Cooperation and Development
PEA	-	Public Expenditure Analysis
PKPA	-	Civil Service Improvement Circulars or Development Administrative Circulars
PPRT	-	Development Program for the Hardcore Poor
SPR	-	Structural Policy Review
TBTA	-	Tri-borough Bridge and Tunnel Authority
TIFIA	-	Transportation Infrastructure Financing and Innovation Act
VAT	-	Value-Added Tax

Regional Vice President:	Mr. Jemal-ud-din Kassum, EAPVP
Country Director:	Ms. Ngozi Okonjo-Iweala, EACSM
Chief Economist:	Mr. Masahiro Kawai, EAPVP
Sector Manager:	Mr. Homi Kharas, EASPR
Task Team Leader:	Ms. Mona Haddad, EASPR

MALAYSIA PUBLIC EXPENDITURES

MANAGING THE CRISIS; CHALLENGING THE FUTURE

TABLE OF CONTENTS

ACKNOWLEDGEMENTS

This report was produced by a team led by Mona Haddad. The core team comprised Ashoka Mody (infrastructure), Louis Charles Viossat (health), Bruce Chapman (Australian National University; education), Vinod Ahuja (Indian Institute of Management, Ahmedabad, India; safety net), and Serif Sayin (consultant; public expenditure management). Ronald Hood and Thang-Long Ton brought the report up to date. Peer reviewers are: Jeffrey Hammer, Malcolm Holmes, and Vinaya Swaroop. Bert Hofman provided overall advice. The report was prepared under the general guidance of Ijaz Nabi (Lead Economist), Homi Kharas and Ngozi Okonjo-Iweala. Production of the report was supported by Barbara Ossowicka (statistics) and David Bisbee (design and layout), Hedwig Abbey and Nancy Mensah (revision processing) and Bonita Brindley (editor).

TABLES:

FIGURES:

BOXES:

ANNEXES:

EXECUTIVE SUMMARY

1. Like other countries in East Asia, Malaysia achieved unprecedented economic growth and dramatic poverty reduction in the two decades prior to 1997. During this period, the government's role evolved from being a main contributor to economic activity to a facilitator of private sector led growth. As a result, pressure on public expenditures was alleviated and when the regional financial crisis hit in 1997, the budget was in surplus—unusual for most countries—and public debt had fallen to around 30 percent of GDP. The fiscal and social impact of the crisis was cushioned by these favorable conditions. The government was able to loosen fiscal policy to stimulate demand without jeopardizing medium-term debt sustainability. Moreover, although growth was largely behind the reduction in poverty, the existing safety net—based on a comprehensive public health system, free basic education, and transfer and income generation schemes for the rural poor and vulnerable—proved resilient to the crisis. An important component of this safety net was the productivity-linked wage which allowed flexibility in the labor market and thus kept unemployment low—only 3.9 percent in 1998 and 3.4 percent in 1999. Repatriating migrant workers, who were largely employed in hard-hit sectors such as construction, also buffered the rise in unemployment and poverty. Moreover, the post-crisis devaluation cushioned the impact on the rural poor (which accounted for the majority of the pre-crisis poor) as it raised agricultural income.

2. But the crisis brought to the fore issues in public expenditure management that might have remained of less significance in a fast-growing economy: large and increasing off-budget liabilities that could undermine fiscal prudence, accountability and efficiency in the use of public resources. Malaysia has reformed its public expenditure management system and it is now largely on par with international best practice. However, the government's strategy of allowing greater private sector involvement in the provision and financing of public services, mainly infrastructure, has put new demands on contingent and off-budget public expenditure management. While this strategy has led to positive outcomes—infrastructure capacity doubled between 1985 and 1995—the government provided extensive financial support to private projects and corporatized entities and did not always foster sufficient competition in awarding contracts to maximize efficiency; this increased the government's direct and contingent liabilities. This public-private interface is also becoming more significant in tertiary education and health, where public universities and hospitals are being corporatized. Although it would improve decision making, performance, and the response to changing socio-economic needs, the resulting off-budget liabilities, if not adequately managed, would raise fiscal risk.

3. Malaysia also faces future challenges in achieving medium term outcomes that will determine whether it can sustain past achievements and move to a fully developed country as envisaged in the government's Vision 2020. The goal is "to transform the economy from investment-driven output growth to one that is productivity- and quality-driven; and to place greater efforts on ensuring equitable distribution of the nation's expansion in income and wealth." For that, the most important challenge ahead may well be in higher education. Although public expenditures in social sectors have led to impressive outcomes—health indicators now

compare favorably with upper-middle income countries, primary education is universal, and secondary education expanded rapidly—higher education has lagged. Malaysia's university enrollment at 11 percent falls behind other East Asian countries—60 percent in Korea and 35 percent in the Philippines. At the same time, over half of public spending on tertiary education goes to the better off. But there are other challenges; regional disparities in social indicators persist and inequality has been on the rise since 1990. Moreover, as typical in an increasingly modern and globalized economy, social protection and health care face new risks as income rises, population ages, and new disease patterns emerge.

4. This is the first Public Expenditure Analysis (PEA) since 1992. Its objectives are to analyze fiscal issues arising from the crisis; gauge the government's public expenditure management system; and assess performance and future challenges in education, health, poverty reduction, and infrastructure. The PEA complements the Structural Policy Review (SPR) of 1999 which covers key challenges for short-term recovery and medium-term growth in the social sector, financial and corporate sector, governance, and macroeconomic policies, including a post-crisis debt sustainability analysis.

Responding to the Crisis

5. The economic and social impact of the crisis deepened in 1998, although less than initially feared—the economy contracted by 7.5 percent and a quarter of a million people became newly poor. The financial and corporate sectors became vulnerable as non-performing loans rose. The crisis has also jeopardized the financial viability of many privatized infrastructure projects. The government has taken a proactive role in managing the crisis. Its National Economic Recovery Plan (July 1998) aimed for quick recovery through fiscal stimulus, plus loosening monetary policy to increase aggregate demand; fixing the exchange rate and imposing selective capital controls to stabilize the currency; providing social protection for vulnerable Malaysians; and restructuring corporate and banking sectors to restore business activity. The government is also reviving privatized infrastructure projects through the Infrastructure Development Fund. At the same time, prospects for the future are improving—growth reached 5.4 percent in 1999 and is expected to average 6 percent or more in the following two years.

6. The crisis and its remedies have immediate implications for fiscal management: Will the fiscal stimulus undermine medium term sustainability? How large are contingent liabilities arising from infrastructure projects (and financial restructuring) and what can be done about them? Is the existing safety net adequate to support the social impact of the crisis?

7. First, the fiscal stimulus was necessary to halt the contraction in aggregate demand—it may have represented the only significant positive stimulus to aggregate demand in 1998—and will not undermine medium term fiscal sustainability thanks to good initial conditions of fiscal surplus and low public debt (see SPR, 1999). Malaysia has correctly focused the fiscal stimulus on increasing public expenditures for infrastructure projects that have strong linkages with the economy and a short gestation period; and on reducing income taxes. However, despite stepped up development expenditures during 1998, the deficit of the federal government was smaller than planned—2.1 percent of GDP instead of 2.6 percent. This reflects higher-than-expected tax revenues and delays in project implementation. The appropriate mix of tax reductions and expenditure increases could therefore be revisited to maximize the efficiency of the stimulus. Moreover, the government may consider applying its balanced current budget rule over the

business cycle rather than yearly in order to allow greater flexibility during recessions without undermining fiscal discipline. In 1999, the budget deficit rose to 3.6 percent of GDP.

8. Second, the crisis has increased the likelihood that contingent liabilities from privatized infrastructure projects become actual liabilities. To reduce its financial exposure, the government has responded by deferring and scaling back some projects and by negotiating the workout and financial restructuring of others. The government's overall approach to manage contingent liabilities from infrastructure projects during the crisis is appropriate to restore confidence and vigor to the economy; however, its implications for the medium term must be recognized because it adds new contingent liabilities. Therefore, decisions to support specific projects could be better guided by two considerations—minimize the burden on the government and maximize efficiency. For that, the government's financial support of ailing projects needs to be rationed to projects that can reasonably achieve long-term self-sufficiency and made in the context of a long-term strategy for each sector that enhances competition, while ensuring network coordination and integrity. Some projects may never regain economic viability, even allowing for sunk cost, and may have to be completely re-appraised.

9. Third, Malaysia has managed to cope with the social impact of the crisis so far, in part because of good initial conditions and a strong built-in safety net mechanism. The solid foundations of the existing network of free health and basic education have remained virtually intact and helped cushion vulnerable groups. Price controls for selected food items—although inefficient as an income transfer—were strengthened, making basic foods more affordable. Flexible wages and repatriation of migrant workers buffered the social impact of the crisis by maintaining low unemployment. However, the scope of the public safety net programs could be further expanded during the crisis. The government took specific measures to mitigate the social impact of the crisis by enhancing income-earning opportunities (micro credit to urban and rural poor, and training to retrenched workers) while maintaining expenditures on health, education, and its existing safety net program. But these measures may not be sufficient because the number of poor has increased, the face of poverty has changed (the new poor are largely urban), micro credits typically do not work well in a recession and may not reach the needy, and international experience with training programs is generally disappointing. The crisis has caused greater hardship for the urban poor and safety net programs will need to be designed carefully in order to provide protection where it is most needed. Furthermore, income transfer programs would provide temporary relief whenever such crises recur.

Public Expenditure Management

10. The Malaysian public expenditure management system performs on par with international best practice as exemplified in a few OECD countries. This is due to extraordinary efforts by central agencies to improve the system over the past 10 years through fiscal discipline, allocation of public resources to strategic priorities, effective and efficient use of public resources, and accountability for the use of public resources. The Modified Budgeting System (MBS), introduced in 1989 and recently implemented, provides greater managerial flexibility and accountability to the public management system, and is being used in some developing countries as a model. Malaysia is also undertaking a self-evaluation of the IMF fiscal transparency code. But Malaysia could further enhance its public management system by better integrating off-budget liabilities in the planning, performance, and budgeting process; and by improving performance management and strengthening links between Cabinet policymaking and the budget process.

11. First, Malaysia could improve its off-budget public expenditure management through a more comprehensive fiscal planning and reporting system. Fiscal prudence is ensured through a balanced budget rule for operational expenditures, and top-down setting of spending targets that enables the Treasury to control aggregate spending effectively. But fiscal planning focuses on the cash flows of the central government—a framework that gives too little attention to the government's financial assets and contingent liabilities—and could be extended to the consolidated financial position of ministries, departments, statutory bodies, and corporatized public entities; it would also require a clear understanding of the contingent liabilities arising from guarantees issued by the government. Public accounting and financial and performance reporting systems are solid—Malaysia has an Accountant General's Department with adequate accounting standards and information systems, an Auditor General's Department that applies internationally accepted auditing standards, and a Public Accounts Committee that scrutinizes the Auditor General's reports to Parliament. But public accounts could be expanded to strengthen fiscal discipline by including: a consolidated financial position of ministries, departments, statutory bodies, and public corporations; a consolidated financial statement of all contingent liabilities of the federal government; and the full cost of transfers to statutory bodies and public corporations. Performance reporting systems, which cover the performance of ministries and departmental entities, could also be applied to statutory bodies and public corporations, and their performance could be covered in the strategic plan of their controlling ministry.

12. Second, Malaysia can achieve better resource allocation by forging a stronger link between the Cabinet's priority and the policies financed by the budget, through some changes in the budget process. The public expenditure management system includes procedures and incentives to ensure that ministries reflect national strategies in their policies and programs. However, chronic supplementary budgets necessitated by the Cabinet's introduction of policies during the fiscal year signal a weak link between the Cabinet's policymaking process and the budget process; the Cabinet does not guide the budget process until the very late stages. Introducing a procedure early in the budget process in which the Cabinet identifies its priorities and announces them publicly in a budget policy statement might help increase its ownership of the budget process.

13. Third, Malaysia can also deliver better public service for less money by enhancing the performance incentives of public sector and nondepartmental agencies. The Malaysian administration developed excellent initiatives for improving performance management by public sector entities—the Program Agreements under the MBS established between the Treasury and line ministries during the budget process to identify performance expectations, the Exception Reports prepared by the ministries to report variations in performance outcomes to the Treasury, and the Civil Service Improvement Circulars aim at promoting and enforcing various aspects of effectiveness and efficiency across government agencies. However, these initiatives are perceived by most public sector managers as regulations; their implementation could be improved by strengthening the strategic planning process in ministries and their departments.

Future Challenges in a Modern Economy

14. Malaysia's outcomes in poverty, health, education, and infrastructure have been outstanding. The government is addressing remaining issues—such as regional disparity in social indicators and rising inequality. It is also preparing to meet the second-generation challenges ahead, arising largely from Malaysia's advanced level of development and its ambitious goals of Vision 2020. These entail a rethinking of the government's role in tertiary education, tertiary

health care, social protection against income risk, and infrastructure. In all these areas, there is a potential role for the private sector in provision and financing, and the government's role is gradually shifting from being a provider of these services to a financial supporter and a regulator. In this evolving public-private partnership, the goal of the government is to reduce the fiscal burden while ensuring equity in delivering public services and efficiency in allocating and using public resources.

15. The most advanced sector in this process is infrastructure, where "privatization" backed up by government support began a decade ago; but Malaysia could learn from international experience in infrastructure strategies that will improve the viability of projects. In tertiary education, there is a need to expand supply and corporatization of universities is underway; but this needs to be accompanied by a better financing system for students to ensure greater accessibility and equity. In health, the government has been contemplating for over a decade the corporatization of hospitals and the introduction of a national insurance scheme; this is a complex issue still debated among OECD countries and there is no perfect solution. In social protection, the role of the government as a guarantor of income risk is debatable; many countries like Malaysia do not support a Western type of social protection, such as unemployment insurance, and are looking for alternative mechanisms.

16. ***Education.*** Malaysia has achieved universal primary education and doubled secondary enrollment, but despite recent increases tertiary education has lagged compared to other East Asian countries. The government intends to increase tertiary enrollment from its current level of 11 percent (excluding overseas students) to 40 percent by the year 2020. This presents a policy dilemma: while enrollments in higher education need to grow substantially if Malaysia is to remain competitive in world markets, costs of providing education are steep—up to RM18,500 ($5,000) per student per year depending on the subject—and the current subsidy goes disproportionately to the better off. The lags in tertiary education are partly due to insufficient qualified secondary education students and partly to insufficient supply of institutions. To resolve the first constraint, the quality of education is being revisited and additional emphasis is being placed on the sciences. To resolve the second constraint, supply of tertiary education needs to increase. Some of the expansion of tertiary education would come from private universities, but public universities will also need considerable expansion. Since a general tertiary education subsidy is inequitable and inefficient, financing becomes important. Malaysia could adopt progressive, fair and efficient reforms by raising university fees while expanding the grant and loan scheme to students. If Malaysia succeeds in implementing its reform agenda, it could become a world leader in education policy.

17. ***Health.*** Malaysia built a public healthcare system that is comprehensive, efficient, and inexpensive. Improvements in health indicators have soared since Independence, outperforming most developing countries—infant mortality dropped to 9 per 1,000 live births, from 75 in 1957; and maternal mortality is down to 0.2 per 1,000 live births, from 3.2 in 1957. These impressive outcomes have been achieved at low cost—national health expenditure is around 1.5 percent of GDP, lower than the average for middle-income countries. Increasingly, private healthcare serves the rich so that public expenditures on health are captured mainly by the poor. Despite these achievements, important challenges remain. There are regional disparities in health outcomes and health expenditures; new patterns of disease are emerging and would require more preventive care; and there is a shortage of public doctors. Moreover, Malaysia has, in common with the rest of East Asia, contemporary problems such as aging populations and increased chronic illnesses. Recognizing the need to enhance the efficiency of health services and retain

qualified personnel, the government is undertaking the corporatization of hospitals, while further strengthening its regulatory and enforcement functions.

18. ***Social protection.*** Malaysia has an enviable record of poverty reduction but as it globalizes it is becoming more vulnerable to external shocks. The government's philosophy of social protection is to build human capital by providing universal basic education and healthcare, selectively grant low-cost housing, improve infrastructure (especially in rural areas), provide income-generating schemes to the poor, and limit income transfers to the hardcore poor or unemployable poor. Over the past 25 years, poverty shrank from over half of the population to about 8 percent (using the national poverty line, equivalent to $2.5 per day). Public interventions in Malaysia have largely focused on reducing the vulnerability of low-income households; but the recent crisis has shown that globalization increases income variability for all. This raises a new role for social protection: helping individuals better manage income risk—from unemployment, disability, sickness, and other shocks—through labor market policies and educational training, pension systems, and disability insurance. Malaysia has a productivity-linked wage system that provides flexibility in the labor market, retrenchment benefits, and a pension system that covers all employees in the formal sector, army, and civil service. The crisis has shown that, to a large extent, Malaysia's safety net is resilient to such shocks. However, safety net programs that grow automatically with a crisis—such as urban workfare programs and additional school meals—can be implemented to allow greater flexibility during crises.

19. ***Infrastructure.*** The quantum leap achieved in infrastructure expansion over the past decade came at a cost. The Malaysian strategy of rapid deployment with substantial government support had merit in the earlier phases of privatization when there was a need to quickly mobilize private capital. But it created structural inefficiencies—weak policy framework and planning process caused inefficiency in technical review and missed opportunities for system integration; lack of competitive elements likely increased project cost though allowed faster process; public-private risk allocation in concession provisions increased government exposure; lack of transparency in awarding concessions reduced public confidence; and lack of technical monitoring and feedback of government's exposure into decision-making at the macro-investment level and project selection level threatens long-term effectiveness of government's investments. As privatization has become a more pervasive feature of Malaysian infrastructure and the overall economy has matured, rapid speed in awarding contracts needs to be balanced against longer-term goals of ensuring project sustainability and minimizing cost to the government. For that, serious consideration should be given to the market structure and the possibilities of competition; a regulatory system that provides incentives for cost minimization and is credible to the public; and a contracting process that is transparent and efficient. Malaysia is gradually moving in this direction. In addition, the infrastructure provision and financing strategy could benefit from international experience (see Matrix).

POLICY MATRIX	
Objective	**Policy Measures**
Public Expenditure Management	
Maintain fiscal discipline Ensure public accountability for public resource use Allocate public resources to strategic priorities Ensure effective and efficient use of public resources	• Extend fiscal planning to the consolidated financial position of central government, statutory bodies and public corporations; and to contingent liabilities. • Follow a multi-year balanced current budget rule. • Expand public accounts to include statutory bodies and public corporations, the cost of subsidies extended to them, and contingent liabilities to privatized entities. • Identify Cabinet priorities early in the budget process and reflect them in medium-term strategic plans of line ministries. • Strengthen the strategic planning process in ministries and their departments and extend the performance management to nondepartmental public entities.
Health	
Enhance resource allocation Improve the public-private partnership	• Spend more on medical staff, broaden the scope of preventive care, and achieve better balance across states. • Raise resources by reassessing entitlements to free care, adjusting fees to better reflect costs, and introducing copayments. • Promote and regulate the private sector. • Reduce the cost of privatization: for outsourcing, revise the legal and financial framework of existing contracts, and increase competition for new contracts; for corporatization, reduce the wage bill and review pricing for civil servants at the National Heart Institute.
Education	
Increase the supply of higher education in a cost-effective manner	• Provide loans to students with a potential to increase fees. • Expand the tertiary education system and improve secondary school retention rates. • Extend the availability of loans to private university students. • Encourage private banks to provide loans for university education by providing loan guarantees.
Social protection	
Reduce rising trends in inequality Manage social risk	• Continue to allocate larger budgets to states that lag behind. • Ensure that low-income people build adequate skills to participate in growing sectors. • Continue to use consumption-smoothing over the lifecycle for all households through labor market policies and educational training, pension systems, and disability insurance. • Design income transfer schemes that can expand easily during crises and are more targeted to urban areas.
Infrastructure	
Improve financial viability of toll roads Improve financial viability and investment efficiency of urban transport Improve the financial viability of sanitation services Increase competition and efficiency in power supply Strengthen the planning process	• Consider alternatives to the Build-Operate-Transfer (BOT) toll road model, such as network-based regional transport utilities. • Review toll formula provisions to provide for more stable and reasonable rate increases. • Create an urban transport fund and finance it through securitization of new revenue sources, such as gasoline tax surcharge, area road pricing scheme, and parking taxes. • Create a Strategic Authority to strengthen multi-modal planning, implementation, and regulation. • Combine water and sanitation services. • Split the concession area into distinct jurisdictions to promote competition. • Use incentive regulation, such as price cap, to limit costs instead of guaranteeing rates of return. • Unbundle the sector into generation, transmission, and distribution; introduce a strong regulatory framework; and allow free entry in power generation. • Create and operate an independent system operator. • Regulate distribution rates through a price cap formula. • Shift the planning process for project selection from quantitative targets to needs assessment. • Rank projects based on realistic criteria for economic return, including consideration for risk exposure. • Increase the role of line ministries in project definition and concession negotiation. • Move technical reviews forward in the review process to ensure adequate project evaluations and cost estimates.

1. RESPONDING TO THE CRISIS

1.1 After initial resistance to the regional shocks of 1997, the economic and social impact of the crisis deepened, although less than initially feared. During 1998, the economy contracted by 7.5 percent after more than a decade of 9 percent annual growth. Unemployment increased from 2.5 percent in 1997, technically a full employment level, to 3.4 percent by December 1998 and remained at this level in 1999. Inflation was contained at 5.4 percent in 1998. Poverty was on the rise—at least a quarter million people became poor in 1998, reversing two decades of continuous decline in poverty. The financial and corporate sectors became more vulnerable—non-performing loans reached 11 percent of total loans by August 1998 (by December 1999 non-performing loans stood at 11.1 percent on a 3-month basis, and 6.6 percent on a 6-month basis). The crisis also jeopardized the financial viability of many privatized infrastructure projects.

1.2 These events posed unprecedented challenges for the government of Malaysia. The government recognized the necessity of making fundamental shifts in policy and took a proactive role in managing the crisis. Its National Economic Recovery Plan (July 1998) aimed for quick recovery by using a fiscal stimulus plus loosening monetary policy to increase aggregate demand; fixing the exchange rate and imposing selective capital controls to stabilize the currency; providing social protection for vulnerable Malaysians; and restructuring corporate and banking sectors to revive businesses. The government is also reviving privatized infrastructure projects through the newly-established Infrastructure Development Fund.

1.3 The crisis and its remedies have serious implications for fiscal management. First, the *fiscal stimulus* strategy is necessary to help pull the economy out of recession but it carries some risks: it creates a higher government deficit and there is a risk that it might not work while the debt to GDP ratio builds up. Second, *contingent and off-budget liabilities in infrastructure* projects have complicated fiscal management. The crisis has lead to widespread liabilities for the government from infrastructure projects (estimated at around 4 percent of GDP, with an upper bound of 11 percent under a high-risk scenario) because their viability has deteriorated as a result of the crisis through costs rising and revenues plummeting. Implicit and explicit contingent liabilities arising from the financial sector restructuring (purchase of non-performing loans and recapitalization of banks) are also very large—estimated at around 10 percent of GDP, with an upper bound of 30 percent under a high-risk scenario (see SPR, 1999). Finally, the government is mitigating the *social impact* of the crisis. However, for the last 25 years or more, it has relied on growth to reduce poverty and it was unclear at the onset of the crisis whether the existing safety net could meet the new social needs.

A. THE FISCAL STIMULUS

A New Economic Reality in Malaysia

1.4 From a surplus of 1.9 percent in 1997, the federal budget was expected to show a deficit of about 2.1 percent of GDP in 1998 and 3.6 percent in 1999 (Table 1.1), excluding off-budgetary expenditures to recapitalize the financial sector and meet the government's liabilities in privatized infrastructure projects. The deficit would result from a decrease in revenue (about 14 percent between 1997 and 1998) and an increase in development spending (of about 15 percent between 1997 and 1998). Revenues would drop primarily because of the recession, but the fiscal stimulus would also contribute by reducing the corporate profits tax rate and other measures. Despite stepped up development expenditures during 1998, the deficit of the federal government was smaller than planned—only 2.1 percent of GDP—reflecting higher-than-expected tax revenues and delays in project implementation. The deficit will continue until the economy emerges from the recession and returns to growth of 4-5 percent. This may take a few years. The debt to GDP ratio may reach 50-60 percent by the year 2000 (including financial restructuring and contingent liabilities on privatized infrastructure projects), from 32 percent at end 1997. The rising debt will impose tradeoffs on policymakers—between the size of the stimulus and the size of the primary deficit, and between domestic and foreign debt financing. Therefore maximizing the effectiveness of the fiscal stimulus is crucial.

Table 1.1: Federal Government Spending and Revenue, 1996-99

RM billion	1996	1997	1998	1999[1]
Revenue	58.3	65.7	56.7	58.7
Direct taxes	25.9	30.4	30.0	27.2
Indirect taxes	21.4	23.2	15.3	18.1
Other	11.0	12.1	11.4	13.3
Expenditure	58.5	60.4	62.7	69.3
Current	43.9	44.7	44.6	46.7
Development	14.6	15.7	18.1	22.6
Surplus/Deficit	-0.2	5.3	-6.0	-10.6
as % of GDP	-0.1	1.9%	-2.1	-3.6%
Total Debt as a % of GDP	35.9%	32.6%	36.2%	37.3%
Domestic Debt as a % of GDP	31.7%	27.9%	31.0%	31.3%
Foreign Debt as a % of GDP	4.2%	4.7%	5.2%	6.1%

1. Preliminary.
Source: Economic Report, MOF; Bank Negara.

Box 1.1: From Fiscal Surplus to Fiscal Deficit

The successful fiscal adjustment strategy over the past decade led to fiscal surpluses and sharp debt reduction (Figures 1 and 2). This is likely to be reversed, however, in the aftermath of the crisis. When the 1998 budget was formulated in October 1997, economic growth was slower but robust. Then a major concern was the continued deficit in the current account position of the balance of payments, arising from insufficient national savings to finance capital formation. Against this background, the fiscal stance had to be prudent to enlarge the stock of national savings, which the private sector could then mobilize to finance its investments and reduce its reliance on external resources. Consistent with this objective, a surplus of 3.2 percent of GNP was budgeted for 1998.

Restrictive fiscal policy at first.... In light of the impact and potential risks of the financial crisis, the fiscal policy continued to aim at reducing the balance of payments current account deficit which had been a drain on the country's external reserves. This required a cutback in domestic demand, particularly goods with high import content. A severe drop in projected revenue for 1998 required a sharp cutback in public expenditure to maintain a budgetary surplus. Consequently, in December 1997, the government announced further expenditure cuts in 1998 of at least 18 percent, with an immediate 10 percent cutback across the board on both operating and development expenditure, and 8 percent discretionary cuts. In March 1998, to minimize the impact of the economic crisis on the vulnerable groups, the government allocated an additional RM1 billion for safety net projects.

...then expansionary. However, by the second quarter of 1998 it was clear that the concerns underlying fiscal restraint no longer prevailed—the current account position of the balance of payments recorded a surplus in 1998, partly due to import reduction measures and partly due to contracting domestic demand from the crisis. Then the priority became revitalizing domestic economic activities through fiscal stimulus. In July 1998, the government announced an additional RM7 billion for development expenditure (also to partly finance Danaharta, the new asset management company). To provide maximum stimulus to economic growth, the projects selected had to have strong linkages with the economy; minimum import content; short gestation period; and capacity to enhance the efficiency of the economy. Priority was given to poverty alleviation projects, such as housing, rural development, and social sectors. Measures were introduced to stimulate private saving, including increased tax deductions on the voluntary contribution by employers to the EPF; and reduced corporate tax from 30 percent to 28 percent.

Figure 1. Total debt to GDP ratio
percent

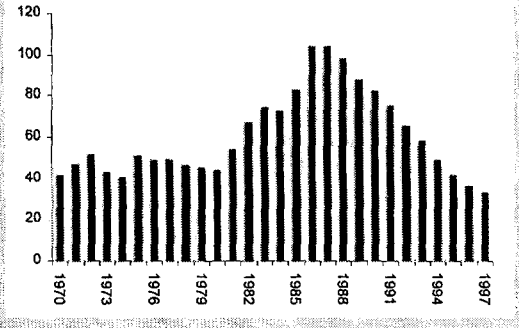
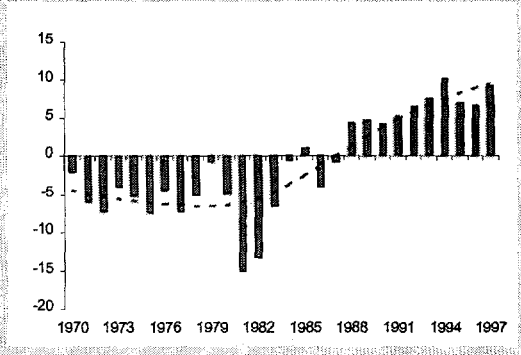


Figure 2. Primary deficit and its trend
percent of GDP



Source: Bank Negara

Fiscal Stimulus: Effectiveness and Risks

1.5 The fiscal stimulus strategy raises some critical questions for fiscal management:

- Will the fiscal stimulus restore growth?
- How can its effectiveness increase?
- How will the fiscal stimulus affect fiscal and debt sustainability?
- How will the deficit be financed?

1.6 First, easing fiscal policy is necessary to restore growth but not sufficient. The dangers of allowing the recession to continue argued for an expansive fiscal policy to stimulate demand. Large declines in private investment and consumption and little export growth during 1998, meant that the countercyclical measures were the only significant positive stimulus to aggregate demand in that year. The 3.6 percent fiscal deficit for 1999 provided a stronger fiscal impulse. Easing fiscal policy is thus crucial to halt the contraction in aggregate demand, although alone it cannot restore growth.

1.7 Second, Malaysia has correctly focused the fiscal stimulus on increasing public expenditures for infrastructure projects that have strong linkages with the economy and a short gestation period and on using tax cuts that have an intertemporal price effect (Box 1.2). The temporary cuts in expenditure taxes are more effective in raising aggregate demand than cuts in income taxes since they bring future expenditures into the present, by reducing the cost of current spending relative to those in the future. Malaysia used this phenomenon to advantage at the end of 1998—the temporary tax cuts on house and auto purchases provided a substantial stimulus for sales. Another example is the temporary investment credit used periodically in the United States—businesses purchasing new equipment subtract a fraction of its cost, the credit, directly from their profits tax bill, but only for a specified period. This reduces their tax bill—the income effect—but it also provides an incentive for moving future investment spending into the present.

Box 1.2: When Does Fiscal Stimulus Become Ineffective?

A recent paper by Paul Krugman (1998) resuscitates and modernizes the idea of a liquidity trap in which expansionary monetary policy is ineffective. The core of his argument is that if the policy is expected to be reversed due to the Central Bank's determination in inflation-fighting, it will not reduce real interest rates by creating the expectation of a period of inflation. In that case, the short-run policy would be ineffective in stimulating output. Krugman advances this argument in an analysis of Japanese monetary policy. His point is that the monetary expansion should be seen to be permanent, so the price level is expected to rise.

A similar point can be made with respect to fiscal expansion in Malaysia. The public must perceive the new level of the debt to GDP ratio as sustainable. If they anticipate that taxes will be raised in the future to reduce the debt, their consumption spending and investments would drop and the tax would go mainly into savings.

Source: Paul Krugman, *It's Back: Japan's Slump and the Return of the Liquidity Trap*, Brookings Papers on Economic Activity, 1998.

1.8 During 1998, however, the fiscal deficit fell short of the target because of higher-than-expected tax revenues and delays in project implementation. To maximize the effectiveness of the stimulus, the appropriate mix between tax reductions and current or development expenditure increases could be re-assessed. Malaysia could also consider a more flexible rule of keeping its current budget balanced over a business cycle rather than on a yearly basis to better counter recessions.

1.9 Third, medium term fiscal sustainability can be achieved. The primary fiscal balance required to stabilize debt to GDP ratio at 60 percent depends on the gap between the real interest rate paid on debt and the real growth rate of the economy. Even if the real interest exceeds real GDP growth by 3 percent, Malaysia can stabilize its debt to GDP ratio at 60 percent by running a zero surplus on the primary fiscal balance, net of seignorage revenue (see SPR, 1999).[1]

1.10 Fourth, the authorities intend to finance two-thirds of the deficit locally. The deficit could partially be financed abroad at concessional rates (mainly from Japan). Excess liquidity in the banking system means that the balance can be financed domestically without any significant effect on interest rates. In the medium term, structural reforms in the financial sector, but also in infrastructure and human capital provision, would increase efficiency and growth, permit movement towards budget balance, and help reducing the debt to GDP ratio and its financial burden.

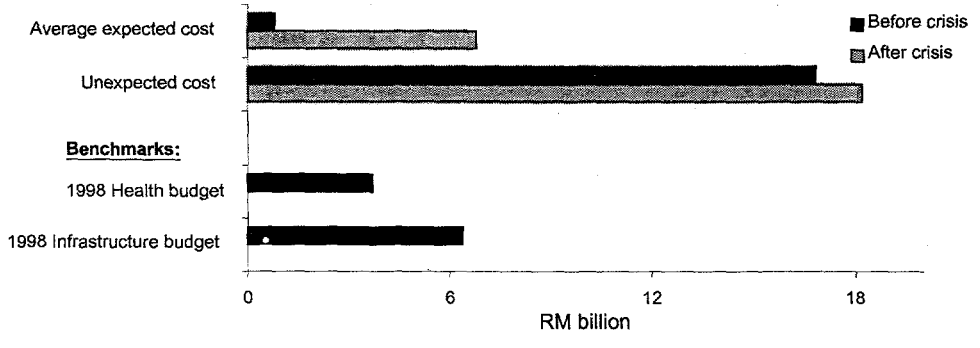
B. MANAGING CONTINGENT LIABILITIES IN INFRASTRUCTURE

1.11 The crisis has brought to the fore the issue of contingent and off-budget liabilities, mainly arising from "privatized" infrastructure projects but also from financial restructuring. Over the past decade, the government has been highly successful in its strategy to mobilize private sector capital and skills to supply and operate infrastructure services with government support. However, direct and contingent liabilities (Box 1.3) to the government have remained large. The crisis has increased the likelihood that contingent liabilities in infrastructure projects materialize as their viability declined, and has complicated fiscal management.

How Bad is it? Government Exposure After the Crisis

1.12 Weak demand (from the recession but also from over-optimistic projections), a growing reluctance to pay for services such as sanitation or toll roads, and financial

Figure 1.1: Contingent liabilities in Infrastructure Before and After the Crisis, 7th Plan.



Note: The figures are based on the average and unexpected cost to the government as the share of project cost estimated in figure 1.4 and applied to the total private investment in infrastructure (road and rail) during the 7th Plan.
Source: World Bank staff calculations.

distress from higher debt burdens (due to Ringgit depreciation and higher interest rates) have caused serious difficulties in Malaysia's infrastructure projects. The nature of the existing private/public partnership caused a large share of the burden to become the government's liability. The government's financial exposure from existing privatized infrastructure projects, both contingent and realized, is substantial and has not been wholly evaluated or quantified.

1.13 Box 1.4 shows illustrative estimates of the government's exposure to two light rail projects, one toll road project, and one power project. The estimates are based on continually evolving assumptions on revenues and costs and so they need to be interpreted with caution. However, they do show that the crisis has had a significant impact in raising the government's obligations. If these projects are representative of other transport projects, the average expected costs from all such projects could be around RM7 billion (Figure 1.1); the unexpected cost could be around RM18 billion.[2] If the government were to appropriate the full amount of its financial exposure (that is, 100 percent of its average expected cost) upfront, as is done in the U.S. in the form of a special fund, it would be equivalent to twice Malaysia's 1998 health budget.

Box 1.3: Contingent Government Liabilities: a Hidden Risk to Fiscal Stability

Recent experiences have shown that major hidden fiscal risks are associated with contingent government liabilities. Therefore, fiscal adjustment that targets deficit and debt reduction does not prevent fiscal instability. All sources of fiscal risks must be addressed if governments are to avoid sudden fiscal instability and realize their long-term policy objectives.

There are four types of liabilities: direct and contingent, each of which is either explicit or implicit. ***Direct liabilities*** are obligations that will arise in any event. They are predictable according to specific underlying economic and policy factors. ***Contingent liabilities*** are obligations that are triggered by a particular discrete event, which may or may not occur. The probability of contingency to occur and the magnitude of the required public outlay are exogenous (e.g., the occurrence of a natural disaster) or endogenous (e.g., implications of market institutions and of the design of government programs on moral hazard in the markets) to government policies. ***Explicit liabilities*** are specific government obligations defined by law or contract. The government is legally mandated to settle such an obligation when it becomes due. ***Implicit liabilities*** represent a moral obligation or an expected burden of the government not in the legal sense, but based on public expectations and political pressures.

Based on these characteristics, there are four types of fiscal risk.

