

Malaysia Economic Monitor

Immigrant Labour

DECEMBER 2015



MALAYSIA ECONOMIC MONITOR

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IMMIGRANT LABOUR

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ABBREVIATIONS

PR1MA	1Malaysia Housing Program
ADB	Asian Development Bank
11MP	11 th Malaysia Plan
AEC	ASEAN Economic Community
ASEAN	Association of Southeast Asian Nations
BNM	Bank Negara Malaysia
BR	Base Rate
Bbl	Barrel
BLA	Bilateral Agreements
BoP	Balance of Payments
BR1M	<i>Bantuan Rakyat 1 Malaysia</i>
BRICS	Brazil, Russia, India, China and South Africa
JKKPA-PATI	Cabinet Committee on Foreign Workers and Illegal Migrants
CEBR	Centre for Economics and Business Research
CGE	Computable General Equilibrium
CIDB	Construction Industry Development Board
RELA	Citizen Volunteer Force
CPI	Consumer Price Inflation
CSC	Critical Skills Monitoring Committee
DSR	Debt Service Ratio
DECPG	Development Economics Research Prospects Group
DOI	Department of Immigration
DOSM	Department of Statistics of Malaysia
EAP	East Asian and Pacific
e-PPM	e-application System
LMD	Labour Market Database
E&E	Electrical and Electronics
ELX	Electronic Labour Exchange
EPF	Employees Provident Fund
EPS	Employment Permit System
EU	European Union
EB	Evidence-Based
ESD	Expatriate Services Division
MYXpats	Expatriate Talent Service Centre
FDI	Foreign Direct Investment
SPIKPA	Foreign Workers Health Insurance Protection Scheme
FBM KLCI	FTSE Bursa Malaysia Kuala Lumpur Composite Index
G&S	Goods and Services
GOF	General Operation Force
GLCs	Government Linked Companies
GNI	Gross National Income
GST	Goods and Services Tax
G2G/G-to-G	Government-to-government
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
FOMEMA	Health screenings of immigrants
HR	Human Resource
HRDF	Human Resources Development Fund
ICT	Information and Communications Technology
I-Card	Identification Card
ILO	International Labour Organization
IMF	International Monetary Fund
MyIMMS	Immigration Information and Monitoring System
ILMIA	Institute of Labour Market Information and Analysis
JTK	<i>Jabatan Tenaga Kerja</i> / Department of Labour
LFS	Labour Force Survey
LFPR	Labour Force Participation Rate
LCR	Liquidity Coverage Ratio
LRT	Light Rail Transit
MASCO	Malaysia Standard of Occupational Categories
MAEI	Malaysian American Electronics Industry

MEF	Malaysian Employers Federation
MMEA	Malaysian Maritime Enforcement Agency
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
MIDA	Malaysian Investment Development Authority
MIDF	Malaysian Industrial Development Finance
MAC	Migration Advisory Committee
MOA	Ministry of Agriculture
MoF	Ministry of Finance
MOHA	Ministry of Home Affairs
MOHR	Ministry of Human Resources
MPIC	Ministry of Plantation Industry and Commodity
MOTAC	Ministry of Tourism and Culture
MOW	Ministry of Works
MPC	Monetary policy committee
MOU	Memorandum of Understanding
MRT	Mass Rapid Transit
MDeC	Multimedia Development Corporation
MSC	Multimedia Super Corridor
MYR	Malaysia Ringgit
NFPC	Non-Financial Public Corporations
NRD	National Registration Department
NTMs	Non-Trade Measures
OMARA	Office of Migration Agents Registration Authority
OECD	Organization for Economic Cooperation and Development
OSC	One-Stop-Center
OBB	Outcomes Based Budgeting
OC	Outsourcing Companies
OPR	Overnight Policy Rate
PPI	Producer Price Index
PLKS	Visit Pass (Temporary Employment)
PMR/SRP	<i>Penilaian Menengah Rendah/Sijil Rendah Pelajaran/Malaysian School Certificate</i>
PBS	Points-Based Systems
PEAs	Private Employment Agencies
PMIs	Purchasing Managers' Indices
q/q	Quarter-on-Quarter
RSE	Recognized Seasonal Employers scheme
RP-T	Residents Pass-Talent
REE	Retraining and Experience Enhancement
SAAR	Seasonally Adjusted and Annualized
SARS	Severe Acute Respiratory Syndrome
SAWP	Seasonal Agricultural Workers Program
SMEs	Small and Medium Enterprises
SOCSSO	Social Security
SPM/SPMV	<i>Sijil Pelajaran Malaysia/Sijil Pelajaran Malaysia Vokasional</i>
ST15	Super Tempatan 15 rice
STPM	<i>Sijil Tinggi Persekolahan Malaysia/ Malaysian High School Certificate</i>
TalentCorp	Talent Corporation Malaysia Berhad
TE	Temporary Employment
TVET	Technical and Vocational Education/Training
UK	United Kingdom
UN	United Nations
UNDP	United Nations Development Programme
UNHCR	United Nations High Commissioner for Refugees
UPSR	<i>Ujian Pencapaian Sekolah Rendah/ Malaysian Primary School Certificate</i>
US	United States
VDR	Visa with Reference
VP	Visit Pass
WPS	Wages Protection System
WDI	World Development Indicators
WB	World Bank
y/y	Year-on-year

TABLE OF CONTENTS

Executive Summary	1
The Malaysian Economy in Pictures.....	4
IMMIGRANT LABOUR in Pictures.....	5
1. Recent Economic Developments and Outlook	6
Growth moderates on domestic and external headwinds.....	6
Renewed headwinds from the external sector	7
Strong E&E exports partially compensated for weak commodities	7
The current account surplus narrowed as the economy adjusted to lower commodity prices.....	7
Domestic demand remains the key driver of growth despite headwinds	10
Steady investment compensates for slower consumption	10
Labour markets remain steady but real wage growth slows.....	11
Inflation rose temporarily but moderated on account of lower oil prices.....	12
Fiscal consolidation proceeds despite declining oil related revenues	13
Growing uncertainties in domestic and external financial conditions.....	15
Monetary policy remains accommodative and watchful amid uncertainty domestic and global demand prospects.....	15
Credit growth to businesses remain strong while household credit moderates	15
Ringgit depreciation accelerated as volatility in external flows picked up	17
Continuous economic growth expected but clouded by domestic and external uncertainties	19
A moderation expected as the economy adjusts to the new global economic scenario.....	19
Domestic demand continues to drive growth despite headwinds.....	20
Increased volatility in the global macroeconomic environment poses risks to growth	21
Fiscal reforms have increased resilience, but as oil related revenues remain dampened fiscal consolidation will become increasingly difficult	23
Risks to the near-term remain elevated as the global economy adjusts to new fundamentals	25
2. Immigrant Labour.....	28
As Malaysia aspires to become a developed economy by 2020, there is growing attention on the role that immigration will play in that process.....	28
Immigrant labour is a crucial contributor to Malaysia's development	28
Immigration is a structural element of Malaysia's economy.....	31
Who are the immigrants and where are they working in Malaysia?	33
Immigration to Malaysia has kept pace with labour force growth.....	33
Immigrant workers are younger and less-educated than Malaysians	34
Malaysian workers tend to have a wage premium over immigrant workers	38
What are the economic and social costs and benefits of immigrant workers in Malaysia?.....	38
Immigration to Malaysia increases GDP.....	39
Immigration increases employment and wages for most Malaysians.....	41
Additional analytical work would serve to better understand the impact of immigration on competitiveness in Malaysia	43
The fiscal impacts of immigration are likely to be small.....	45
Remittance outflows from Malaysia are significant but efforts to minimize them would have undesirable effects	47
Significant challenges exist in Malaysia's current approach to migration	48
Fragmentation and lack of coordination has hampered efforts to control illegal immigration	49
Agreements with other governments are not fully aligned with labour market needs	50
The current immigration admission system does not respond well to market needs.....	52
Admission of foreign workers relies on arbitrary cut-offs which can be easily violated	53
The sourcing and recruitment process for immigrant workers is lengthy and does not accord the necessary protection to workers	55
The current B2B recruitment process imposes high costs on immigrant workers, which yields perverse incentives for immigrants to become undocumented.....	56
Current enforcement efforts focus largely on punishing workers rather than on non-compliant employers.....	58
Malaysia's repatriation policies is not well balanced between stakeholders	61
Leveraging immigrant labour to boost growth – policy considerations for Malaysia.....	62
Align the economic immigration system with broader development objectives	62
Making the immigration system market-driven	64
Making the immigration system comprehensive	66
Making the immigration system balanced	69