- ***Direct explicit liabilities*** are the main subject conventional fiscal analysis. The repayment of sovereign debt, expenditures based on budget law in the current fiscal year, and expenditures in the long term for legally mandated items, such as civil service salaries and pensions, and in some countries even the overall social security system.
- ***Direct implicit liabilities*** often arise as a presumed consequence of public expenditure policies in the longer term. Given their implicit nature, these obligations are not captured in government balance sheets. Typically, they are high for demographically driven expenditures. For example, in a public pay-as-you-go scheme, future pensions constitute a direct implicit liability, the size of which reflects the expected generosity of and eligibility for a benefit, and the future demographic and economic developments.
- ***Contingent explicit liabilities*** are government legal obligation to make a payment only if a particular event occurs. Since their fiscal cost is invisible until they are triggered, they represent a hidden subsidy, blur fiscal analysis and drain government finances in the future. Therefore, *state guarantees* and financing through *state-guaranteed institutions*, look politically more attractive than budgetary support even if they are more expensive later. In the markets, contingent government obligations may immediately create moral hazard, particularly if the government guarantees the whole rather than a part of the underlying assets, and all risks rather than selected political and/or commercial risks. *State insurance schemes* often cover uninsurable risks of infrequent losses that are enormous in total magnitude. Thus, rather than financing themselves from fees, they redistribute wealth and rely on government net financing.
- ***Contingent implicit liabilities*** are not officially recognized until *after* a failure occurs. The triggering event, the value at risk, and the required size of government outlay are uncertain. In most countries, *the financial system* represents the most serious contingent implicit government liability. Experiences have indicated that markets expect the government to help financially far beyond its legal obligation if stability of the financial system is at risk. Fiscal authorities are often compelled also to cover the uncovered losses and obligations of the *central bank, subnational governments, state-owned and large private enterprises, budgetary and extra-budgetary agencies*, and any other institutions of political significance. Contingent liabilities rise with weaknesses in the macroeconomic framework, financial sector, regulatory and supervisory systems and information disclosure in the markets. With private capital flows, for instance, such weaknesses elevate the risks in assets valuation, intermediation and borrowing behaviors in the markets.

Source: Hana Polackova, *Contingent Liabilities: A Threat to Fiscal Stability*, World Bank Prem Note, 1998.

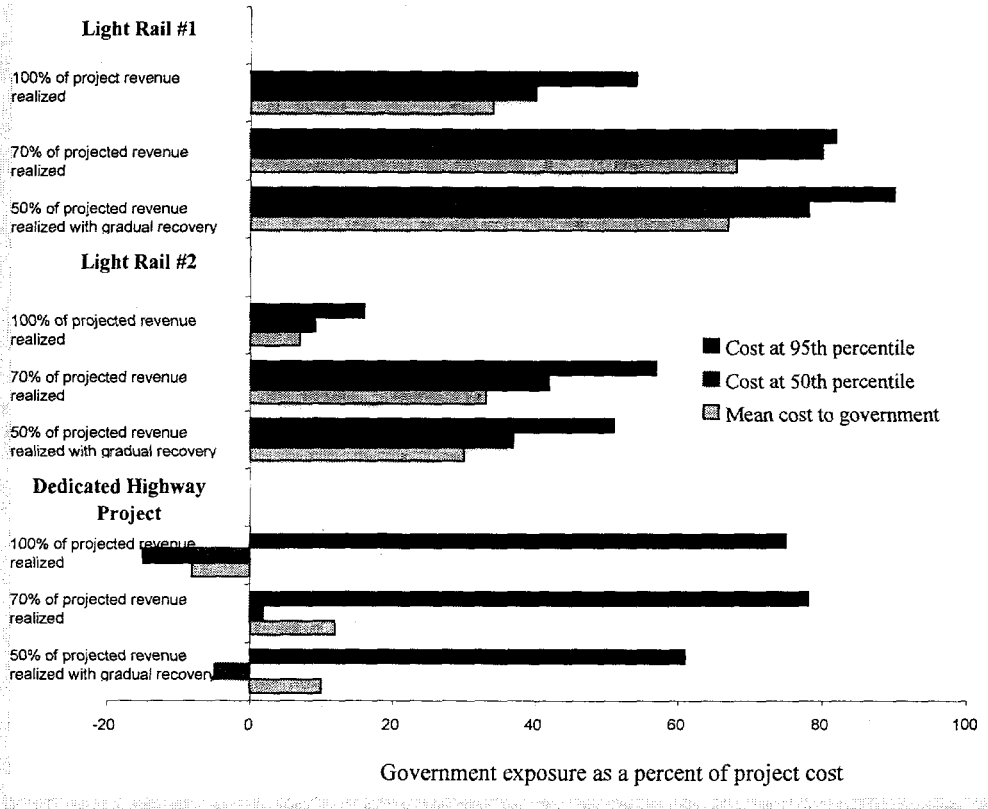
Box 1.4: Estimating Government Exposure in Infrastructure Projects

Estimating government's exposure in infrastructure projects is a complex exercise. There are different estimation techniques and we do not have full information about projects. The following estimates are computed using the Monte Carlo simulation technique, and using partial project information. They are meant to provide some order of magnitude but should be interpreted with caution.

The financial problems faced by transportation projects generally stem from two sources. First, an optimistic outlook on development which did not account for possible downside risks. The recent economic and financial downturn thus led to severe departures from original financing structures as they were unhedged to currency exposure, changes in interest rates, and decline in demand. Second, overly optimistic ridership forecasts—and hence revenue forecasts—at the initiation stage of projects; ridership forecasts often had to be revised even prior to the crisis. Each downward revision raises the costs to the government substantially. Ridership declined further with the current economic situation—recent daily ridership statistics for some light rail systems have averaged about half the break-even level.

The government bears much of the direct and indirect commercial risk of concessions. Its ability to terminate contracts is constrained by guarantees it provides on project debt and, in some cases, on return on equity. The likelihood and extent of projects defaulting are highly sensitive to ridership and traffic flows which determine revenue. For light rail projects, assuming current ridership drops to half the most recent government projections during the crisis then gradually improves after the crisis, the average cost to the government would increase from 34 percent to about 70 percent of total project cost in one light rail project and from 7 percent to 30 percent of total project cost in another. The 95th percentile scenario shows that the unexpected cost (that is, the cost with low probability of occurring), which highlights potential vulnerability, also rises substantially. The dedicated highway project performs better than the light rail projects. Assuming 50 percent less traffic than projected by the project and a gradual recovery after the crisis, the average cost to the government will be around 10 percent of the total project—from a revenue of 8 percent prior to the crisis.

Government Exposure in Selected Transport Projects Under Three Revenue Scenarios



Methodology: In estimating the government's exposure, a Monte Carlo simulation approach was used. The stochastic (uncertain) cash flows are projected into the future. Two thousand and five hundred scenarios are run. Under some scenarios the project is economically viable and no default occurs. Under other scenarios, the project defaults on its commercial debt and is taken over by the government. The estimated expected cost to the government is the average cost over all the scenarios. This is the cost the government can expect to pay out on average. However, if several unfavorable factors coincide, e.g., low ridership and higher than anticipated costs, then the pay out can be larger. In this case, the unexpected cost is defined as the amount paid out in the 95 percentile case (i.e., there is only a five percent chance that such an eventuality would occur). In addition to these costs arising out of project default, the government is committed to subsidies, such as low interest rate loans, which would need to be paid.
Source: World Bank staff estimates.

The Response to the Crisis: Implications for Future Liabilities

1.14 As the contingent liabilities in infrastructure projects began to materialize, the government sought to inject new funds and facilitate financial restructuring in order to ease the immediate burden of debt repayment on concessionaires. The government's short-term strategy of rescuing these projects is driven by the aim of quickly restoring confidence and vigor in the economy and minimizing the fiscal burden from the contingent liabilities. However, the implications for the medium term must also be recognized—by extending its financial commitment to infrastructure projects, the government is taking on an increased financial burden, explicit or implicit.

1.15 To help finance ongoing projects, the Ministry of Finance has established the Infrastructure Development Corporation (IDC)—the infrastructure counterpart to financial sector entities Danaharta (purchasing/restructuring non-performing loans) and Danamodal (bank recapitalization). The goal for IDC is to secure up to RM11 billion in capital by 2000, although its funding targets are somewhat fluid as they depend on which projects are selected and their structuring approach. A RM1 billion has been raised to date through a short-term loan from Petronas (a public oil company). A RM3 billion loan from the Employers' Provident Fund (EPF) is being considered, part of which will be used to repay the Petronas loan.

1.16 It will be exceedingly difficult to access adequate levels of capital from non-government institutions, domestic or foreign, because revenue sources needed to service IDC's future debt obligations have not yet been established. Given the current economic situation and the nature of most infrastructure projects—which take time to generate significant levels of revenue—it is unlikely that cash flows generated from IDC's investments will suffice. Because of the difficulty in securing private capital, EPF and other government entities such as Khazanah, Petronas, and Tenaga will be an important source of funding. Since Danaharta and Danamodal are also likely to draw heavily upon the same government investment vehicles, the latter's risk profile will worsen measurably as their investments in troubled projects increase. This will raise the government's implicit contingent liabilities.

1.17 In addition to providing new funds for ongoing projects, the government is also scaling back and deferring certain projects, assisting with corporate workouts, and restructuring concessions and debt schedules to facilitate debt repayment over longer periods. The various financial restructuring options that the government is considering to support ailing projects are suitable but may increase its contingent liabilities.

1.18 First, the *use of zero-coupon or other forms of deferred payment debt* is aimed at providing near-term cash flow relief. Although economic recovery would help repay the loans at a future date as project revenues ramp up, the approach also increases financial risk since the principal base grows considerably as deferred interest accrues, making future debt service more difficult. If the economy does not fully recover, the problem would worsen in the future.

1.19 Second, *lengthening the concession term* may also defer project financial obligations. However, in circumstances where long-term financial viability is in question,

the government will eventually either have to assume financial responsibility for the project or allow it to fail.

1.20 Third, another debt restructuring option involves the *government forgiving all or a portion of its soft loans* to a concessionaire in exchange for foregoing government guarantees of future price increases previously allowed under the concession agreement. Since this option involves trading future cash inflows (from repayments of soft loans) for a reduction in contingent liability exposure, the budgetary impact over the project's life would be neutral to positive. Such an approach provides the government with greater certainty about its liabilities while giving cash flow relief to concessionaires; but it should be undertaken in a balanced manner as it involves foregoing future revenue.

Risk Management in a Crisis and Beyond

1.21 The government's overall approach to manage contingent liabilities from infrastructure projects during the crisis is appropriate; but because it adds new contingent liabilities decisions to support specific projects could be better guided by two considerations—minimize the burden on the government and maximize efficiency.

1.22 First, while continuing the government's soft loan and other financial support program is appropriate in this crisis context, its use should be rationed to projects that can reasonably achieve long-term self-sufficiency. Further, soft loans can be adjusted to incentive structures and management practices that reduce costs. For example, in the United States, a recently enacted infrastructure credit support program—the Transportation Infrastructure Financing and Innovation Act (TIFIA)—allows for subordinated federal loans, not unlike Malaysia's soft loans, loan guarantees, or lines of credit for public and private infrastructure projects of national significance. The TIFIA is limited to one-third of project costs and requires that the non-federally supported portion be financially viable, as demonstrated by an investment grade credit rating of a leading third party rating agency. Moreover, the government's participation must be budgeted. This approach is intended to encourage project development in cases where the private capital market is unable to do so on its own—because the project has a public good element and is not financially viable.

1.23 Second, new revenue sources could be raised. Increased petrol taxes represent a large and relatively inelastic potential revenue source, with positive transport policy ramifications. Malaysian petrol prices are among the lowest in the world and have contributed to the rapid rise of private automobile use. This, in turn, has necessitated huge infrastructure investments. The government has estimated that a modest ten sen per liter increase in the petrol consumption tax would result in about RM70 million per year. Other similar measures, such as higher vehicle registration fees and elimination of parking tax deductions for employers, could also be considered.

1.24 Third, as the government continues its efforts to reinvigorate the domestic economy, quantifying its direct and indirect obligations to privatized infrastructure projects is essential to calibrate and maximize the efficiency of the fiscal stimulus, and also to determine the extent of government borrowing or other financial assistance

needed to support existing on- or off-budget commitments. Full accounting of the government's support to infrastructure projects, should include direct and indirect obligations, direct and indirect guarantees, off-budget funding mechanisms, and existing system maintenance needs that need to be adequately budgeted for. A risk management strategy for the medium term could be developed (Box 1.5).

1.25 Finally, government decisions to support specific infrastructure projects need to be made in the context of a long-term strategy for each sector that enhances competition, while ensuring network coordination and integrity (see chapter 3). For stranded assets—assets that have been created or are under construction, and are not financially viable—such as some highway and urban rail projects, the government could assume all capital commitments and take over ownership of the fixed and operating assets, then issue new and improved concessions to operate them; while projects under construction need to be subject to more stringent oversight measures to avoid unnecessary costs or be completely re-appraised.

Box 1.5: A Risk Management Strategy for Contingent Liabilities

An integrated risk management process should perform three principal functions:

Identifying and controlling the risks. A dedicated cell within the Ministry of Finance could be mandated to record all explicit guarantees that the government provides, while also tracking and assessing all contingencies that may increase the government's debt. Regulators first examine an enterprise's general categories of risk (financial, business, operational, and event risks) then focus their scarce resources on the highest risk areas. Systems of early warning indicators, though imperfect, could be instituted to allow for early preventive measures.

Budgeting and reserving for contingent liabilities. The first step is measuring contingent liabilities—the probability that the guarantee will be called and the payment obligation if that happens. The measuring method can be actuarial or econometric, but the preferred one is the contingent claims analysis, which essentially simulates different scenarios that may unfold in the future and determines the payments required under those scenarios. From this, the expected and unexpected costs are derived. The expected costs (average costs over the different scenarios) measure the likely payments that will incur and are equivalent to the subsidy implied by the issuance of the guarantee. The unexpected costs represent the payments likely to be incurred at the 95th percentile (close to the highest payment). Budgeting decisions are then made. From a policy point of view, the expected cost estimate can be used to judge whether the government would be willing to support the project through an equivalent cash, up front subsidy. Expected costs, being akin to subsidies, need to be directly budgeted for, and thus be included in the appropriations process. In contrast, unexpected costs are dealt with by setting aside capital to deal with the extreme events.

Budgeting for expected costs requires accrual or present value accounting, which, in turn, implies a medium-term multi-year budget framework. Cash-based budgeting misrepresents the aggregate exposure associated with loan guarantees and government insurance programs and creates perverse incentives for selecting one form of financing assistance over another (under a cash-based system of budgeting, a government equates the budgetary cost of issuing financial assistance with the cash outlay created by the transaction in the current budget year; thus, when a government issues a direct loan, the entire face value of the loan at the date the loan is issued is recorded as a budgetary cost, with loan repayments recorded as cash inflows in subsequent years, while loan guarantee and insurance programs are not recorded as costs until a claim is made at some future uncertain date). The use of a present value system requires the recording of the expense and appropriating against it the expected cost of the action at the time the transaction is undertaken. Under this system, all actions (e.g., upfront subsidy or loan guarantee) receive equivalent accounting treatment and thus the choice between various forms of government support can be made on the basis of their intrinsic merits rather than being driven by accounting conventions. Use of a present value system need not affect or distort cash-based estimates of the government's fiscal deficit, since the effect on the deficit is not recorded until actual cash payments are disbursed from the reserve fund. Adoption of a present value method of guarantee budgeting simply forces agencies to set aside resources up front for the expected costs of the guarantee issued.

In addition to budgeting for the full expected present value of costs from credit and insurance programs governments need to set aside reserves against unexpected losses. Preparing for unexpected losses prevents the political backlash associated with redirecting scarce public resources to cover the sudden increase in costs, obviates the need for political battles over additional funding, and eliminates the perception that any sudden increase in costs represents program mismanagement. Setting up reserves to protect against such events can mitigate these problems by reducing the number of events for which the executive branch or administering agency needs to seek additional budgetary resources to cover program costs and by reducing the size of any budgetary requests that are made. Once a government can assess its risk tolerances and goals, in terms of both which risks and the level of loss it is willing to bear, it can establish reserves against unexpected losses ("risk capital") within its credit and insurance programs. To do so, however, a government needs to determine include whether reserves will be set based on the additive unexpected loss exposure of each guarantee or on a portfolio value-at-risk (VaR) approach to account for portfolio diversification, what the investment policy of the reserves will be once they are established, and where the reserves should reside.

Mitigating risks through better policies. In infrastructure, the government could renegotiate tariffs with the concessionaires, bid for new contracts, and provide incentives to lower cost when giving a guarantee. The difference between the cost of buying the contracts from the current project sponsors and the price received from new bidders may well be considerable. However, that price has, in effect, to be paid in any case. The Government may choose to wait a few years for demand to recover somewhat so that the net cost to the Government is lowered. However, the longer the wait, the greater the possibility that the fiscal drain on the Government may continue; with the high implied rates of return to the private sponsors and lenders, the net costs actually rise through waiting. Also to be taken into account are the efficiency gains that may accrue from an early move to a more competitive system.

Source: World Bank.

C. The Social Impact of the Crisis

1.26 The crisis has damaged the financial well being of Malaysian households and has temporarily closed the opportunity to use growth as a safety net. Declining stock and asset prices and lower returns to investments and savings have eroded personal wealth—in 1998 the KLSE plummeted by more than 50 percent. As domestic and foreign demand for goods fell and the economy began to contract, private sector real wages stagnated but unemployment remained low, unlike other crisis countries. Inflation was also kept under control; it increased to 5 percent but the price of basic necessities such as food and medicine shot up to over 8 percent. At the onset of the crisis, the social consequences seemed unclear: Who has been affected? How badly affected are they? And is the existing safety net adequate to address their needs?

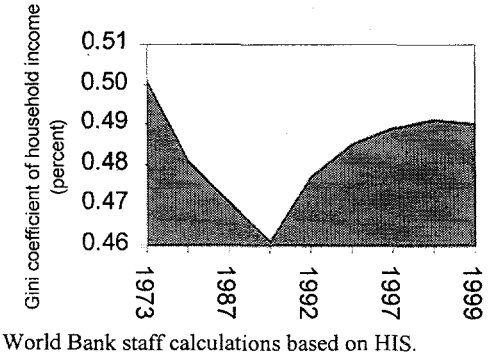
Gauging the Social Impact of the Crisis

1.27 The number of poor has increased by at least a quarter million (government estimate). Another estimate of the headcount index, obtained from the 1997 Household Income Survey by changing the sources of income for households during the crisis according to the aggregate changes in the economy,[3] shows that around 400,000 individuals—2 percent of the population—could have fallen into poverty by 1999 as their income drops below RM98 per month or $2.5 per day. Of these, one-third would be hardcore poor, with income below RM44 per month. However, the Gini coefficient, an indicator of inequality, may stabilize as a result of the crisis, after deteriorating sharply in the early 1990s (Figure 1.2).

1.28 Repatriating migrant workers (from Indonesia, Philippines, Bangladesh) who were employed in shrinking sectors such as construction and manufacturing buffered the social impact of the crisis—since most of these workers earn little, losing their jobs would have plunged them into poverty which would have increased the headcount index.

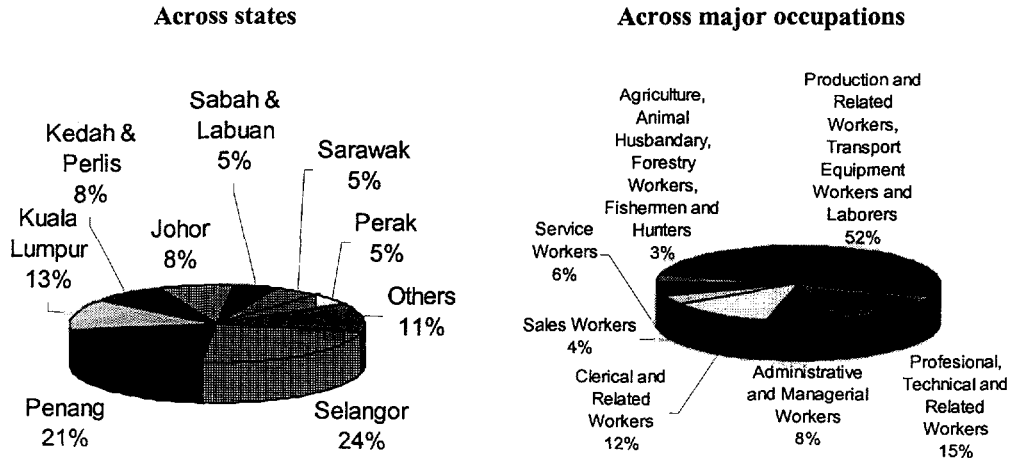
1.29 The economic slowdown and the drop in business activity was felt more in urban areas—the newly poor are mainly urban self-employed. Income derived from the agriculture sector grew at a slightly faster rate in 1998 compared with 1997 owing to higher prices of palm oil, increased production of food crops in response to the higher costs of imports, and increased revenue from exports due to the devaluation and the low import content of agriculture products.

Figure 1.2 : Inequality May Level off After the Crisis



Source: World Bank staff calculations based on HIS.

Figure 1.3: Most Retrenchments Were in Urban Areas and for Low-Skill Workers (1998)



Source: Manpower Department, Ministry of Human Resources.

1.30 Despite reduced economic activity, unemployment has remained low, rising from 2.7 percent in 1997 (technically full employment) to 3.5 percent in 1998. Given that GDP has dropped by 7 percent while employment has declined by less than 3 percent, the resulting drop in labor productivity is partly due to labor hoarding—firms working their employees less intensively but with the same hours of work, or maintaining the same number of employees on reduced hours. It could also signal a major increase in low labor productivity employment—for example, construction laborers who become petty traders to see themselves through the construction slowdown.

1.31 More than half of the retrenched workers are in construction; more than half are in the largely urban states of Selangor, Pinang and Kuala Lumpur; and more than half are unskilled (Figure 1.3). However, it was migrant workers who took the real brunt of the unemployment burden. In 1998, about 400,000 registered foreign workers were repatriated—which absorbed about 40 percent of that year's reduction in employment.

Is the Existing Safety Net Adequate to Mitigate the Crisis?

1.32 The government took specific measures to mitigate the social impact of the crisis. The thrust of the government's program is to enhance income-earning opportunities while maintaining expenditures on health, education, and its existing safety net program (Table 1.2). This practice is consistent with Malaysia's underlying philosophy of providing the poor with the means to improve their livelihoods rather than giving them cash transfers. The program includes four main measures.

1.33 First, protecting social assistance spending. The government has protected recurrent expenditures on social assistance programs for needy children, the handicapped, the elderly and the hardcore poor. Among the measures were: (i) retaining the original 1998

budget allocation for the Development Program for the Hardcore Poor (PPRT); and (ii) making smaller cuts to the 1998 budgets of ministries involved in the provision of social programs, rural development, and agriculture programs which are mainly targeted for the poor and low-income group as well ensuring that the budget for 1999 is sufficient to meet program objectives.

1.34 Second, promoting income-earning activities. Following its philosophy of promoting income-generating opportunities for those who can work, the government allocated funds to targeted schemes for different groups that cover the hardcore poor and groups made vulnerable by the crisis. These allocations include (i) an additional RM100 million to Amanah Ikhtiar Malaysia for the provision of interest free loans to more hardcore poor; and (ii) RM200 million for a new micro credit scheme to provide assistance to petty traders and hawkers in urban areas.

1.35 Third, safeguarding employment. Since cost-cutting is essential during the economic slowdown, the government has urged employers to use retrenchment as a last resort and instead to consider alternatives such as training, retraining, pay cuts or reduced working hours. In August 1998, the government introduced a new amendment of the Employment Act that require prior notification of the Manpower Department by employers who plan to implement pay cuts and temporary lay-offs. Moreover, the Ministry of Human Resources launched a RM5 million Retraining of Retrenched Workers Scheme in May 1998.

1.36 Fourth, protecting health and education budgets. The health and education budgets were largely restored in 1998.[4] In health, remaining cuts were concentrated to management programs and support services, and in education they were mainly in assets (e.g., office equipment and vehicles) and service and supplies (e.g., training, transport allowance). Since the 1999 budget restored the pre-crisis trends, these cuts should not have lasting effects. However new budgetary strain has emerged. In health, there was a substantial price increase for imported products used by health facilities (such as drugs and medical equipment). The MOH adjusted to the unexpected cost increase in drugs by

Table 1.2 : Social Sector Budgets Have Been Largely Maintained

RM million

	1994	1995	1996	1997	1998	1999/p
Total Social	14826	15654	18808	19970	20845	23548
Development	3285	3513	3984	4919	5783	6936
Recurrent	11541	12141	14824	15051	15062	16612
Education	10108	10603	12489	12881	13443	15323
Development	2010	2044	2091	2521	2915	3865
Recurrent	8098	8559	10398	10360	10528	11458
Health	2529	2772	3474	3727	4047	4461
Development	354	388	459	449	716	835
Recurrent	2175	2384	3015	3278	3331	3626

p. preliminary.

Source: Economic Report, MOF, 1999.

reducing quantity and prices—tighter prescriptions and shift to cheaper, local drugs—and postponed the import of equipment whenever feasible. Moreover, more people used public health facilities, putting greater demands on public resources. In education, government-sponsored overseas study programs for university students were suspended due to the depreciation of the ringgit, although students who were already studying overseas were allowed to continue. A larger share of university students had to be absorbed by domestic universities, increasing the 1999 recurrent budget for tertiary education.

1.37 To a large extent the Malaysian social protection mechanisms proved resilient to the crisis, although the scope of the public safety net programs could be further expanded during the crisis.

1.38 So far, Malaysia has managed to cope with the crisis, in part because of good initial conditions and a strong built-in safety net mechanism. The strong foundations of the existing network of free health and basic education have remained virtually intact and helped cushion vulnerable groups. Price controls for selected food items, such as rice, flour, cooking oil, and sugar—although inefficient as an income transfer—were strengthened, making basic foods more affordable. Traditional values such as strong family ties and a solid commitment between employers and employees in the private sector has provided a private safety net that is often more important than that of the government, although private transfers are likely to decline during the crisis. An important component of this safety net was the productivity-linked wage which allowed flexibility in the labor market and thus kept unemployment low. Moreover, employers are legally obligated to pay layoff benefits or compensation to retrenched workers. This built-in safety mechanism has complemented the role of the government in mitigating the crisis.

1.39 However, the scope of safety net programs could be further expanded during the crisis. The government has largely aimed at maintaining the social sector budgets at their initial levels, when in fact the number of poor and the depth of poverty have increased. Moreover, the government has kept the same safety net programs when in fact the face of poverty has changed. Although the existing programs are well targeted to the new *rural* poor (70 percent of the pre-crisis poor were rural), they do not benefit the new *urban* poor. Existing programs for the urban poor—such as the grant program for secondary school children and the micro-credit program for female headed households—are now insufficient. The new programs—the micro credit for urban petty traders and the training programs for retrenched workers—are not optimally designed. Training for retrenched workers may not be useful in the new economic context since job loss was caused by a cyclical economic downturn and not by a structural mismatch of skills, plus many workers would rather be under-employed but earn income than participate in retraining. The micro-credit program for petty traders has disbursed very little because it appears that people are not willing to borrow and invest under such economic conditions. Furthermore, it is often hard to prevent the gains in credit from being captured by the nonpoor.

1.40 The government is reluctant to introduce new poverty programs for a temporary crisis because they may be difficult to reverse later, and in any case go against Malaysia's

traditional strategy for poverty alleviation which relies more on income generation rather than income transfer. Moreover, if growth picks up quickly, as the government is expecting, many of the social problems will be overcome. But the crisis has raised a new class of social problems for Malaysia and other countries—more urban and shock-related. To the extent possible, the government could rethink its safety net programs in light of the need to provide additional income transfers on a temporary basis, but keep their amount modest to minimize incentive costs, rely on self-targeting, and allow them to automatically grow during a crisis (Box 1.6).

Box 1.6: Protecting the Poor in a Crisis and Beyond

A two-pronged approach to protect the poor and vulnerable during a crisis could consist of:

- designing workfare programs for the unemployed in urban areas
- expanding existing poverty programs in rural areas and strengthening programs in urban areas

Workfare programs have two attractive features for an economic crisis—they provide work and they automatically dwindle as the economy recovers. Workfare programs are a public guarantee of low-wage work on community-initiated projects—those seeking relief must work to obtain support and the work develops needed public works such as infrastructure or housing for the poor. Wages should not exceed the unskilled wage to avoid rationing, ensure self-targeting by those in need, and maintain the incentive to take up regular work when available. Work should be performed only on technically feasible projects proposed by bona fide community groups, to help ensure that the relief effort response to the needs of local communities, and small contractors. Proposals would be submitted to a central agency that simply assesses whether the project qualifies under the rules of the safety net program, with full public disclosure.

Complementary transfers in cash or food are also needed to reach those who cannot or should not participate in relief work—notably elderly or students. For that, the government could build on its existing programs. In order to limit the expansion to the duration of the crisis, it could pre-announce that a program expansion is for one year only to avoid future expectations by beneficiaries. School feeding programs and food transfers are good candidates for expansion. The food transfers can be used through self-targeting mechanisms, such as providing low-quality rice or distributing food in poor neighborhoods. These transfer schemes will need to be allocated administratively and turned off and on according to indicators of crisis. The demand for relief work can provide a useful signal for this purpose.

Source: Martin Ravallion, *Protecting the Poor in a Crisis and Beyond*, World Bank Prem Note, January 1999.

[1] The dynamics of the increase in the debt depend on the initial debt/GDP ratio d, the effective real interest rate at which the debt is financed r, the growth rate of GDP g, the primary surplus p, and the money-financed proportion of the deficit s (for seignorage). The basic relationship is as follows (terms on the right-hand side of the equation are all period t variables):
$d(t+1) - d(t) = (r - g)d - (p + s)$

[2] With a total private financing of RM17.5 billion in roads during the 7th Plan, the total expected cost to the government could be RM3.7 billion, assuming 50 percent less traffic than initially projected. For rail, with a total private financing of RM10.6 billion during the 7th Plan, the total expected cost to the government could be RM9.4 billion, assuming 50 percent less revenue than the latest government projections.

[3] The estimations are based on 1997 Household Income Survey. The official poverty line of RM 545 per household per month is used, equivalent to RM 98 per capita per month. The hardcore poverty line is half of that. The assumptions for changes in real income during 1998 and 1999 (respectively, in percent) are: wages 0; 0; agriculture self-employment -6; 3.9; non-agriculture self-employment -9; 0; capital -30;-20; private transfers -20; -10; social transfers –12; 0; rent -20;-10. A more detailed explanation is provided in Annex 1.

[4] Although at the beginning of 1998, as part of its austerity program, the government cut health and education budgets across the board (by 12 percent on the development side and 2 percent on the current side), cuts were gradually lifted during the year as the government switched to the fiscal stimulus strategy and reinforced its commitment to safeguard the social sectors. In health, final 1998 allocations represented 96 percent of initial allocations for operating expenditures and 94 percent for development expenditures. In education, final cuts in the recurrent budget for primary and secondary education were limited to 11 percent and were concentrated to a large extent in least disruptive areas (such as office equipment and vehicle purchase, minor repairs, etc.).

2. PUBLIC EXPENDITURE MANAGEMENT: HOW MALAYSIA PERFORMS

2.1 Malaysia has been at the forefront of public expenditure management reform among developing countries. Over the past ten years, central agencies devoted extraordinary efforts to improve the system through better fiscal discipline and improved effectiveness, efficiency, and accountability in the use of public resources. Malaysia had to adapt and customize reforms before achieving a successful public expenditure management system, as no best practice was available from developing countries. The Modified Budgeting System (MBS), introduced in 1989 and gradually implemented, provides greater managerial flexibility and accountability to the public management system. It performs on par with international best practice and is being used in some developing countries as a model. The MBS could be refined, however, especially in establishing strategic linkages between the budget reform and institutional changes that improve performance and between the budget process and Cabinet's policymaking process.

2.2 The crisis brought to the fore issues in public expenditure management that might have remained of less significance in a fast-growing economy: large and increasing off-budget liabilities that could undermine fiscal prudence, accountability and efficiency in the use of public resources. The government's strategy of allowing greater private sector involvement in the provision and financing of public services—mainly in infrastructure, but increasingly in health and education as well—has put new demands on contingent and off-budget public expenditure management as the government provided extensive financial support to private projects and corporatized entities. The fiscal planning framework, which currently focuses only on the cash flows of the central government, could therefore be expanded to cover contingent and off-budget liabilities.

A. THE PUBLIC EXPENDITURE MANAGEMENT SYSTEM

2.3 Malaysia has been a leader of public administration reform among developing countries. In the late 1960s, it moved from a traditional budget system—which relies on line item budgeting and detailed line item control, and is highly centralized—to a program performance budgeting system—which uses program and activity structures, performance measurement elements, and performance evaluation. In the 1990s, it shifted to an output and outcome-based budgeting system, the Modified Budget System (MBS), which focuses on outputs and impacts, performance measurement, and evaluation (Box 2.1). The implementation of the MBS across federal agencies was spread over a period of five years. It was piloted in 1990 in three agencies—Health, Public Works, and Welfare Ministries—to introduce and cultivate familiarity with the new system among select Ministries. The number of agencies adopting the MBS gradually increased and by 1995, the MBS was operational through all federal ministries and departments. The MBS

focuses only on the operating budget, which forms about 70 percent of the total budget. The budget reform did little to integrate the operating and development budget, but the preparation and examination of these budgets are undertaken at the same time, although in separate exercises, and tabled before Parliament together.

Box 2.1 Malaysia's Modified Budgeting System—at the Forefront of Developing Countries

The traditional Program and Performance Budgeting System in Malaysia was replaced by the Modified Budgeting System (MBS) in 1989 to introduce greater managerial flexibility and accountability to the public management system.

Main objectives:

- *Promote a rational allocation of resources* to government programs by imposing fiscal limits upon agencies and forging a link between inputs and outputs.
- *Improve discipline and rationality into the budget process* by explicitly quantifying a binding expenditure limit for each agency, shifting from line item budgeting to performance-based budgeting, and producing output-oriented program structures.
- *Improve program management* by adopting better management practices, including encouraging greater delegation of authority from Treasury to agencies and then on to line managers.
- *Reorient the focus of accountability* on issues of program efficiency and effectiveness, by measuring performance against predetermined targets, evaluating programs and activities according to their impact and relevance, and matching accountability and authority by holding managers accountable for performance.

Main features:

- An *Expenditure Target* is provided to each Ministry/Department at the start off the budget process to which existing policy budget submissions must comply.
- A *Program Agreement* is signed between the Treasury and the line ministry which determines the level of performance that can be achieved for a budget year with the allocation approved. At the end of the fiscal year, an *Exception Report* is prepared by the line ministries regarding the performance of activities which do not reach the levels specified in the program agreement.
- *Program Evaluation* takes place for each activity at least once every five years.
- A *Generalized Approach to Expenditure Control* is adopted which enables the Treasury to tighten the controls of overall expenditure and delegates the control over details to line ministries.

Source: John Anthony Xavier, *Budget Reform—the Malaysian Experience*, 1996.

2.4 Understanding the public expenditure management system in Malaysia requires first understanding the structure of the federal government, the budget, and the accounts. This is described in Box 2.2 and in Annex 1 and Annex 2. A public expenditure management system has four functions: providing fiscal discipline, allocating public resources to strategic priorities, ensuring efficient and effective use of public resources, and ensuring public accountability for the use of public resources. In all four areas the Malaysian public expenditure system performs on par with international best practice, although it could be further refined.

2.5 First, the government has always been fiscally prudent. It has a balanced budget rule for operational expenditures and has had an overall budget surplus for the past several years. It has systems to ensure fiscal discipline, and a prudent central administration that uses the systems effectively. Top-down setting of spending targets enables the Treasury to effectively control aggregate spending. But fiscal planning

focuses on the cash flows of the central government, and framework that gives too little attention tot he government's financial assets and contingent liabilities.

2.6 Second, sound systems are in place to ensure that public resources are allocated to strategic priorities. Several documents set out the long- and medium-term national strategies for development, most notably the Look East Policy, Vision 2020, and the National Development Plans. Cabinet decisions are geared toward implementing these national strategies. The public expenditure management system includes procedures and incentives to ensure that ministries reflect national strategies in their policies, though they many not be very well structured or systematic. Chronic supplementary budgets necessitated by the Cabinet's introduction of policies during the fiscal year signal a missing link between Cabinet's decision-making and the budget process.

2.7 Third, the Malaysian administration developed two excellent initiatives for improving performance management by public sector entities: (i) the Program Agreements under the MBS established between the Treasury and line ministries during the budget process to identify performance expectations, and the Exception Reports prepared by the ministries to report variations in performance outcomes to the Treasury at the end of the fiscal year; and (ii) the Civil Service Improvement Circulars aimed at promoting and enforcing various aspects of effectiveness and efficiency across government agencies. However, these initiatives are not fully integrated into a coherent performance management framework.