Overarching Principle: Continue filling knowledge gaps to guide the reform process.....	71
Annex 1: The Levy System since its Inception.....	73
Annex 2: Estimating the causal Impact of Immigration on Economic and Social Outcomes	75
References	76

BOXES

Box 1: How are commodity producers responding to the commodity downturn?	9
Box 2: Strengthening public financial management for better service delivery.....	23
Box 3: Potential implications of the Trans-Pacific Partnership	26
Box 4: Foreign Domestic Workers and Female Labour Force Participation	30
Box 5: The Labour Force Survey and administrative sources provide quality data for the analysis of the impact of immigration in Malaysia	33
Box 6: The trade-offs of restrictive immigration policies	39
Box 7: Understanding the impact of immigrant workers on competitiveness	43
Box 8: The importance of the Economic Census for studying the productivity impacts of immigration	44
Box 9: Impact of Immigrant Labour on Crime	47
Box 10: Singapore's management of levy rates	53
Box 11: Results of the 6P program	60
Box 12: Main tiers of migrant labour.....	66

FIGURES

Figure 1: Malaysia's GDP growth moderated in the third quarter... ..	6
Figure 2: ...as ASEAN growth remained subdued alongside soft external demand.	6
Figure 3: Commodity exports remained soft despite increases in volumes of crude oil.....	7
Figure 4: E&E exports picked up across all major trading destinations, especially the US	7
Figure 5: The current account surplus narrowed further... ..	8
Figure 6: ... as lower commodity prices led to a narrowing of the commodity surplus	8
Figure 7: Lower tourist arrivals led to decline in tourism revenues	9
Figure 8: ...while current transfers remain large, largely motivated by the high number of foreign workers	9
Figure 9: Steady fixed investment helped to offset slower private consumption.....	11
Figure 10: The average investment-to-GDP ratio remained largely steady throughout 2015	11
Figure 11: The labour force participation remains stable and the unemployment rate remains low	12
Figure 12: Real wages and employment decelerated in manufacturing	12
Figure 13: Core inflation increased after the introduction of GST... ..	13
Figure 14: ...but price movements throughout 2015 are driven by transport (fuel) prices	13
Figure 15: Containment of operational expenditures helped to meet the fiscal target	14
Figure 16: The dependency on oil-related revenues continues to decline	14
Figure 17: Fiscal consolidation proceeds more slowly.....	14
Figure 18: Non-financial public corporations continued to ramp up development spending	14
Figure 19: Real policy rates have remained in positive territory since the latest hike	15
Figure 20: Loans continued to expand faster than deposits.....	15
Figure 21: Growth in working capital loans continues to drive business credit expansion	16
Figure 22: Household loan growth declined mainly in the riskier segments	16
Figure 23: The financial account deficit remained significant... ..	18
Figure 24: ...as foreigners reduced appetite for government bonds.....	18
Figure 25: Real effective depreciation of the ringgit intensified in Q3 compared to countries in the region	19
Figure 26: Reserves further declined, but remain above the levels prior to the Euro area crisis	19
Figure 27: The median consensus forecasts for 2016 declined over the last two quarters.....	20
Figure 28: Inflation is expected to remain subdued as oil prices stabilize	20
Figure 29: PMIs further deteriorated across the board in 2015... ..	22
Figure 30: ...dampening the outlook for Malaysian export growth	22
Figure 31: The current account is expected to remain in a small surplus.	22
Figure 32: More high-skilled jobs are being created... ..	29
Figure 33: ...but low- and mid-skilled jobs remain dominant.	29
Figure 34: Most foreign domestic workers are from Indonesia and the Philippines	30
Figure 35: Malaysia has one of the largest migrant stocks in East Asia and the Pacific	31
Figure 36: The immigrant labour share of the labour force remained in a narrow range between 2001 and 2014	31
Figure 37: Large income disparities in the region attract migrant flows towards Malaysia.....	32
Figure 38: In the medium term, younger immigrants may further compensate for Malaysia's ageing population.....	32
Figure 39: Labour force participation rates of male and female immigrants are much higher than those of Malaysians.	34

Figure 40: Unemployment is low among both Malaysian and immigrant workers, but slightly lower among immigrants	34
Figure 41: The immigrant workforce is younger than the Malaysian workforce... ..	35
Figure 42: ...and is concentrated in Sabah where immigrant workers make up 35 percent of the total workforce.....	35
Figure 43: Indonesians remain Malaysia's main immigrant group	36
Figure 44: Immigrant workers from Bangladesh and Nepal are less concentrated in plantations and agriculture	36
Figure 45: Malaysians are much better educated than immigrant workers... ..	36
Figure 46: ...and this educational gap has increased since 2001.	36
Figure 47: Immigrant workers represent a significant share in some manufacturing and services sectors... ..	37
Figure 48: ...and dominate elementary occupations where they are almost half of the workforce.	37
Figure 49: Malaysian workers earn significantly more than immigrant workers and this gap has grown since 2007	38
Figure 50: Malaysian workers earn a wage premium in the occupations where most immigrants work.	38
Figure 51: Immigrants do not affect local unemployment and labour force participation rates, but increase employment for Malaysians... ..	42
Figure 52: ...especially for Malaysians aged 20-49 years old and those with more education.	42
Figure 53: Immigration causes a small increase in the wages of Malaysians but a large decline in those of immigrant workers.	43
Figure 54: The impact of immigration on the wages of Malaysians differs based on their educational background	43
Figure 55: More immigrant workers are associated with higher productivity... ..	44
Figure 56: ... and generally firms with immigrant workers have higher value-added per worker.....	44
Figure 57: Immigrants have a small fiscal impact in OECD countries.....	46
Figure 58: In Malaysia, the levy on foreign workers currently raises RM2.6 billion or 0.24 percent of GDP	46
Figure 59: Economic immigration reduces both property and violent crime statistics.	48
Figure 60: Fundamentals of Immigration Management Systems	49
Figure 61: Overview of Malaysia's Migration Management System.....	50
Figure 62: The number of registered foreign workers from Indonesia declined substantially after the signing of the MOU between the two countries.....	51
Figure 63: Decreasing the levy levels does not increase the number of foreign workers in manufacturing... ..	53
Figure 64: ...nor is it effective in the construction sector	53
Figure 65: The Tier 3 threshold seems to have an effect on wages in the construction sector... ..	55
Figure 66: ...and there is some evidence of a peak in the distribution of wages around the lower RM2,500 threshold. 55	55
Figure 67: Percent of costs paid by employers, outsourcing companies and foreign workers	58
Figure 68: Most undocumented people legalized in the 6P program worked in unidentified sectors	60
Figure 69: Policy proposals and relevant actions for Malaysia to consider.....	63

TABLES

Table 1: Commodity producers have responded to the downturn using a range of policies	10
Table 2: Slower growth is expected in 2016-17 as private consumption cools... ..	20
Table 3: ...and the economy adjusts to a new global economic scenario.	20
Table 4: Factors used to calculate the dependency ceiling at the firm level.....	52
Table 5: Categories of foreign worker and expatriate passes.....	54
Table 6: Percentage of respondents who do not comply with labour laws	59
Table 7: Historical Overview of Malaysia's MOUs	74

EXECUTIVE SUMMARY

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Growth moderated throughout 2015, affected by a slowdown in private consumption and weak export growth. Real Gross Domestic Product (GDP) in 2015 has slowed down (Q3: 2.6%; Q2: 4.7%, q/q saar). After a strong Q1 performance in anticipation of the Goods and Services Tax (GST) implementation in April, private consumption remained subdued (Q2: -1.0%, Q3: +1.0%, q/q saar). In a context of lower commodity prices and depressed external demand, net exports reduced overall growth in the first half (Q1: -1.3%, Q2: -1.0%), but buoyant Electrical and Electronics (E&E) exports lifted growth slightly in the third quarter (Q3: +0.2 percent q/q saar). Services exports declined in part due to lower tourism revenues.

GDP growth is projected to be 4.7% in 2015, easing to 4.5% in 2016 and 2017. The outlook reflects some slowdown in domestic demand in 2015 from tighter fiscal conditions, which are expected to continue in 2016-17. As a result, private consumption growth will moderate from 7.0% in 2014 to 5.3% in 2015 and 2016, affected by the slowdown in disposable income, and a soft labour market. Despite headwinds from the oil and gas sector, fixed investment is projected to continue expanding, driven by strong public infrastructure development. Overall, domestic demand is projected to grow by 5.1% and 5.0% in 2016 and 2017, respectively, and remain the main driver of growth in a context of soft global demand.

The authorities have generally managed the downturn in commodity prices and the financial market volatility with a reasonable mix of macro policies. Weaker-than-expected global growth, uncertainty about the normalization of the US monetary policy and perceived risks from a slowdown in China have translated into strong net portfolio outflows from emerging markets, including Malaysia (RM44.0 billion until Q3 2015), as well as substantial depreciation of currencies across emerging markets. The strong and rapid decline in commodity prices further reinforced this process for commodity producers. To adjust to this new scenario, the authorities have allowed the Ringgit to nominally depreciate by 20.5% as of December 8, and have drawn down official reserves by USD21.9 billion in 2015 (19% of total reserves) to smooth the rapid adjustment. This was also accompanied by monetary and fiscal restraint.

The current account balance is projected to remain in a small surplus. With depressed commodity prices, strong investment expansion, and rising import costs due to the weaker ringgit, the current account surplus is projected to narrow from 4.3% of GDP in 2014 to 2.5% of GDP in 2015, and remain at 2.6% in 2016. Ringgit depreciation could however support non-commodity exports.

Monetary policy remains accommodative. Inflation remains at 2.5% (y/y) as of October 2015 due to low fuel prices and slower wage growth. The overnight policy rate is unchanged at 3.25% since July 2014 due to support growth. Moving forward, interest rate increases are constrained by substantial-but-moderating household indebtedness (88.4% of GDP) and slower GDP growth. Interest rate reductions are limited by the expected raising of the U.S. raises interest rates.

Introducing the GST and scrapping fuel subsidies were timely and critical reforms. Fuel subsidy removals have led to savings of 0.9% of GDP, while GST collection is expected to amount to 2.3% of GDP in 2015. Together, these compensate for losses from foregone oil-related revenue amounting to 2.2% of GDP. If key revenue sources decline, development expenditures under the 11th Malaysia Plan may be difficult to maintain. With public debt close to its legal limit, there is a need to contain operational expenditures, improve the quality of public expenditure and take further tax measures to achieve a balanced budget by 2020. This may be achieved by reducing tax exemptions and zero-rated products in the GST, and expanding Malaysia's narrow personal income tax base.

Heightened external volatility calls for prudent macro policies and acceleration of structural reforms. In a context of uncertain global growth, subdued oil prices and financial market volatility, a focus on boosting investor sentiment is critical. Delivering on policy commitments such as fiscal consolidation, and resolving political issues that challenge Malaysian institutions and transparency can reassure foreign investors. Also, the recent conclusion of the Trans-Pacific Partnership (TPP) agreement represents an important commitment on structural reforms that may further increase output potential in the medium term, further boosting investor sentiment.

IMMIGRANT LABOUR

The 11th Malaysia Plan stresses the importance of effective migration management to achieve high-income country status by 2020. An accounting of the costs and benefits associated with the 2.1 million registered- and likely over 1 million undocumented-immigrants is crucial to understanding how Malaysia can leverage immigration to achieve its goal.

Immigration continues to play a crucial role in Malaysia's development. While job growth has recently been concentrated in high-skilled occupations, three quarters of all jobs in Malaysia are still low- and mid-skilled. As Malaysians have become more educated and have sought out higher-skilled jobs, and as the labour market remains tight, immigrant labour has filled important gaps in low- and mid-skilled jobs. In parallel, highly skilled expatriates provide specialized skills not available locally.

Econometric modelling suggests that immigrant workers could raise GDP and create employment for Malaysians. Results indicate that a 10% net increase in low-skilled foreign workers increases real GDP by 1.1%. Low skilled immigrants fill workforce gaps, reduce production costs and expand output and exports. As a result, unskilled employment increases and profits rise which increases investment and the demand for higher skilled Malaysians. Results also show that immigration increases employment of Malaysians; for every 10 new migrant workers in a sector in a state, there are 5.2 additional Malaysians employed, indicating immigrant and Malaysian workers, on average, are complements. This is mostly a reallocation effect where Malaysian workers move from sectors and states with low to high immigrant presence. Furthermore, under reasonable assumption on labour supply elasticities, it can be shown that 10 new migrant workers would create between 0.3 and 0.5 new jobs nationwide. These are much more positive impacts of migration on employment than most studies, which typically find small but negative impact on employment.

Immigrant labour slightly increases the wages of most Malaysians. A 10 percent increase in immigration flow slightly increases overall wages of Malaysians by 0.14% but reduces significantly salaries of immigrant workers already in the country by 3.94%. The increase is largest for Malaysians with at least some secondary education, suggesting an impact on supervisory and management jobs held by Malaysians. Immigration

has negative impacts on the wages of the least-educated Malaysians, which represent 14 percent of the total labour force, and whose wages decline by 0.74%. There is no statistical impact on labour force participation or unemployment.

Rigorous evidence of the relationship between low-skilled immigrants and innovation and technology adoption is very limited, and inconclusive. One study finds that immigrants cause a decline in the capital-to-labour ratio in Malaysia and other East Asian countries. However, another study finds that there is no negative impact on technology adoption as a result of immigrant labour in the manufacturing sector. Both studies contribute to a better understanding of the impacts, but they are not sufficient to ascertain the impact on Malaysia's development storyline as they are not representative of the economy as a whole. Further research is needed.

The overall fiscal impact of immigrant workers is small, and the fiscal burden is mostly borne by undocumented people. The fiscal contribution of documented immigrants in Malaysia is likely to be positive. Indirectly, they raise employment and wages of Malaysians which in turn contributes to public revenues. Directly, levies on documented immigrant workers raised 1.2% of total revenues in 2014. They are also insured against health costs, limiting government's exposure to social welfare costs. Undocumented people represent a higher fiscal burden, as they do not pay a levy, are often uninsured and raise costs associated with their health care and detention. For instance, expenditures for incarceration (food and transport) and deportation of undocumented immigrants in 2015 was about RM26 million.

Malaysia's current approach to migration poses challenges. Malaysia's economic immigration management system is fragmented, which hampers efforts to control the number of immigrants admitted. There are more than ten different ministries, and departments within these ministries, directly engaged in the approval of immigrant labour. Fragmentation limits coordination between institutions, resulting in frequent duplication of functions and difficulty in controlling non-compliance with immigration and labour law. The current approval of immigrant labour does not reflect labour shortages or labour market demands. Also, to manage immigration flows, the system uses a combination of quotas and levies that are semi-static (they seldom change) and uncorrelated with the varying of market conditions.