2.8 Fourth, Malaysia has solid public accounting and financial reporting systems: an Accountant General's Department with adequate accounting standards and information systems, and Auditor General's Department that applies internationally accepted auditing standards, and a Public Accounts Committee that scrutinizes the Auditor General's reports to Parliament. Malaysia also has sound performance reporting systems covering the performance of ministries and departmental entities. Program Agreements are submitted to Treasury for review and scrutiny. For the purpose of Parliamentary review, the Treasury prepares and submits a comprehensive Program and performance Budget Estimate as a supplement to the government's budget request. Exception Reports are internal to the Treasury. The public accounts and the performance reporting are not integrated enough to include nondepartmental public entities.

2.9 The most important challenge ahead for public expenditure management in Malaysia is the integration of off-budget liabilities in the planning, performance, and budgeting process. Moreover, improving performance management and strengthening links between Cabinet policymaking and the budget process would further refine the public expenditure management system in Malaysia. These issues are revisited in the following sections.

Box 2.2: Structure of Government, Budget, and Accounts

Structure of the federal government. The Malaysian Parliament is bicameral, consisting of the Senate and the House of Representatives. The Parliament is assisted in its oversight of the executive branch by three autonomous agencies, which receive their authority from the Constitution. The Auditor General audits the final accounts of the federal government and its entities and reports to Parliament. A parliamentary subcommittee, the Public Accounts Committee, reviews the audit reports, questions officials about any wrongdoing or shortcoming, and reports its recommendations to Parliament. The Public Services Commission sets principles and standards for managing public services. A government is formed upon receiving a majority vote of confidence from both Houses.

Policy implementation is generally the responsibility of sector ministries. The budget voting structure and the expenditure management system give ministries the flexibility needed to control the resources under their charge. To ensure proper management of resources, the finance minister appoints controlling officers with that responsibility, generally the secretary general of a ministry or the head of a department or agency. Their activities in this area are governed by such laws and regulations as the Financial Procedure Act and the Treasury instructions and circulars. A steering committee led by the controlling officer is responsible for the policymaking, planning, and budgeting by each ministry. Sector ministries implement policies through agencies—the departmental entities, statutory bodies, and public corporations under their purview. Performance standards such as impact, output, and cost are determined in a program agreement between the ministry's steering committee and the program manager responsible for delivery of the services. The program agreements establish the basis for budget negotiations with the Treasury and are scrutinized by central agencies.

Budget structure. The expenditure budget consists of two parts, the operating budget and the development budget, which are voted separately. The Treasury has primary responsibility for preparing the operating budget, and the Economic Planning Unit primary responsibility for preparing the development budget. The government has a balanced budget principle: it borrows only to finance development expenditure. The operating budget covers two types of expenditure: charged and supply. Charged expenditure, which is provided for by law, is for obligatory payments such as royal allowances and settlement of public debt. Supply expenditure is for routine expenditures maintained by annual vote of Parliament, such as salaries and other administrative expenses of government agencies. The development budget is based on projects that have been approved under the National Five-Year Development Plan.

Budget process. Aided by the Treasury and the Economic Planning Unit, the Cabinet decides on the overall fiscal ceilings. The Treasury issues targets for the operating expenditures of ministries and departments based on the previous year's allocations with allowances for new policies introduced by Cabinet during the fiscal year. In each ministry, a steering committee headed by the Secretary General carries out annual planning and budget formulation. The committee determines the ministry's priorities and strategies, reviews programs, and introduces new policies. Each agency prepares a budget based on the expenditure targets. Each ministry examines the budget of the agencies under its purview, establishes the program agreements with program managers, and submits them to the Treasury. The ministry also decides on transfers to statutory bodies and public corporations. Once the budget submissions for individual agencies are vetted by the respective budget review officers in Treasury, they are then integrated according to sectoral requirements and sent to the Cabinet for review and deliberation. Only then it is sent to both Houses of legislature for fund approval through the Supply Bill.

Accounts structure and public accounts. Public expenditure is governed by the federal constitution and relevant statutes. All public funds are accounted for under the federal consolidated fund or the memorandum account, or specified under any specific statute, except for rates and dues under Islamic law (such as *zakat, fitrah*, and *baitulmal*). All public revenues and expenditures must be covered under the federal consolidated fund or memorandum account, as appropriate, and must be approved by Parliament, thus providing the opportunity for elected representatives to scrutinize and debate all aspects related to the management of public funds. The public accounts of the federal government are prepared by the Accountant General and audited by the Auditor General. These statements are generally submitted for audit two to three months after the end of the fiscal year, certified by the Auditor General six months after the end of the fiscal year, and tabled in Parliament at the same time as the new budget is submitted.

B. Extending Fiscal Planning and Performance Management to Off-Budget Expenditures

2.10 Like many other developing countries, Malaysia has made strategic use of different types of nondepartmental public entities in development and capacity-building initiatives. These entities include off-budget agencies for specific development purposes, public enterprises, and, for the past 15 years, corporatized and privatized agencies. To support these government, semi-government, and private activities, the government extends public funds in the form of direct grants, recoverable loans, and loan guarantees. Unlike in many other developing countries, in Malaysia these funds are generally budgeted and their use reported. But despite the often considerable resources going to nondepartmental organizations, these entities are not part of the government's fiscal planning and are not subject to the same level of scrutiny through the regular budgetary process or to the same level of performance regulation as departmental entities are.

Extending the Coverage of Fiscal Planning

2.11 At the beginning of the budget process the Treasury and the Economic Planning Unit prepare an economic and fiscal report reviewing national and global economic developments and projecting fiscal revenues and expenditures under various macroeconomic scenarios. This report has an annual outlook, focuses on the cash flows of the federal government, and omits contingent liabilities. On the basis of this report the Cabinet determines the government's fiscal strategy and the overall spending ceiling for the next fiscal year. The Treasury then allocates indicative ceilings to ministries for ongoing programs. The Treasury submits a final version of the economic report to Parliament with the budget.

2.12 The Malaysian government has the basic process right; but it can be refined by: (i) extending the focus of fiscal planning and projections (in the economic and fiscal report) from cash flow requirements to the financial position of the whole of government, including statutory bodies and public corporations; and (ii) incorporating the contingent liabilities of the government in fiscal planning. Incorporating the government's financial assets as well as its contingent liabilities in the analysis of the economic and fiscal report would enable the Cabinet to consider these issues in its fiscal strategy. To separate bureaucratic accountability for fiscal analysis from political accountability for fiscal strategy, the Cabinet could make the economic report publicly available and publish its fiscal strategies separately in a fiscal strategy statement. Moreover, publishing the Cabinet's fiscal strategy before its discussions on the budget policy statement would bind the Cabinet to a fiscal constraint before it discusses new policies. Moreover, publishing the three reports—showing the government's fiscal situation, its medium-term fiscal strategy, and its policy priorities—would lessen the uncertainties faced by investors and the public at large.

2.13 ***Extending fiscal planning and projections to the financial position of the whole of government.*** This is not a difficult task. Almost all the financial information needed is available in public accounts. Two steps are required: finding out the financial position of the central government (ministries and departments), and consolidating it with that of the other public sector entities (statutory bodies and public corporations). Although the

government operates on a cash basis, information on its financial assets (equity investments, recoverable loans) and liabilities (including the guarantees) is reported in memorandum accounts (see Annex 2). The statutory bodies and companies already operate on an accrual basis and publish their balance sheets, so their financial position is known. The government's pension liabilities and funds are managed by statutory bodies, so their financial position is also known. All this information is in databases of the Accountant General's Department, which can produce these reports on request from fiscal policymakers. The Budget and Finance Divisions could request financial statements for the whole of government from the Accountant General's Department. These divisions carry out the projections for the central government's cash flows and have the capability to extend their analysis. The key issues are to calculate the impact of macroeconomic variables on government assets and liabilities and to extend the planning horizon to two or three years.

2.14 ***Incorporating fiscal risks.*** Governments issue many types of guarantee—deposit insurance to the banking sector, guarantees on pension funds, guarantees on the borrowings of statutory bodies and public corporations, contractual guarantees on corporatized and privatized operations. The consequences of such guarantees are rarely taken into account in fiscal planning. Nor are guarantees subject to the same rigorous rules as on-budget items. As a result fiscal policymakers seldom comprehend the full fiscal risks from guarantees, and often see them as an inexpensive and politically attractive form of government support—fiscal risks in Malaysia arise primarily from explicit and implicit guarantees to financial institutions.

2.15 As the role of the state in Malaysia shifts from providing services directly to guaranteeing against residual risks, it faces a growing need for expanded capacity to analyze and manage the contingent liabilities associated with guarantees. And a well-developed regulatory and public disclosure system becomes particularly important when the government embarks on privatization while holding explicit or implicit obligations to cover residual risks and ensure particular outcomes for the private sector. In a growing economy the government's risk of contingent liabilities becoming actual liabilities is smaller because guaranteed entities are more likely to fulfill their debt obligations, and corporatized and privatized operations are more likely to become profitable. But this risk is higher in a shrinking economy and uncertain macroeconomic environment. Thus current conditions call for immediate attention to improving the management of the government's contingent liabilities.

2.16 There are several means for doing this. Accrual-based budgeting and accounting standards would make the potential fiscal cost and hidden subsidies of contingent liabilities more transparent before a guarantee is issued. Quantitative risk analysis would reveal the difference between the full risk premium and the fees charged by the government to assume an obligation. Bringing off-budget commitments into the budget and recognizing the hidden subsidies associated with contingent support would reveal the long-term costs and benefits of the government's commitments and increase public scrutiny of the potential use of public funds. But while accrual-based budgeting and accounting and sophisticated risk measurement methods constitute best practice in managing contingent liabilities, building such systems requires much time and administrative capacity. As the government builds its capacity to manage contingent

liabilities, it is more sensible to have a system requiring it to assess current risks, make a rough provision for contingent risks in the budget, and publish a statement of contingent liabilities and overall risk exposure (Table 2.1).

Table 2.1. Steps to Control the Risk of Government Programs and Promises

	Fiscal policy	Public finance institutions
Before the government accepts an obligation (program, commitment)	• Assess how the obligation fits with the state's role and strategic priorities • In considering options for policies and forms of support, take into account the associated financial risks and the government's capacity for managing risk • Define and communicate the standards for and limits of government involvement to minimize moral hazard	• Evaluate the program's risks on their own and as part of a portfolio with existing risks, estimate the potential fiscal cost of the obligation, and set additional reserve requirements • Design the program well to protect the government against risks
While the government holds the obligation	• Stick to the preset limits for government responsibilities	• Budget and account for the obligation and disclose it • Monitor the program's risk factors
After the obligation falls due	• Execute the obligation within its preset limits and observe lessons for future policy choices	• Report the actual fiscal cost relative to the estimates, evaluate performance, and penalize failures

Note: Annex 3 explains these steps in greater detail.

2.17 The government can take immediate steps to deal with existing contingent liabilities. First, it should review programs associated with existing guarantees, identify contingent liabilities and risk factors, and quantify them to the extent possible. And when possible, it should restructure programs to minimize its risk. Next, to link contingent liabilities to fiscal planning, the Treasury could combine them in a portfolio with state debt and other public liabilities when evaluating correlations, sensitivity to macroeconomic and policy scenarios, and overall risk exposure.

2.18 Meanwhile, the Budget Division should improve controls over the issue of new guarantees by streamlining the review process for program risks with the budget process. It should develop measures to consider any noncash program involving a contingent fiscal liability like any other budgetary or debt item—from the viewpoint of aggregate fiscal stability, allocative and technical efficiency, and accountability. The government should choose contingent and implicit forms of financial support only to the extent of its ability to manage risks and absorb contingent losses. In addition, the Accountant General's Department could develop reporting standards for contingent liabilities. Even though government accounting is cash-based, memorandum statements in the public accounts could be used to report contingent liabilities. The statement of contingent liabilities should include all quantifiable contingent liabilities—not just direct

government loan guarantees, which are already reported. The Budget Division could also prepare a statement of fiscal risks, for submission to Parliament with other budget documents. The statement should show existing fiscal risks separate from new ones.

2.19 The expanded fiscal reporting would enable the public and the market to monitor the government's full fiscal performance. As investors, credit rating agencies, and other market agents consider both direct and contingent fiscal risks in their analysis and investment decisions, they would encourage not only budgetary but overall fiscal discipline. Greater fiscal transparency would also facilitate parliamentary scrutiny. In the medium term the government could develop a comprehensive risk strategy with a picture of overall risk exposure, a clear statement of risk preference, a reserves policy, and guidelines for evaluating, regulating, controlling, and preventing risks. While specific risks could be monitored by particular regulatory and supervisory agencies, the Treasury—particularly the Finance Division—bears responsibility for managing the government's overall fiscal risk. The Finance Division is probably best equipped to analyze the contingent fiscal risks and to decide on hedging and other risk control instruments. And risk evaluation and program design are probably best placed with the Budget Division, which would have the authority to approve potential financial commitments of the government. The Treasury is currently reorganizing the Finance Division and intends to create a unit dealing specifically with issues related to privatization and contingent liabilities. The new unit would provide better coordination between budgetary requirements and allocations and will undertake risk management on government investments. Moreover, a trust fund has been created to make early provision for contingent liabilities expected to be realized.

Extending Performance Management to Nondepartmental Public Entities

2.20 The support to nondepartmental entities can be substantial relative to the total budget. Under the memorandum asset account, recoverable loans amounted to RM48 billion in December 1996 (over 80 percent of the total budget) and RM52 billion at the end of 1997. Of the total of RM48 billion outstanding at the end of 1996, statutory bodies accounted for 19 percent and companies for 20 percent. Investment expenditure for nondepartmental entities and operations amounted to RM10 billion in 1996 and RM12 billion in 1997. Most went to companies, almost all of which also received direct grants and loans. In 1996 the government extended guarantees worth RM13 billion, and in 1997 RM23 billion—almost twice as much. At the end of 1996 the government had extended guarantees for at least 10 statutory bodies and 16 companies (see Annex 5).

2.21 Many of these transfers to nondepartmental entities may not be fully transparent. Direct assistance through grants, investments, and loans is treated as expenditure in the budget—included in the annual estimates and listed under specific expenditure categories. But the information is inadequate to allow much detailed or meaningful parliamentary examination and debate through the annual Supply Bill. Moreover, indirect assistance through guarantees and tax expenditures—an array of tax benefits, breaks, and exemptions—is not budgeted. And the tax benefits are not reported.

2.22 Most nondepartmental entities face few requirements in performance reporting and measurement. While statutory bodies are required by law to prepare an annual report, the emphasis is usually on detailed reporting of financial performance, with only limited reporting on program performance despite being required to prepare Program Agreements for budgetary purposes. Corporatized and privatized entities—in all respects private concerns, often taking the form of a public or private limited company—are subject to corporate laws governing financial and other performance reporting, but face no reporting obligations for budgetary purposes. Although a special unit in the Ministry of Finance monitors their activities and progress, the results do not enter into budget deliberations.

2.23 To improve fiscal discipline and accountability for the use of public resources, all those nondepartmental entities, including statutory bodies which impose budgetary costs, should be required to undertake more structured annual reporting. These reports should be used as inputs in the annual budget estimates and Supply Bill deliberations. The entities should report not only their financial performance, but also their goals, objectives, and strategies and how these fit in with broader national goals. The resources allocated to the entities should be closely tied to their performance. For these purposes, three actions are suggested: (i) relate the objectives of nondepartmental entities to the strategic plan of their controlling ministry; (ii) group transfers to nondepartmental entities as administered items in the budgets of their parent agency and include the expected benefits from these transfers in the agency's program agreement; and (iii) improve the transparency of nondepartmental entities.

2.24 ***Bringing nondepartmental entities into parent agencies' planning and budgeting***. The first two suggestions require understanding the difference between departmental and administered items and the implications of this difference for managerial accountability. Departmental items are those controlled by a department, such as salaries, allowances, and outsourced activities. Administered items are not controlled by the department but administered by it on behalf of the federal government or parent ministry. These include benefit payments, grants to other levels of government, and other types of transfer payments, though the focus here is on subsidies to nondepartmental entities. Decisions on these transfers are generally made at the Cabinet or ministry level, with little participation by program or department managers.

2.25 While using departmental resources, department managers can decide whether or not to make a transaction, or to direct resources to one use rather than another—and thus can be held fully accountable. But what about administered items, where managers have little or no ability to influence the use of the resources? Here the main focus of accountability relates to the department's contribution to achieving the desired outcomes from the transfers. The expectations for the nondepartmental entity receiving the transfer can also be set in terms of its contribution to achieving the planned outcomes.

2.26 Where appropriate, information on the planned uses of administered items and their planned contribution to outcomes should be required in the program agreement and other external planning and reporting documents. This is one channel through which

nondepartmental entities could be brought under the performance management framework.

2.27 ***Improving the transparency of nondepartmental entities.*** Not only are many of the subsidies to nondepartmental entities less than fully transparent in the budget, these entities seldom identify their performance plans, strategies, and performance milestones in the annual estimates, making it difficult to evaluate the performance of the controlling ministry. Thus it would be desirable for all nondepartmental entities to provide a strategic plan showing in detail how their performance would contribute to achieving the controlling ministry's overall goals and objectives. The strategic plan should be reflected in the annual budget estimates and subject to scrutiny and debate by the controlling ministry, central agencies, and elected representatives. If in addition performance information on the use of the subsidies were included in the parent department's program agreement, all operations of the nondepartmental entities would come under the full scrutiny of the annual budget process.

2.28 All financial assistance packages for privatized or corporatized operations should be pegged to detailed information on financial and nonfinancial performance as part of the normal budget process. Even where such entities do not seek financial assistance, they should be required to report on their performance to the appropriate regulatory agency, which should use the information in justifying its own annual budgetary allocations. And implicit subsidies—guarantees and tax breaks—that are not shown as expenditures should be calculated and included as memorandum items in the vote budgets of ministries and, when possible, in program agreements.

2.29 Transparency also needs to extend to the financial reporting for nondepartmental entities. Although the government's annual statement of accounts contains details on public expenditures, it does not show any details on the use of budgeted transfers and subsidies in nondepartmental entities. These details can be found in the books of the nondepartmental entities, and some aspects of financial performance are picked up by the Auditor General. However, in order to make the nondepartmental entities more fully accountable, all their expenditure details could be disclosed in public accounts.

2.30 To ensure accountability for tax expenditures, which are not presented in the public accounts, these expenditures should be accounted as transfers to nondepartmental entities and treated like any other subsidy. Memorandum items could include a statement showing the cost of tax incentives provided to nondepartmental public organizations, particularly to corporatized and privatized entities. Direct guarantees on the borrowings of nondepartmental public organizations are shown in the public accounts as memorandum items, but indirect guarantees arising from privatization and corporatization contracts are not. The statement of guarantees could be extended to include all types.

2.31 Although statutory bodies submit an annual report and audited accounts to Parliament, as required under their enabling statute, these reports are often two to three years late. Just as annual reports are an essential part of performance management and accountability for departmental entities—complementing the strategic plan by showing what has actually been achieved—they are also essential for nondepartmental entities.

Timely and relevant annual reports should be mandatory for all types of nondepartmental public entities.

C. Strengthening Links between Cabinet Policymaking and the Budget Process

2.32 Supplementary budgets seem to be the norm in Malaysia. They occur every year, ranging in size from 10 to 30 percent of the original budget. Although the Modified Budgeting System has lessened the pressure from line ministries for supplementary budgets, it has not lessened the pressure from the Cabinet. The budget restrains the administration—but not the politicians. New policies introduced by the Cabinet during the fiscal year have been the main cause of supplementary budgets in the past five years.

2.33 ***Supplementary budgets undermine fiscal discipline and distort the strategic allocation of resources*** agreed to during budget formulation. They show that the Cabinet may not have full ownership over the resource allocation agreement and faces weak incentives to adhere to it. A close look at the budget process reveals the missing link between the Cabinet's policymaking process and budget formulation: there is no procedure early in the budget process in which the Cabinet determines its priorities and announces new policies. Instead, it introduces new policies during the year. Once these policies can no longer be financed by budget transfers, the government requests a supplementary budget. When that falls short, it overspends appropriations.

2.34 During budget formulation the Cabinet is consulted twice—at the beginning, to set the expenditure ceiling, and at the end, to approve the allocation of resources. At the second stage the Cabinet generally cuts the overall budget, identifies a few programs as priorities, and sends the budget back to the Treasury to reflect these cuts in program budgets. These last-minute, generally across-the-board cuts undermine the credibility of earlier budget negotiations between the Treasury and the line agencies. Although central agencies such as the Treasury and the Economic Planning Unit are consulted during policy formulation by the Cabinet, their consultation does not necessarily link policymaking with the budget process. Since the new policies are dealt with piecemeal throughout the year, they are not considered under a single fiscal constraint nor do they compete for resources. Some of the policies have nonbudgetary financial implications but involve contingent liabilities. State guarantees issued on the debt of public corporations or during privatization and corporatization have almost no immediate budgetary implications, but they have future financial implications and increase the government's risk exposure. These contingent liabilities are not fully considered during fiscal planning.

2.35 Two measures would help in forming a transparent link between the Cabinet's policymaking and the budget process: (i) extend the coverage of fiscal planning and projections to the consolidated fiscal position of government and publish a fiscal strategy statement (see above); and (ii) announce the Cabinet's policy intentions through a budget policy statement early in the budget process.

Reflecting Cabinet Priorities Early Through a Budget Policy Statement

2.36 An announcement of the Cabinet's collective policy decisions early in the budget process—in a budget policy statement—could help improve fiscal discipline. It would create an initial position for the Cabinet to adhere to, and pressure to justify any later deviations from this position. In addition, by linking the government's medium-term strategy (the development plan) to annual budget formulation, the budget policy statement could provide line ministries with policy direction on which to base new policies, and the Treasury with guidance for negotiating these policies with the line ministries during budget formulation. The Cabinet's decisions on policy priorities should be made under a jointly recognized fiscal constraint, and thus should follow the announcement of fiscal policy in the fiscal strategy statement. At this point the Cabinet would know how much room there is in the budget for new policies.

2.37 Ideally, the Cabinet would decide on its priorities after reviewing the annual reports and evaluations of line ministries, and its policy directives would guide the ministries' strategic plans. But line ministries are not required to prepare strategic plans or annual reports. Although a few do publish annual reports, they appear too late in the year to provide inputs to the Cabinet's discussions of new policies. In the medium term the government could consider requiring line ministries to publish timely annual reports, which could be used in discussing the budget policy statement. It could also require line ministries to prepare medium-term strategic plans reflecting the Cabinet's priorities on sector policies and tying them to the ministries' budget requests. This arrangement would not necessarily eliminate the introduction of top-down policies during the year, but it would discipline it. Ministers who submit new policies to the Cabinet during the fiscal year would have to explain why they did not do so during budget formulation and why their policies deserve to be treated as exceptions. And Cabinet members would have to explain to each other why they are deviating from their collective decisions.

D. Improving Performance Management

2.38 The Malaysian government embarked on a concerted effort to improve the quality and performance of public services in the early 1980s. It introduced Total Quality Management in the late 1980s and early 1990s, transforming the work and performance management culture in the public sector. At the same time, it introduced the Modified Budgeting System as part of reforms of budgeting and performance management. This brought about a major change in public sector performance, both financial and nonfinancial. The government complemented the two reforms with a set of management improvement initiatives—the Civil Service Improvement Circulars, or PKPAs—introduced in phases from the late 1980s through the mid-1990s. The PKPAs provide basic guidelines for improving service delivery and management processes.

2.39 All these initiatives were part of a range of public sector reforms under the government's New Public Management drive. The New Public Management philosophy aimed at building a culture of excellence in the Malaysian public sector. It emphasized accountability, improved performance, service quality, and service delivery. But several issues went unaddressed or received too little attention, including the need for a strategic implementation plan to integrate the public sector reforms. As a result, public managers

have difficulties relating to the goals of these innovative reforms. And few ministries or agencies have a comprehensive strategic plan integrating the policy goals, the program objectives, and the rationale for resource allocation.

2.40 Moreover, implementation of the performance management system has been less than successful. Public sector managers show a perceptible lack of enthusiasm for performance management and most avoid performance measurement, perhaps for fear of being labeled inefficient or ineffective. Managers tend to focus on inputs, perhaps assuming that a larger budget allocation or a larger staff equates with good performance. They are reluctant to undertake strategic planning, perhaps out of a belief that it is arduous. And the public sector lacks a sense of accountability that can create pressure to produce results. Financial accountability—compliance with financial rules and regulations—is often the focus of legislators, program managers, and auditors, and little attention is given to management and program accountability—managing for results. Compounding this neglect is an apparent lack of leadership by the central agencies—vital if results-based management is to be institutionalized.

2.41 These are typical problems in most countries that reform their public sectors. To address these issues, the central agencies need to: provide strategic direction and guidance to operating agencies on how to incorporate the PKPA guidelines into an integrated performance management framework; and strengthen the links between program performance management and the budget process by requiring the line agencies to prepare strategic plans and annual reports, and improve performance monitoring and evaluation across the government.

Building an Integrated Performance Management Framework

2.42 Each of the PKPAs on its own is an excellent tool for improving performance, and all have helped to varying degrees to enhance government products and services. Together, they have the potential to ensure the effectiveness of all government programs and activities. What is lacking is their integration into a coherent framework of performance management. The Modified Budgeting System calls for an integrated approach toward program performance management, and it is complemented well by the ISO, total quality management, and related initiatives. But neither the central agencies nor the operating agencies seem to have looked at the PKPA initiatives with a view to developing a comprehensive, integrated performance management system that is closely linked with policymaking and budgetary allocation.

2.43 Moreover, there is a lack of strategic direction and guidance from central agencies on how to incorporate the PKPAs into integrated performance management. All government agencies are required to fully implement every circular, and their progress is closely monitored by the Panel on Administrative Reforms, to which the agencies must submit regular progress reports. But the panel is concerned only with ensuring that the agencies implement the circulars fully and on time. And under the panel's close monitoring and supervision, the agencies do whatever it takes to be able to report progress in implementing the circulars—all while performing a host of functions and tasks with increasingly limited resources and no coherent strategic performance plan.

Not surprisingly, the result of all this is often only superficial implementation of the circulars. Faced with growing constraints and pressures and the demand to implement the many circulars, many agencies have resorted to meeting requirements merely on paper. And agencies tend to look at each initiative in isolation rather than as part of a whole. For example, an agency may claim to comply fully with the requirements under a circular, but it may not be able to link those requirements with the achievement of certain outcomes or with the policymaking process in resource allocation. Thus while the PKPAs are a commendable effort and certainly in line with the goals and objectives of the New Public Management movement, their implementation has weaknesses that need to be addressed.

2.44 ***Moving from compliance to accountability for results.*** To be effective, performance management must link inputs, processes, outputs, and outcomes. Measures of performance management that look at each of these factors in isolation will provide only a narrow picture of performance. For example, we can assess the effectiveness of a process by looking at cost, timeliness, and similar measures. But even if we find that the process is effective by these measures, it does not necessarily mean that the program itself is effective or that it achieves the desired outcomes. Nor does assessing outputs by such performance criteria as quantity ensure either effectiveness or desired outcomes.

2.45 Under the Modified Budgeting System there is a strategic performance management framework in place. All program managers are required to work out a program performance agreement that identifies most of the key factors in ensuring a program's effectiveness and thus essentially forms an integrated performance framework. The performance agreement addresses the four key focuses of a performance management system—inputs, processes, outputs, and outcomes—and links them with others—including goals and objectives, needs assessment, and evaluation. But this basic framework could be strengthened by integrating the PKPA guidelines. Each circular can be fitted into one or more of the four key focuses of performance. And each can contribute to the achievement of program goals and objectives (see Annex 4).

2.46 Program managers should be required to review the PKPAs to see how they could fit into the MBS framework and could help in enhancing program performance in different areas. To encourage managers to see the PKPA requirements as essential performance management tools rather than mere regulations with which they must comply, implementation of the requirements could be made optional. Agencies and program managers could instead be held accountable for program performance, linked to resource use through the budgetary process. Incentives should be built in to reward them not only for achieving specified results but also for innovative and strategic use of the PKPA management tools.

2.47 ***Creating a sense of ownership.*** Implementation of the PKPAs is overseen by MAMPU and two other agencies. MAMPU's tasks are carried out by its Inspectorate Division, which reports to the Panel on Administrative Reforms. This panel is charged not only with monitoring progress in implementing the PKPA requirements, but also with encouraging ownership of the PKPAs by the agencies. The Financial Management

Services Division of the Ministry of Finance is tasked with overseeing all financial reforms, and the Establishment Division of the Public Services Department is responsible for all personnel issues related to the PKPAs.

2.48 The agencies' efforts to create a culture of excellence in the Malaysian public sector through the PKPAs emphasize training and retraining, documentation, dissemination, and appreciation and recognition activities. While both laudable and necessary, these activities focus more on bureaucratic compliance than on ownership and effective use of the initiatives. For example, senior officers due for a promotion are asked to prove that they have assiduously implemented the PKPAs in their agency, not that they have used these management tools strategically to improve its performance. Further compounding the problem, the PKPA-based reform agenda is seen more as generated by MAMPU than as inspired by the government. This perception has undermined support for the agenda even among central agencies such as the Economic Planning Unit, the Public Services Department, and the Treasury. The large number of circulars and their lack of focus have also contributed to the skepticism and cynicism among public officials about their purpose and utility.

2.49 To overcome these weaknesses, the government needs to undertake reform efforts focused on a "developmental" philosophy emphasizing greater ownership of the reform agenda and the role of the PKPAs as useful management tools for improving performance. A marketing approach to create awareness and participation will have better chance of success than the present administrative "reward and punishment" approach. In addition, the central agencies need to allocate to line agencies the resources to implement the reform agenda. Otherwise, the PKPA reforms will continue to be seen by agency heads as an add-on agenda, to be undertaken only when time permits or sanctions are imminent—or worse still, as purely a reporting requirement.

Strengthening the links between program performance management and the budget

2.50 Like many developing countries, Malaysia uses a macro-level indicative planning approach to development—and has done so since the 1960s. But the lack of strategic planning at all levels of the public sector in Malaysia means that there is only a tenuous link between development plans and the annual budget and the tendency to see the development plan exercise as distinct and different from the annual budget exercise is a common problem. The lack of strategic planning also leads to weak linkages between program performance management and budget formulation. A range of problems could be attributed to lack of strategic planning: the gap between objectives and outcomes, weak links between outputs and outcomes, neglect of evaluation, high level of budgetary transfers, and frequent supplementary budgets.

2.51 Improving the links between program performance management, budget formulation and development plan through strategic planning will require concerted effort by all key institutional players—Parliament, the Cabinet, central agencies, and operating agencies. But the initiative, drive, and leadership must come from the Treasury, which as guardian and principal manager of the limited public resources is best positioned to strengthen these links. A first step is to ensure that each agency clearly

understands its role in national development. The national planning documents—Vision 2020, the National Development Policy, the Second Outline Perspective Plan (1990-2000) and its components, the Sixth and Seventh Malaysia Plans—provide the big picture. If adopted, a budget policy statement would provide a means for the Cabinet to explain its medium-term policy priorities, clarifying the links between the national plans and annual budget formulation.

2.52 Based on this national direction, each agency needs to: develop its own three-year strategic performance plan containing its long-term goals and objectives, and break down the strategic plan to annual performance plans of programs, activities, and projects with clear performance objectives; and strategize the use of the budget as a tool for realizing the annual plan. Also essential in strengthening the links between performance management and the budget are monitoring, evaluating, and reporting on performance. Much of this is provided for in the Modified Budgeting System, in itself a well-planned performance management system. It looks strategically at all important aspects of performance management. It recommends the use of program logic and strategic planning and of a performance management tool in the form of the annual performance agreement between agency managers and the Treasury. It also has in place a suitable requirement for program evaluation.

2.53 ***Developing a strategic plan.*** Planning for performance sets the parameters for an agency's success. The agency decides what needs to be done and how to do it. Through strategic planning, the agency: (i) establishes its mission, formulating a brief, clear statement of the fundamental reason for its existence; (ii) establishes the long- and short-term goals it must meet to achieve its mission, focusing on key areas where results are needed; and (iii) determines the strategies, programs, and activities for achieving the goals.

2.54 Once the agency has identified the package of programs and activities, it could: (i) identify the needs of its clients and stakeholders; (ii) review the priorities of the Cabinet; (iii) prioritize programs and activities on the basis of current stakeholder and customer needs and Cabinet priorities; (iv) define specific, measurable, and attainable objectives for each program and activity—what results are to be achieved and when; (v) identify implementation strategies and alternatives; (vi) establish relevant, suitable, and verifiable performance indicators for each program and activity; (vii) set milestones for checking progress and ensuring deliverables; and (viii) set up an effective program evaluation system to ensure the effectiveness and appropriateness of each program.

2.55 Another part of strategic planning is to look at organizational design, the budget, and personnel to ensure that the structure and resources to implement the programs and activities effectively are in place. Form must follow function. Once the strategic planning is completed, the outcome must be communicated to all agency personnel—to galvanize an orientation to results-based performance.

2.56 ***Formulating the budget.*** The budget process follows on the strategic plan. The agency could: (i) review the implementation of the previous year's plan and the degree to which objectives have been achieved, to identify programs needing to be strengthened, modified, or terminated; (ii) analyze the current year's plan to identify major issues that

need to be addressed, including key external factors and internal strengths and weaknesses; (iii) review the rationale for programs and activities in terms of their contribution to the strategic plan and their targeted results; (iv) set realistic performance objectives in terms of quantity, quality, cost, and time; (v) identify the resources needed to implement the programs and activities—and an alternative course of action in case the optimal resources are not available; and (vi) identify and establish a clear framework for evaluating program performance.

2.57 ***Monitoring performance.*** Monitoring against the milestones set is essential to ensure that programs and activities are on the right track. The task is to determine whether the results that have been achieved are in line with the standards set for quantity, quality, cost, and time. If there turn out to be problems in implementation, the management can reprioritize goals and objectives, refine strategies, and reallocate resources.

2.58 Today's monitoring efforts, by both operating and central agencies, tend to focus on the fiscal resources expended and the physical progress made by projects. The Implementation and Coordination Unit of the Prime Minister's Department, which monitors development projects, captures this information in detail but scarcely touches on outcome or impact. The Treasury's monitoring of operating expenditures also leaves much to be desired. Its performance tracking system relies heavily on financial performance. Where output measures receive attention, they tend to be easily quantifiable ones, and even then there is no clear link with the budgetary and program performance management process.

2.59 The Treasury needs to make serious and immediate efforts to devise a clear and practical system for tracking, monitoring, and reporting program performance. It could begin by reviewing the integrated management information systems that several agencies and statutory bodies have successfully put in place on their own initiative.

2.60 ***Evaluating performance.*** Essentially, evaluating performance means asking simple questions: Are we doing the right things in the right way to achieve the results we want? Is our current performance good or bad? Is it reaching our targets or meeting last year's performance levels—or is it falling short? If so, by how much? And what is causing the shortfall—manpower, material, money, method?

2.61 Evaluating performance enables management to take action to improve future performance. But the evaluation results are also essential inputs in resource allocation. Program managers should use them in strategic and annual planning, for decisions on the effectiveness of programs and activities in addressing a problem or meeting a societal need. The central agencies need to ensure that the information is used strategically in resource allocation to reflect the government's long-term policy goals—allocating resources based on priorities rather than relying on across-the-board cuts or increases.

2.62 Evaluation at the macro level is subsumed under the Economic Planning Unit, though mostly for development expenditures. The Treasury is supposed to take the lead for operating expenditures, but does not seem to have played an effective role. Although mandated by the Modified Budgeting System, program evaluation has been given serious

attention by only a handful of agencies, such as the Ministry of Health. Other operating agencies are equally keen to fully implement the Modified Budgeting System and the necessary program evaluation, but the Treasury, despite preaching the agenda for the past nine years, has not given adequate encouragement or support.

2.63 Nor has the Office of Auditor General played much of a role in reviewing agencies' performance and their use of scarce resources. Although it has undertaken performance audits in the past, the efforts have failed to produce results. And the office is unclear about the need for and importance of evaluating program performance. Its functions thus far have been limited to ensuring financial accountability, despite the leadership's strong and repeated emphasis on ensuring management and program accountability.

2.64 ***Reporting performance.*** Communicating the results of performance monitoring and evaluation is vital to the continued credibility of an agency and its programs and activities in the eyes of its stakeholders and clients. The information needs to be communicated to policymakers, central agencies, and other authorities with the power and responsibility to allocate resources and to support programs and activities. It also needs to be communicated to agency managers and staff to ensure their support, commitment, and ownership.

2.65 Today, performance results are reported to Parliament annually through the budget performance report of the Ministry of Finance, but little or no debate takes place among legislators and key policymakers on program outcomes and results. Again, financial accountability tends to be the focus, not performance management and program accountability.