The current process for sourcing immigrant workers is complex and costly for the migrant.

Foreign workers who come to Malaysia face high costs of migration, potentially ranging from approximately RM9,000 to RM14,000, depending on sector of employment and country of origin. While costs set in bilateral agreements between governments are generally much lower, the real costs are much higher, primarily due to third-party intermediaries who play a central role in the sourcing and placement process, and who charge substantial fees to the immigrant. Much of the evidence finds that high fixed costs for immigrants incentivises perverse behaviours such as overstaying, in the case of documented workers, or entering the country illegally to avoid paying fees altogether.

The immigration system can better meet the country's development objectives if it is aligned with Malaysia's human resource development strategy.

Global experience shows that successful immigration systems recognise the long-term role of immigrant workers in the hosting country's economic/social objectives if they are: (a) **market-driven**, with immigration flows aligned with labour market demands; (b) **comprehensive**, acknowledging the need for immigrants of all types; and (c) **balanced**, minimising the negative impacts on Malaysian workers, and protecting immigrant workers from abuse.

In order to tackle the challenges in the current immigration system in a comprehensive way, six policy areas must be addressed.

Figure below presents the six policy proposals for the government of Malaysia to consider; each with a subset of related actions based on international best practices. The first three policy proposals address the need to make the immigration system meet Malaysia's economic requirements by making it more responsive to labour market shortages. The fourth proposal seeks to adopt a more comprehensive and relevant categorisation of immigration in order to better inform and respond to policies in the sector. The fifth and sixth policy proposals aim to keep the immigration approach balanced by encouraging strict enforcement, and by proposing strategies to reduce over-dependence on immigrant labour. It is worth noting that many policy proposals and actions suggested in this document

have been presented by international experts in the past, are currently being considered by the government, are in the planning stage, or are slowly getting underway. All six policy proposals can yield positive outcomes in the immediate term (within two years). Also, as these proposals are complementary, impact may be maximised if they are tackled in parallel.

Policy proposals for Malaysia to consider

I. Revising employment immigration policies to be aligned with Malaysia's new human resource strategy rather than with security priorities

II. Scaling up Malaysia's existing evidence-based system for identifying labour shortages in the full economy to identify which occupations immigrants are allowed to fill*

III. Phasing out static quotas by restructuring the levy system to serve as a pricing mechanism that controls migrant inflows and keeps immigration aligned with evolving genuine labour market needs

IV. Determining distinct immigrant categories with a set of criteria focused on productivity and value-added for Malaysia (e.g. education-skill level, age, experience) instead of wage-cut-offs. Managing each category distinctly to meet economic goals

V. Establishing risk-based systems to target enforcement efforts. Pursuing joint enforcement of immigration and labour regulation to prevent a culture of non-compliance among employers and third-party intermediaries. Applying penalties for non-compliance in a consistent manner

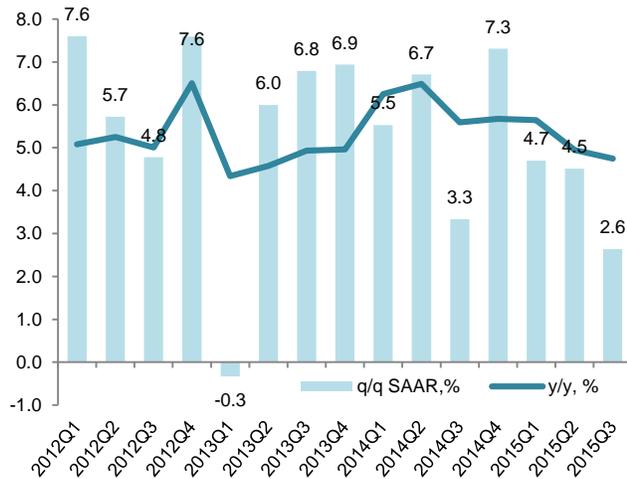
VI. Using levy-revenues for strengthening local workers' skills to fill medium-high skill jobs and for easing conditions for firms to adopt productivity-enhancing technology (where available and cost-effective)

* While some countries use employment negative list systems, there is no analysis with a systematic comparison of positive list vs negative list systems, which would of interest to look at in the future.

THE MALAYSIAN ECONOMY IN PICTURES

Growth moderated on a quarter-on-quarter basis...

Real GDP, seasonally adjusted, annualized change from last quarter, percent



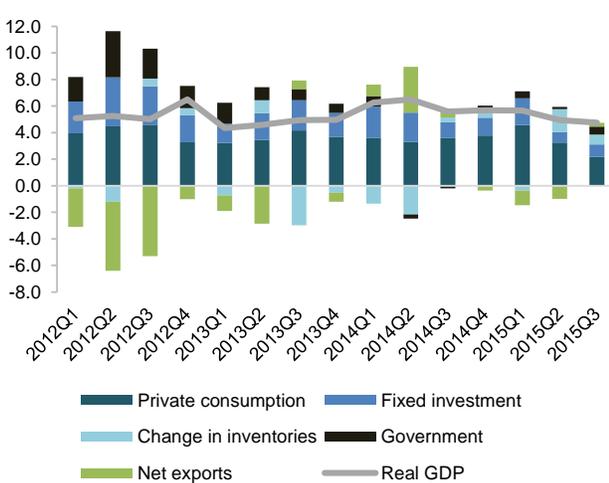
...and growth for 2016 is expected to slow.

Change from the previous year, percent



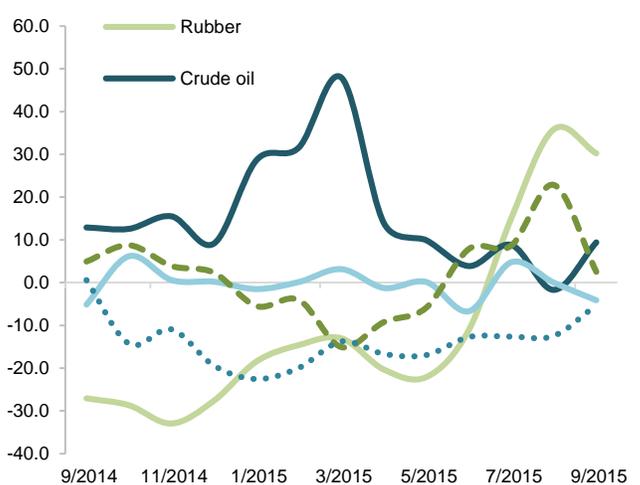
Fixed investment partially compensated for slower private consumption...

Contribution to growth, year-on-year



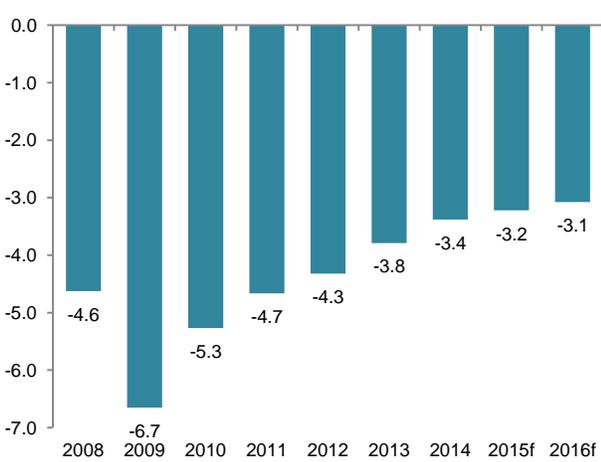
...while commodities continued to drag down exports.