2.66 Annual reports showing how agencies implemented the previous year's plan, their progress toward objectives, and the reasons for any deviations from the plan are an essential part of performance management and accountability. Yet line agencies face no requirement to prepare them. Some agencies, such as the Ministry of Health, do prepare annual reports, but the reports appear too late to provide input to budget allocations for the next year or to the Cabinet's discussion of policy priorities. The Treasury could strengthen performance management and accountability by requiring line ministries and agencies to publish timely annual reports and disseminate them to stakeholders, clients, and the public.

E. An Enhanced Public Reporting Framework

2.67 The suggestions above imply an enhanced public reporting framework—one that would bring Malaysia into the league of best practice along with only a handful of industrial countries. This may seem as an overambitious goal but Malaysia already has a transparent public reporting framework and excellent management capability—and the will to improve its systems even more. So while the goal could be considered overambitious for other developing countries, for Malaysia it requires simple modifications to its public reporting system.

2.68 The modifications are in two distinct but complementary areas: fiscal reporting and performance reporting. The suggestions for fiscal reporting can be summarized as follows: (i) expand the coverage of the economic and fiscal report to incorporate the balance sheet items and fiscal risks of the whole of government; (ii) publish a statement of fiscal strategy in which the Cabinet announces its overall fiscal targets; (iii) publish the economic and fiscal report twice a year—once before the statement of fiscal strategy to provide an update and again with the budget document to provide an outlook; and (iv) extend the coverage of the public accounts to include the fiscal risks arising from all types of government guarantees.

2.69 The suggestions for modifying performance reporting are aimed at a common performance management regime across the government, with each ministry, departmental entity, and nondepartmental entity preparing: (i) a three-year strategic plan showing its mission, objectives, goals, and strategies; (ii) an annual business plan showing how it will achieve its goals through implementation of programs and activities; and (iii) an annual report presenting its achievements at the end of the fiscal year. Also suggested is that the Cabinet publish a budget policy statement early in the budget process announcing its policy priorities and guiding the strategic planning of line agencies.

3. FUTURE CHALLENGES IN A MODERN ECONOMY: GOVERNMENT'S EVOLVING ROLE

3.1 Malaysia's economic growth over an extended period has been phenomenal, similar to other East Asian miracle countries. Sound macroeconomic management, prudent fiscal policies, an open economic environment supportive of competition, a strong and well functioning civil service, political stability, and a vibrant private sector have been key to Malaysia's success in achieving high rates of economic growth and dramatically reducing the level of poverty. The economy has been transformed from one that produced primary commodities to one with a diversified export base and significant high-tech manufactured export. Over the past two decades, the standard of living enjoyed by the Malaysians has increased tremendously. Growth and modernization have improved people's welfare; life expectancy has increased, educational attainment has risen, infant mortality rates have dropped, and there is improved access to health and educational facilities.

3.2 These enviable outcomes were a direct consequence of government strategy—initially public sector led through the New Economic Policy of the 1970s, with a vision of equity and poverty reduction, export orientation, and heavy government involvement in economic activities; and then private sector led through the concept of Malaysia Incorporated of the 1980s and the National Development Policy of the 1990s with a vision of facilitating private sector growth through greater deregulation, better incentives, and closer collaboration between the public and private sectors. The government's privatization policy of the past decade enabled the private sector to participate in economic activities which were once the domain of the public sector, particularly in developing infrastructure. Reducing the role of the state activities which were once the domain of the public sector, activities which were once the domain of the public sector, particularly in developing infrastructure. Reducing the role of the state in the economy alleviated the pressure on public expenditures. The budget has recorded a surplus from 1993 until the East Asian crisis.

3.3 ***The role of government is evolving.*** The government is preparing to meet the second-generation challenges ahead, arising largely from Malaysia's advanced level of development and its ambitious goals of Vision 2020. These entail a rethinking of the government's role in tertiary education, tertiary health care, social protection against income risk, and infrastructure. In all these areas, there is a potential role for the private sector in provision and financing, and the government's role is shifting more and more from being a provider of these services to a financial supporter. In this evolving public-private partnership, the goal of the government is to reduce the fiscal burden while ensuring equity in delivering public services and efficiency in allocating and using public resources. The most advanced sector in this process is infrastructure, where "privatization" backed up by government support began a decade ago; but Malaysia

could learn from international experience in infrastructure strategies that will improve the viability of projects. In tertiary education, there is a need to expand supply and corporatization of universities is underway; but this needs to be accompanied by a better financing system for students to ensure greater accessibility and equity. In health, the government has been contemplating for over a decade the corporatization of hospitals and the introduction of a national insurance scheme; this is a complex issue still debated among OECD countries and there is no perfect solution. In social protection, the role of the government as a guarantor of income risk is debatable; many countries like Malaysia do not support a Western type of social protection, such as unemployment insurance, and are looking for alternative mechanisms.

3.4 This chapter reviews Malaysia's achievements in major sectors that affect the budget—health, education, safety net, and infrastructure—and raises some challenges that Malaysia faces in dealing with second-generation issues—tertiary health care, tertiary education, income risk management, and infrastructure financing. The chapter does not attempt to provide solutions to these complex issues but provides some observations and suggestions.

A. Fiscal Patterns and the Role of Government

3.5 Malaysia is a federation with three tiers—a federal government, 13 states, and an extended local government network. Financial arrangements in the federation concentrate to a large degree the powers of taxation and spending responsibilities at the federal level. The federal government undertakes sizable transfers to lower levels of government to finance both their recurrent and development budgets.

3.6 ***The patterns of public expenditures over the past two decades reflect the changing role of government.*** In pursuit of the objectives of the New Economic Policy of the 1970s, which aimed at restoring ethnic balance of the Bumiputera population and investing in people, the government was directly and heavily involved in economic activity. This extensive intervention in the economy led to a huge increase in the size of the public sector relative to the economy—from about 20 percent of GDP in the 1970s to a peak of about 58 percent in 1981. The large government presence meant a growing public sector deficit, leading to a sharp increase in domestic and external borrowing. External debt more than quadrupled between 1980 and 1985. It became apparent that government revenues could not keep pace with the growing expenditures. A looming recession prompted the government's policy changes.

3.7 The shift in strategy from public sector led growth to private sector financed development began in 1983, when a national policy announced the concept of "Malaysia Incorporated." This concept treats the country as a corporate entity in which the government provides the enabling environment—infrastructure, deregulation, liberalization, and macroeconomic management—and the private sector serves as the main engine of growth. This new approach reduced the need for the public sector to borrow both domestically and in foreign financial markets. Thus, the overall public debt burden, unlike in many middle income countries, has remained modest at 30 percent of GDP.

Table 3.1: Fiscal Summary of the Federal Government

in percent GDP	1980	1990	1995	1996	1997	1998	1999	1998
Total Revenue	**26.9**	**25.5**	**23.3**	**23.0**	**23.3**	**19.9**	**19.6**	**19.7**
Tax Revenue	24.7	18.3	19.1	18.6	19.0	15.9	15.1	15.4
Corporate	4.9	3.9	5.4	5.6	5.9	6.1	5.3	5.7
Individual	1.9	2.2	2.8	2.5	2.3	2.4	2.1	2.2
International Trade	8.9	4.7	3.0	2.8	2.7	1.6	1.8	1.7
Sales Tax	1.3	2.1	2.2	2.2	2.2	1.4	1.5	1.4
Excise Tax	1.9	2.0	2.4	2.3		1.3	1.6	1.1
Nontax Revenue	2.2	7.1	4.2	4.4	4.3	4.0	4.4	4.2
Total Expenditure	**40.7**	**30.8**	**23.2**	**23.1**	**21.4**	**22.0**	**23.9**	**23.6**
Current Expenditure	26.3	21.6	16.7	17.3	15.8	15.7	16.3	16.6
Wages and Salaries	--	7.9	6.0	5.6	4.7	4.9	4.8	5.1
Pensions	--	1.0	1.3	1.4	1.3	1.3	1.4	1.3
Interest Payments	3.0	5.9	3.0	2.7	2.3	2.4	3.0	2.3
Transfers to Local gvts.	--	1.3	0.6	0.4	0.3	0.4	0.4	0.6
Supplies and Services	--	2.5	2.7	2.2	2.3	1.8	2.1	1.7
Subsidies	--	0.4	0.3	0.3	0.3	0.4	0.3	0.4
Capital Expenditure	14.4	9.2	6.4	5.8	5.6	6.4	7.5	6.9
Current Surplus/Deficit	**0.6**	**3.9**	**6.6**	**5.7**	**7.5**	**4.3**	**3.3**	**3.0**
Overall Surplus/Deficit	**-13.8**	**-5.3**	**0.2**	**-0.1**	**1.9**	**-2.1**	**-4.3**	**-3.9**
Primary Surplus/Deficit	**-10.8**	**0.5**	**3.1**	**2.6**	**4.2**	**0.3**	**-1.3**	**-1.6**

a. Latest estimates.
Source: Ministry of Finance, Economic Report; various years.

3.8 ***Prudent fiscal policy has led to budget surplus over the past five years, rare in most countries.*** As a result of the private sector-led growth strategy, total federal government spending declined from about 30 percent of GDP in 1990 to only 20 percent in 1998 and 19.6 percent in 1999 (Table 3.1). Most of the decline came from a reduction in development spending, debt service payments, and wage bill. First, capital expenditure declined from about 9.2 percent of GDP in 1990 to 5.6 percent of GDP in 1997 as a result of the shift in investment responsibility to the private sector, especially in infrastructure. Second, interest payments dropped from 6 percent of GDP in 1990 to about 2 percent of GDP in 1997, reflecting reduced levels of net borrowing by the government, pre-payment of outstanding debt, and lower interest rates resulting from strong economic and fiscal fundamentals. Third, the wage bill decreased from 8 percent of GDP in 1990 to 5 percent of GDP in 1997, due to the introduction of the Modified Budget System which allowed further staff rationalization. At the same time, buoyant revenues were fueled by rapid economic growth without raising tax rates. These favorable trends resulted in an overall fiscal surplus since 1993, reaching 2 percent of GDP in 1997 (RM5.3 billion). As a result of the government's balanced current budget objective, the current budget was in surplus for most of the past two decades. The consolidated budget has also been in surplus since 1994 until the crisis (Table 3.2).

3.9 The impact of the regional economic crisis is clearly evident in Malaysia's fiscal account. In 1998, Malaysia recorded its first fiscal deficit in five years. Revenue collections in 1998 reflected the slowdown in domestic economic performance and lower tax rates to boost the private sector (see chapter 1), declining 13.7 percent over the 1997

level. As a share of GDP, revenue declined to 20 percent in 1998 and 19.6 percent in 1999 after holding steady at about 23 percent of GDP between 1994 and 1997. Operating expenditures were only slightly lower than 1997 levels. Development expenditure increased to 6.4 percent of GDP in 1998, after holding for several years over 5 percent, as part of the fiscal stimulus. However, although allocations were sharply increased to RM19.4 billion and RM17.6 billion for 1998 and 1999 respectively, the actual outturn for 1998 was RM18.1 billion because of delays in implementation (at the beginning of 1998, development expenditures were curtailed to reduce the deficit). The decline in revenues in combination with the counter-cyclical increase in development expenditure resulted in an overall deficit of 2.1 percent of GDP for 1998.

Table 3.2: Consolidated Public Sector Finance (percent of GDP)

	1993	1994	1995	1996	1997	1998	1999
General Government							
Revenue	31.8	32.1	28.5	27.9	28.3	24.4	22.9
Operating Expenditure	22.8	21.3	18.9	19.9	17.8	17.7	18.7
Current Surplus/Deficit	9.1	10.8	9.5	8.1	10.5	6.7	4.2
Non-Financial Public Enterprises' Surplus	8.3	7.8	7.3	8.0	9.8	7.9	6.5
Total Public Sector Current Surplus/Deficit	17.3	18.6	16.9	16.1	20.3	14.6	10.7
Development Expenditure	19.6	15.1	13.6	12.1	14.2	15.6	16.2
General Government	7.8	6.6	7.4	6.0	6.6	6.0	8.4
Non-Financial Public Enterprises' Surplus	11.8	8.5	6.2	6.1	7.6	9.6	7.8
Overall Surplus/Deficit	-2.2	3.5	3.2	4.0	6.1	-0.9	-5.5

Note: General government comprises Federal government, state governments, statutory authorities and local governments.
Source: Economic Report, Ministry of Finance.

3.10 ***Malaysia has a diverse revenue base.*** Direct taxes, composed primarily of income tax on individuals and corporations, and natural resources tax, accounted for 40-45 percent of total revenue collection over the period 1994-1997. Tax reforms in the mid-80s followed the world-wide trend towards flatter, more streamlined rate schedules. Malaysia has an integrated system of personal and corporate income taxes with moderate statutory rates. Although personal and corporate income tax receipts have grown to 8 percent of GDP in 1997, up from 6 percent in the early 1990s, there is concern that tax receipts did not expand as rapidly as the economic base. Statutory rates have fallen across all income groups; however, progressivity was compromised as rates for higher income groups have been reduced by more than those in lower income groups. Moreover, under-reporting of income and differential treatment for fringe benefits have also reduced collection potential. The importance of taxes on natural resources declined as the Malaysian economy moved away from natural resource extraction toward more developed manufacturing and service sectors.

3.11 ***The crisis presents an opportunity to broaden the tax base by switching to VAT.*** Indirect taxes consist of export, import and excise duties, sales and service taxes. With a more open trade regime, export duties, levied on primary commodities, have become minimal and import duties have dropped. The sales tax was introduced in 1972 and imposed on manufactured goods only. The effectiveness of the sales tax has been eroded over time by exempting many industries and gradually raising the size threshold of firms liable to pay the tax. Although the design of the sales tax involves a tax credit system to compensate for tax 'cascading,' similar in some respects to a value-added tax (VAT),

movement to a full fledged VAT, at both manufacturing and consumption stages, presents greater advantages than the current tax credit system, both in terms of increased revenue collection and reduced administrative burden. Most countries that have switched to a VAT have achieved at least significant one time gains in revenue collection. Moreover, information gathered through the intermediate process of crediting firms for taxes already paid, would provide tax authorities with an integrated view of both direct and indirect taxation. The rate of VAT can also be varied to achieve equity and public welfare goals under a unified tax, rather than relying on the three separate sales, excise and service taxes which are administratively more demanding. To broaden the tax base by including value addition at the wholesale and retail stages and minimize the incidence of taxation on business inputs, VAT has been found the most efficient form of sales tax that can achieve these objectives throughout the world.

3.12 ***Sectoral allocations of spending have changed to reflect the new economic strategy of the government.*** The share of agriculture and rural development in total expenditure halved between 1980 and 1997 as a result of the policy shift that led to rapid industrialization and increased employment opportunities in manufacturing industry coupled with reduced availability of prime agricultural land. Expenditures on commerce and industry in the 1980s reflect the investments made in hi-tech industries, and start up contributions to programs designed to meet the goals of the New Economic Policy in terms of restructuring, but they have declined in the 1990s.[1] The allocations for the transport sector reflect greater reliance on the private sector for infrastructure development, most of which was in transport. Malaysia spends slightly more on education than comparable countries—21 percent of total spending, compared with an average of 16 percent for similar countries in 1997 (Table 3.3). Conversely, Malaysia spends a comparable share of its budget on health than similar countries. It spends much less on social security than Latin American countries. Like other East Asian countries, Malaysia spends a large share of its budget on transport compared to Latin America, despite the government's effort to privatize. The share of general administration is also much higher. As the economy modernizes and globalizes, the government's role would need to evolve. To a large extent, Malaysia does not have a fiscal problem and is unlikely to have one even after the crisis (see chapter 1). The government's efforts are therefore concentrated on providing the enabling environment for the private sector to thrive and the high growth rates of the past to be maintained. For that, policies in various sectors—health, education, social protection, and infrastructure—would need to progress.

Table 3.3: Fiscal Expenditures of the Federal Government by Sector

	1980	1990	1995	1996	1997	1998 [a]	1999 [b]
Total Expenditure/GDP (%)	**40.7**	**30.8**	**23.2**	**23.1**	**21.4**	**22.0**	**24.7**
As a percent of Total Expenditure							
Defense and Internal Security	16.1	13.6	17.6	15.5	14.8	11.6	13.0
Education	13.2	18.5	20.9	21.4	21.3	21.4	20.6
Health	3.7	5.0	5.5	5.9	6.2	6.5	6.1
Housing	1.4	0.3	1.0	1.2	1.4	1.8	1.7
Infrastructure /c	11.4	9.2	9.7	11.3	10.9	10.4	12.8
Agriculture and Rural Development	6.1	6.6	4.9	4.5	4.0	3.3	3.4
Trade and Industry	8.3	9.3	3.6	4.6	4.2	7.2	7.6
General Administration	6.6	7.3	12.7	10.8	11.5	11.7	9.7
Others	33.2	30.2	24.1	24.9	25.7	26.2	25.2
Current Expenditure	64.6	70.1	72.2	75.0	73.9	71.1	66.2
Development Expenditure	35.4	29.9	27.8	25.0	26.1	28.9	33.8
As a percent of GDP							
Defense and Internal Security	6.5	4.2	4.1	3.6	3.2	2.6	3.2
Education	5.4	5.7	4.8	4.9	4.6	4.7	5.1
Health	1.5	1.5	1.3	1.4	1.3	1.4	1.5
Housing	0.6	0.1	0.2	0.3	0.3	0.4	0.4
Infrastructure [c]	4.7	2.8	2.2	2.6	2.3	2.3	3.2
Agriculture and Rural Development	2.5	2.0	1.1	1.0	0.9	0.7	0.8
Trade and Industry	3.4	2.9	0.8	1.1	0.9	1.6	1.9
General Administration	2.7	2.3	2.9	2.5	2.5	2.6	2.4
Others	13.5	9.3	5.6	5.7	5.5	5.8	6.2
Current Expenditure	26.3	21.6	16.7	17.3	15.8	15.7	16.3
Development Expenditure	14.4	9.2	6.4	5.8	5.6	6.4	8.3
Memo Items:							
GDP (RM million)	51,838	115,828	218,671	253,732	281,888	284,473	299,683
Total Expenditure (RM million)	21,080	35,715	50,624	58,493	60,415	62,688	73,936

Notes: a. Latest estimates. b. Budget allocation. c. Includes transport, communications and utilities.

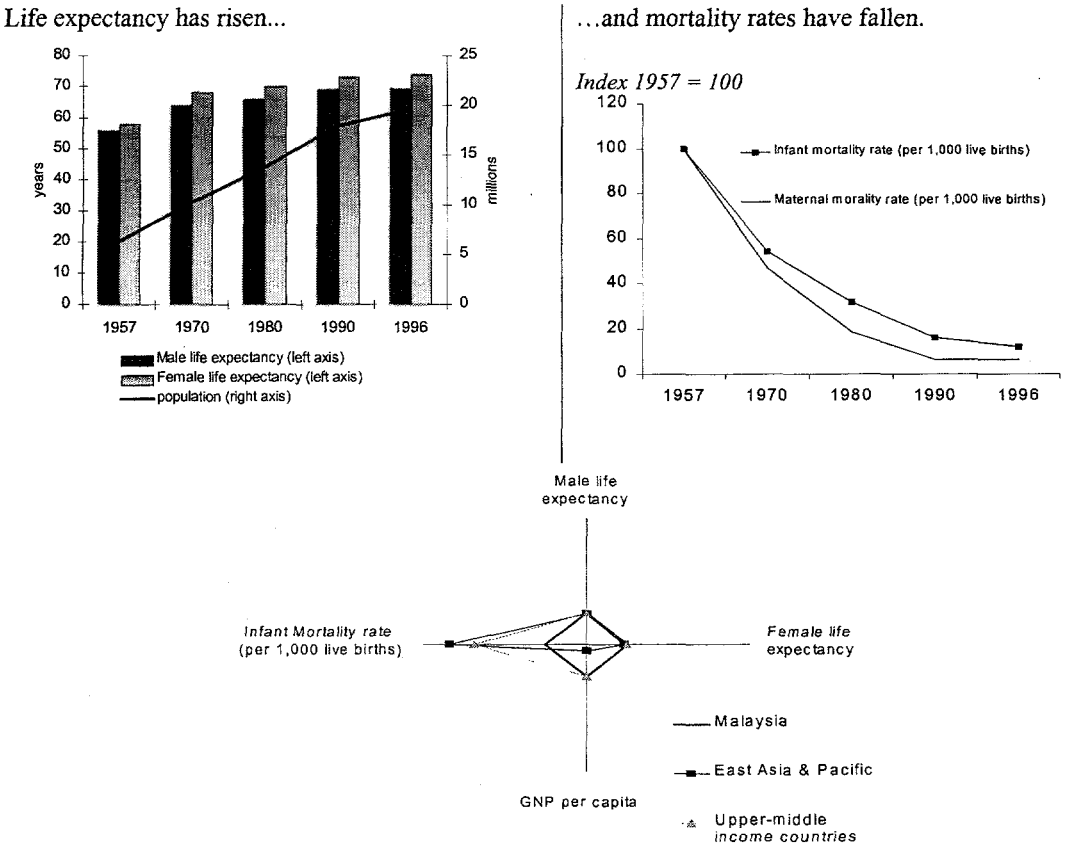
Source: Ministry of Finance, Economic Report 1998/99 and various previous issues.

B. Health System for the Future: A Difficult Choice

Impressive Achievements in the Health Sector

3.13 Malaysia has been extremely successful in building a public healthcare system that is comprehensive, efficient, and inexpensive. Improvements in health indicators have leaped since independence, outperforming the vast majority of developing countries. With an increasing private healthcare supplying the rich, public expenditures on health were captured to a large extent by the poor. Today, Malaysia has, in common with the rest of East Asia, new problems such as aging populations and increased chronic illnesses. To tackle these general difficulties, the government is rethinking its healthcare system: maintaining its existing public system or privatizing it while introducing a national health insurance scheme. The choice is difficult but the goal is to preserve an efficient and equitable healthcare system.

Figure 3.1 Health Outcomes Have Leapt Since 1957

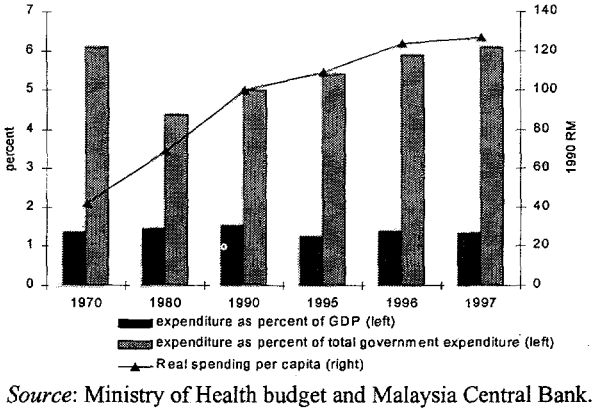


3.14 ***Remarkable health outcomes at low cost.*** Health indicators have improved considerably since independence. They have outperformed many developing countries and compare well with upper middle income ones (Figure 3.1). In particular, Malaysian men now live thirteen years longer than their counterparts in 1957, and women live sixteen years longer. In addition, births are no longer a serious threat to mothers and children—infant mortality rate has dropped to 9 per 1,000 live births (from 75 in 1957)

and the maternal mortality rate is down to 0.2 per 1,000 live births (from 3.2 in 1957). These impressive outcomes have been achieved at a low cost—national health expenditure is estimated at around 1.5 percent of GDP in 1996, compared with 5 percent for the average of middle-income countries.

3.15 ***Efficient and well targeted public spending.*** The government's continuous and strong commitment to health since independence has resulted in a comprehensive and remarkable public network of health services which encompasses all aspects of care and includes a very good referral system. The government remains the main provider of health care in Malaysia. As for tertiary care facilities government hospitals provide 80 percent of inpatients beds. The government is also the main provider of primary care facilities. Public spending is well targeted to the poor partly due to self-selection by the rich to use private health care (Hammer, et. al. 1996) and partly due to good access to health services and low fees. Some 95 percent of the population is located no more than five kilometers from a public health facility; 90 percent of the population has access to safe drinking water (compared to 62 percent in Indonesia). Fees for out-patient treatment are only RM1 for a generalist and RM5 for a specialist (double for foreigners) and quite low for inpatient care (they differ according to class of service). Between 1970 and 1997, the MOH budget has remained constant and low at around 1.3 percent of GDP and 6 percent of total government spending (Figure 3.2).

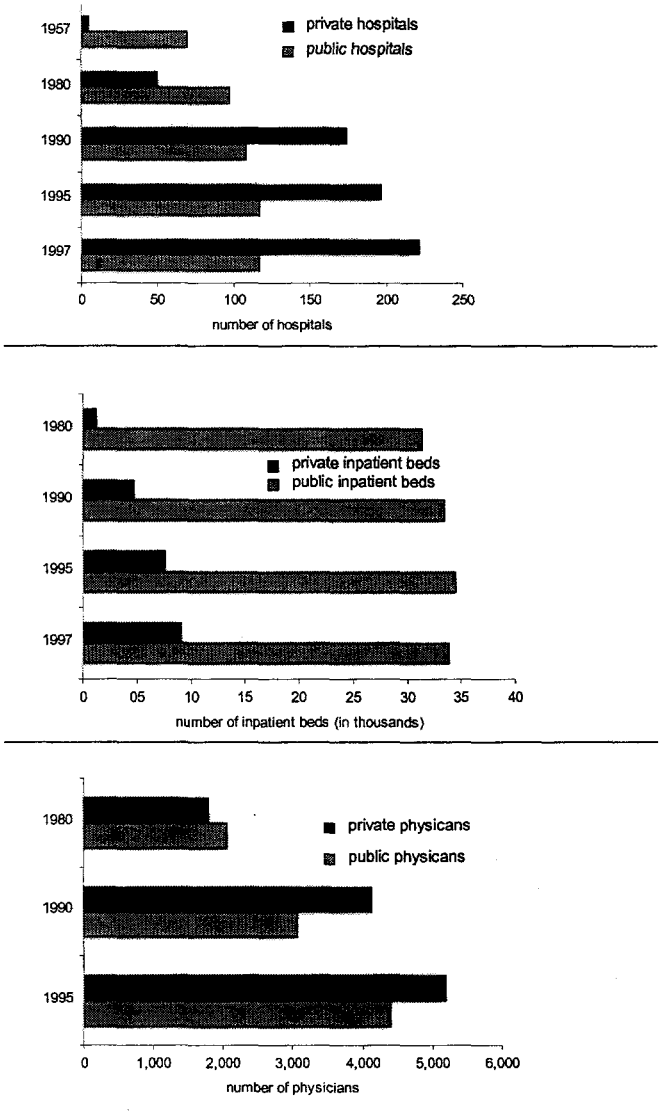
Figure 3.2: Public Health Expenditures Have Held Steady



Source: Ministry of Health budget and Malaysia Central Bank.

3.16 ***An increasing role for the private sector.*** The government has encouraged the private sector to expand[2] since the late 1980s to "develop the hospital system without increasing public expenditure to steer Malaysian society away from a welfare state for health care" (Figure 3.3). The private hospital sector is predominantly urban-based, concentrated on high-return curative care, and is largely for-profit. The government has also embarked on a strategy of corporatization for public hospitals and privatization of some healthcare services. Accordingly, the National Heart Institute was corporatized in 1992, while the General Medical Store was privatized in 1993. These changes were followed in 1997 by outsourcing major non-medical hospital support services (a clinical waste management facility, biomedical engineering maintenance services, facility engineering maintenance services, cleaning services, and linen and laundry services). Private care accounts for half of total health spending and is predominantly financed by user payments.

Figure 3.3: Participation by the Private Sector Has Increased Dramatically



Source: Ministry of Health, Malaysian Medical Association, World Bank staff estimates.

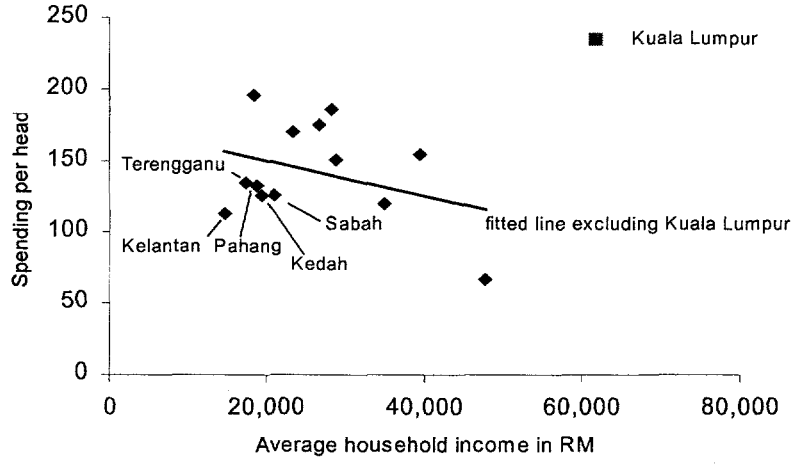
Improving Budgetary Allocation in the Health Sector

3.17 Despite the great achievements in the Malaysian health sector, important challenges remain. There is regional disparity in health outcomes which has probably contributed to increased inequality; a declining spending on preventive care; and a shortage of public doctors.[3]

3.18 ***Regional disparity prevails.*** Despite good access to public health care, a major concern remains the unequal distribution of hospitals and primary care facilities, especially in poor states. In hospital care, Kuala Lumpur has over four times more beds per 1,000 inhabitants than Kedah. In primary care, Kuala Lumpur or Melaka have more than twice the number of health facilities per 10,000 people than Sabah. Although the

uneven distribution is partly due to differences in population density across states—the lower the density the higher the cost of sustaining the facilities—a more balanced allocation could be achieved. There are regional differentials in health status as well,

Figure 3.4: Do State Health Expenditures go Where Incomes are Lowest? Not Quite.



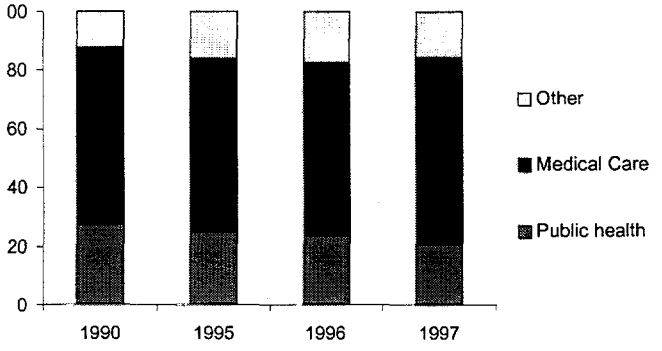
Source: Ministry of Health, World Bank staff estimates.

particularly detrimental to poor states such as Sabah and Sarawak. Maternal mortality rate in 1993 ranged from 16 per 1,000 live births in Penang to 77 in Sabah (MOH 1996 annual report). Immunization coverage for measles in 1996 ranged from 76 percent in Selangor to 95 percent in N. Sembilan. The incidence of typhoid (per 100,000 people) in 1996 varied from less than one in Pahang to 22 in Kelantan, while the incidence rate for TB (per 100,000) ranged between 5 in Perlis and 164 in Sabah. Despite the clear need to spend more in certain regions, the relationship between state income and health budgets is weak (Figure 3.4).

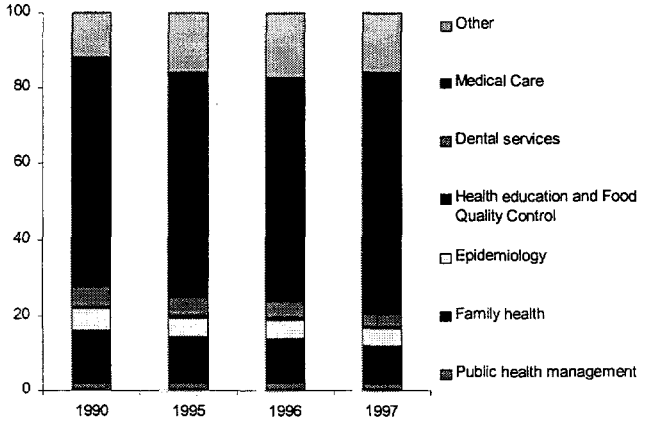
3.19 ***Spending on preventive care is declining.*** Malaysia has done so well in public health that its disease pattern has shifted towards those that are curative in nature. Curative care costs more than preventive care, and thus accounts for a larger share of expenditure—in 1997, about two-thirds of current expenditure went to secondary and tertiary care. But preventive care should have the first claim on public resources because it creates large externalities and is subject to under-spending by households. Control of communicable diseases also alleviates poverty.[4] Recent trends in spending have not favored preventive care (public health)—it has been declining as a share of total health spending since 1990 (Figure 3.5) and in absolute terms since 1996. Although the government has so far been able to finance all necessary public health programs, new communicable diseases have emerged following world trends, such as TB and HIV/AIDS epidemics, and would require higher budgetary allocations. In Malaysia, the HIV prevalence rate, at 0.62 percent, is above the average for the region. Moreover, prevention of chronic diseases is crucial in reducing the future burden of disease and is usually not adequately reflected in public policy. Three particularly important areas for action include: tobacco use, unhealthy food (such as fat intake which increases the risk of coronary heart disease); and secondary prevention of major cardiovascular diseases (e.g.,

monitoring blood pressure and cholesterol or cancer screening). There is also room for improving immunization coverage. Singapore and Thailand have achieved almost universal inoculation while 4 percent of one-year-olds in Malaysia remain non-immunized against DPT and polio and 14 percent are not immunized against measles. Spending on preventive care could therefore be increased in light of these developments.

Figure 3.5: Distribution of Health Expenditures 1990-1997
In percent of health expenditures



In percent of public health expenditures



Source: Ministry of Health budget.

3.20 ***There is a shortage of medical personnel.*** Wages account for only 50 percent of operating expenditure in health, well below levels in most upper-middle income countries. The low payroll level is due to relatively low wages in the public sector and a larger public-private gap in health than in other sectors. The wage differential could reach 3-4 times for experienced doctors and double for nurses. Also, fewer staff than deemed necessary operate the public health service because of the difficulty of maintaining staff in public facilities. MOH operates all health facilities, including 80 percent of the country's inpatient services, with only 45 percent of the country's doctors. In 1996, the vacancy rate in government posts was 35 percent for highly-skilled "managerial and professional" staff 13 percent rate for "support and administration" staff. In 1997, 7 percent of doctors left the public service.

Malaysia is Adjusting to the Challenges Ahead

3.21 The Malaysian health care system has worked very well but new challenges are emerging: the population is aging, incomes are rising, and the pattern of disease is evolving. These changes are expected to alter both the overall level and the composition of health care expenditures. To meet new demands and continue to provide its population with better living standards, the government's goal throughout the Seventh Plan is to expand and improve health services. An important aspect of this goal is the corporatization and privatization of health facilities and services. Because this increased role of the private sector in provision of health care would mean higher cost to consumers, the government would complement its privatization strategy with the introduction of a health financing scheme.

3.22 Malaysia confronts significant challenges in implementing these major policy reforms, which could dramatically transform its health care system. The pro-poor accomplishments of the existing system need to be preserved under any future transformation. Policymakers appear unsure of the appropriate scope and pace of new reform initiatives. There is a perception that substantial capacity building in health policy and management still needs to take place to successfully design, implement, monitor and evaluate the reform process.

3.23 ***Aging population, increasing chronic sickness, and rising incomes will increase Malaysia's medical expenditures***. First, Malaysia's population is aging—in 1990 less than 6 percent of the population was over 60 years old; by 2020 that proportion will double. As the population ages, the cost of care increases. For example, in Singapore in 1997 in public sector hospitals, the average admission rate was 74 patients per 1,000 over the whole population, but this rate doubles for patients over 60 and triples at 70. Second, the country's disease profile is changing as the level of development increases. In 1990, less than 40 percent of the global burden of disease came from non-communicable diseases; by 2020, this share is expected to rise to 60 percent. As the pattern and incidence of diseases alter, so too do the demand for and the costs of health services. Third, rising incomes will generate proportionately larger increases in health spending. On average, studies have shown that healthcare rises by 11.4 for every 10 unit rise in income. Considering all these factors, a growing share of income is likely to be devoted to healthcare in Malaysia.

3.24 ***Malaysia's fiscal costs are bound to rise.*** The government's current investment strategy, which focuses on expanding and improving health services, will result in higher level of operating expenditure in the next five to ten years. *First*, the government is expanding its coverage of rural and under-developed areas and merging hospital outpatient departments with existing health facilities to form new (and expensive) community clinics. *Second*, the government is committed to a long term, ambitious investment program to upgrade existing public hospitals and build expensive new high-tech hospitals. This leads automatically to increased operating expenditure in the budget. *Third*, cost recovery is very low because it is not an objective of the Ministry of Health—in 1997, hospitals recovered less than 3 percent of their current spending. Health facilities in the public sector are funded from general taxation revenues. This is consistent with the principle of a national health service like that in the United Kingdom, for instance. Thus,

rising health expenditures combined with a policy of low cost recovery will raise fiscal costs.