Change in export volumes of past three months from the previous year, percent



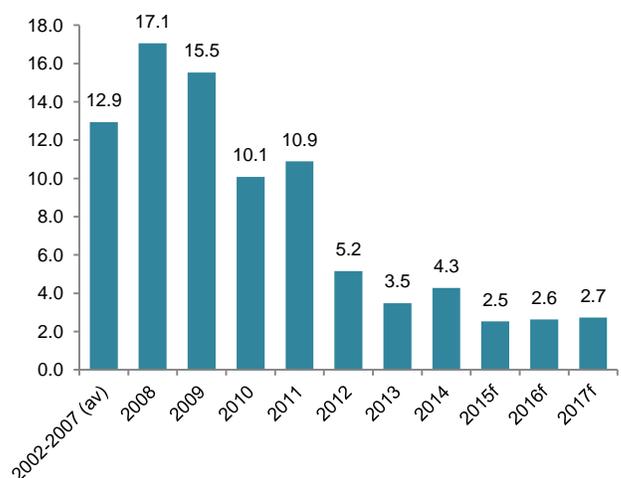
Fiscal consolidation continues, albeit at a slower pace

Federal Government balance, percent of GDP



The current account is projected to remain in a small surplus

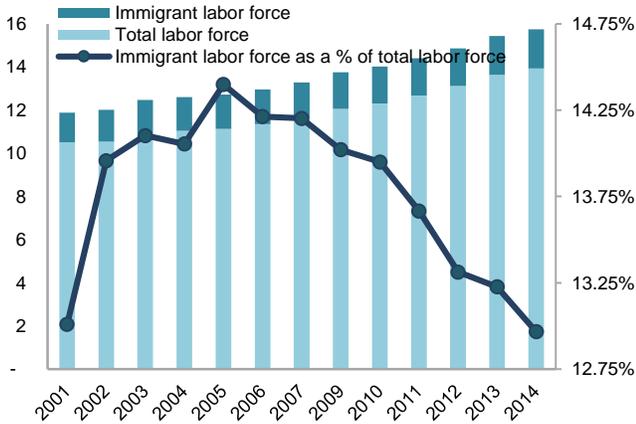
Percent of GDP



IMMIGRANT LABOUR IN PICTURES

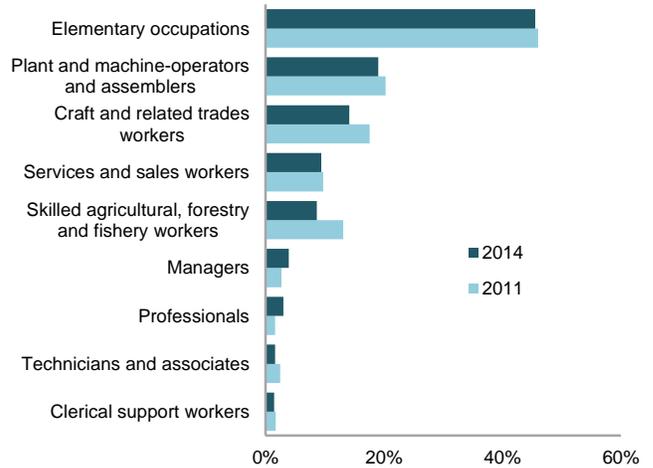
Immigrant labour share remains in a narrow share from 2001

Left axis: number of workers in the immigrant labour force and local labour force (millions); right axis: immigrant labour as a share of the total workforce, percent



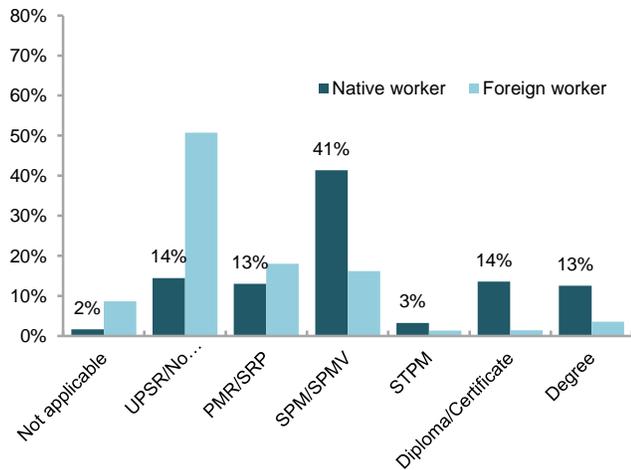
Immigrants fill gaps in low-skilled sectors...

Immigrant workers as a share of total employment, percent



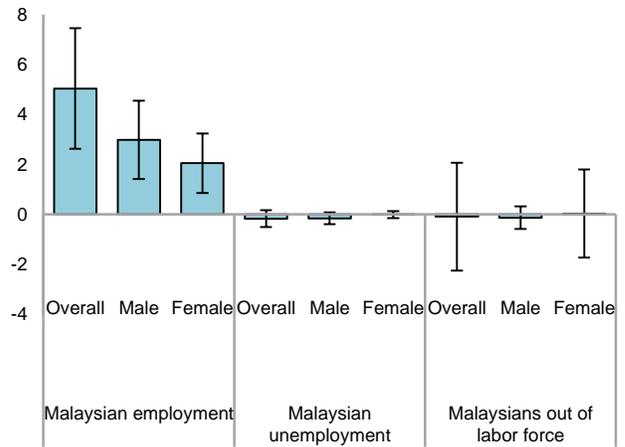
...as higher-educated Malaysians seek higher-skilled jobs

Share of workers by schooling level (percent), 2014



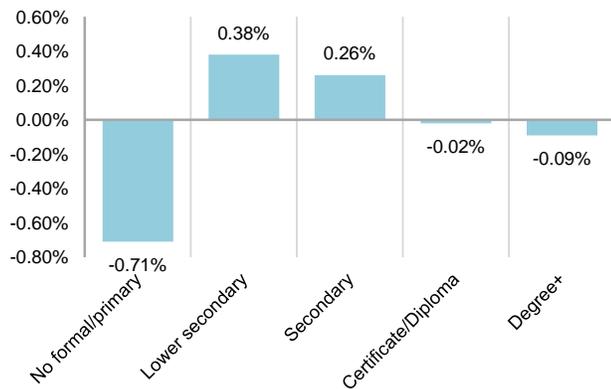
Lower-skilled immigrants generate local employment...

Change in Malaysians employed, unemployed, and out of labour force due to 10 additional immigrants



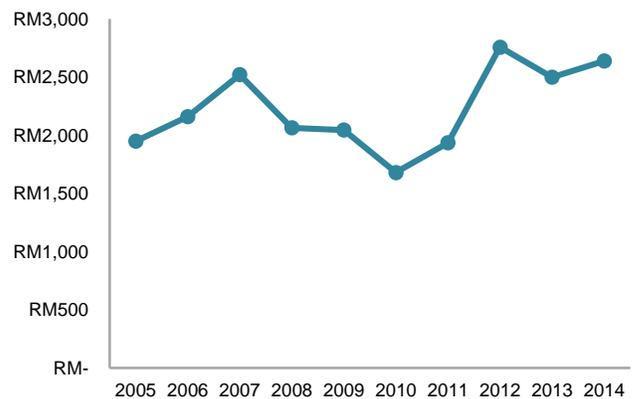
...and slightly increase the wages of most Malaysians

Change in wages due to a 10 percent increase in immigration



Immigrants are likely to have a small positive fiscal impact

Revenue from foreign worker levy in real terms, 2014 (RM million)



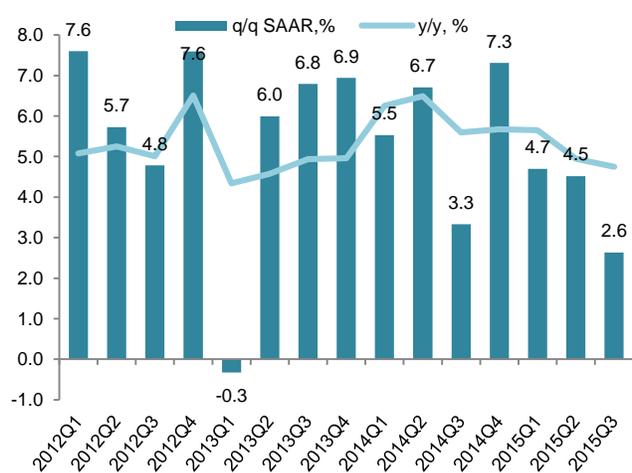
1. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Growth moderates on domestic and external headwinds

1. The Malaysian economy continued to expand, albeit at a slower pace. Real Gross Domestic Product (GDP) grew by 2.6 percent in the third quarter of 2015 on a sequential (quarter-on-quarter, seasonally adjusted and annualized – q/q saar) basis¹, compared to 4.7 percent and 4.5 percent in the first and second quarters respectively (Figure 1). This brought year-on-year real GDP growth for the first nine months of 2015 to 5.1 percent. Domestic demand continued to drive growth despite a deceleration in private and public consumption, while external demand improved but remained soft. ASEAN growth remained subdued around 3.0 percent q/q saar in the Q3, broadly reflecting the effects of lower commodity prices, slower growth in China and slower than expected global growth (Figure 2).