3.25 ***The government is formulating a new strategy to reform the health sector.*** The government's two-pronged structural reform agenda aims for major changes in both the provision and financing of health care. *On the provision side,* Malaysia has initiated significant measures to privatize some components of its health services. One set of measures has outsourced a variety of support services used by public hospitals, including laundry, cleaning, diagnostic services and drug procurement. Another set of measures aims at "corporatization" of the public hospitals themselves, initiated with corporatization of the National Heart Institute (NHI) in 1992. Malaysia's corporatization model appears analogous to Singapore's restructuring program, which retains a reduced but significant role for public subsidy of certain classes of patient, while charging at least full cost recovery to other classes. Thus, 52 percent of NHI's patients during 1992-1997 were subsidized (including civil servants, pensioners, students and the lower income group).

3.26 *On the financing side,* since the mid-1980s the government has been considering diversifying from its heavy reliance on budget subsidies by introducing an extrabudgetary health financing scheme. While no policy decisions have been announced, this could take the form of intertemporal risk pooling through medical savings accounts analogous to the Singapore model, instead of the conventional social insurance approach taken by Korea and Taiwan. However, specifying basic design parameters such as payroll contribution rates remains uncertain. Once established, the new national health fund is expected to complement corporatization by mobilizing additional resources necessary to absorb the higher cost recovery imposed by privatized hospitals.

3.27 ***Privatization has not yet led to fiscal savings.*** Furthering the role of the private sector in health care to reduce the fiscal burden and improve quality of service is a general strategy of the government. In practice, however, the fiscal outcomes of outsourcing are mixed so far. Fiscal costs of five engineering support services that were contracted out have doubled (from less than RM200 million per year to RM520 million in 1998). The cost increase was not matched by enhanced quality. Despite some improvements, the quality of services remains imperfect, partly due to the shortage of adequately trained personnel. Moreover, the legal and financial framework of outsourcing has significant weaknesses, including limited competition and transparency.[5] However, the concession companies are to implement quality assurance programs for all the five engineering support services so as to achieve ISO 9002 registration within 5 years of takeover.

3.28 The financial impact of NHI corporatization has not been very encouraging. Costs per unit (and budget subsidies) have risen since the corporatization. This is related to a significant rise in the payroll—civil servants agreed to leave the public sector and be "privatized or corporatized"; they lost the job security they have enjoyed so far but got higher wages. This policy was adopted to ensure employment opportunities to the affected employees and to retain medical expertise within NHI after corporatization.

Options for the future

3.29 One of the difficult questions facing Malaysia is how to pay for the expected rapid escalation of medical bills in an efficient and equitable way. Malaysia is well positioned since it has both a significant public and private sector which allow various options to be considered. The choices confronting Malaysia in reforming its health care system include (i) keeping its current dualistic system of heavily subsidized public health care combined with a rapidly emerging private sector for those who can afford it; and (ii) introducing a national health financing scheme and privatizing public health services (there is no convincing evidence that relying solely on private insurance schemes works well).

3.30 Health care financing is a complex issue outside the scope of this review; thus some options are spelled out with no specific recommendation (further work will be done in this area). The first option—maintaining the current system—is certainly viable but it is likely to lead to increased fiscal costs if quality is to improve. However, there is considerable room for growth in healthcare spending before cost containment becomes a major concern since Malaysia has a low ratio of public health expenditure to GDP (around 3 percent, compared with 8 percent in OECD countries), and rapid and sustained economic growth would help pay for rising healthcare costs. The second option—privatizing major health care services and introducing a health financing scheme—is consistent with the privatization strategy of the government and is likely to achieve better results in enhancing quality, but it implies a complete overhaul of a successful public system. It also presents risks in terms of its impact on healthcare cost and equity. If Malaysia decides to pursue the second option, a government-run insurance would probably be cheaper than that provided by the private sector because the government has greater potential for controlling prices due to economies of scale and standardization. Whatever decision the government makes, its challenge is to maintain a clear definition of its responsibility for promoting efficient and equitable resource allocation in the health sector, and effectively regulating the private sector.

3.31 ***Maintaining the existing system.*** The Malaysian public health care system is working well. It is efficient, equitable, and cheap. Maintaining this system is certainly a viable option. If the government decides to do so, it will need to spend additional resources to increase the system's sustainability and efficiency. Some measures include: (i) change the composition and level of spending to achieve greater intra-sectoral and regional balance and meet the new health challenges; (ii) raise resources to better maintain the system by improving cost recovery and pricing in public facilities; (iii) promote and regulate the private sector; and (iv) reduce the cost of privatization.

3.32 *Change the composition of expenditures:* More investment in specialized facilities and equipment and more spending on specialized doctors will be required to provide adequate treatment for the increasing incidence of chronic disease. Moreover, the scope for preventive care needs to be broadened. Finally, distribution of health expenditures across states could better reflect needs.

3.33 *Raise resources:* Cost recovery has been very low so far as it was not a government objective. However, with rising costs ahead, pricing policy may need to change to sustain higher expenditures on health and contain demand. Moreover, outpatient care is over-

subsidized when in fact many people can afford it without subsidy. Since most people incur minor health risks, any subsidy per unit will absorb a large proportion of the total subsidy—outpatient care accounts for two-thirds of expenditures.

3.34 First, too many people have virtually free access to public facilities, especially for inpatient treatments involving costly operations. These include (i) civil servants, their children, and their parents, who are charged 1 percent of their monthly salary, up to RM8 (about US$2) per day, for inpatient treatment; (ii) government pensioners who get free medical services at all government hospitals and are reimbursed for private care if public medical service cannot be obtained; (iii) students below "O" level, who have free access to second class wards; and (iv) blood donors, people on welfare, members of certain NGOs, and aborigines, who also have free access to inpatient care in public hospitals. Second, fees are low and have not been revised since 1982 (the government is currently reviewing the Fees Act). In addition, the fee structure of public facilities is not linked to costs. The result is over-utilization of health services, especially those where quality is good and price differential with private sector is large (such as tests).

3.35 Fees need to be adjusted to better reflect costs; the list of people entitled to free care needs to be reassessed; and significant co-payments could be introduced. This can be done through more differentiated fee structure among classes in hospitals to improve self-selection. The means-testing procedure for those who cannot pay at all would remain, while the eligibility threshold could be adjusted if necessary. Cutting the outpatient subsidy will allow channeling resources to improve inpatient care without necessitating much budgetary resources.

3.36 *Promote and regulate the private sector:* One reason why the public health care system in Malaysia has benefited the poor is because the rich opted out. This happened because the private sector was allowed to develop. On the one hand, a rapidly growing private sector needs to be encouraged, as more of the publicly provided services can be concentrated on the poor. On the other hand, this growth has taken place with little or no regulation of fees, modes of payment, or financing arrangements by the Ministry of Health. Left unregulated, the impact on health status of the private sector is ambiguous; and exodus on higher-income people to seek care in the private sector may exacerbate problems in the private markets for health care and lead to serious efficiency problems in the market. The government has passed a new Health Facilities and Services Act in 1998 that will regulate the private sector.

3.37 *Reduce the cost of privatization:* For outsourcing, the government could take the opportunity provided by the crisis to revise the legal and financial framework of existing contracts, looking for more competition and flexibility, more transparency, better quality of service, and lower costs. Moreover, the financial crisis provides an excellent opportunity to further develop outsourcing and contracting-out. With private providers under-utilizing past investments (such as MRI and other heavy medical equipment, as well as acute care beds), it will help both the government and the private sector to get into a contract. This might provide urban areas, and in particular Kuala Lumpur, with a low-cost alternative to expensive public investment financed through the MOH budget. For corporatization, the government could reassess ways of curbing the rising costs at NHI, a rise that is not sustainable in the future. This could include a lower number of staff and a

decrease in wages, at least in real terms, in a way that does not jeopardize the quality of service. The government might also review the pricing of health care for civil servants, in particular in expensive corporatized facilities (a change in the payment method by government staff to the NHI is currently being considered).

3.38 ***Introducing a national health insurance scheme: lessons from East Asia.*** If the government decides to introduce a national health financing scheme, it may consider experimenting it first in one state, such as Kuala Lumpur, given the difficulty in predicting the outcome. Nevertheless, some issues need to be addressed relating to resource mobilization, coverage, co-payment, and pricing. The experience of East Asian countries may be relevant to Malaysia (Box 3.1).

Box 3.1: Health Insurance Schemes—Concepts and Lessons from Other Countries

Resource mobilization: The large-scale health financing reform that Malaysia is contemplating is likely to be similar to the mandatory medical savings account introduced in Singapore in 1984. In Singapore, the government finances medical care from taxation and contributions to the state's mandatory saving scheme, the Central Provident Fund (CPF). At present, employees pay 20 percent of their salary into their CPF accounts. Their employer contributes the same amount, making a monthly total of 40 percent of salary entering the CPF. Of this monthly amount, 6-8 percent goes into an individual's Medisave account, depending on age, subject to an upper ceiling. An individual can withdraw funds from the Medisave account to meet hospitalization charges incurred by himself or his immediate family. China is experimenting with the medical savings account model in 58 major cities.

On the advantage side, unlike social insurance and tax-based financing, the savings approach will not place an unduly heavy burden on the decreasing share of young and productive workers, and will free public expenditure from the vagaries of economic cycles. The current generation of wage-earners is obliged to save for the future, instead of relying on the uncertain taxes of the next generation for future support. This promotes financial independence among the aged, whose medical needs are expected to increase. Moreover, there is less disincentive to work compared to taxation since the contribution remains in the account of the individual. The disadvantage is that, employees and employers will be squeezed hard to make Central Provident Fund contributions, on top of rising wage costs that will subtract from private incomes and profits. In addition, the present cohort of wage-earners could be doubly affected, since they not only have to save for their own old age but also have to provide for elderly dependents without substantial Central Provident Fund savings.

The other more conventional healthcare system is the social insurance scheme. Throughout East Asia, the broadly-defined public sector pays for about half of health expenditures and government health budgets raised from general

Box 3.1: Health insurance schemes—Concepts and lessons from Other countries (contd.)

tax revenues actually finance only one-third of the total on average. In the past few years, East Asian governments have attempted to augment their public healthcare funds through various types of social insurance schemes which tap into the payroll tax base, itself expanding as economies shift towards urban industrial employment. In 1988, South Korea launched its national health system, which is largely financed out of its social insurance scheme. In 1995 Taiwan followed suit. Thailand and Indonesia, in 1990 and 1992 respectively, introduced legislation to extend existing social insurance coverage to include private sector industrial workers as well as civil servants. Vietnam has gone some of the distance with the launch in 1993 of a mandatory health insurance program for civil servants and state enterprise employees. Extra-budgetary social insurance funds have an advantage over general taxation because there is a better link between health revenue and health expenditure, and an advantage over individual savings account because there is redistribution since all contributors have equal access independent of their contribution.

Coverage: National insurance programs which seek to cover all aspects of ill-health, including routine out-patient care where coverage is not really needed, spread the pool of available funds too thinly across the entire population and increase overheads. The administrative costs associated with processing claims of broad health insurance programs are greater, and such programs provide inadequate coverage for very costly treatments that really need to be insured. Countries that have opted for systems which supply more comprehensive coverage of care, instead of focusing on hospital in-patients, often find themselves spending most of their money on out-patient services. In 1996, two-thirds of Taiwan's national health insurance bill went towards reimbursing ambulatory care. The average Taiwanese citizen makes 14 visits to the doctor each year, well above average. Thus far few countries, except for Singapore, explicitly focus on high-cost areas of medicine in the design of their social insurance programs. Singapore's Medisave scheme generally excludes coverage of out-patient services, so that Medisave balances are reserved to pay for less frequent, but high-cost, in-patient care. But because Medisave depends on "inter-temporal pooling of risks," an unconventional insurance tool which pools the resources of individuals throughout their lifetime, it is not actuarially feasible for Medisave balances to insure against truly catastrophic contingencies—what if people fall ill early on in their lives and their Medisave account is still immature? To solve this problem, Singapore created a back-up health insurance program, called Medishield. Medishield is based on conventional cross-sectional risk pooling (i.e., across individuals) and is a low-premium scheme which covers most of the population and finances catastrophic care.

Co-payments: If Malaysia introduces a national health insurance scheme, it will be important to control demand put on healthcare systems through mandatory patient contributions. Governments which manage health insurance programs without imposing a limit on patient demand have experienced an abrupt escalation in medical costs. In Thailand, spending on the civil servants medical scheme, which effectively pays for all civil servants' medical care, rose 13 percent per year in real terms between 1978 and 1992. Expenditures of a similar scheme in China have grown at over 11 percent per year in real terms during the same period. Singapore, for example, requires patients to make personal financial contributions to their medical care—two-fifths of Singapore's state-owned hospital costs are met by the government; the remaining three-fifths are charged to patients, who settle their bills out of their Medisave accounts and out of their own pockets. Typically, Medisave covers 45 percent of patients' expenses and out-of-pocket payments cover 55 percent. Patients are thus held accountable on two fronts. Medishield also requires patients to take responsibility for one-fifth of the costs of their catastrophic care. Some countries have implemented cost-sharing alongside their comprehensive health insurance programs. Under the South Korean social insurance program, patients are expected to bear 55 percent of the insurance costs for out-patient care and 20 percent towards in-patient care coverage. In practice, because of a shortage of funds, in-patients end up paying much more towards their own care. In 1992, the proportion paid by patients towards their entire medical care amounted to 51 percent of the total cost. Taiwan's new National Health Insurance Program has set very low cost-sharing ratios—patients have to pay 9 percent of the cost of all out-patient visits and 8 percent towards the cost of insuring hospitalization expenses.

Pricing: Pricing policy is an important device to improve medical services distribution throughout the economy. Sometimes patients cannot afford the out-of-pocket costs charged by government, especially in the case of expensive hospital treatments. The poor may be discouraged from seeking important medical services if fees are prohibitively high. This situation calls for selective pricing for certain segments of the population. Such a pricing policy consciously differentiates prices according to income bracket so that public subsidies can be targeted instead of distributed indiscriminately. One mechanism by which this can be achieved is self selection: charging lower prices for services more likely to be used by the poor (e.g., by location). Alternatively, subsidies can be directed to individual users by means-testing. Singapore's recent health reforms demonstrate that the combination of these approaches promotes a fairer public healthcare system. Explicit price discrimination is built around four different classes of hospital ward in public-sector hospitals, from class C, through class B2 and B1 to A, in ascending level of comfort. The subsidy provided by government to each class varies from 84 percent of hospital costs in the lowest class C, to 71 percent in B2, 36 percent in B1, and 13 percent in A. Public hospitals provide financial counseling to help in-patients select an affordable class of ward. Patients unable to pay their subsidized hospital bills can apply for a means-tested grant from their Hospital Medifund Committee. This safety net is available to households in the lowest one-third of the income distribution.

Source: Nicholas Prescott, *A Script—How to Manage Rising Healthcare Costs in East Asia,* The Economic Intelligence Unit Healthcare Asia, 1997.

C. Leading the Way in Higher Education

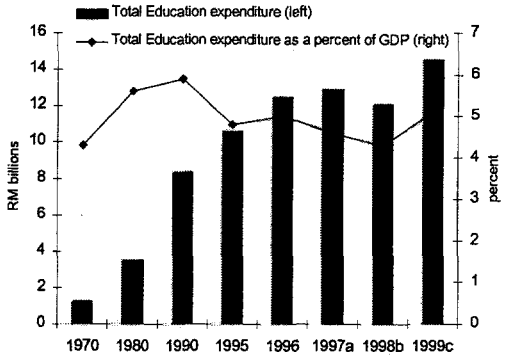
3.39 Malaysia has achieved universal primary education and doubled secondary enrollment. However, spending on higher education has not been progressive. After independence, the NEP aimed to redistribute income and human capital to the Malay population who were disproportionately located in the poorer areas. As a result, primary and secondary enrollment rates have soared. The ethnically-based targeting policy raised education outcomes by reaching lower income groups and increasing Malays' participation. The government has fulfilled and exceeded its commitment to provide services with substantial external effects (primary education); and even services that are essentially private goods (higher education) to aim for ethnic balance. Although providing primary and secondary schooling is pro-poor, higher education is regressively subsidized. Moreover, tertiary enrollment rates in Malaysia are lower than other countries with similar income levels and growth prospects—only about 11 percent of those aged 19 to 24 are enrolled in tertiary education (including students overseas may add another 5 percent), compared with 60 percent in Korea and 35 percent in the Philippines. The government intends to increase tertiary enrollment to 40 percent by the year 2020.

3.40 The lags in tertiary education are partly due to insufficient qualified secondary education students and partly to insufficient supply of institutions. To resolve the first constraint, the quality of education, mainly at the secondary level, is being revisited to increase the pool of qualified students that would go to tertiary education. To resolve the second constraint, supply of tertiary education needs to be expanded in an efficient and equitable manner. Some of the expansion of tertiary education would come from private universities, but public universities will also need considerable expansion. To accomplish this, financing tertiary education becomes an important issue. The potential exists to adopt progressive, fair and efficient reform by expanding and improving the grant and loan schemes to students. Income-contingent loans that are repaid according to income, and are thus less burdensome, are one option. If Malaysia succeeds in implementing similar or even better reforms of this type, it could become a world leader in education policy.

Achievements and Challenges

3.41 ***Educational outcomes have risen but remain low at the tertiary level.*** Over the last several decades the Malaysian government has stressed the value of education as an economic and social instrument. This commitment has manifested in considerable expansion of public outlays from the early 1970s to the mid-1990s by a factor of around nine (Figure 3.6). A major consequence of this policy has been the extraordinary growth in enrollments (Figure 3.7)—enrollment rates increased by nearly two-thirds in lower secondary education and more than doubled in upper secondary. Adult literacy rates are about 95 percent, among the world's highest. Arguably this has contributed to the rapid economic and productivity growth in the last quarter of a century. Despite very fast growth, enrollment in tertiary education remains low—it increased from 4 percent in 1980 to 11 percent in 1996 (excluding students overseas).

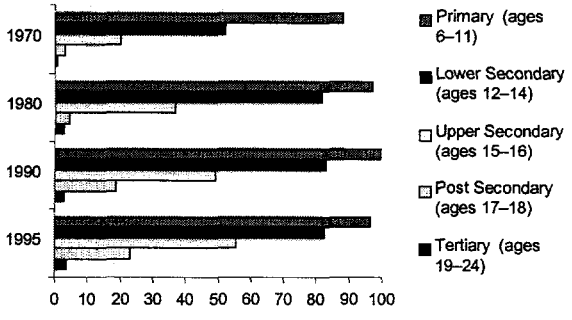
Figure 3.6: Education Expenditure on the Rise, 1970 to 1999



a. estimated actual. b. latest estimate. c. budget allocation

Source: Ministry of Finance, Ministry of Education.

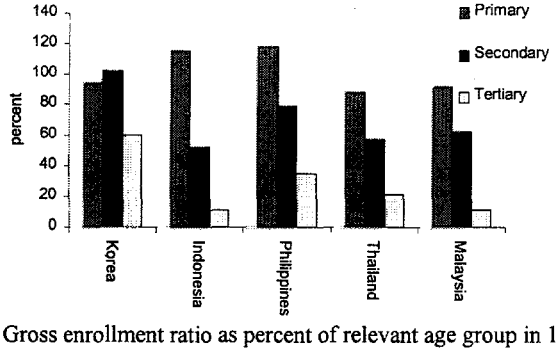
Figure 3.7A: Enrollment Rates in Public Institutions Have Risen 1970 to 1995



Note: 1970 data refer to Peninsular Malaysia only.

Source: Ministry of Education.

Figure 3.7B: Malaysia Lags in Tertiary Education Compared to the Region



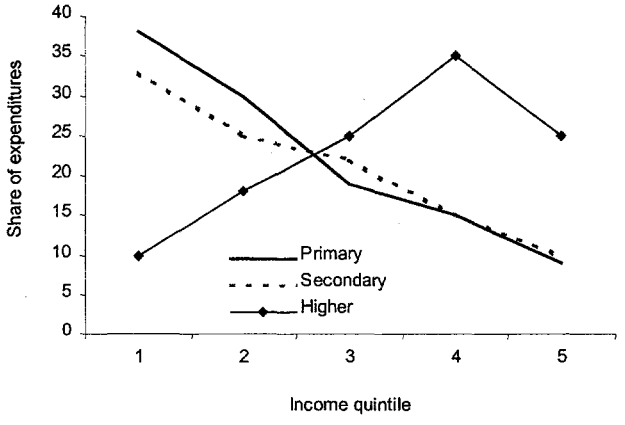
Note: Gross enrollment ratio as percent of relevant age group in 1996.

Source: UNESCO Statistical Yearbook, 1998.

3.42 ***Subsidies have been progressive for primary and secondary but regressive for tertiary education.*** Government expenditures have become better targeted to the poor over the period of the NEP. For primary education, 28 percent of expenditure went to the

poorest 20 percent of the population in 1973; by 1989, this share had increased to 36 percent (Hammer et. al.). Subsidies to higher education are improving but still regressive, being a transfer to relatively wealthy groups. In 1973, only 3 percent of higher education expenditure went to the poorest 20 percent of the population, while more than 50 percent went to the richest 20 percent (Figure 3.8). The richest 40 percent of the population received 70 percent of expenditures. By 1989, 10 percent of expenditures went to the poorest quintile, 24 percent to the richest quintile, and still over 55 percent to the richest 40 percent.

Figure 3.8: Higher Education Subsidies are Usually Regressive
(Distribution of education benefits, 1989)

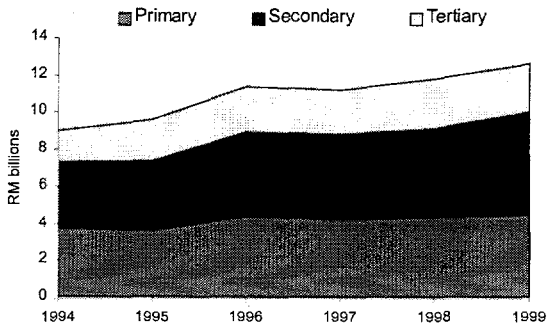


Source: Hammer, et. al. 1992.

3.43 ***Education accounts for a high and increasing share of the government's total budget.*** Education has absorbed around 5 percent of GDP (20 percent of the total budget). Compared to other similar countries, this is high (typically it is less than 3 percent of GDP). The highest share of the education budget goes to primary and secondary education (about 35 percent each in 1998); tertiary education accounts for 20 percent (Figure 3.9). This intra-sectoral allocation is in line with the public good principle of primary and secondary education. Recently, there has been increasing emphasis on university education because there are huge gaps in enrollments—budgetary allocations grew at 11 percent per year on average since 1994, compared with 9 percent for secondary education and 4 percent for primary education. However, the increase in the tertiary budget (150 percent between 1985 and 1995) has far exceeded the increase in enrollment (70 percent) and the cost per student rose by 50 percent to about RM20,000 per year (Figure 3.10). Since current enrollment, excluding students abroad, is about 11 percent, the government's goal of raising tertiary education enrollment to 40 percent by 2020 implies the need for substantial increase in the budget, even if private universities expand.

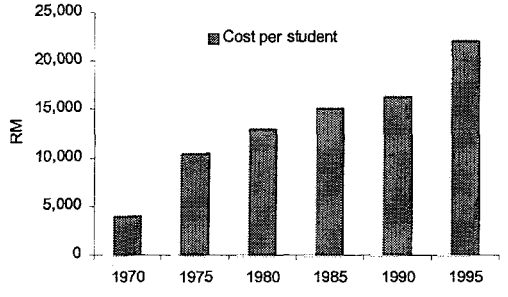
Figure 3.9: Allocations to Tertiary Education are Increasing

Total expenditure allocations for education



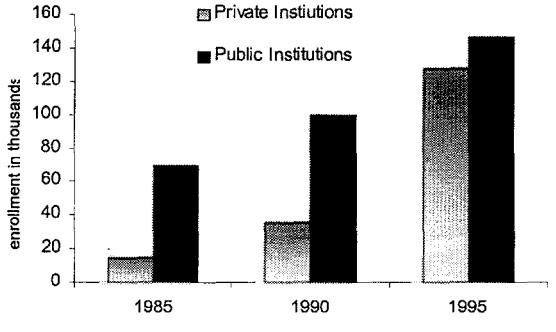
Source: Ministry of Education.

Figure 3.10: The Cost of Tertiary Education is Rising



Source: Ozat Mehmet and Yip Yat Hoong. Human Capital Formation in Malaysian Universities, Kuala Lumpur, Institute of Advanced Studies, 1986. Ministry of Finance.

Figure 3.11: The Private Sector is Growing Rapidly in University Education



Source: World Bank, 1998.

3.44 ***Private universities are assuming a bigger role.*** Recently, private higher education has expanded from 156 institutions in 1992 to 417 in 1997. Between 1985 and 1995, the number of students rose eightfold and private share of total higher education enrollment increased from 18 percent to 46 percent (Figure 3.11). This rapid expansion is attributed

to (i) restricted supply of places in public institutions; and (ii) the ethnic quota system for admission to public institutions of higher education—more than 90 percent of private college students are non-Malays who cannot be admitted to local public universities.

3.45 The government is handling governance and control of private institutions carefully to achieve acceptable standards. In 1996, the government passed three education bills that affect private higher education so that the private and public sector are better coordinated; to regulate private institutions; and to set up an accreditation board. Higher education institutions are incorporating to improve their effectiveness, and efficiency. Except for the economic downturn, the University of Malaya would have been the first to be corporatized. Twinning programs with foreign universities are now very common.

3.46 ***Next steps.*** Although investing in tertiary education is crucial to upgrade skills and increase productivity-based growth, it should not undermine the achievements in primary education by reallocating budgetary resources to higher education. Since tertiary education has a high cost per student and, arguably, has little externalities,[6] it is inequitable and unsustainable to finance it from revenue, so it is essential to start raising public university fees, foster the private education sector, and establish a funding mechanism. For that, international experience is useful.

Funding arrangements in Malaysia's higher education

3.47 There are two main government funding arrangements for higher education: (i) a heavy subsidy in public universities; and (ii) scholarships and loans to students in private universities. *First,* tuition subsidy is one of the highest in the world. Annual full-time fees are around RM1,500–2,000 while average annual costs are about RM20,000, implying a subsidy of around 90 percent. On average the public sector higher education subsidy is around 30-60 percent in the U.S., Australia, New Zealand and Canada. In 1998 the Dearing Committee on higher education financing in the U.K. recommended charging fees consistent with a subsidy of this order.

3.48 *Second,* a large proportion of Malaysian higher education students have been supported with scholarships and loans. However, the loans were essentially grants since repayments were considerably reduced for most students, based on results. Usually scholarship assistance was contingent on graduates working in the public sector for up to a decade. Moreover, the government has been supporting overseas studies for many of the best students—tuition plus generous subsidized living allowances. However, the government overseas scholarships were discontinued for new students at the onset of the crisis.

3.49 In 1997, the government introduced a new loans scheme, designed to eventually replace grants and scholarships, which covers both (minimal) tuition charges and living costs. To be eligible candidates must prove financial need.[7] In 1998, only 10 percent, or fewer than 15,000 students, received loan assistance. Repayment conditions stipulate that students must begin to repay six months after graduation, or upon employment, whichever comes first, and the total loan must be repaid within 15 years. These repayment arrangements are insensitive to graduates' financial circumstances because set payments are due each month regardless of circumstances. Graduates in financial

difficulties can request deferred payments depending on their circumstances, but this process is not formalized. Loans are collected through the Inland Revenue Service.

3.50 ***The high public subsidy is neither equitable nor efficient.*** The demand for local higher education is likely to rise substantially in the coming years. This is due to the government's 2020 enrollment goals, plus the sharp increase in overseas tuition coupled with the depreciation of the Malaysian Ringgit. Public and private institutions will have to expand. There is little ground for subsidizing higher education, first from an efficiency point of view because the benefits of higher education accrue to the individual receiving it, and second from an equity point of view because all taxpayers will have to pay for the higher education received by students.

3.51 ***Collecting loans through the Inland Revenue Service is sensible and efficient.*** Other countries that use the IRS have successful and low cost collection operations. Malaysia has the institutional framework to allow and facilitate an improved loan system.

Towards higher education reform: options for the future

3.52 Higher education reform would include:

- raise fees in public universities;
- expand funds for means-tested grants and loans
- introduce a universal student loan scheme;
- continue to collect loan repayments through the Inland Revenue Service;
- continue to expand and improve quality of secondary education.

3.53 Raising fees in universities is a politically sensitive issue in Malaysia, as in many other countries; however, it makes sense from an economic point of view. The following suggestions are provided within this perspective.

3.54 If high up-front fees are charged (in public and private universities) without recognition of financing problems that a significant part of the student population will face, adverse economic and social outcomes will follow. Adequate financing mechanisms thus need to be put in place to support students. For those who cannot afford to pay, there is an ineffective capital market available for borrowing. The basic concern for a bank lending for human capital is that, unlike many other investments, there is no saleable collateral in the event of default such as in the housing capital market for example. There is therefore justification for government intervention to correct for the credit market failure in tertiary education. Government typically addresses the problem by acting as a guarantor for student loans by paying the interest for the period before graduation. However, because of the expense involved, loans are usually made available only to students with poor parents. Loan schemes could be provided directly by the government, or by the private sector with a government guarantee. They can be used in public universities or in private universities. Loan collection through the Inland Revenue Service will continue, since the IRS has access to information concerning graduates' incomes.

3.55 Revenues from higher fees in public universities could be used to expand the education system and retain secondary students. In Australia, the revenue is hypothecated

and placed into a trust fund which can only be used for higher education expenditure; this offers the political advantage of the charge underwriting the expansion of the system, and would serve Malaysia well given the stated goal of substantial expansion of university places. However, the radical enrollment goal in Malaysia by the year 2020 also requires a large increase in upper secondary retention rates to supply sufficient eligible students for higher education. Thus some higher education revenue could be targeted to increase enrollments in upper secondary. One possibility would be to offer means-tested financial assistance to families contingent on their children remaining in post-compulsory education. This offers equity and could become part of social protection.

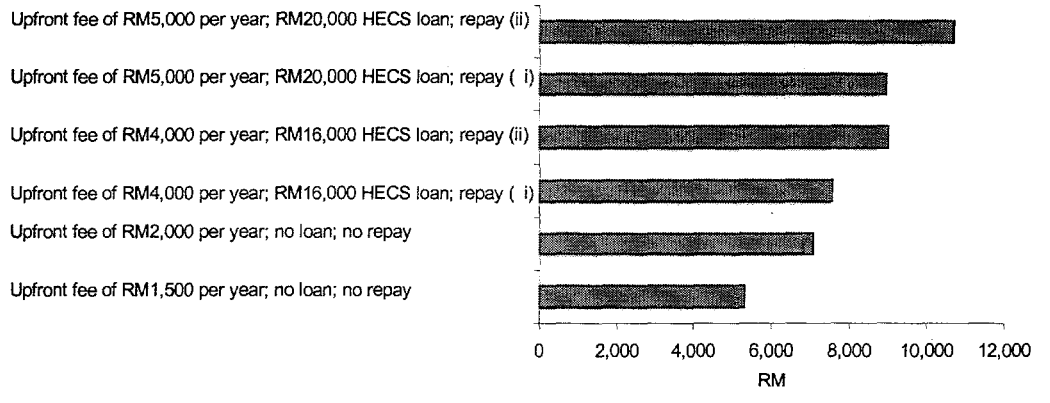
3.56 Private banks can provide funds to eligible students with a government guarantee. In Australia, for example, when a private bank gives a loan to an eligible student to pay university fees, the student signs a contract with the government for repaying the loan, conditional on the student's future income and collected through the tax system. The government signs a contract with the private bank on commercial terms agreed between the two parties. To make the arrangement revenue neutral for the government—given that some students will default and others will repay with an interest subsidy—the government would collect slightly more from the student than what the government would owe the bank. This arrangement will benefit all three parties: students get a loan with low burden, banks lend money on commercial terms with a low-risk customer, and the government fulfills its goal of tertiary education provision in a revenue-neutral way.

Box 3.2: Australia's Income-Contingent Student Loan Scheme: Can It Be Applied to Malaysia?

A hypothetical model of reform. *First,* charges in public universities could be raised substantially. If charges quadruple, students would pay RM4,000–5,000 for each year of full-time study (RM16,000–20,000 for a four year degree). This would bring Malaysia in line with the subsidies implicit in many other countries. *Second,* all students could choose a repayment plan contingent on their income, and lower fees could be charged if students pay upon enrollment. Australia used this approach which has the considerable advantage of immediate revenue. *Third,* interest could be set to zero in real terms; thus, the outstanding debt would be increased annually by the rate of inflation. The interest rate subsidy would be progressive since it will redistribute income towards graduates with prolonged repayment periods—likely the poorest of the group. *Fourth,* loan collection through the Inland Revenue Service will continue, since the IRS has access to information concerning graduates' incomes and can collect loan repayments according to financial circumstances.

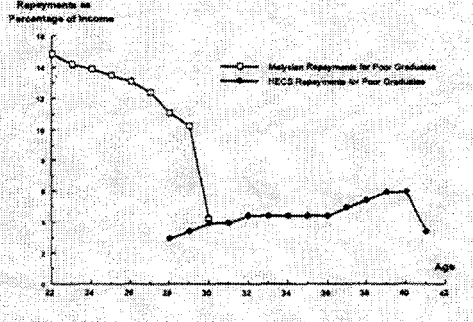
Will the new system affect demand for higher education? If higher charges reduce demand, the proposed new arrangements will be self-defeating and should not be contemplated. However, estimates show that even significant fee increases are unlikely to reduce demand for higher education, if repayments are based on future income—the net present value of charges that are four times higher than current ones is not much higher than the current upfront fees (Figure 1). Moreover, these estimates do not consider the charge being collected depending on income. In Australia, even though an income charge was implemented at 10 times the previous upfront fee, enrollments actually increased. This was also because the government increased the number of places given the substantially improved funding base. Further, relative to repayment of a loan on a mortgage-style basis (that is, according to time, not income) an income-contingent charge might reduce considerably a student's perception of the hardship entailed in repayment (Figure 2).

Figure 1: Higher Fees Combined with Income-Contingent Loans are not Burdensome
(net present value of charges under four scenarios for a four-year degree)



Note: The RM16,000 or RM20,000 loan for a four-year degree is paid back via an income-contingent charge per year, until the total is repaid. Repayment schedules vary according to income and are less stringent under Repay (i) scenario than under Repay (ii) scenario.

Figure 2: Repayments as a Share of Income under Two Systems



Source: Staff calculations based on ICC data.

D. Social Protection: Past and Future

Great Achievements in Poverty Reduction

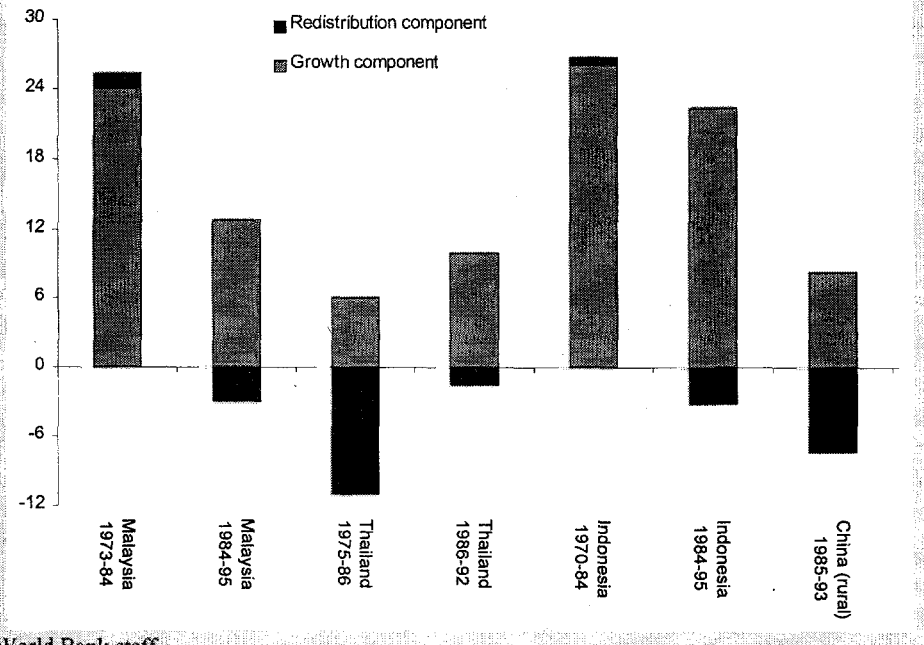
3.57 ***Malaysia has an enviable record of poverty reduction.*** In a quarter of a century (1973-95), Malaysia's real average per capita income increased 2.5 times and the poverty rate shrank from slightly over half of the population to about 8 percent. This impressive achievement has been driven almost fully by strong economic growth rather than by redistribution, like many other countries with rapid poverty reduction (Box 3.3).