Figure 1: Malaysia's GDP growth moderated in the third quarter...

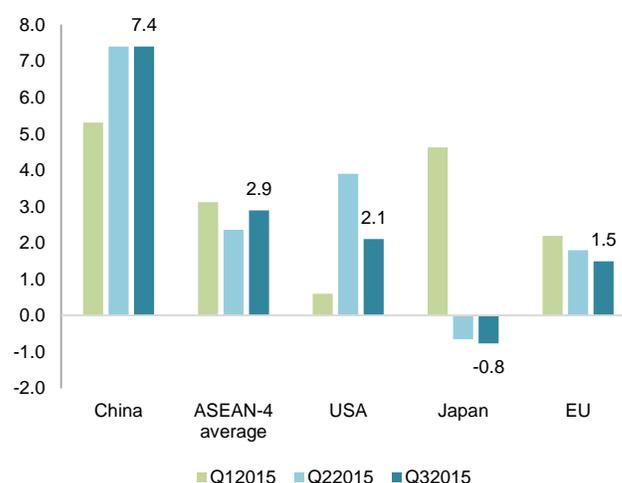
GDP adjusted for inflation and seasonal fluctuations, change from the previous quarter, annualized (bars), and from the previous year (line); percent



Source: CEIC, DOSM, World Bank staff calculations

Figure 2: ...as ASEAN growth remained subdued alongside soft external demand.

GDP adjusted for inflation and seasonal fluctuations, change from the previous quarter, annualized; percent



Source: CEIC, DOSM, World Bank staff calculations

Notes: ASEAN-4 refers to the simple unweighted average for Malaysia, Thailand, Indonesia and Singapore.

2. Growth was mainly driven by domestically-oriented services and sectors. Domestic demand (GDP less net exports) contributed 4.5 percentage points (pp) to year-on-year growth in the third quarter, down from 6.8 pp and 5.9 pp in the first and second quarters, respectively. Following a negative second quarter (Q2: -31.9 percent q/q saar), construction surged by 30.7 percent on a sequential basis in Q3, supported by a substantial increase in construction investment (11.1 percent q/q saar, WB estimate) and the ongoing implementation of petrochemical (i.e. RAPID project) and transport (i.e. MRT, LRT extension) projects. Services also returned to a steady path, rising by 6.5 percent q/q saar in Q3 after a previous dip (Q2: -0.6 percent q/q saar). The largest contributions came from wholesale trade, communications and real estate/business services (Q3: +10.5 q/q saar, +9.8 q/q saar and +8.4 q/q saar respectively, all WB estimates). Reflecting restrained household spending, retail trade and motor vehicles registered moderate growth of 4.2 percent and 4.5 percent respectively after contracting in Q2 (-12.4 percent q/q saar and -3.6 percent q/q saar, WB estimates). The finance and insurance sector contracted for a fourth consecutive quarter by 1.6 percent on a sequential basis (Q2: -8.7 percent q/q saar, WB estimate). On the external side, net exports contributed positively to growth in the third quarter (+0.3 pp) due to continued expansion in manufacturing (Q3: +1.4 percent q/q saar). In particular, the electrical and electronics (E&E) sector performed strongly in the third quarter, expanding by 24.4 percent on a sequential basis after previously declining by 4.4 percent in Q2 2015 (WB estimate). Following a strong performance in Q2, agriculture and mining both contracted in Q3 at an annualized pace of 14.2 percent and 9.6 percent, respectively.

¹ Unless stated otherwise, annualized quarter-on-quarter GDP figures are calculated based on the national account series seasonally adjusted by the Department of Statistics of Malaysia (DOSM).

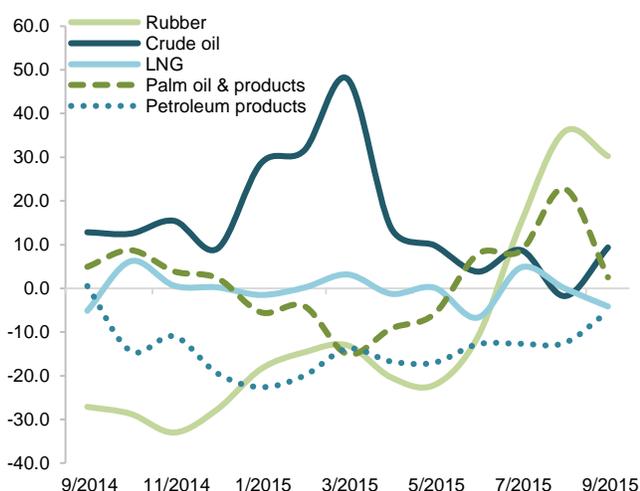
Renewed headwinds from the external sector

Strong E&E exports partially compensated for weak commodities

3. Export growth was largely subdued for the first three quarters of 2015 due to continued weakness in commodity-related exports. Exports of goods and services (G&S) declined 0.4 percent y/y until Q3 2015 largely due to a contraction in Q2 (-10.4 percent q/q saar), but Q3 showed a significant improvement of 23.9 percent on a sequential basis. The recent export performance was associated with a sharp increase in electrical and electronics (E&E) exports of 24.4 percent q/q saar in Q3 (Q2: -4.4 percent q/q saar). The overall slowdown in exports was mainly explained by the decline in commodity-related exports. Although crude oil export volumes increased by 21.9 percent y/y as new fields off the shores of Pahang and Terengganu came online in Q2 and Q3 respectively, further declines in Brent crude oil prices (-48 percent in the first ten months of 2015 compared to the same period last year) led crude oil export values to fall by 24.8 percent January until September (y/y) (Figure 3). LNG export levels similarly plummeted (Q3: -33.8 percent y/y) on lower volumes and the lagged effects of lower crude oil prices, which drove natural gas prices to decline by 31 percent y/y. Agricultural commodity export values remained soft, although volumes of palm oil and palm-based agriculture products increased by 2.0 percent y/y until Q3 2015. Rubber volumes largely remained flat, with a sharp increase in Q3 (30 percent y/y) compensating for the decline during the first half of the year.

Figure 3: Commodity exports remained soft despite increases in volumes of crude oil

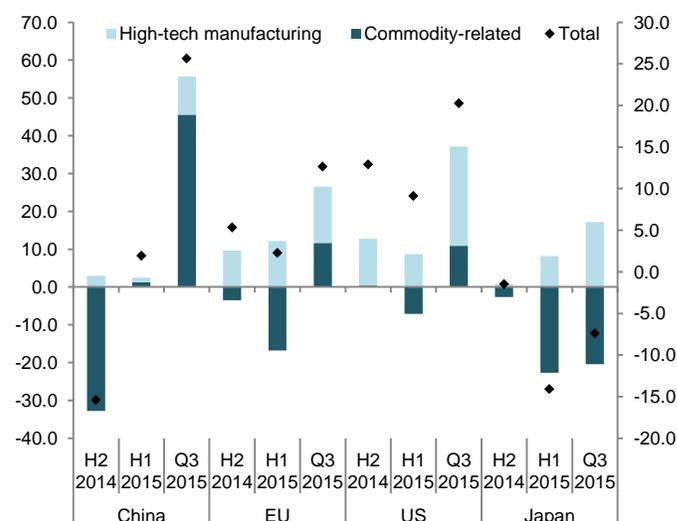
Change in export volumes of past three months from the previous year, percent



Source: CEIC, DOSM, and World Bank staff calculations

Figure 4: E&E exports picked up across all major trading destinations, especially the US

Change in the value of exports from the previous year (MYR mn), percent



Source: CEIC and World Bank staff calculations

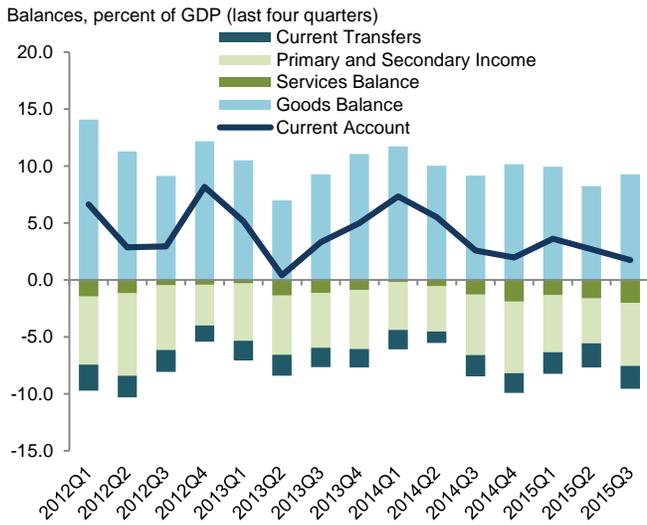
4. Electrical and electronics (E&E) exports reached historic levels. E&E exports performed solidly in Q1 and Q3, partially compensating for the decline in commodity exports. Year-to-date E&E exports at end Q3 2015 was 8.1 percent above its 2014 level. This solid performance is explained by strong demand from US, EU and Chinese markets (Figure 4). While year-to-date exports of telecommunications equipment was significantly weaker (1.2 percent annual growth in 2015 compared with 26 percent in 2014), exports of parts and accessories recovered (from -14.0 percent in 2014 to 0.3 percent in 2015). However, the bulk of the overall increase in E&E exports was due to the exports of thermionic valves & tubes, photocells etc. and exports of other E&E products, with the former subsector representing half of all E&E exports and the latter 35.1 percent. Both of these subsectors displayed a robust growth of 9.5 percent and 9.4 percent, respectively. Concomitant with this performance, import growth of E&E was limited to 6.0 percent y/y. This, combined with a Q3 overall growth of the sector (by 10.3 percent) suggests domestic value added may have increased.

The current account surplus narrowed as the economy adjusted to lower commodity prices

5. The current account surplus continued to narrow as exports declined and imports grew. The current account surplus narrowed to 1.7 percent of GDP in Q3 compared to 2.7 percent of GDP in the previous quarter (Figure 5). The decline

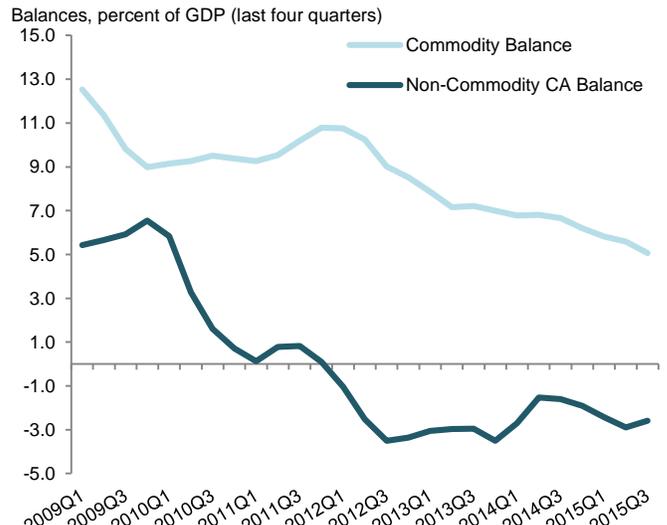
was largely driven by a widening of the primary income deficit (Q3: -RM10.3 billion; Q2: -RM5.1 billion) due to lower direct investment income. Current transfers remained high (RM5.8 billion), reflecting remittances from the growing foreign labour force. The commodity surplus also continued to narrow (Q3: RM10.7 billion; Q2: RM12.7 billion) as the increase in the volume of oil exports was offset by the decline in oil prices (Figure 6). However, the non-commodity goods surplus widened thanks to the solid E&E export performance and lower imports of intermediary goods, which reflected the growing value-added contribution of the E&E sector. Consumer goods imports grew substantially (Q2: 25.4 percent, Q3: 27.2 percent y/y), reflecting sustained import volumes and despite strong depreciation of the ringgit. The services deficit also broadened substantially to RM5.9 billion (Q2: -RM4.6 billion) due to the weaker growth of services exports (-2.6 percent y/y until Q3 2015) compared to the growth of services imports. This is in part explained by the reduction in tourism export revenues that declined during the first three quarters of 2015 (-7.8 percent y/y until Q3 2015; Figure 7).

Figure 5: The current account surplus narrowed further...



Source: CEIC and World Bank staff calculations

Figure 6: ... as lower commodity prices led to a narrowing of the commodity surplus

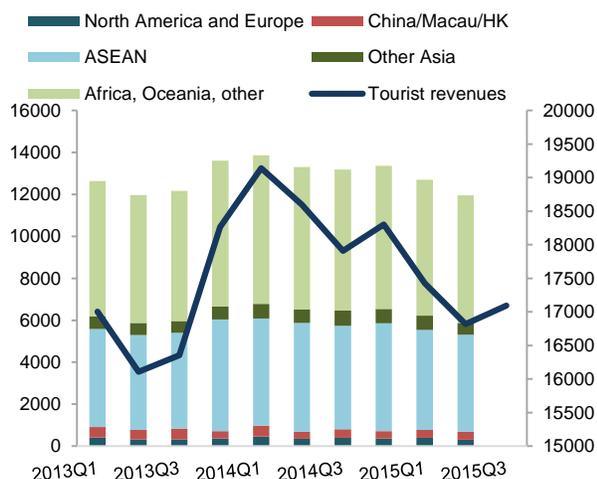


Source: CEIC and World Bank staff calculations

Notes: Commodity-related exports include food, beverages & tobacco; mineral fuels & lubricants; chemicals; animal and vegetable oils and fats

Figure 7: Lower tourist arrivals led to decline in tourism revenues ...

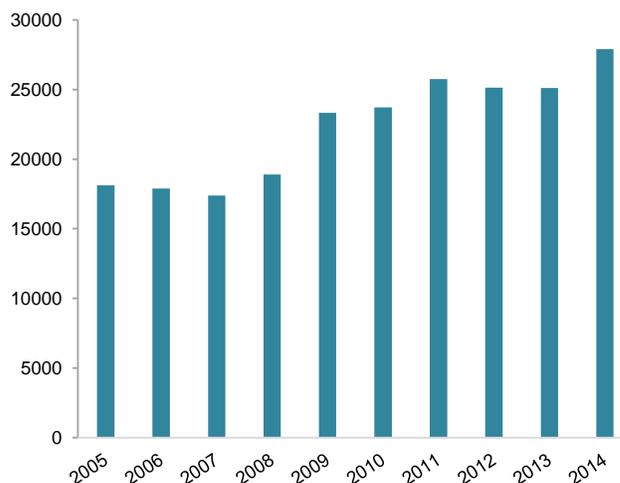
Left axis: Tourist arrivals by destination (thousands of persons), right axis: tourism revenues (RM millions)



Source: CEIC and World Bank staff calculations

Figure 8: ...while current transfers remain large, largely motivated by the high number of foreign workers

Current transfers (RM millions)



Source: CEIC and World Bank staff calculations

Box 1: How are commodity producers responding to the commodity downturn?