3.58 ***But inequality has increased.*** After a steady decline in inequality during 1973-89, trends reversed during the 1990s—the Gini coefficient dropped from 0.50 in 1973 to 0.46 in 1989 (8 percent), then rose to 0.48 in 1995 (4 percent). Thus, although mean incomes of all income groups were increasing, the growth in mean income diverged across groups—since 1989, the share in income of the richest 10 percent has increased sharply

Box 3.3: Income Distribution Worsened in Many East Asian Countries

During 1973-95, only about 1.5 percentage points out of 36.3 percent reduction in poverty is attributed to redistribution, the rest is due to growth. A small redistribution component has been found in most countries across the world that have achieved rapid reduction in poverty. Within East Asia, income distribution worsened in many countries. In Malaysia, although the redistribution component remained positive during 1973-95, it turned negative starting 1989, signaling worsening income distribution. If the distribution had remained the same, poverty would have declined by over 5.5 percent between 1989-92, the period with the worst redistribution component, instead of by just 2.5 percent. After 1992, the distribution component remained negative but much smaller (see figure).

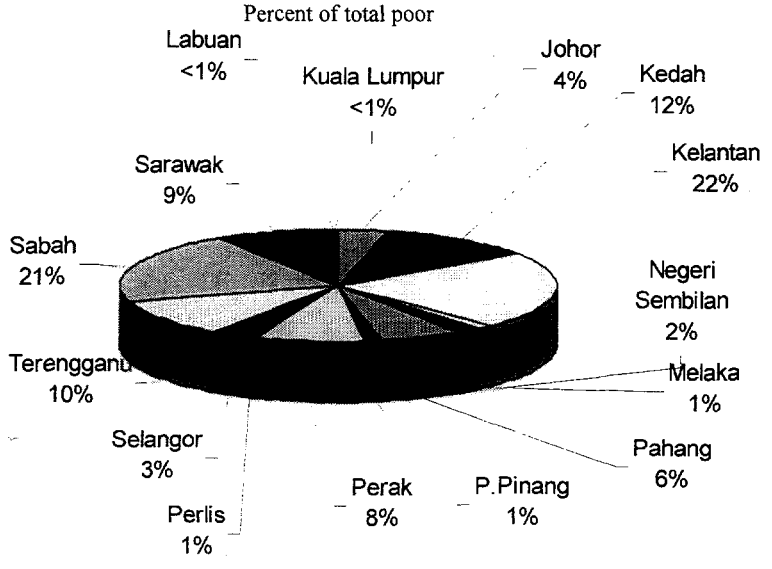
Decomposition of Poverty Reduction into Growth and Redistribution Components in East Asia



Source: World Bank staff.

whereas the bottom seven 70 percent have lost income shares (Ahuja 1997). A similar pattern is found across states—inequality declined between 1973-89 and increased between 1989-95 in most major states. States which showed continuous decline in inequality (Kedah, Penang, Perak, Perlis and Federal Territory of Labuan) are those that lost population shares during 1984-95 due to migration of the poor. The widening income gap was mainly due to the difference between the growth rates of the rural and urban economies—almost all modern and urban-based sectors registered double-digit growth rates, while agriculture grew only by 2 percent per year.

Figure 3.12: The Distribution of Poor across Malaysia, 1997



Note: Poverty line used is the official poverty line at RM425 per household per month for a household size of 4.6 at 1995 prices. This translates into RM 98 per person per month, close to $2.5/day using purchasing power parity exchange rate.
Source: Malaysia Household Income Survey, 1997.

3.59 ***The poor are mainly rural and concentrated in a few states; but they are literate and show no gender bias.*** There is clear regional concentration of the poor (Figure 3.12). Kelantan, Terengganu, and Sabah accounted for about 27 percent of the poor in Malaysia in 1984; this share increased to 50 percent in 1997. Another 25 percent of the poor lived in Perak, Kedah, and Sarawak. Also, over 75 percent of the poor lived in rural areas in 1995; and poverty was three times higher among farmers. Poor households have a larger family size—the headcount index is more than double the national average in families with more than seven children. Unlike most other countries including the East Asian countries, Malaysia's poor are relatively educated. Also unlike other countries where poverty is concentrated on the female population, Malaysia's poor are both men and women. Over 65 percent of poor household heads had at least primary education, and the mean schooling years for the poor, at about 6.5 years, is very close to that of the population as a whole, at about 8 years. Moreover, women have benefited relatively equitably from rapid economic growth—they have about the same income and access to social services. Female life expectancy is about five years higher than males; infant and maternal mortality has declined steeply.

3.60 ***The high rate of employment has contributed to social protection.*** Malaysia had virtually reached full employment prior to the crisis. To meet the labor needs of the growing economy, the government adopted a more liberal foreign labor policy—over one million legal and about 800,000 illegal foreign workers were in Malaysia in 1997, about 2 percent of the labor force. Reflecting the sectoral growth in the economy, over 50 percent of total workers were employed in manufacturing, construction, wholesale and retail trade and hotels and restaurants; only 15 percent were employed in agriculture.

The Malaysian Safety Net

3.61 The main components of the social safety net are:

- free and accessible health care and education;
- rural development;
- welfare programs for the hardcore poor;
- social assistance programs for elderly, disabled, orphans, and other vulnerable groups;
- flexible labor market;
- retraining and retrenchment benefits for the unemployed;
- provident fund for workers in the formal sector;
- pension for workers in the public sector.

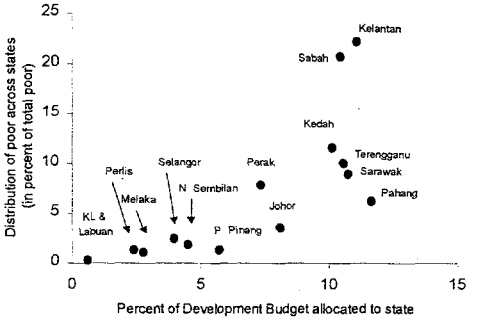
3.62 ***The Malaysian poverty reduction strategy is well rounded and aims to increase the productivity and self-reliance of the poor.*** The government's philosophy of social protection is to build human capital by providing universal basic education and healthcare, selectively granting low-cost housing, improving infrastructure (especially in rural areas), providing income-generating schemes to the poor, and limiting income transfers to the hardcore poor or unemployable poor (Box 3.4). Heavy public investment in education and quality health care for all citizens of Malaysia can be singled out as the main component of the social policy to eradicate poverty and reduce inequality. This, in turn, has contributed to Malaysia's spectacular economic growth.

3.63 ***Social assistance programs to the poor have been adequate in scale and in scope...*** Social assistance encompasses a variety of programs meant to support the poor by promoting rural development, assisting in nutrition and education of their children, providing low-cost housing, and helping vulnerable groups such as the elderly, disabled, single mothers, and orphans. Overall income-tested social assistance spending in Malaysia in 1997 was around RM650 million (Table 3.4). If micro-credit programs, which are similar to social assistance programs, are included the total expenditure comes to about RM750 million. This was expected to go up to about RM800 million by 1998 and represents less than 2 percent of current spending.

.... and regional budgetary allocations continue to be further targeted to match needs. The government's strategy for balanced regional development is directed at diversifying the economic base of the less-developed states by investing in infrastructure, including road, water, and power. The Ministry of Rural Development (MRD), which oversees most safety net programs, gives priority to the seven poorest states namely, Kelantan, Sabah, Kedah, Terengganu, Sarawak, Perak and Pahang (as reflected in Figure 3.13).

These states constitute up to 72 percent of the MRD budget for the Seventh Malaysia Plan Development Expenditure, and each of these states (with the exception of Perak) was allocated no less than 10 percent of the total development budget (compared with an average of 5 percent for the other states, excluding Federal Territory). There is still some discrepancy, however, between social allocations and poverty alleviation needs. For the Seventh Plan period, state-wise budget allocations of MRD show that three poorest states—Kelantan, Sabah, and Terengganu—which account for over 60 percent of the poor and over 75 percent of the hardcore poor, were allocated 32 percent of total development budget; and six states—Pinang, Melaka, Negeri Sembilan, Johor, Perlis, and Selangor—which account for about 8 percent of the poor, were allocated 28 percent of budget, excluding multi-state projects (Figure 3.13).

Figure 3.13: There is some Discrepancy Between Social Allocations and Needs across States



Source: Ministry of Rural Development, Seventh Malaysia Plan.

3.64 ***Social insurance schemes include pension, social security, and some retrenchment benefits; there is no unemployment insurance.*** Malaysia has three main pension/social insurance schemes—the Employment Provident Fund (EPF) which covers the entire labor force in the formal private sector, the Pension Trust Fund for retired civil servants, and the Armed Forces Fund for retired military personnel. The EPF is a mandatory contributory provident fund in which 23 percent of gross earnings of employees are deposited. Of the total EPF savings, 48 percent is contributed by employees and 52 percent by employers. There are three different accounts within the EPF: Account 1 holds 60 percent of the savings and cannot be withdrawn before the retirement age; Account 2 holds 30 percent of the savings and can be withdrawn every five years strictly for house purchase/renovation; Account 3 holds the remaining 10 percent of total savings and can be withdrawn for financing expenses of major medical catastrophies. At the end of 1997, EPF membership stood at 8.27 million, an increase of over 7 percent from the previous year. The stock of contributions in 1997 stood at RM131 billion, up by over RM16 billion from 1996.

Box 3.4: The Malaysian Philosophy of Poverty Reduction

A well rounded strategy: In 1990 the National Development Policy (NDP) was launched as the successor of the New Economic Policy (NEP). The ultimate goal was to achieve national unity by directing anti-poverty programs at the hardcore poor, while other programs for the eradication of poverty in general continued, mainly through rural development where most of the poor live. The government's strategy gives priority to income-generating projects, improvement of infrastructure and amenities, and programs for attitudinal change among the poor. Welfare assistance is also provided to hardcore poor households. The rapid expansion of the economy facilitated these efforts, while non-governmental organizations and the private sector complemented them by implementing their own poverty programs.

Raising the income of the poor: Rural poor benefited from the Integrated Agricultural Development Projects, the provision of agriculture infrastructure, replanting schemes, land consolidation and rehabilitation, and support services. These programs led to increased productivity of agricultural labor. Efforts to eradicate hardcore poverty was spearheaded by the PPRT, introduced in 1989 to meet the varying needs of this group. It encompasses income-generating projects and the inculcation of positive values, such as self-reliance and hard work, plus direct welfare assistance. The government launched the Amanah Saham Bumiputera (ASB)-PPRT loan scheme in 1992 which enabled each hardcore poor household to obtain an interest-free loan to increase their income.

Partnership with NGOs: In addition to PPRT, with the support of private companies, NGOs implemented various programs, in particular Amanah Ikhtiar Malaysia (AIM) and the state-based Yayasan Basmi Kemishinan (YBK). These complemented the government's efforts to reduce hardcore poverty. AIM provided interest-free loans to hardcore poor households so they could raise poultry and livestock and open small-scale businesses such as food retailing and vehicle servicing and repair. YBK programs focused on skill training with guaranteed employment, educational assistance, and better housing. Recognizing the effectiveness of AIM, the government will provide it with an interest-free loan to increase its capital fund.

Access to basic amenities: The government also implemented programs that improved the poor's quality of life by extending coverage of basic amenities and services, particularly to rural areas. Access to safe water or to a health clinic (within 9 km from each household) is pretty much universal. Rural areas are also served by mobile dental teams and dispensaries, village health teams and the flying doctor service to remote areas. Access to educational facilities to the poor is ensured—households are within 9 km of a primary school and have good access to secondary schools. In addition, various kinds of educational assistance such as scholarships and free textbooks, food and accommodation, and uniforms, were provided to students in poor households.

Source: The Seventh Malaysia Plan.

3.65 Like many developing countries that do not support the Western type of social protection, Malaysia has been reluctant to introduce an unemployment insurance,[8] fearing disincentive to work and increased production costs. Instead, the government maintains a flexible labor market by linking wages to productivity—this policy has worked well during the crisis by keeping unemployment low. The government also provides retraining opportunities for retrenched workers and bears the entire direct costs of retraining. Further, according to Section 69 of the Employment Act, 1955, retrenched workers must be paid layoff benefits, or compensation. According to a labor report released by the Human Resources Ministry, a total of RM119 million in severance pay and retrenchment benefits was paid to 28,196 workers by 1,223 employers between January and May 1998 in peninsular Malaysia. Thus, on average, each retrenched worker was paid RM4200. This compares well to a basic unemployment insurance.

Social Risk Management for a Brighter Future

3.66 Recent trends in the evolution of trade and technology have created great opportunities for improvements in welfare around the world. The other side of the coin, however, reveals that the exact process that increases the opportunity for welfare improvement also increases the variability of the outcome for society as a whole and even more so for specific groups (Box 3.5). This was demonstrated by the recent financial crisis in East Asia. However, although growth was largely behind the reduction in

Box 3.5: Social Protection as Social Risk Management

As countries develop and globalize, they become more vulnerable to systemic risks The role of the government in social protection becomes one of social risk management. This raises a new role for government about social protection: helping individuals, households, and communities to better manage income risk. Social risk management consists of public measures intended to assist individuals, households, and communities in managing income risks in order to reduce vulnerability, improve consumption smoothing, and enhance equity while contributing to economic development in a participatory manner. Social protection seeks to: (i) reduce vulnerability of low-income households with regard to consumption and access to basic services; (ii) allow for better consumption smoothing over the lifecycle for all households and for more equal welfare distribution of households; and (iii) enhance equity particularly with regards to the exposure to shock and the effects of shocks.

Public interventions for more effective risk management can be: indirect—fostering the capacity of households to reduce variability of income—or direct—providing transfers, implementing public works, mandating old-age income insurance. Measures can be provided by public or private sector, either formal or informal, ex-ante (prevention and mitigation) to reduce income variance dissavings, such as portfolio diversification or insurance or ex-post (coping interventions once damage has occurred) such as transfers, public works. While income risk is considered to be individual, the measures to manage the risk are largely co-operative or social. The government has many important roles in social risk management. The most important are to: (i) facilitate the set up of financial market institutions; (ii) establish a regulatory and supervisory framework (iii) provide risk management instruments where the private sector fails (e.g., unemployment insurance) or individuals lack the information of self-provision (e.g., pension, because of myopia in individuals' behavior); (iv) provide social safety nets and large scale transfers in the case of main or recurrent shocks; and (v) provide income distribution mechanisms when the market outcome is considered unacceptable from a societal welfare point of view.

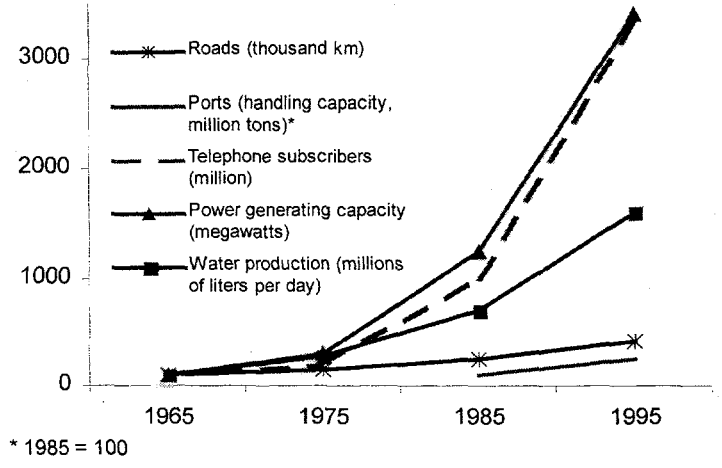
Table 3.4: An Integrated Approach for Social Risk Management

Arrangement Strategies	Informal/Personal	Formal/Financial market-based	Formal/Publicly-mandated/provided
Risk reduction			
	*Less risky production *Migration		*Labor standards *Vocational and educational training *Labor market policies *Disability policies
Risk mitigation			
Portfolio	*Multiple jobs *Investment in human, physical, and real assets	*Investment in multiple financial assets	*Multi-pillar pension systems *Social Investment Funds *Asset transfers
Insurance	*Marriage/family *Community arrangements *Share tenancy *Tied labor	*Old-age annuities *Disability/Accident	*Mandated/provided insurance for unemployment, old age, disability, survivorship, sickness, etc.
Hedging	*Extended family *Labor contracts		
Risk coping			
	*Selling of real assets *Borrowing from neighbors *Intra-community transfers/charity *Sending children to work *Dissaving in human capital	*Selling financial assets *Borrowing from banks	*Transfers/Social assistance *Subsidies *Public works

Source: Holzmann and Jorgensen, 1999.

poverty in Malaysia over the past decades, the existing safety net—based on a comprehensive public health system, free basic education, and transfer and income generation schemes for the rural poor and vulnerable—proved resilient to the crisis. An important component of this safety net was the productivity-linked wage which allowed flexibility in the labor market and thus kept unemployment low. Enforcement of retrenchment benefits, however, could be strengthened to ensure that retrenched workers are paid in a timely manner. Moreover, safety net programs that grow automatically with a crisis and are better targeted to urban areas, where future shocks are more likely to emerge, can be implemented to allow greater flexibility during crises (see chapter 1).

Figure 3.14: Growth of Infrastructure Stocks, 1965-1995
Index 1965 = 100



Source: Naidu and Lee, 1997.

3.67 ***The rising trend in inequality is being addressed.*** As the economy develops, it will be important to ensure that all income groups benefit equally. In order to maintain an equitable growth, the government is allocating larger public resources to states that are lagging behind, given that inequality is regional (Malaysia 7th Plan). With growth being driven by high-tech industries, building up the skills of people in lower income groups will also be important to allow them to participate in this development. Although 60 percent of the poor have primary education, this is not enough to allow their income to grow as fast as the rest of the economy.

F. Pursuing Sustainability in Infrastructure

3.68 Over the last two decades infrastructure has been a priority in Malaysia because the government recognized its essential role in increasing the pace of economic development. Since government alone was unable to sustain the high targeted levels of investment, it turned to the private sector and soon became an Asian leader in privatization, achieving a quantum leap in infrastructure expansion. However, these accomplishments have come at a cost. The 'Asian tiger' years of economic growth and increasing demand for infrastructure services may have induced an excessive level of government involvement in private infrastructure projects. Not only has this created an alarming level of direct and

contingent liabilities for government, but also the urgency of development needs led to methods for awarding concessions that entailed little or no competition—a strategy which may lead to broader structural inefficiencies. Since the onset of the crisis, infrastructure development has ground to a virtual standstill providing a perfect opportunity for Malaysia to realign its infrastructure strategy to suit the new economic reality, and to better reflect international recommended practices. This would be consistent with the principles of competition, efficiency and productivity clearly outlined in the Seventh Malaysia Plan.

Strategy and Achievements

3.69 ***Infrastructure growth has been exceptional.*** Until just over a decade ago the provision of infrastructure in Malaysia was almost entirely the public sector's responsibility. As a result of the privatization strategy of the mid-1980s, based on the concept of "Malaysia Incorporated", the provision of infrastructure accelerated between 1985 and 1995; the absolute increase in capacity was greater, in most sectors, than existing capacity had been up to that point (Figure 3.14).

3.70 ***Infrastructure still accounts for a third of the government's development budget.*** The Federal and State governments finance transport and water expenditures; electricity investments are financed by non-financial public enterprises; and communications expenditures are excluded from public expenditures because they are largely privatized. Despite greater reliance on the private sector, the share of infrastructure (transport, water and sanitation, and electricity) in the development budget during the Seventh Plan (1996-2000) remained the same as in the Sixth Plan (Table 3.5); but the private sector is expected to invest RM68 billion on infrastructure (excluding power which is undertaken by Independent Power Producers), three and a half times the RM19 billion that the public sector plans to spend on infrastructure.

Table 3.5: Public and Private Financing for Infrastructure and Energy, 1991-2000

RM millions	6th Plan 1991-1995 Expenditure	7th Plan 1996-2000 Allocation	Private sector investment in privatized projects: 1996-2000
Transport	11.6	15.5	38.3
Roads	*7.6*	*9.8*	*17.5*
Rail	*1.7*	*3.4*	*10.6*
Ports	*0.4*	*0.5*	*4.2*
Airports	*1.8*	*1.3*	*6.0*
Urban transport	*0.1*	*0.5*	--
Water supply and sewerage	2.8	3.7	4.3
Telecommunications	0.0	0.0	25.6
Total infrastructure and utilities	14.4	19.2	68.3
Electricity *	17.6	26.3	--
Total	32.0	45.5	--
Share of development budget	27.2%	27.9%	--

*In the electricity sector, substantial expenditures are undertaken by non-financial public enterprises; in power generation, private sector investment undertaken by Independent Power Producers, not shown above, is about 50 percent of total investment.
Source: Sixth and Seventh Malaysia Plans.

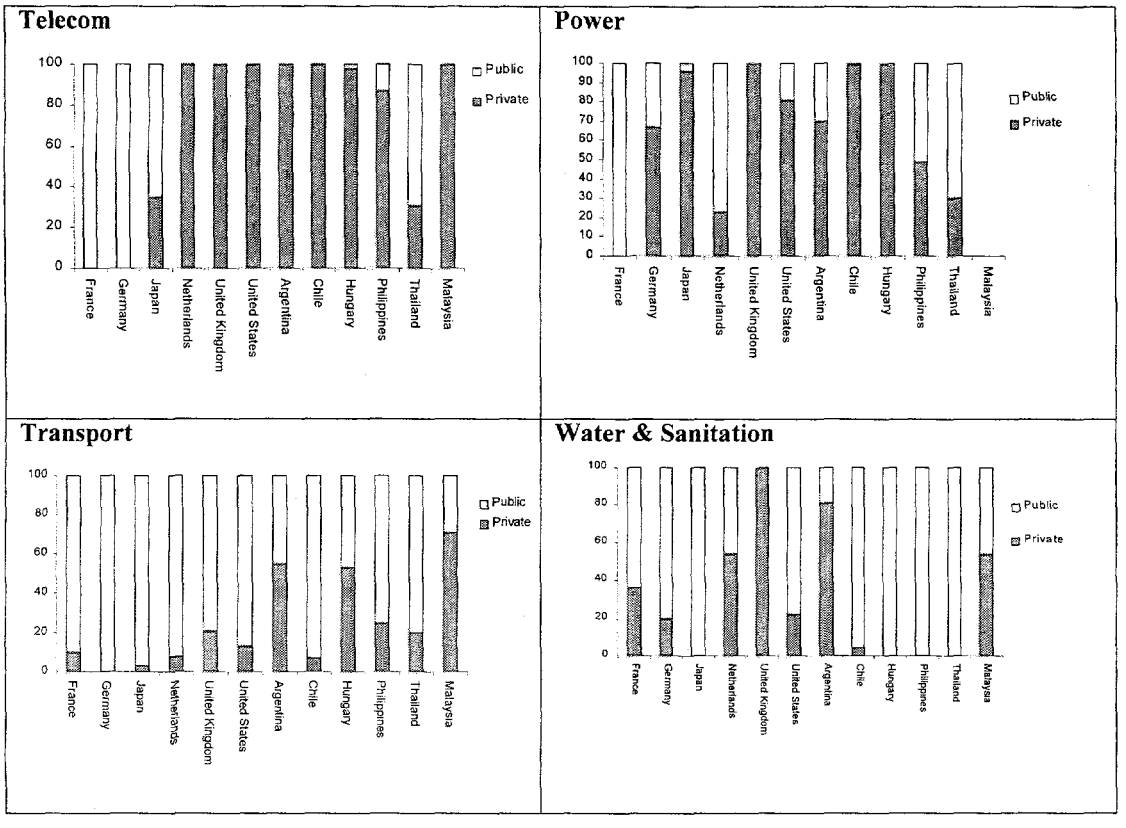
3.71 ***Malaysia's privatization strategy has unique characteristics in scope and scale compared to leading developing countries***. Chile, for example, had a very different strategy in infrastructure privatization (Box 3.6). Except for the power sector, the private share of infrastructure financing is higher in Malaysia than in many developed countries, and most developing countries (Figure 3.15). For example, during the Seventh Plan period, the private sector's share of the infrastructure market was targeted at 71 percent in transport, 54 percent in water supply and sewerage, and 100 percent in telecommunications. In power generation, the share of private investment by Independent Power Producers was 50 percent during 1990-95 and continues at this level in the Seventh Plan period. In contrast, other countries had rather small private investment in transport or water and sanitation. However, these shares may overstate the true extent of private participation. Similar to other countries, establishing the true extent of private sector participation in the infrastructure market is difficult due to the many levels and types of government support—soft loans, equity investment, direct lending through bank and provident funds, explicit and implicit guarantees.

Sectoral Options for the Future

Toll Roads

3.72 ***In Malaysia, the next generation of toll roads will face increasingly difficulties***. As of October 1998, concessions were signed for 26 toll bridge and expressway projects. Of these, 12 projects are open to traffic, six are under construction, and the remaining eight are under negotiation. The full program is expected to cost about RM39 billion and create about 1700 kilometers of toll roads. Roads under the toll road program represent only about two percent of the total length of the country's road network but it is not clear that the government's toll road strategy—privatization using the BOT model—is sustainable. Some earlier roads, including the major North-South Expressway, succeeded financially, but more recently contracted roads will face financial difficulties due to the recent economic downturn—which has reduced demand for new highways and affected users' willingness to pay tolls—and to the long-term economics of the next generation of toll roads—typically, toll roads form a small fraction of the road network in a country, so when traffic levels fall below a threshold (which varies by country characteristics and toll rates charged), their viability declines rapidly.

Figure 3.15 Public and Private Investment in Infrastructure across the World, 1995
(as a percent of total investment)



3.73 ***Lessons from other countries.*** The Asian crisis not withstanding, worldwide few countries have succeeded in using a stand-alone BOT model to deliver a large scale highway program on a privatized basis. This is due to the complex relationships between toll rates, user demand, and financing structures for the project, especially in the early stages of implementation. In 1998, only one new toll road was brought to successful financial closure in the developing world (in Croatia). Recently Mexico launched a major toll road program which stressed the state-owned banks that had financed it. In Bangkok, Thailand, private expressway financing has been greatly scaled back since the government and private concessionaires failed to agree on and adhere to contractual terms. Even on heavily traveled roads, such as the one from Guangzhou to Shenzen in Southern China, cost overruns have led to unanticipated financing requirements. Therefore, the government's involvement is essential to increase financial viability, but it should minimize budgetary constraints while creating incentives for efficient investment and operation.

Box 3.6: Malaysia and Chile: A Different Experience in Infrastructure Privatization

Difference in motivation—gap filling vs. competition: Malaysia and Chile differ in their philosophical motivations for privatization. Whereas Chilean privatization is integrally linked to a competition policy, competition within the infrastructure sector is virtually absent in Malaysia. Instead, privatization in Malaysia has been, and continues to be, driven by the aim to fill a perceived financing gap, although other considerations including socio-economic factors are at play as well.

Difference in sectoral emphasis: Although the share of privatized infrastructure investment in Malaysia and Chile are at comparable levels, significant sectoral differences exist between the two countries. Malaysia is unusual in targeting its privatization initiatives to the "hard" sectors: transportation and water/sanitation. Unlike Chile, where the power sector is almost entirely private but transportation and water/sanitation investments continue largely in public hands, Malaysia has pursued nearly the reverse strategy. The sectoral difference is explained by the difference in motivation. Chilean privatization of transport and water has been limited because competition in these sectors is difficult to achieve.

Difference in approach within sectors: Also, because of difference in motivation, there are differences in privatization approaches within a sector. In the electric power sector, power generators compete to supply to a power grid in Chile. In Malaysia, the five private power producers have long-term contracts with Tenaga giving them a virtually assured market for the power they produce irrespective of efficiency. So while Chilean authorities have been concerned with maintaining adequate separation between generation, transmission and distribution of electricity, until recently, unbundling power sector services has not been a high priority policy matter in Malaysia.

Source: World Bank.

3.74 Countries which had moderate success in leveraging private participation in highway development used the regional transport utility concept to cross-subsidize different transportation segments within their jurisdiction geographically and temporally (international experience shows that toll road and rail projects rarely generate positive cash flows in their early years). This model has been piloted by the Provincial Chinese Communications Ministries in tolled highway development. In several provinces, Provincial Toll Road Companies securitize existing toll road assets on domestic and Hong Kong stock exchanges, using the proceeds to finance new toll highway development. Another approach is to use toll road companies that operate multiple roads. France and Spain, two countries that have more extensive toll road programs, have experimented with this system, relying extensively on private operators.[9] It is important to secure political support for tolling. One strategy to generate a stable flow of revenues at reasonable toll rates is to utilize an elasticity-based approach that allows increasing tolls when demand is most able to absorb it—when demand is high--and decreasing tolls when demand is low—to encourage usage. This is the basis for "congestion pricing" and may have more application near urban settings. Capturing excess toll revenues when demand is high could facilitate a "rainy day" fund to provide revenue support when demand, and thus revenue, is low. Alternatively, France utilizes an inflation-based approach, which allows tolls to increase at 95 percent of the CPI. If public tolling is infeasible, the government may consider a "shadow toll program" as developed in Britain, whereby the government makes direct payments to concessionaires according to revenue guarantee arrangements.

Urban Transport

3.75 ***Existing urban transport projects suffer from financial and structural problems.*** Today, all of the urban rail projects in Kuala Lumpur face severe financial difficulties. This modern city is the employment center of the Klang Valley and is served by a network of rapid rail systems and high quality roads, mostly built with private sector participation. The government has considerable financial exposure to capital costs for the major light and commuter rail projects under construction in the city, arising from projects defaulting and being reverted to the government. This exposure is estimated at RM7 billion (US$2 billion) and at RM13.5 billion (US$3.5 billion) if projects under construction are finalized (see Draft Kuala Lumpur Transport Sector Report, November 1999, World Bank).

3.76 The rapid growth of infrastructure and real estate development has abated recently because the economic crisis has raised costs of debt and imported inputs, and lowered ridership and revenues. Even so, to a large extent, these privatized projects were inherently unviable on a total cost basis. They have many financial and structural flaws: revenue projections were based on overly optimistic ridership projections; physical interfaces between rail-based systems are too inconvenient to compete favorably with private vehicles. The lack of an integrated, sector-wide pricing structure and fare medium means that public transport cannot compete with private vehicles and rail transport compares unfavorably with bus transport.[10] Finally, rail concessionaires have been undermined by exposure to directly and indirectly competing projects, even though this contradicts the stated policy—to support public transport development.[11]

3.77 These challenges are not surprising given that only a handful of urban rail projects in the world contribute to their capital debt service obligations—Hong Kong, Seoul, and Manila (Table 3.6). Metros achieve the greatest degree of financial sustainability in relatively high-income countries with densely used systems. This usually requires a population of at least 4-5 million, an expanding city center, a growing national economy, and an average income of US$2,000 per capita. Financial viability also requires total passenger flows of at least 700,000 trips per day, door-to-door journey times able to

Table 3.6: Metro Performance in Selected World Cities

	Economic Rate of Return	Revenue Operating Cost Ratio	Income Per Pass (US cents)	Cost Per Pass (US cents)	Cost per Km (US cents)	Staff per pass/yr.	Corridor Vol/day (000's)
Hong Kong	18.5	2.2	40.5	19.0	2.0	8.5	9,121
Seoul	14.7	1.4	21.5	15.0	1.7	9.1	12,705
Pusan	14.2	1.0	20.7	20.0	2.6	14.4	3,615
Santiago	13.5	1.6	16.8	11.0	2.0	10.1	2,700
Manila	11.4	1.8	14.0	8.0	1.0	12.5	3,309
Mexico	11.4	0.4	4.1	10.0	1.2	6.4	10,184
Sao Paulo	10.7	0.6	9.1	14.0	1.9	15.0	11,245
Porto Alegre	8.9	0.2	6.6	35.0	3.2	36.1	850
Rio de Janeiro	7.1	0.5	11.3	23.0	4.6	33.0	4,299
Calcutta	2.8	0.4	8.1	18.0	3.0	high	992

Source: World Bank staff.

match or better that of private transport, and an established system on which to build new links. Kuala Lumpur lacks many of these elements, making financial self-sufficiency difficult.

3.78 ***Options for more efficient long-term investment in urban transport.*** The government could create an urban transport fund, a dedicated and locally-targeted revenue stream to support transport development in the KL metropolitan area. In addition to general fund support from the KL Department of Public Works and central government, the KL urban transport fund could be financed by new sources of revenue, including: a gasoline tax surcharge—a small tax (e.g., RM0.10 per liter) could generate large revenue given its large base[12]; an area road pricing scheme (e.g., RM0.10 per vehicle) which will link specific transport investment costs to actual users (this needs to be combined with strengthening of public transport provision to provide users with choices); and a parking tax (e.g., RM500/space/year). These measures could generate half a billion ringgit per year and would progress towards sustainability of the overall KL transport strategy: by generating revenue for public transport and discouraging the use of personal vehicles in the congested central business district. The revenue base could also offer an opportunity for the strategic authority responsible for the fund to issue non-recourse revenue bonds for the sector, as its creditworthiness improves.

3.79 Different transport modes could be better coordinated. Lessons from the Metropolitan Transportation Authority (MTA) in New York, a relatively successful transport utility, may be relevant for Kuala Lumpur. The MTA operates the subway, bus and commuter railroad systems, which run chronic operating deficits, but it also owns the Tri-borough Bridge and Tunnel Authority (TBTA). TBTA generates operating profits well in excess of half a billion U.S. dollars per year, which are directed to subsidize transit operations or enable infrastructure investments. For Kuala Lumpur, it may not be necessary or even appropriate to place all the modes of transport under one authority; however, some elements of the transport network could be jointly concessioned while ensuring that the planning for the whole system is coordinated by a central public authority. But to take advantage of this concept, coordination among the different transport modes needs to improve.

Sanitation

3.80 ***Privatization of sanitation services is innovative but costly.*** Malaysia has taken important steps towards privatization. For water services, which are under the provincial authorities, several water supply and treatment projects have been constructed on a build-operate-transfer basis. Sewerage is under national authority, but local governments were responsible for providing services. Most lacked necessary financial or technical resources. As a result, physical plants were not maintained, and needed investments were not undertaken. In 1994, the Indah Water Konsortium (IWK) national sewerage concession was awarded and offered an innovative approach to dealing with an increasingly urgent sewerage problem. The level of investment and quality of service improved, but IWK quickly began to encounter problems that have since become more serious and threaten the financial viability of the concession (Box 3.7).

Box 3.7: The Benefits and Limits of the Malaysian Approach to Privatization —The Case of the National Sewerage Project

In 1994, the unsolicited Indah Water Konsortium (IWK) national sewerage proposal offered an innovative, if unorthodox, approach to an increasingly urgent sewerage problem. The proposal was processed and approved rapidly, the concession rights were to provide for sanitation services only, not water services. The contract was negotiated directly with a potential sponsor, it was national in scope, and a targeted rate of return was guaranteed by the government. Although the award yielded dramatic improvements in investments and services, problems quickly arose that threaten the concession's financial viability. Consumers protested the rates, and there was a high level of non-payment. The contracted tariff structure was suspended without compensation arrangements and was reestablished only in 1997, but at much lower levels. Poor collection rates are a chronic problem, exacerbated by lack of enforcement. Compounding its revenue woes, Indah Water inherited an unanticipated magnitude of physical rehabilitation for the existing sewerage infrastructure, and in the midst of all this—IWK's ownership changed hands three times during its first four years of operation. As a result, the government made long term soft loans to IWK of more than RM450 million, in addition to other support.

The Malaysian approach runs counter to international trends and may have undermined, rather than promoted, the privatization process.

- **A competitive bidding process** might have helped to avoid the consumer backlash against higher rates. IWK embarked on a large public awareness campaign to inform the public of the scale of its investments and service improvements which eventually paid dividends in terms of positive media reporting. But competition in bidding might have accomplished this much earlier as well as revealing some of the potential problems.
- **Splitting the concession area into distinct jurisdictions** would have aided the government's capacity to regulate the private supplier. The U.K. and some developing country cities (Manila and Mexico City), have used benchmarked competition so that the regulatory authority is able to compare and assess performance of the different operators, even though the operators do not directly compete with one another.
- **Incentive regulation,** such as "price-cap" regulation, offers a strong incentive to limit costs. Guaranteeing the minimum rate of return undermines this, and creates contingent liabilities for the government.
- **Linking water and sewerage** makes it easier for private sector concessionaires to collect revenues. They can charge for sewerage services as an add-on to the water service, because consumers are more willing to pay for water utilities. In Malaysia, failure to reconcile water and sewerage authorities led to serious problems.

Source: World Bank.

3.81 ***Learning from past mistakes.*** The failure of the Indah Water Konsortium stems largely from de-linking water and sanitation—water and sanitation have not been considered together because water is state controlled and sanitation is federally controlled. Serious consideration of a regional approach that combines water and sanitation services would permit states to offer distribution concessions for water and sanitation combined to private entrepreneurs. Considerable international experience with such concessions suggests that they need to be carefully designed and they require a regulatory authority to deal with the complex issues of water and sanitation, but they can yield high pay-offs.

Power

3.82 ***The power sector in Malaysia is not competitive enough.*** New power generation technology permits smaller scale economic efficiency, and regulatory innovations have introduced a major upheaval from a vertically integrated power structure to one that unbundles the sector into generation, transmission, and distribution,[13] and fosters competition through free entry into power generation. A strong regulatory framework is required to maintain a competitive structure. This model has brought about lower prices and higher quality service, but there are some limitations. Free entry can be restricted, especially where supply depends upon access to limited resources (in particular, the

Box 3.8: Argentina May Well Have the Most Competitive Power Industry in the World

At the end of 1997, generation capacity of 19,000 megawatts was shared by over 40 generation plants. Another 14 plants with total capacity of over 5000 megawatts were expected to be operational by the end of 2001. Most of the new plants were expected to employ the combined cycle technology, which allows greater operational efficiency and is economical at smaller scales than traditional thermal and hydro powered generation. Distribution concessions were awarded to 17 principal distributors plus several smaller ones. Distributors are organized largely in line with state boundaries.

Large consumers are able to bypass the distributors. Argentina has one of the most liberal definitions of large users: thus, many relatively small users are able to directly contract with generators. Two categories of large users are recognized: those with a requirement of more than 1.0 megawatt and a minimum annual consumption of 4380 megawatt hours must contract directly for at least 50 percent of their needs; those with peak requirements of between 0.1 and 2.0 megawatts must contract for all of their energy needs directly with generators. Most contracts, in practice, are of relatively short duration since prices have been falling.

The competitive system is held together by a transmission and dispatch system and an overall regulatory framework for ensuring coordination and efficient pricing. The National Interconnected System covers about 90 percent of the Argentine population and the rest is served by a smaller grid. The system is managed by Compania Administrdora del Mercado Mayorista Electrico S.A. (CAMMESA), which is owned half by the government and the rest by various suppliers and users. While CAMMESA has been successful in operating the spot market for electricity, through which the various generators supply power to the transmission grid, expansion of the network has been more difficult to coordinate since it needs joint approval by several parties.

The regulatory task includes setting price caps for the transmission and distribution segments of the network. It is also intended that the regulator will supervise the periodic re-auctioning of the distribution networks. To augment the independence of the regulator, high standards have been set for qualifying as a regulator, the regulators have fixed terms and cannot be easily removed, the terms are staggered in the style of U.S. Public Utility Commissions to provide continuity to the regulator's activities, and an independent source of funding has been created through a levy on the various industry participants.

Source: Duff and Phelps 1998 and Estache and Rodrigues-Pardina 1998.

rights to water). In Malaysia, electricity is supplied by three public enterprises,[14] each operating as a monopoly in its own area, and private participation exists only in the generation phase. But since the independent power producers (IPPs) supply wholly through long-term contracts, they do not compete with one another on a continuing basis. Also, there is no competition in power distribution. In fact, Malaysia has much to learn from the rapid worldwide spread of the competitive model (Box 3.8). But the government must determine whether to adopt a more competitive model and at what pace.

3.83 ***Moving toward a more competitive model?*** Ongoing actions in the power sector seem contradictory: some are laying the foundation for introducing competition and others are reinforcing the existing structure. The proposed Independent System Operator (ISO) moves in the direction of unbundling the sector and is a key step to introduce competition. But the sale by Tenaga of its power generating assets to existing IPPs and the possibility of adding new IPPs could further limit future competition if this new capacity sells power exclusively through long-term contracts to Tenaga and the other utilities. If Malaysia chooses a more competitive model, it must resolve how to: (i) deal with stranded assets in the transition period; (ii) finalize the institutional and pricing rules for setting up the ISO; (iii) organize regional distribution companies and their pricing regime; and (iv) introduce a regulator to ensure fair access and pricing.

3.84 First, to create more competition in power generation, Malaysia would have to deal with its stranded assets from past contracts—assets whose economic value potentially declines after deregulation, either because the market test shows they are no longer needed, or because they face greater market risks. Although past contracts are only implicit, considerable controversy surrounds how much compensation is due to the owners of the stranded assets. Where the contracts are explicit, they must be honored, which necessitates identifying the level and source of funding—two choices are taxpayers, or consumers. In general, the consumer pays through a levy on the electricity bill, although this need not raise the cost of electricity if competition lowers the basic charges, but it will delay the benefits of lower overall bills. Also, it favors larger consumers—their benefits will be larger and more rapid because they have wider opportunities to source power in a deregulated environment.

3.85 Second, creating and operating an independent system operator (ISO) is crucial. This has, in practice, proven to be a simpler task than fostering competition in generation. The ISO ensures equal access to transmission lines and ensures the economic utilization of generation assets through overseeing the functioning of a spot market for electricity. Although the details of the spot market vary somewhat across countries, the principle is the same everywhere. Generators bid for defined time slots by declaring their marginal cost of supply. The ISO dispatches requirements for that slot choosing the generators with the lowest marginal costs; all generators receive a price equal to the marginal cost of the highest cost supplier, thus creating an incentive for efficiency. The price paid by the electricity distributor for electricity received from the ISO is regulated and equals some variable cost elements (including the spot price of the electricity in the relevant time periods) and transmission charges, or "tolls" that are limited through a price cap formula.

3.86 Third, competition also occurs through direct contracting between generators and the larger users of electricity as well as with distributors who then retail power to final consumers. Typically, these contracts are not regulated and hence the price charged and length of the contracts is determined through direct negotiation between the buyer and the seller. The spot market for electricity and the direct contracts provide benchmarks for each other and, where competition is effective, average prices in the two markets should converge. Some key regulatory issues, however, do arise. The generator will not typically transmit electricity to the customer buying the power. Rather, the customer "will take physical service from the local utility which will deliver power commingled from an undifferentiated array of generators who are making common, simultaneous use of the

transmission grid and distribution facilities" (California Public Utilities Commission 1996). Thus, the generator requires the agreement of the local utility to conclude its obligation to its customer; the pricing of such access requires regulatory oversight.

3.87 Finally, distribution rates are typically regulated through a price cap formula. Once again, certain variable costs of the energy are passed through while the fixed charges for distribution (for connection and making capacity available) are capped. Competition between distributors is increasingly permitted, especially for larger consumers, although as the Argentine example shows, small consumers are increasingly benefiting from choice of energy sources.

3.88 Recently the government has demonstrated its commitment to restructure the power sector and open it up for competition. A study on the restructuring of the Electricity Supply Industry is currently going on and other major works are being undertaken to review the regulatory framework, market design and commercial arrangement for operationalizing the restructuring of the electricity supply industry. This encompasses amending the existing Electricity Supply Act 1990, introducing new regulations and codes of conduct for relevant parties, and creating new institutional establishments such as the Energy Commission. A National Steering Committee on Restructuring of the Electricity Supply Industry comprising heads of government agencies, utilities and IPPs has also been formed to oversee the restructuring efforts.

Competition, Regulation, and Contracting

3.89 ***Contracting procedures in Malaysia are different from international norms.*** Liberalized entry into infrastructure has not meant free entry: private firms that want to develop or operate infrastructure must contract with the government. Contracting between the public and private sectors in Malaysia for infrastructure provision, operation, and maintenance has taken various forms—leases, concessions, contractual arrangements, and licenses—and is undertaken by the Privatization Unit of the Economic Planning Unit (Box 3.9). Foreign participation has been limited due to explicit and implicit restrictions. Malaysia has avoided open competitive bidding in the belief that it

Box 3.9: Contracting—the Malaysian Approach

Either the public or the private sector can initiate a privatized project in infrastructure (unsolicited proposals). The initiating party submits a feasibility study to the Economic Planning Unit (EPU) who calls for a restricted tender. The choice of approach and of the private contractor (even in the case of restricted tender) is made at the highest political level.

- The private company (or companies in the case of a restricted tender) must undertake a detailed feasibility study at its own expense and prepare a detailed proposal.
- Two committees established by the Privatization Unit, the Technical Committee and the Financial Committee, evaluate the detailed proposal and undertake negotiations with the private firm. The committees then prepare a joint recommendation and submit it to the EPU.
- The EPU submits the recommendation to the Cabinet, which either accepts or rejects it.
- If accepted in principle by the Cabinet, the privatization proposal goes through a round of detailed negotiations between the private company and the relevant ministry.
- Upon completion of the negotiations, the privatization proposal is again submitted for approval by the Cabinet, which even at this point may reject it.
- If the Cabinet accepts the draft agreement (a lease or a concession), the ministry and the private company enter into a contract.

Source: G. Naidu, 1997.

would cost more, take more time, and harm the progress of the New Economic Policy objectives by impeding the Bumiputera business community.

3.90 The process of concessioning, contracting and divestiture has not been very transparent. Privatization of infrastructure involves both sale of equity in existing infrastructure enterprises (divestiture) and concessioning private funding to develop new infrastructure facilities and services. Most of the privatization exercises in Malaysia—such as the issuance of telecom licenses, IPP concessions, BOT road projects, or divestiture of ports—have tended towards direct negotiations between the government and a pre-selected private firm. The Privatization Masterplan, while viewing competitive negotiations and sole-source negotiated deals as being among the ways to contract for private provision of infrastructure, failed to point out the downside effects of not awarding contracts by competitive bids. It also did not specify the circumstances under which direct negotiations or competitive negotiations may be preferred to competitive tenders.

Box 3.10: Privatization of Port Klang: from Competitive to Direct Negotiations

The privatization of the facilities at Klang Port Authority (KPA) was undertaken in three stages spanning 1986 through 1994, encapsulating the general trends in Malaysian infrastructure privatization. In the first exercise, the container facilities of KPA were privatized as Klang Container Terminal (KCT) in 1986. In this exercise, essentially a sale/lease arrangement, five companies were invited by the government to bid for the project. The winning bid was selected on the basis of the highest offer price. Although the privatization of KCT did not strictly meet the requirements of a competitive tender process—in essence it could be classified as a case of competitive negotiations—it was certainly more transparent than sole-source contracts. In the second exercise, the then-remaining facilities of PKA were privatized in 1992. Privatization efforts were preceded by a market valuation of the targeted facilities by Price Waterhouse. As for the contracting process itself, unlike the KCT exercise, this second effort involved direct negotiations between a pre-selected consortium, now known as Klang Port Management, and the government. The consortium's initial offer appears to have been only one half the value put on the assets by Price Waterhouse. In the end, however, the government did succeed in selling the facilities at the value estimated by Price Waterhouse. However, while the government may have finally sold the assets at the value determined by an independent assessor, opportunities for a higher sale price were forgone by virtue of the direct negotiation process. The third phase of the KPA privatization was the sale of its newly developed West Port in 1994. Here a number of interested firms were encouraged by the government to form a consortium. Upon the formation of the Klang Multi Terminal (KMT) consortium, KPA was instructed by the government to hand over the facilities that had already been constructed to KMT under a sale/lease arrangement. The concession agreement also had a BOT component for the construction of new berths by KMT. Under the privatization agreement, KMT was required to pay only the construction cost of the assets and for the value of the land over a thirty-year period. In the privatization of West Port, there was neither an effort at open, competitive bidding, nor an attempt to obtain the most favorable price for the assets of KPA sold to KMT.

3.91 The practice of awarding concessions primarily on a negotiated basis is a departure from the standard government practice for contract awards. At the start of the privatization policy there were several competitively negotiated projects, but the trend shifted gradually to direct, sole-source negotiations (Box 3.10). Projects not categorized as "privatization" continue to be awarded by the Ministry of Finance's Contracts Division, the main entity responsible for awarding government contracts, and other government agencies per the Treasury (Arahan Perbenderaan) and the Administrative Instructions (Arahan Pentadbiran). All contracts awarded by government departments and

agencies are subsequently scrutinized by the office of the Auditor General. Reports on the award of contracts—including those not compliant with the tender procedures of the Contracts Division—are submitted by the Auditor General to Parliament for scrutiny and are publicized. Considering the existence of such a well-tested competitive tendering system, the question arises as to why it is not utilized for privatization projects.

3.92 The change in the award procedure for privatization projects—that is, the removal of the privatization policy from the provisions of the Treasury and Administrative Instructions—was precipitated by the controversy and criticisms which followed the award of the North-South Expressway (NSE) project to a company which did not offer the lowest bid. Since the NSE project, all infrastructure concessions have been awarded by the Privatization Unit of the EPU, which is not required to follow Treasury and Administration Instructions.

3.93 Another practice that has a bearing on transparency is the fact that in Malaysia the private sector is afforded an opportunity to initiate projects for privatization to encourage innovations. In the past, firms initiating a privatization proposal were given a "letter of exclusivity," thus effectively ruling out competing bids and resulting into sole-source contracts. Firms obtaining such letters of exclusivity, however, often sold them for reportedly large sums. To prevent such abuse, the government now only provides "letters of acknowledgement" to firms initiating projects. This practice provides the private company with only a go-ahead to prepare a detailed project proposal within a specified period. Within this time period, the firm is accorded the privilege of "first right of refusal." The letter of acknowledgement apparently also makes it very clear that the government is not obligated to accept submissions. However, despite this improvement the government's approach to private sector-initiated projects severely restricts the opportunity for competitive tendering and renders them de facto direct negotiation contracts.

3.94 ***Malaysia is gradually moving towards a more competitive model for infrastructure provision.*** The Malaysian strategy of rapid deployment, while waiting for the regulatory process to catch-up, had merit in the earlier phases of privatization when there was a need to quickly establish private capital. Also extensive infrastructure development was meant to nurture a strong domestic corporate sector, a goal now largely fulfilled. But as privatization has become a more pervasive feature of Malaysian infrastructure and the overall economy has matured, a rapid mandate award process needs to be weighed against longer-term goals of ensuring project sustainability and minimizing cost to the government. For that, serious consideration should be given to the market structure and the possibilities of competition; a regulatory system that provides incentives for cost minimization and is transparent and credible to the public; and a contracting process that is transparent and efficient.

3.95 The vast majority of Malaysian infrastructure projects have been awarded through direct negotiations with private sponsors rather than through competitive tendering.[15] Malaysian authorities point to the strengths of their approach—speedy award of mandates and scope for private sector innovation. Increasingly, the government is recognizing the benefits of competitive tendering. Recent concession agreements tend to shift more risk to the private sector and are more precise to avoid unanticipated windfalls to

concessionaires. Large regular tariff hikes are not found in concession agreements as frequently as before. This contains the government's risk since it must compensate the concessionaire when economic and political circumstances prevent increases.

3.96 A new regulatory framework, proposed by EPU and awaiting Cabinet approval, is expected to improve the existing ad hoc arrangements for regulating private infrastructure providers. It would: (a) consolidate the existing regulatory authorities into fewer sectoral regulatory authorities; (b) clarify the role/responsibilities of the regulator vis-a-vis the oversight minister; (c) enhance the power of the regulator; and (d) provide more human and financial resources to the regulatory authorities. It may still fall short of a truly independent and autonomous regulatory system, but it would address many of the present weaknesses. It is also part of a transition process towards an efficient and effective system of regulating private suppliers of infrastructure services.

3.97 ***Competitive tendering for future infrastructure projects.*** Efficient allocation of scarce government resources require changes to project selection and procurement, and also changes to the overall business philosophy underlying concession agreements (Box 3.11).

- Shift the planning process from strictly quantitative targets geared to match overall economic growth, to selecting projects based on a needs assessments using input from all affected ministries.
- Rank projects based on realistic criteria for economic return.
- Increase the role of the line ministries in project definition and concession negotiation They should lead in shaping projects by publishing development plans and technical standards to guide proposals either before they enter the pipeline or, better yet, as part of the specifications contained in requests for proposals.
- Move technical reviews forward in the review process to ensure that project evaluations are undertaken only for technically conforming and fully costed projects.

Box 3.11: Improving Transparency and Competitiveness in Infrastructure Concessions

Most countries favor ***competitive bidding*** because it ensures transparency in the contract award, it provides a market mechanism for selecting the best proposal and typically results in lower costs, and it stimulates interest among a broader range of potential investors. Competitive bidding is easiest to design and implement when the product or service required is fairly standard, the technical parameters can be defined with reasonable certainty in the bidding documents, and there is limited scope for innovation and creativity on the part of an operator. In countries without a track record or a proven legal and regulatory framework for private concessions, governments may choose to enter ***direct negotiations*** for some initial projects on a pilot basis in order to gain experience and build a record with investors. This approach provides the necessary time and experience to properly design the framework for infrastructure concessioning before launching a broad competitive bidding process for other infrastructure projects. Some governments, such as the United Kingdom and the Australian State of Victoria, allow some degree of flexibility in public tendering of private infrastructure projects. They recognize that, although competition must keep its central place in public procurement, its form may vary according to the value and complexity of individual cases; in the context of private finance initiative, the advantages in terms of stimulating innovation may in exceptional cases justify alternatives to competitive tendering.

Under the Philippines BOT Law, for example, national or local authorities may accept unsolicited proposals for BOT projects on a negotiated basis if: (i) the project involves a new concept or technology and is not already listed on the roster of priority projects identified by the government; (ii) no direct government guarantee, subsidy, or equity is required; and (iii) the project is submitted to a price test or "Swiss challenge" from competitors. The price test works as follows: the agency awarding the project must invite comparative proposals to any unsolicited proposal it has received. The invitation to tender must be published in a newspaper of general circulation for at least three weeks. The published invitation must inform potential bidders where to obtain tender documents, however, proprietary information contained in the original proposal is confidential and may not be disclosed in the tender documents. Competitors have 60 days to submit competitive proposals. If a lower-priced proposal is received, the original proponent has 30 days to match it and win the contract. Otherwise, the award goes to the lower bidder.

In general, in cases where governments do not use competitive bidding, they should introduce some degree of competition into the process, or otherwise replicate competitive forces, in order to ensure both transparency and economically efficient outcomes. Several mechanisms could be used. For example, if innovative designs or technology are being proposed, it may be possible to contract the design phase directly and then hold competitive bidding for implementation. If it is not possible to separate design and implementation, and the government proceeds without using competitive bidding, safeguards could be built in to ensure transparency and efficiency. These could include: (i) using external advisers and consultant to assist the government in assessing proposals; (ii) benchmarking against the cost of similar projects; (iii) announcing the proposed project terms and conditions, and allowing other developers an opportunity to better the terms within a specified period; (iv) establishing an independent advisory panel to review the proposed transaction. Periodic rebidding of the concession would also help ensure longer-term economic efficiency in cases where the initial concession was directly negotiated.

It may also be possible to combine elements of competitive bidding with direct negotiation to promote transparency, while preserving the innovative or propriety aspects of developers' proposals. For examples, governments could initially use a competitive process to solicit proposals in response to broad output specifications and then negotiate directly with one or more developers. In this manner, competition would be used to narrow the number of potential developers, and negotiations would be used to work out detailed terms and conditions of the contract. The government would have fallback bidders if negotiations with the preferred bidder failed. Alternatively, the government could negotiate simultaneously with several developers to further enhance the competitive aspects of negotiated transactions. This is often referred to as ***competitive negotiations***. Under this method, governments or government-owned utilities specify their objectives and solicit proposals from private operators through a request for proposals (RFP). The government or utility then reviews the proposals, selects those that are deemed technically responsive to the RFP, and negotiates with several bidders with the objective of awarding a single contract. Alternatively, it may result in the award of several contracts. This competitive negotiation is well suited to projects in which: there is scope for innovation and different approaches by developers, and authorities hope to elicit imaginative proposals for projects; and it would be difficult to secure financing on the basis of standardized contract document. In these circumstances, simultaneous negotiations with several prequalified bidders may be the preferred approach for awarding one or several projects. Many states and utilities in the United States use this approach for procuring new power generation.

Regardless of the method of award chosen, the solicitation and evaluation of bids and the negotiations of contracts involve complex legal, financial, and technical issues. It is important to stress the importance of qualified, professional advisers to the success of concession design and implementation. The issues involved in such projects typically lie outside the scope of traditional civil service work, and the use of specialized external advisers to the government is advocated, especially given that private investors will generally employ their own teams of experienced advisers on such projects.

Source: Kerf, M., et.al. *Concessions for Infrastructure: A Guide to Their Design and Award*, The World Bank, Washington D.C., 1998.

ANNEX 1: THE PUBLIC EXPENDITURE MANAGEMENT SYSTEM TODAY

Structure of the federal government

The Malaysian Parliament is bicameral, consisting of the Senate and the House of Representatives. The Parliament is assisted in its oversight of the executive branch by three autonomous agencies, which receive their authority from the Constitution (Figure A1.1). The Auditor General audits the final accounts of the federal government and its entities and reports to Parliament. A parliamentary subcommittee, the Public Accounts Committee, reviews the audit reports, questions officials about any wrongdoing or shortcoming, and reports its recommendations to Parliament. The Public Services Commission handles service-related matters for the public services, while the Public Services Department under the Prime Minister's Department handles all other personnel matters. A government is formed upon receiving a majority vote of confidence from both houses. The Cabinet (the Council of Ministers) consists of all ministers; there are 23 ministries in addition to the Prime Minister's Department.

Assisting the Cabinet in its policymaking, planning, budgeting and public resource management are several strong executive central agencies (Box A1.1). Several of these agencies come under the Prime Minister's Department and report directly to the Prime Minister—the Economic Planning Unit (EPU), Malaysian Administrative Modernization and Management Planning Unit (MAMPU), Public Services Department, National Development Plan Committee (NDPC), and Implementation and Coordination Unit (ICU). Others report to the Minister of Finance—the Treasury, Revenue Departments, and Bank Negara Malaysia (the Central Bank).

Policy implementation is generally the responsibility of sector ministries. The budget voting structure and the expenditure management system give ministries the flexibility needed to control the resources under their charge.[16] To ensure proper management of resources, the Finance Minister appoints Controlling Officers who are generally the Secretary General of ministry or the head of a major department or agency. Their activities in this area are governed by such laws and regulations as the Financial Procedure Act and the Treasury Instructions and Circulars. A Budget Steering Committee led by the Controlling Officer is responsible for the policymaking, planning, and budgeting by each ministry.

Sector ministries implement policies either directly or through various agencies under them—the departmental entities, statutory bodies, and public corporations under their purview. Performance standards such as impact, output, and cost are determined in a program agreement between the ministry's Steering Committee and the program manager responsible for delivery of the services. In principle, the program agreements establish the basis for budget negotiations with the Treasury and are scrutinized by relevant central agencies, such as the Treasury and the Public Services Department.

Budget structure

The expenditure budget consists of two parts, the operating budget and the development budget, which are voted separately. The Treasury has primary responsibility for preparing the operating budget, and the Economic Planning Unit primary responsibility for preparing the development budget. The government has a balanced budget principle: it borrows only to finance development expenditure. The operating budget covers two types of expenditure: charged and supply. Charged expenditure, which is provided for by law, is for obligatory payments such as royal allowances; salaries of the president, chief justices, judges, president of the Senate, speaker of the House, Auditor General, and the Public Services Commission; and settlement of public debt. Supply expenditure is for routine expenditures maintained by annual vote of Parliament, such as salaries and other administrative expenses of government agencies. There are 52 supply budget headings (covering all ministries and departments) voted on in the operating budget. The development budget is based on projects that have been approved under the National Five-Year Development Plan. The current Plan, the seventh, covers 1996–2000. There are 37 budget headings in the development budget. See Annex 2 for the accounts structure supporting this budget structure and the budget process.

Box A1.1: Functions of Executive Central Agencies

Agencies reporting to the Prime Minister's Department

- *Economic Planning Unit:* Prepares and supervises the National Development Plan and the development budget and oversees implementation of the development program. Also serves as the secretariat of the National Development Plan Committee.
- *National Development Planning Committee:* Brings together key members of the Cabinet and chief managers of executive central agencies to guide preparation of the Development Plan, evaluates the mid-term review of the Plan, and oversees its implementation. The committee is chaired by the chief secretary to government.
- *Implementation and Coordination Unit:* Coordinates development programs and projects involving more than one sector ministry.
- *Public Services Department:* Regulates the government's human resource management practices.
- *Malaysian Administrative Modernization and Management Planning Unit:* Develops and issues Civil Service Improvement Circulars (PKPAs) to improve management across the government. Promotes total quality management and ISO efforts, and oversees all performance management efforts for all government agencies.

Agencies reporting to the Ministry of Finance

The Ministry of Finance consists of the Treasury, four departments (Accountant General, Inland Revenue Department, Customs and Excise Department, and Valuation and Property Services Department), and four statutory bodies (Bank Negara Malaysia [the Central Bank], the National Savings Bank, Employees Provident Fund, and the Securities Commission). The Accountant General's department formulates accounting standards, principles, and procedures and ensures compliance with them by federal and state agencies; it also serves as the main repository of financial and accounting data and prepares the public accounts. The Treasury has 10 divisions, of which 5 are important for understanding public expenditure management:

- *Economic and International Division:* Advises on the formulation of macroeconomic policies, particularly fiscal and monetary policies.
- *Budget Management Division:* Examines and analyzes all government plans and programs.
- *Financial Management Systems Division:* Reviews, develops, and implements financial management systems and procedures.
- *Tax Division*
- *Finance, Debt, and Investment Division:* Has primary responsibility for procuring loans from foreign and domestic sources to finance national development projects.

Budget process

The budget appropriations cycle begins about 14 months before the fiscal year, which is the same as the calendar year. The budget process is detailed in below.

Budget Process

1. Aided by the Treasury and the Economic Planning Unit, the Cabinet decides on the overall fiscal ceilings in November.
2. The Treasury issues targets for the operating expenditures of ministries and departments in November. The targets are based on the previous year's allocation, with allowances for normal salary increases and other expected costs, such as new policies introduced by the Cabinet during the fiscal year. They are meant to discourage haggling during budget negotiations between the Treasury and the ministries. Central directives for the development budget are straightforward because the projects are already approved by the government under the macro Five-Year Plan, and allocations are based on the project work programs.
3. In each ministry a budget steering committee headed by the secretary general carries out annual planning and budget formulation. The committee determines the ministry's priorities and strategies, reviews programs, and introduces new policies. All these efforts are geared toward achieving the ministry's goals. The committee also looks at development projects—their progress, problems, and financial requirements for the next year.
4. The Treasury issues the budget call circular in January. The circular provides guidance on how to prepare and present budget proposals to the central agencies—to the Treasury, with copies to the Public Services Department (on personnel matters), the Economic Planning Unit (on development programs), and the Implementation and Coordination Unit (on monitoring development projects). It also spells out the overall strategies and policy thrusts based on the current economic situation and prospects for the next year.
5. Each agency prepares a budget based on the expenditure targets and call circular and submits it to its controlling ministry for review. The agency representative at the ministry level—usually the agency head or senior program manager—defends the budget at the controlling ministry.
6. Each ministry examines the budgets of the agencies under its purview (including statutory bodies), establishes the program agreements with activity heads and agency heads, and submits them to the Treasury by the end of March with copies to the Public Services Department, Economic Planning Unit, and Implementation and Coordination Unit. Program agreements include an evaluation plan for program activities. The ministry also prepares proposals for transfers and subsidies to statutory bodies and public corporations.

7. From April to July the central agencies review the budget proposals. Budget examination meetings are held, chaired by a senior officer of the Treasury's Budget Division and attended by representatives from other central agencies. The Treasury's focus is on controlling the aggregates by ensuring compliance with the expenditure targets and on reviewing the program agreements between ministries and agencies, not on examining every expenditure item. For the development budget, the focus is on how much to allocate annually for each project from the pre-approved Five-Year Development Plan.
8. The budget review officer at the Treasury chairs the budget examination meetings and decides on interim resource allocations. Sometimes an agency may be asked to submit a revised budget based on the review. The budget review officer generally has a ceiling to work with, usually set by the finance minister and the Treasury's top management.
9. After the budget examination is completed for all agencies, the recommendations are reviewed by a budget review and consolidation committee chaired by the director of the Treasury's Budget Division. The Budget Committee then submits the recommendations first to the finance minister for approval and then to the Cabinet for final review.
10. After revising the recommendations as requested by the Cabinet, the Budget Division prepares the final draft of the government's budget request. After the budget is approved by the Cabinet, the finance minister tables it in Parliament on the last Friday of October.
11. The House of Representatives debates the Supply Bill at the House stage (general examination) and then at the Committee stage (detailed expenditure review) before the bill is passed.
12. The bill goes to the Senate for similar review and deliberations. After it is passed it goes to the King for approval and royal endorsement.
13. As soon as royal endorsement is obtained, the Treasury issues allocation warrants to the ministries and agencies as approved by Parliament. No later than mid-January of the budget year, the Accountant General then notifies all government agencies of their authority to spend and commit expenditures.
14. As controlling officers, ministry and department heads are accountable for proper management of the approved allocations under their charge. They are allowed to transfer money from one activity to another within a program. For operating expenditures, transfer across programs is also allowed, with prior approval of the Treasury. For development expenditures, transfers are allowed with prior approval of the Economic Planning Unit.
15. Controlling officers request supplementary allocations from the Budget Division when needed by way of proposals for "One-Offs" or new policies that need to be implemented. If approved, the supplementary allocations can take the form of advanced warrants or direct supplements. The advanced warrants draw on contingency funds for operating expenditures and contingency reserves for development expenditures. Both advanced warrants and direct supplements must be approved by Parliament.
16. The Office of the Accountant General performs the accounting function for all ministries and their departments except for a few large ones which are self-accounting.
17. The management efficiency of agencies is regulated through a set of management improvements circulars issued by MAMPU, the Civil Service Improvement Circulars (PKPAs), and operational circulars from the Treasury and other relevant central agencies.
18. Three months after the end of the fiscal year the accountant general is required to submit the public accounts to the auditor general. The Auditor General audits all the accounts of ministries, departments, and statutory bodies every year and submits its reports to Parliament, where they are examined by the Public Accounts Committee. Controlling officers are obligated to appear before the committee to explain any wrongdoing or mismanagement of public funds under their charge. The committee then reports to Parliament.
19. At the end of the year line ministries prepare an exception report on activities whose performance did not reach the levels specified in the program agreement. And each activity is evaluated at least once every five years.

ANNEX 2: ACCOUNTS STRUCTURE AND PUBLIC ACCOUNTS

Public expenditure in Malaysia is governed by the federal constitution and relevant statutes. All public funds are accounted for under the federal consolidated fund or the memorandum account, or as prescribed under any specific statute, except for rates and dues under Islamic law (such as *zakat, fitrah*, and *baitulmal*). All public revenues and expenditures must be covered under the federal consolidated fund or memorandum account, as appropriate, and must be approved by Parliament—thus providing the opportunity for elected representatives in Parliament to scrutinize and debate all aspects related to the management of public funds.

Accounts Structure

The government uses several types of accounts to meet its commitments and liabilities:

- Consolidated revenue account.
- Consolidated trust account.
- Consolidated loan account.
- Memorandum account.

The first three accounts make up the federal consolidated fund.

Consolidated Revenue Account. The consolidated revenue account covers all revenue collections received and paid into the revenue account. These revenues fall into four categories: tax revenues, non-tax revenues, non-revenue receipts, and revenue from federal territories. The revenue account also covers all recurrent expenditures and all transfer payments. The transfer payments go to a number of purposes and entities, including the development fund, the housing loan fund, statutory bodies; state-owned enterprises (financial and nonfinancial), corporatized government entities, and privatized government concerns (with or without government equity). Transfer payments are treated as expenditures and made in the form of direct grants, loans or investments.

The consolidated revenue account also includes all charged expenditures—statutory payments to various entities charged to the consolidated fund as required by law. These include grants to state governments and the pension fund, debt charges, and compensation payments by government. These payments are authorized and mandated by federal law and therefore are not included in the Supply Bill for debate in Parliament. But the annual budget estimates include adequate funds to cover the payments.

Consolidated Trust Account. Several trust accounts operate under the consolidated trust account:

- *Development fund*—used to cover all development expenditures under the Malaysia Development Plan.
- *Housing loan fund*—used to pay for all housing loans to civil servants, statutory bodies, local authorities, the legislature, and the judiciary.
- *Personal advance fund*—used to provide personal advances based on specific criteria,
- *Conveyance loan* fund—used to provide vehicle loans based on specific conditions
- *Computer Loan fund*—used to provide computer loans as part of the information technology improvement program;
- *Public trust accounts*—special funds set up under various government agencies for special purposes,
- *Trust account for deposits*—used to account for all special funds received for a specific purpose as required by law or by any contractual requirements,
- *Accounts payable trust accounts*—used to pay off liabilities still owed by government agencies to suppliers of goods and service. The payments are usually made in January.

Consolidated Loan Account. The consolidated loan account covers all proceeds of loans raised, loans issued, and repayments of outstanding loans. The account also covers all public debt, both domestic and foreign.

Memorandum Account. The memorandum account covers all assets and liabilities of the government that are not covered by the consolidated fund including recoverable loans, investments, subscriptions to international organizations, statutory deposits, public debt, government guarantees, and notes payable.

Public Accounts

The public accounts of the federal government are prepared by the accountant general and audited by the auditor general. These statements are generally submitted for audit two to three months after the end of the fiscal year, certified by the auditor general six months after the end of the fiscal year, and tabled in Parliament at the same time as the new budget is submitted (October). The public accounts are presented in two volumes. Volume 1, a summary of the federal public accounts, contains the balance sheet, the summary account under the consolidated fund, the summary of the memorandum account, and the accountants general's report on the public accounts. The volume is printed in Bahasa Malaysia and English. Volume 2 is a detailed federal public account and memorandum account and is printed only in Bahasa Malaysia. The format of public accounts is shown in Box A2.1.

Box A2.1. Format of the Public Accounts

Accountant general's report
Auditor general's certificate
Statement of Public Account
- Balance sheet statement
- Memorandum account statement
- Notes to the public account

Balance sheet statement
- Assets
  - Cash
  - Investments
- Consolidated revenue account
  - Revenue
  - Operating expenditure
- Consolidated trust account
  - Development fund
  - Housing loan funds
  - Government trust fund
  - Public trust funds
  - Deposits
  - Accounts payable
- Consolidated loan account

The balance sheet of the federal government shows the cash and investments held in the three accounts of the federal consolidated fund: the consolidated revenue accounts, consolidated trust account and consolidated loan accounts. Consistent with the cash basis used in government accounting, only investments held for specific trust purposes are reported in the balance sheet. Other investments, particularly equity investments are charged to expenditure and are therefore not reported in the balance sheet. The same is true of fixed assets, stock, and financial claims acquired by the government, such as accrued revenue, recoverable loans, and financial claims on the government (for example, public debt, guaranteed debt, and notes payable). The major assets and liabilities of the federal government, although not included in the balance sheet, are reported in the memorandum accounts.

Memorandum Account Statement
- Assets
  - Recoverable loans
  - Investments
  - Subscriptions to international organizations
  - Statutory deposits
- Liabilities
  - Public debt
  - Guarantees
  - Notes payable

Appendixes
- Financial reports of selected departments
- Financial reports of selected programs
- Performance reports of government trust funds
- Federal government financial statistics (1977-96)

ANNEX 3: CONTROLLING FISCAL RISKS

A government can take several measures to control the fiscal risks of an obligation—before accepting the obligation, while holding it, and after it falls due (Table A3.1)

Table A3.1. Steps to Control the Risk of Government Programs and Promises

Measures	Fiscal Policy	Public Finance Institutions
Before the government accepts an obligation (program, commitment)	• Assess how the obligation fits with the state's role and strategic priorities • In considering options for policies and forms of support, take into account the associated financial risks and the government's capacity risk for management • Define and communicate the standards for and limits of government involvement to minimize moral hazard	• Evaluate the program's risks on their own and as part of a portfolio with existing risks, estimate the potential fiscal cost of the obligation, and set additional reserve requirements • Design the program well to protect the government against risks
While the government holds an obligation	• Stick to the preset limits for government responsibilities	• Budget, account for, and disclose the obligation • Monitor the program's risk factors
After an obligation falls due	• Execute the obligation within its preset limits and observe lessons for future policy choices	• Report the actual fiscal cost relative to the estimates, evaluate performance, and penalize failures

Before government admits an obligation

Policy:

Assess how the obligation fits with the state's role and strategic priorities. A government decision to offer possible support through the budget or outside it molds the actual role of the state. This budgetary and extrabudgetary programs should in principle, be subject to the same policy analysis and considerations. For contingent support programs such as guarantees, the government needs to consider whether their objectives, are consistent with the state's role and priorities and whether their potential risk-adjusted long-term fiscal cost in justified.

In considering options for policies and forms of support, take into account the associated financial risks and the government's risk preferences and risk management capacity. In considering programs and forms of support for pursuing policy objectives, it is important to recognize the cost of uncertainty about future public financing requirements. For the government, just as for a corporation, an unexpected financing requirement disrupts financial planning and increases the cost of borrowing or, worse, runs the risk of no credit financing being available. Thus the government should judge program options not only on their potential costs and benefits but also on the uncertainty they involve for future public financing. For contingent forms of support, the government should also take into account information asymmetries and transaction costs. These considerations should be weighed against the government's risk preferences, risk management capacity, and access to credit.

Define and communicate the standards for and limits of government involvement to minimize moral hazard. More than budgeted expenditures, contingent liabilities, particularly implicit liabilities as perceived by the public and the market, define the outer limits of state responsibilities and influenced the behavior of the public and of market agents. The more formally and precisely the government defines and signals its responsibilities (its commitment area), the clearer are its explicit liabilities and the smaller are its implicit liabilities. The more credibly the government defines its responsibilities and the more significant the pain it implies for market agents in the event of their failure and recourse to government rescue, the smaller is the problem of moral hazard. A key the task for the government is to signal credibly to markets which actions are *not* to be expected from the state in the event of various failures. Ultimately, the government will gain the credibility needed to reduce moral hazard—and thus curtail its fiscal risks—by acting on its announced policy (by refusing to submit to pressures for a bailout, or to provide support beyond predefined levels).

Institutions:

Evaluate the program's risks on their own and as part of a portfolio with existing risks, estimate the potential fiscal cost of the obligation, and set additional reserve requirements. Qualitative analysis of the risks of alternative programs, and estimates of the programs' potential long-term fiscal cost and hidden subsidies—carried out before the government enters into any commitment—helps lead to the best choice and

design of programs by improving the information available to policymakers. Specialized methodologies (option pricing, actuarial, rate setting, value-at-loss, loss cost ratio) can be used if a more precise estimate of the potential cost of a program is needed.

Design the program well to protect the government against risks. Based on the qualitative risk analysis, the government can identify the risks it can control reasonably well, decide which risks to cover under its proposed program of contingent support, and develop effective risk-sharing, regulatory, and control mechanisms to monitor the performance of the parties under the program. Besides exogenous risks such as drought, a government program is subject to endogenous risks, which depend mainly on the program design, implying various levels of market distortions and moral hazard. A program to be implemented through an intermediary agency, such as a guarantee fund, should take into account the risk management incentives and the performance monitoring by the government. A good design addresses these issues explicitly, reducing moral hazard and potential endogenous risks.

While the government holds an obligation

Policy:

Stick to the preset limits for government responsibilities. After the government approves a program or commitment, and throughout the life of the obligation, the main policy challenge is to ensure that the market and the public do not expect the state to provide support beyond the preannounced limits. For parties potentially benefiting from the program, any indications that the government might provide financial support beyond the limits would increase moral hazard and distort behavior.

Institutions:

Budget, account for, and disclose the obligation. To prevent unknown contingent liabilities from coming to light only when they fall due, under the public finance law an obligation should be valid only if it was assessed, budgeted, accounted for, and above all, disclosed at the time of its adoption by the government.

Monitor the program's risk factors. Throughout the life of an obligation, the government needs to actively monitor its risk factors and the performance of the agents under the program. Monitoring is particularly important intermediary agencies, such as banks and credit and guarantee funds, that implement the state's policy objectives, with its guarantee. If the government lacks good monitoring capacity, it could contract out this task for a performance-based fee. The cost of monitoring and administering programs of contingent support may be relatively high and should be reflected in the calculations of the potential fiscal cost of the programs.

After an obligation falls due

Policy:

Execute the obligation with its preset limits and observe lessons for future policy choices. Executing an obligation after the falls due strictly within the preset limits is critical to the credibility of future government announcements and for limiting future moral hazard. For example, payouts to depositors deposit insurance coverage shows the markets that the government submits easily to political pressure, shows depositors that banks offering high yields are "safe", and shows banks that excessive risks are worth taking. By taking a lesson from a past involvement under its direct and contingent, both explicit and implicit, liabilities the government is able to adjust its role in an incremental manner rather than in an abrupt shift in a crisis. A timely and credible explanation of these adjustments will prompt the public and market agents to adjust their expectations and behavior. For example, by explaining that the public pension scheme is not fiscally sustainable and that future governments will have to significantly reduce the pension benefit, the government influences saving behavior of people in the labor force.

Institutions:

Compare and report the estimated and actual cost of government support, evaluate performance and punish for failures. The requirement to report and compare the ex-ante risk evaluation and the actual layouts associated with a program is critical for accountability of the government. Performance evaluation applies to the government departments and officials as well as to the parties under the program. The punishment may involve government officials, for instance if the ex-ante risk analysis had been distorted by particular interests, the management of state-guaranteed and intermediary agencies implementing government programs, e.g. for exposing the government to unnecessary and excessive risks, and the parties under the program for breach of any agreements.

ANNEX 4: THE DEVELOPMENT ADMINISTRATION CIRCULARS (PKPAS)

The Malaysian government introduced the Development Administration Circulars (also known as the Civil Service improvement Circulars—and PKPAs for short) in phases beginning in the early 1990s. These tools for improving performance has all helped to enhance government products and services. What is lacking is their integration into a coherent framework of performance management. But each of them can be fitted into one or more the key focus areas of performance management (Table A4.1.)

1. Development Administration Circular No. 1 of 1991: Guidelines for the Improvement of the Quality of Telephone Communication

This circular procedure guidelines for government departments on improving the quality of telephone communication services. The telephone communication system is an important frontline service in government departments. The public uses it frequently for inquiries and information and expects prompt service and accurate information. Increasing efforts have been made to meet these expectations by upgrading the telephone communication services in all government departments. This circular was issued to help expedite these efforts. The circular was a direct result of the government's efforts to further improve frontline services and to respond to the public feedback on the quality of these services.

2. Development Administration Circular No. 2 of 1991: Guidelines for Management of Meetings and Government Committees

This circular provides guidelines for the secretariats of government committees on conducting their responsibilities in a systematic and organized manner. The guidelines stipulate activities and work norms to ensure that meetings of government committees are properly managed. The circular resulted from much feedback and soul-searching by the government on productivity in government programs and activities. Review of management trends and feedback from agencies their clients showed that much time was wasted in meetings that were not always productive or efficient. The frequent recourse to meetings tended to waste precious time and delayed critical management decisions that affected public services.

3. Development Administration Circular No. 3 of 1991: Public Service Innovation Awards

This circular introduces a system of recognition and rewards—the Public Service Innovation Awards—for government agencies that have introduced new ideas or innovations to improve service. The circular came out of public feedback on performance of public sector agencies and an awareness of the need to provide incentives to government agencies, particularly those providing frontline service. The recognition system prompted renewed effort by many public agencies to improve performance, particularly service delivery, efficiency, and productivity.

4. Development Administration Circular No. 4 of 1991: Guidelines for Quality Improvement Strategies in the Public sector

Among the most important for improving public services this circular, provides guidelines for heads of government agencies on planning and implementing seven quality management programs:

- Q Suggestion System,
- Q Process System,
- Q Inspection System,
- Q Slogans,
- Q Day,
- Q Feedback System,
- Q Information System.

These initiatives have helped increase the emphasis on performance and quality in the of government agencies. But there have been some distortions in the implementation of the circular.

5. Development Administration Circular No. 5 of 1991: Guidelines on the integrated Scheduling System (SIAP)

This circular is aimed at assisting heads of departments in preparing implementation schedules for public development projects and in managing, controlling, and monitoring these projects using the Integrated Scheduling System (SIAP). The SIAP complements the Integrated Information System of the Central Agencies (SETIA) introduced earlier is directed more toward improving financial performance. The SIAP is designed to provide more comprehensive information on the implementation status of government development projects and to improve the effectiveness of coordination, implementation, and management.

6. Development Administration Circular No. 6 of 1991: Guidelines on Productivity Improvement in the Public Service

The objective of this circular is to help heads of departments understand the concept of productivity and to plan and implement measures to improve productivity. The circular defines productivity as the value or quantity of output that can be produced by one unit of input. It identifies associated with the concepts of efficiency, effectiveness, and quality eight factors as critical in determining productivity:

- Manpower,

- Systems and procedures,
- Organization structure,
- Management style,
- Work environment,
- Technology,
- Materials and
- Capital equipment.

The circular also outlines an approach for measuring the productivity of a department or office and individuals. The circular has attention to improving productivity in all agencies and brought about real change. But such efforts have not been linked with program performance management or with outputs and outcomes.

7. Development Administration Circular No. 7 of 1991: Guidelines on Quality Control Circles (QCC)

This circular provides guidelines on establishing and managing of quality control circles (QCCs) in government departments. The guidelines elaborate on the concept of QCCs, their implementation, the work improvement processes, and problem-solving techniques. The government encourages the establishment of QCCs as an effective mechanism to mobilize expertise, experience and employee creativity in solving productivity and quality problems. Like the preceding circular, the QCC initiative was seen in a narrow sense as being useful for improving work processes and outputs. The link between effective and efficient work processes and program outcomes has never been emphasized in implementing.

8. Development Administration Circular No. 8 of 1991: Guidelines on the manual of Work Procedures and Desk Files

This circular emphasizes the importance of having well-documented work procedures and processes in every government agency in the form of work procedure manuals and personal desk files. It contains guidelines for heads of departments on preparing the manual of work procedures and desk files efficiently and effectively. The manual gives an overall picture of the objectives, responsibilities, functions, and procedures of a department and the staff responsible for implementing these procedures. Desk files describe the responsibilities, duties, activities, and work processes of each staff member in a department. The introduction of these important management tools has substantially improved the understanding and performance of functions and tasks in most government agencies.

9. Development Administration Circular No. 9 of 1991: Guidelines on the implementation of the Malaysia Incorporated Policy

This circular provides guidelines for implementation of the Malaysia Incorporated Policy ministries, federal departments, state governments and district offices, including local authorities. These guidelines cover several programs:

- The establishment of consultative panels at each ministry, department, or office at the federal, state, and district levels.
- Annual dialogue sessions between the ministry, federal department, or state secretariat and the private sector.
- Information sharing through discussions at consultative panel meetings, annual dialogue Sessions and special forums involving both the private and public sectors;
- Interaction through forums for the exchange of ideas, knowledge and experience, example: government officials participating in seminars sponsored by chambers of commerce and industry, business councils, professional bodies, and similar organizations.
- Social interaction with the private sector through sports activities.
- Private Sector recognition for excellent performance of government departments.

10. Development Administration Circular No. 10 of 1991: Guidelines for the improvement of the Quality of Counter Services

This circular has been instrumental in improving service in government agencies, particularly the frontline agencies. The circular provides guidelines on upgrading counter services. These services include collecting revenue, processing applications and issuing licenses, permits, passports, identity cards, and certificates of marriage and citizenship. The concept of counter services has three components: the Front Section of the Counter which is the Customer, the Counter Section which is service at the counter, and the support services.

11. Development Administration Circular No. 11 of 1991: Guidelines on the Use of the Work Action Form

This circular is aimed at assisting government departments in using the work action form as a management tool for monitoring the implementation of activities. It is also meant to ensure that all involved in each activity are taking the necessary actions. It thus provides a useful guide for the managers responsible for an activity—on the actions to be taken, the time needed to carry out the actions, and any subsequent actions to be taken. This work productivity initiative has helped improve performance in the public sector.

12. Development Administration Circular No. 1 of 1992: Guidelines for Total Quality Management in the Public Sector

The total quality management (TQM) circular has been instrumental in bringing about much-needed improvement in service quality and organizational performance. The circular provides information and guidance to heads of departments

on implementing TQM. It sets out several important management principles aimed of helping to ensure that the quality movement continuously expands and creating an environment conducive to a culture of excellence:

- Supporting top management.
- Implementing of long-term strategic plan focused on quality.
- Focusing on the customer.
- Providing training and recognition.
- Fostering teamwork.
- Measuring performance.
- Emphasizing quality assurance.

TQM is a continuous process of cultural transformation involving changing of values and attitudes, systems and procedures, operational practices, and organizational structures in order to produce quality output and services that satisfies customers. Despite the obvious strengths of the TQM initiative, some aspects of its implementation may need to be further reviewed and strengthened to realize its full benefit.

13. Development Administration Circular No. 2 of 1992: Guidelines for Development Project Planning and Preparation

This circular provides guidelines for planning development projects and preparing project proposals for approved by the Economic Planning Unit of the, Prime Minister's Department. It also serves as an aid for general project preparation by all agencies. The methods and techniques in the circular are intended to address problems in project planning and management such as shortfalls in development expenditure. Implementation of the circular has brought about a marked improvement in project planning and implementation.

14. Development Administration Circular No. 3 of 1992: Manual on the Micro Accounting System (SPM)

This circular represents a second attempt to introduce cost consciousness among government agencies. Its implementation has increased awareness among all agencies on the need for and importance of capturing and using cost information for all outputs. The circular consists of a manual with guidelines for implementing the Micro Accounting System (SPM) in government agencies. The SPM is included to improve financial management at the department level by requiring departments to determine the cost of producing their main outputs. The government hopes that this requirement will instill cost-consciousness and a sense of accountability among public sector managers and further strengthen performance management. The of SPM complements the Modified Budgeting System (MBS) introduced in 1990, which requires comprehensive planning and control of inputs, outputs, and outcomes for all activities. The MBS requires the measurement and evaluation of government programs as a means of enhancing quality and productivity. It also requires units to identify the cost of producing outputs under each project, program, and activity. The SPM provides the means for doing so.

15. Development Administration Circular No. 4 of 1992: Managing Public Complaints

This circular informs government agencies and the relevant authorities about the new system for managing public complaints and their roles in implementing the system. The role of the Public Complaints Bureau is to receive and investigate public complaints about government administrative actions and decisions alleged to be unfair or to involve misappropriation, abuse of power, and the like. The results of investigations are presented to the Permanent Committee on Public Complaints for deliberation and decisions. The committee can direct the heads of agencies to appear before it to respond to complaints. Its decisions must be implemented by the federal or local agency concerned. The Public Complaints Bureau is responsible for monitoring the corrective actions taken and reporting on them to the committee. Setting up the Public Complaints Bureau as an avenue for the public to complain about its dealings with any government agency was a significant step in improving performance management.

16. Development Administration Circular No. 1 of 1993: Guidelines on Morning Meetings

This circular contains guidelines for morning meetings (often referred to as morning prayers) in ministries, federal departments, state governments, and district offices. The objective of morning prayers is to inculcate a spirit of national interests predominating over departmental interests. They are also intended to resolve on the spot any problem in implementing development programs and projects or issuing of licenses and permits. This mechanism for coordinating development projects at different levels is not new; it was first introduced during implementation of the First Malaya Plan in 1961-65. The circular provides guidelines on whom should attend the morning meetings, how long the meeting should last, what should be on the agenda, and how the minutes of the meetings should be prepared and handled.

17. Development Administration Circular No. 2 of 1993: Guidelines for the Award of the Excellent Service Award

This circular provides guidelines for the award of the Excellent Service Awards in the public sector. It complements the other circulars on recognition and rewards for innovation and productivity and, like them is aimed at motivating public officials to constantly perform with excellence. Together with the other, complementary circulars, this circular has helped bring about a shift in the culture and work norms of the public sector. Awards for excellence and innovation have helped raise productivity and the quality of service.

18. Development Administration Circular No. 2 of 1993: Guidelines on Clients' Charter
Among the most important circulars, the clients' charter circular was meant to complement the performance management efforts of government agencies. It focuses on identifying performance contact points in an organization and the critical performance factors that are most important to clients and other stakeholders. Through this, the circular compels each agency to review all its outputs and identify performance standards that meet the needs of its clients and other stakeholders. This circular is aimed at assisting heads of agencies in instituting clients' charter—a written commitment by agency to deliver its outputs or services at quality standards that will meet clients' needs and expectations. The circular explains the concept of the charter and the process for implementing it.

19. Development Administration Circular No. 3 of 1993: Guidelines on Implementation of Service Recovery
This circular is linked with the government's efforts to be responsive to the needs of the public. It recognizes that agencies can plan for the provision of products and services according to specific criteria but that it is not always possible to plan for special requirements of the public. The demands on an agency often require quick action that was not anticipated in the original plans for delivering services. Some agencies also commonly handle contingencies in the delivery of products and services to the public, which requires more comprehensive planning and preparation. The service recovery circular provides guidelines agencies on how to plan for service contingencies and how to handle them when they arise. It recognizes that service failures may as a result of such factors as:

- Equipment failure.
- Process design failures.
- Planning failures.
- Failures by service delivery personnel.
- Difficult work processes and procedures.
- Complex and multijurisdictional work procedures.
- Introduction of new services.
- Use of new systems and procedures.
- Ad-hoc and unexpected service demands.
- Work processes that are heavily dependent on external agency inputs.

The circular provides examples of possible service failures and suggests remedies. By requiring agencies to prepare action plans to meet contingencies, the circular has helped reduce the incidence of service failures through intensive planning, review, and analysis of work processes. The circular represents an important effort to improve performance and should be linked with performance management.

20. Development Administration Circular No. 1: 1996: ISO 9000 Standards in the Public Sector
This circular on implementation of the ISO 9000 standards is one of the performance improvement initiatives introduced by the government since the beginning of the 1990s. The circular explains the concept of ISO and its significance to the quality and effectiveness of service delivery in government agencies. It reemphasizes the importance of setting service quality standards and specifications and provides guidance for agencies on preparing for ISO certification. Of particular significance is the circular's emphasis on the need for agencies to review their service quality and delivery mechanisms and specifications. Because of its comprehensive focus on processes and their components, the ISO 9000 circular is an excellent tool for further improving performance management. But like other performance improvement initiatives, the ISO circular fails to use an integrated approach. It does highlight the need for agencies to look at the ISO requirements as an integral part of their performance management.

21. Treasury Circular No. 2 of 1991: Use of New Forms for Asset, Inventory, and Office Supply Management
Although this is a Treasury circular, it is also part of the overall civil service improvement effort and has therefore been regarded as part of the PKPA series. This circular addresses the need for managers to manage their agency's assets, inventory, and office supplies more efficiently and effectively. The circular was issued because of a perception by policymakers that the government needed to improve asset and inventory management. Studies in the late 1980s showed substantial waste and inefficiency in the management of government assets and inventory. This inefficiency not only had serious financial implication but, more importantly reduced the efficiency and effectiveness of agency operations and services. The circular reviews existing forms and procedures for asset and inventory management and recommends several new forms for agencies to use in registering assets inventory, office supplies, and the movements of assets and inventory. Although this circular attempts to further streamline agency operations and enhance management accountability, nowhere does it spell out its strategic link with other performance improvement initiatives.

Table A4.1 The PKPAs and Their Links with Performance Management Focus Areas

No	Circular	Performance Focus Area Affected	Comments
1	Guidelines for the Improvement of the Quality of Telephone Communication	Process Outputs Outcomes	Focus on quality of processes and outputs and may affect outcomes (client satisfaction)
2	Guidelines for Management of Meetings and Government Committees	Process Operational strategy	May improve effectiveness and efficiency of work processes
3	Public Service Innovation Awards	Process Operational strategy	Incentive system that forms an operational strategy
4	Guidelines for Quality Improvement Strategies in the Public Sector	Process Outputs Outcomes	Has direct impact on service quality.
5	Guidelines on The Integrated Scheduling System (SIAP)	Process Operational strategy Outputs	Affects work processes and efficacy of work and outputs
6	Guidelines on Productivity Improvement In The Public Sector	Inputs Process Outputs	Focuses on improving efficiency and has a bearing on outputs
7	Guidelines on Quality Control Circles (QCCS)	Inputs Process Outputs	Focuses on efficiency and productivity and on improving outputs
8	Guidelines on the Manual of Work Procedures and Desk Files	Process	Focuses on improving work processes to increase efficiency
9	Guidelines on the Implementation of The Malaysia Incorporated Policy	Process Operational strategy	Focuses on improving efficiency and involves operational strategies
10	Guidelines for the Improvement of the Quality of Counter Services"	Process Outputs Outcomes	Touches process but also linked with service quality and client satisfaction
11	Guidelines on the Use of the Work Action Form	Process Operational strategy	Helps improve efficiency of work processes
12	Guidelines for Total Quality Management in the Public Sector	Process Operational strategy Outputs Outcomes	Focuses on improving quality of outputs and outcomes
13	Guidelines for Development Project Planning and Preparation	Process Operational strategy	Focuses on improving process efficiency and effectiveness
14	Manual on the Micro Accounting System (SPM)	Inputs Outputs	Improves efficiency
15	Managing Public Complaints	Process Outputs Outcomes	Focuses on improving process management and affects outcomes (client satisfaction)
16	Guidelines On "Morning Meetings"	Process Operational strategy	Improve process efficiency and effectiveness
17	Guidelines for the Award of the Excellent Service Awards	Process Operational strategy Outputs	Has bearing on process, productivity, and outputs
18	Guidelines on Clients' Charter	Process Operational strategy Outputs Outcomes	Improves work process, identifies performance standards, and sets benchmarks; linked to outputs and outcomes
19	Guidelines on Implementation of Service Recovery	Process Outputs Outcomes	Focuses on improving process and outputs and has bearing on outcomes.
20	ISO 9000 Standards in the Public Sector	Inputs Process Outputs	Helps set process and output standards, determines inputs, and allows benchmarking
21	Use of New Forms for Asset, Inventory, and Office Supply Management	Process Operational strategy	Focuses on improving process efficiency
	The Modified Budgeting System (MBS)	Inputs Process Operational Strategy Outputs Outcomes Evaluation	Focuses on all aspects of program performance and emphasizes monitoring and evaluating performance

ANNEX 5: TRANSFERS TO NONDEPARTMENTAL ENTITIES

The Malaysian government subsidizes nondepartmental entities through several mechanisms: direct grants, recoverable loans investments, guarantees, and tax expenditures. Direct assistance to these entities in terms of grants, investment and loan are treated as expenditures in the budget, indirect assistance such as guarantees and tax expenditures are not budgeted.

Direct Grants

Direct grants are made annually or on a one-time basis (for example, a launching grant). A substantial share of the direct grants go to statutory bodies in the form of financial assistance by the federal statute relevant to the statutory body, these grants usually continue until the agency is abolished. For public enterprises, the assistance is usually annual and subject to review from time to time. Corporatized and privatized entities usually receive either an initial launching grant or loans (recoverable) with special conditions. Often such assistance continues for years, especially for corporatized government agencies. In 1997 grants (including fixed charges) totaled more than RM40 billion (table A5.1).

Table A5.1 Grants, Fixed Charges, and Loan Disbursements, 1995-97
(RM millions)

	1995	1996	1997
Operating expenditure -			
Grants & Fixed Charges	31,077	36,127	43,237
Development expenditure -			
Direct expenditure	12,458	11,970	13,670
Loan disbursements	1,593	2,658	2,080
Total	**45,128**	**50,755**	**58,987**

The bulk of the grants are under the operating budget and come under the revenue account of the federal consolidated fund. These transfers go mainly to agencies (including state governments) for meeting various expenditure commitments. They also include grants to all universities, which appear only as a line item in the budget estimates with no expenditure details (as is also the case for most transfer payments). The direct expenditure in the development expenditure category takes the form of approved development budget allocations applied directly to development projects under the Malaysia Plans.

Recoverable Loans

The total amount of loans to nondepartmental entities is substantial compared with the budget. For example, under the memorandum asset account recoverable loans totaled a massive RM48.1 billion in December 1996, 80 percent of the budget (table A5.2). This figure increased to RM51.8 billion at the end of 1997.

Table A5.2 Federal Government Recoverable Loans, 1996

Category of loan recipients	RM millions	Percentage of total
State governments	7,499	15.6
Local authorities	653	1.4
Statutory bodies	9,045	18.8
Cooperatives	91	0.1
Companies	9,444	19.6
Individuals	14,900	31.0
Others	6,497	13.5
Total recoverable loans	***48,129***	***100.0***

Of the total RM48.1 billion in loans outstanding at the end of 1996, 18.8 percent accounted for statutory bodies and companies for 19.6 percent. Loans often provide the bulk of the start-up and short-term operating funds for such entities. See table A4.3 for the breakdown of recoverable loans by entity.

Table A4.3: Federal Government Recoverable Loans by Type of Entity 1996:

Loan Categories	RM Million	Percentage of total
State governments	7,499	15.6
Local Authorities	653	1.4
Statutory Bodies	9,045	18.8
Agricultural Bank	*489*	
Perak Water Authority	*264*	
South Kelantan Development Authority	*164*	
South-east Pahang Development Authority	*93*	
Federal Land Development Authority	*3,371*	
Sabah Land Development Authority	*13*	
Sarawak Land Development Authority	*39*	
Central Terengganu Development Authority	*113*	
Jengka Regional Development Authority	*6*	
Kedah Regional Development Authority	*31*	
Penang Regional Development Authority	*92*	
Malaysia Highway Authority	*1,223*	
Sabah Electricity Board	*277*	
Port Kelang Authority	-	
Kuantan Port Authority	*22*	
Federal Agricultural Marketing Authority	*1*	
Construction Industry Development Board, M'sia	*7*	
Langkawi Development Authority	*24*	
Federal Land Consolidation & Rehabilitation Auth	*1,088*	
Citizens Trust Council (MARA)	*108*	
Kuala Lumpur Commodity Exchange	*2*	
Melaka Water Corporation	*3*	
Railway Assets Corporation	*1,453*	
Sarawak Electricity Supply Corporation	*(29)*	
National Farmers' Association	-	
Rubber Industry Smallholders Development Authority	*186*	
Cooperatives	91	0.1
Companies	9,444	19.6
Asean Bintulu Fertilizer Pte Ltd	*(565)*	
Industrial Bank Malaysia Ltd	*362*	
Development Bank Malaysia Ltd	*539*	
Composites Technology Research Malaysia Ltd	*56*	
Equal Concept Pte Ltd	*105*	
Johor Port Pte Ltd	-	
Keretapi Tanah Melayu Ltd	*203*	
KESAS Pte Ltd	*36*	
Kompleks Kewangan Malaysia Ltd	-	
Malaysia Building Society Ltd	*157*	
Malaysia Shipyard & Engineering Pte Ltd	*117*	
MTD Prime Pte Ltd	*137*	
Malaysian Rubber Development Corporation Ltd	*12*	
Malaysian International Shipping Corporation Ltd	-	
Heavy Industries Corporation of Malaysia Ltd	*476*	
Peremba Ltd	*559*	
Perwaja Terengganu Pte Ltd	*2,403*	
Petroleum Nasional Ltd	*52*	
Projek Lebuhraya Utara Selatan Bhd. (PLUS)	*2,266*	
Projek Usahasama Transit Ringan Automatik Pte Ltd	*1,200*	
Sistem Transit Aliran Ringan Pte Ltd	*329*	
Sukom Ninety Eight Ltd	*10*	
Syarikat Air Johor Pte Ltd	*133*	
Syarikat Grand Saga Pte Ltd	*30*	
Syarikat Indah Water Konsortium Pte Ltd	*151*	
Syarikat Jengka Pte Ltd	*33*	
Syarikat JKP Pte Ltd	*33*	
Syarikat SME Ordinance Pte Ltd	*20*	
Syarikat Padiberas Nasional Ltd	*61*	
Syarikat Seremban-Port Dickson Highway Pte Ltd	*22*	
Syarikat Permodalan Kemajuan Perusahaan M'sia Ltd	*6*	
Syarikat Takaful Malaysia Ltd	*500*	
Syarikat Telekom Malaysia Ltd	*749*	
Tenaga Nasional Ltd	*(159)*	
UDA Holdings Pte Ltd	*734*	
United Engineers (M) Ltd	*131*	
Individuals	14,900	31.0
Others	6,497	13.5
Total Recoverable Loans	**48,129**	**100.0**

Investments

Another area of public expenditure important for nondepartmental entities and operations is investment expenditure. This too is quite substantial, amounting to RM9.5 billion in 1996 and RM11.9 billion in 1997. For annual budgetary purposes, all investments appear in the estimates as expenditures under the consolidated revenue account. These fall under the transfer payment category, which in 1997 accounted for RM43.2 billion. Among investment categories, the most significant is equity, which accounts for a substantial share of both general and special trust fund investments (table A4.4).

Table A4.4: Federal Government Investments, 1996

Investment Categories	RM Million	Percentage of total
General investments	667	7
Malaysian government securities	142	
Equity	403	
Foreign government securities	104	
External deposits	16	
Others	2	
Special trust funds investments	8,842	93
Malaysian government securities	44	
Equity	3,199	
Domestic deposits	4,168	
Foreign government securities	145	
External deposits	484	
Others	802	
Total investments	**9,509**	**100**
Investments charged to expenditure	***6,685***	

Companies received the bulk of total investments charged to expenditure (table A4.5). Almost all the companies that received government investments also received direct grants (where applicable) and loans from the government. This is to be expected and may even be justified because many of the companies are actually government agencies or functions that have been corporatized or privatized.

Government Guarantees

The government also assists nondepartmental entities and their operations through standing guarantees for loans entered into by these entities. In 1996 the government extended guarantees worth RM13.1 billion; in 1997 the figure almost doubled to RM 23.3 billion (table A4.6). At the end of 1996 the government had extended guarantees for at least 10 statutory bodies and 16 companies (table A4.7). All these were companies in which the government had a direct interest because of their being corporatized or privatized or because of its regulatory role. They include companies in banking and finance, construction, transportation, telecommunications, and energy.

Table A4.6: Federal Government Loan Guarantees, 1996

Type of entity	RM millions	Percentage of total
Statutory bodies	1,388	10.6
Companies	11,712	89.4
Total guarantees	**13,100**	**100.0**

Tax Expenditures

Nondepartmental entities also enjoy an array of tax benefits, breaks, and exemptions. Although these tax expenditures should be accounted as transfers to nondepartmental entities and treated like any other subsidy, they are neither budgeted nor reported in Malaysia.

Table A4.5: Federal Government Investments by Entity, 1996 Investment Category

Entity	RM million
Statutory bodies:	
Central Bank Malaysia	100
Agricultural Bank Malaysia	41
Port Kelang Authority	9
Railway Assets Corporation	117
Companies:	
Aerospace Industries Systems Pte Ltd	0
Aerospace Technology Systems Corp. Pte Ltd	8
Amanah Raya Ltd	6
Asean Copper Products Incorporated	228
Asean Potash Mining Co. Ltd	7
Bank Bumiputera Malaysia Ltd	1,278
Bank Industri Malaysia Ltd	188
Bank Islam Malaysia Ltd	
Bank Pembangunan Malaysia Ltd	104
Bintulu Port Pte Ltd	
Cableview Services Pte Ltd	
Composites Technology Research M'sia Pte Ltd	112
Dataran Perdana Pte Ltd	29
Equal Concept Pte Ltd	49
Export-Import Bank Malaysia Ltd	
Felda Holdings Ltd	
HICOM Holdings Ltd	26
HVD Holdings Ltd	20
Institut Jantung Negara Pte Ltd. (heart institute)	72
Institut Terjemahan Negara Malaysia Ltd	29
JKP Pte Ltd	
Johor Port Ltd	0
Kelang Port Management Pte Ltd	0
Keretapi Tanah Melayu Ltd (railway)	146
Khazanah Nasional Ltd.	1,582
K.L. International Airport Ltd	200
Lembaga Letrik Sabah	472
Malaysia Airports Ltd	0
Malaysia Batek & Handicraft Ltd	0.3
Malaysian International Shipping Corp. Ltd	
Malaysian Airline Systems Ltd	0
Malaysian Broadcasting Corporation Pte Ltd	0
MARDEC Ltd	126
MIMOS Ltd	
Naval Dockyard Pte Ltd	
Pelabuhan Tanjung Pelepas Pte Ltd	0
Penang Port Pte Ltd	73
Perbadanan Nasional Ltd (PNB)	747
Percetakan Nasional Ltd	45
Perwaja Terengganu Pte Ltd	650
Petrolium Nasional Ltd (PETRONAS)	10
Pos Malaysia Ltd	0
Radio Lebuhraya Pte Ltd	
Rangkaian Hotel Seri Malaysia Pte Ltd	5
Sports Toto Malaysia Pte Ltd	
Syarikat Perumahan Pegawai Kerajaan Pte Ltd	26
Syarikat Padiberas Nasional Ltd	
Syarikat Tanah & Harta Pte Ltd	0
Technology Park Malaysia Corporation Pte Ltd	
Telekom Malaysia Ltd	66
Tenaga Nasional Ltd	54
UDA Holdings Ltd	300
International agency:	
International Finance Corporation	35
Total investments[a]	**6,685**

Does not include General Investments

ENDNOTES

[1] In1998, almost a fifth of the total development budget was allocated to this sector as a result of the government's efforts in counteracting the adverse effects of the crisis on the financial and infrastructure sectors—seed money for Danaharta, Danamodal, and the Infrastructure Development Fund, entities set up with the objective of recapitalization of the banks, restructuring of privatized corporate entities and funding stalled infrastructure projects.

[2] The government has provided incentives to the private sector by: i) raising tax concessions for the costs of medical treatment for a taxpayer's parents, ii) increasing tax relief on medical insurance, iii) abolishing import duties and sales taxes on all basic medical equipment and vehicles used in medical services, iv) creating an income tax deduction for individual investments in health facilities, and v) giving an investment allowance of 60 percent to private hospitals for qualifying capital expenditure incurred to establish special wards for lower-income patients. Moreover, in 1994 the government introduced a scheme to allow withdrawals of up to 10 percent from the Employees Provident Fund (EPF) to pay for the medical treatment of major diseases and conditions, in either the public or private sectors.

[3] Public health programs are also undertaken by local authorities and teaching hospitals and these expenditures must also be taken into consideration in assessing the overall budget allocations.

[4] Although poor people suffer from all health problems, the gap between rich and poor is widest for communicable diseases, which affect poor people at twice the rate at which the rich are affected (Murray and other, 1992).

[5] First, the number of bidders for non-medical supply services was reduced (to ten, according to sources) and the government awarded three separate contracts, each for a particular ad hoc region. This is better than the initial plans for a sole concessionaire but remains incompatible with real competition. Second, the duration of the concession (fifteen years) is too long given the nature of the services contracted out and the initial investment by the concessionaires. Third, negotiations with the concessionaire have been made despite very poor knowledge of the real cost of the services. Fourth, it seems that the government's costs can be revised only upward and not downward, and only every three years, which is not flexible enough. Fifth, there is evidence that financial penalties, levied in accordance with an agreed-upon deduction formula, are difficult to enforce.

[6] Spillovers from higher education include: more informed debate and voting behavior; and benefits accruing to workers from the imitation of the skills of the highly educated that do not accrue to graduates.

[7] The cut-off point for family income for 1998 loans was 46,666 RM per annum—seven times the official poverty line.

[8] Recently, the idea of setting up a national retrenchment fund was mooted. The proposal was to pay RM1 per month to the fund while employers would pay another RM1 per worker and this could be used to provide flat and modest unemployment benefits for the retrenched workers. The government rejected the idea on the ground that such a fund could increase the production costs incurred by employers and in turn affect the competitiveness of the market. The Employers rejected the proposal saying that it would cause them to incur additional expenses and that retrenched workers were already adequately covered under the Employment Act 1955.

[9] Since the oil crisis of the 1970s, France has also used a system of cross-subsidization across companies to assist investment programs in underdeveloped regions. Spain has eschewed this system because it reduces incentives for improved efficiency.

[10] Although original project proposals assumed that government would encourage the traffic shift from private to public transport, the government has not implemented many of the proposed strategies. While a

lag in phasing-in restraints is consistent with the stated aim of completing a satisfactory alternative public transport system before controlling car traffic, this reality was not reflected in project forecasts.

[11] The relative attractiveness of private cars and public transport depends significantly on the degree of road congestion. The latter has continued in KL partly due to low charges on gasoline.

[12] Gasoline prices in Malaysia are low compared to Korea, Japan, Hong Kong, or Singapore.

[13] Unbundling is not always enough to foster true competition: in the U.K., two generating companies dominated the market after the system was unbundled, which kept prices high; in Chile, although the sector was unbundled, a major holding company had significant ownership in generation, transmission, and distribution, once again raising concerns regarding the degree of effective competition.

[14] The partially privatized Tenaga Nasional Berhad (TNB), earlier the National Electricity Board supplies power in Peninsular Malaysia. The Sabah Electricity Sdn. Bhd., under the majority ownership of TNB with the state government retaining a minority share, supplies power in Sabah. The Sarawak Electricity Supply Company, wholly owned by the state government, supplies power to Sarawak.

[15] A distinction is made between competition "in" the market and "for" the market. When economies of scale do not permit multiple suppliers to compete directly against each other ("in" the market), competition is possible "for" the right to provide service. Malaysia not only passed up the opportunity to create competition "in" the market (e.g., the electric power sector) but also chose not to use competition "for" the supply of power and most other infrastructure services by avoiding competitive bidding.

[16] Parliament votes on 35 supply expenditure heads and 33 development expenditure heads for 23 ministries; and ministries have the flexibility to move funds between programs during budget implementation.