The built up of excess capacity during the commodity boom and the rise of the US dollar have driven energy prices down by 56 percent from the beginning of 2014 to end-November 2015. Although other commodities initially held up better, the prices of metals, minerals and agricultural commodities have also started to soften.

Malaysia has confronted the commodity downturn by allowing the exchange rate to depreciate, drawing on foreign reserves and tightening its fiscal policy. Countries similar to Malaysia – Chile and Colombia, for instance -- have implemented similar policies than Malaysia in response to the downturn (Table 1). Exchange rate adjustment has been the main policy response across commodity producers. However, most of them find the resulting pressures on the domestic economy too hard to bear, or they fear that the volatility would feed on itself. As a result, most of the countries analysed mitigate the exchange rate adjustment drawing down reserves to partially absorb the full brunt of such external shocks.

Overall, countries' policy responses relate in large extent to their available policy space in terms of external and fiscal buffers. For instance, Peru had high external and fiscal buffers that allowed a looser monetary and fiscal policy response. Similarly, countries that had previously built up substantial buffers – such as Malaysia, Mexico and Algeria – were also able to keep policy interest rates untouched.

Despite the high buffers that many commodity exporters had at the beginning of the commodity downturn, many have also taken proactive measures to shore up their fiscal situation. For emerging and developing countries, commodities typically play a bigger role in the fiscal accounts than they do in the economy as a whole since the fiscal impact of commodity cycles is magnified on both the upswing and the downswing. As often is the case in these circumstances, some countries have reached for tax rate hikes rather than broadening the tax base and have curbed their public investment programs. Malaysia, however, maintained its infrastructure program and maintained its commitment to introduce the Goods and Services Tax (GST) in April 2015 to broaden the tax base. It also eliminated fuel subsidies as of December 2014. Encouragingly, a growing number of the countries have similarly seized the opportunity to tackle longstanding energy subsidies and improve the quality of public spending:

- Mauritania refrained from passing the drop in international petroleum prices to its consumers;

- Mexico moved to liberalize domestic fuel sales and to shift from a fixed price-variable excise tax to a variable price-fixed excise tax;
- Mongolia is phasing out its Price Stabilization Program;
- Ghana has adopted an automatic price adjustment for petroleum and utility prices with a view to eliminate fuel subsidies;

There is considerable consensus that the new configuration of commodity prices and exchange rate is here to stay, which calls for a systematic effort to make the best of this fresh opportunity to diversify their economies. Some countries such as Peru and Australia are pursuing comprehensive programs to improve the business environment and Mexico has an ambitious structural reform agenda. Nonetheless, it is too early to tell whether these worthy endeavours reenergize ongoing, locally motivated plans, or constitute the harbingers of new development models among commodity producers more generally. This reform agenda will become even more relevant as buffers may erode faster than expected and the economies will have to transition to this new equilibrium rather quickly.

Table 1: Commodity producers have responded to the downturn using a range of policies

Exchange rate policy	Commodity exports (% of GDP, 2014)		Buffers (High/Medium/Low, 2014)	Monetary Policy					Fiscal Policy					Structural Measures					
	Gross	Net		Stance			Instrument		Stance			Instrument			Price/Tariffs /Incentives	Entry	Operation	Competition/Exit	Other
				Looser	Neutral	Tighter	Rate	Reserve requirement	Looser	Neutral	Tighter	Revenue	Current expenditure	Capital expenditure					
Exchange rate only																			
Colombia	10.6	8.7	H		x					X	+	-	-	+	+			+	
Canada	10.4	7.6	H	x			-		X									+	
Australia	11.1	8.5	H	x			-		x		-	-	+	+	+				
Exchange rate and reserves																			
Peru	12.0	9.0	H	X			-	-	X		+	-	-	+	+	+	+		
Chile	18.9	12.9	H		X				X						+				
Mexico	4.3	1.6	M		X					X	-	-	+	+	+	+	+	+	
Malaysia	19.1	8.1	M		X					X	+	-						+	
Mongolia	46.2	34.7	L			X	+			X	+	-	-		+	+			
Mauritania	26.1	13.4	L		X					X	+	-			-			+	
Zambia	28.9	23.9	H			X	+	-	X						+	+			
Algeria	28.3	26.9	H		X				X										
Nigeria	15.8	13.5	H			X	+			X	(+)		-	-					
Ghana	16.6	15.2	L			X	+			X		-	-						
Angola	46.1	n.a.	H			X	+	+			X		-	-		+			
Reserves only																			
Ecuador	15.0	10.7	M		X														
Iraq	40.3	40.3	H		X			X			+	+	+						

Source: World Bank, Macroeconomic and Fiscal Management Brief, October 2015.

Notes:

Countries are ranked according to the combined strength of their (i) external buffers (reserve coverage of short debt at remaining maturity and current account balance, flexibility of exchange rate regime); and (ii) fiscal buffers (fiscal deficit, public debt, both as a percentage of GDP).

Countries ranked in the top, middle and low thirds are considered to have high, medium or low buffers, respectively.

The terms "looser," "neutral," and "tighter" refer to the direction of policy change.

'+' indicates an increase or an improvement, '-' indicates the opposite. () indicates measures decided, but not yet implemented.

Domestic demand remains the key driver of growth despite headwinds

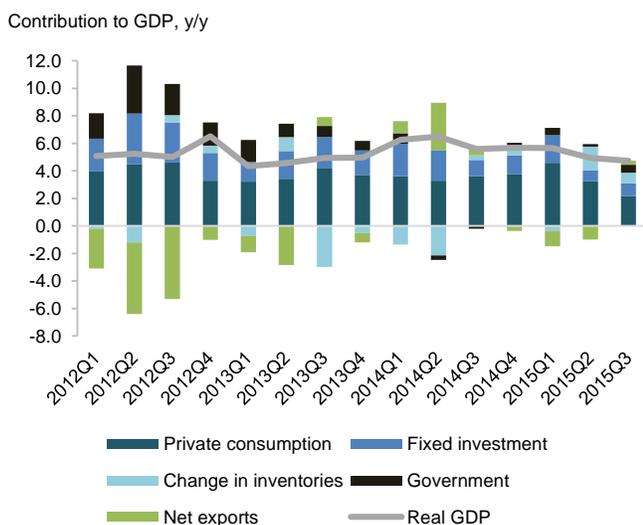
Steady investment compensates for slower consumption

6. Household spending moderated in response to tighter fiscal and monetary conditions. Following an initial surge in 2015 (Q1: +10.0 percent q/q saar) in anticipation of the implementation of the GST on April 1st, private consumption

receded in Q2 (for the first time since Q1 2009) by 1.0 percent on a sequential basis and remained subdued in Q3, growing by 1.0 percent q/q saar. This brought growth in private consumption to an average of 3.3 percent in the first nine months, compared to 8.0 percent over the same period last year. Slower real wage growth due to the uptick in inflation associated with the GST and softer labour markets appear to have subdued Malaysian consumers' appetite. Low prices of rubber and crude palm oil (despite a slight pick-up in the third quarter) also continue to dampen the income of smallholder households. In line with ongoing fiscal consolidation, government consumption declined by 1.2 percent q/q saar in the third quarter due to lower spending on supplies and services. The resulting contribution of consumption to y/y GDP growth in the third quarter was 2.2 percentage points or 46.4 percent of total GDP growth.

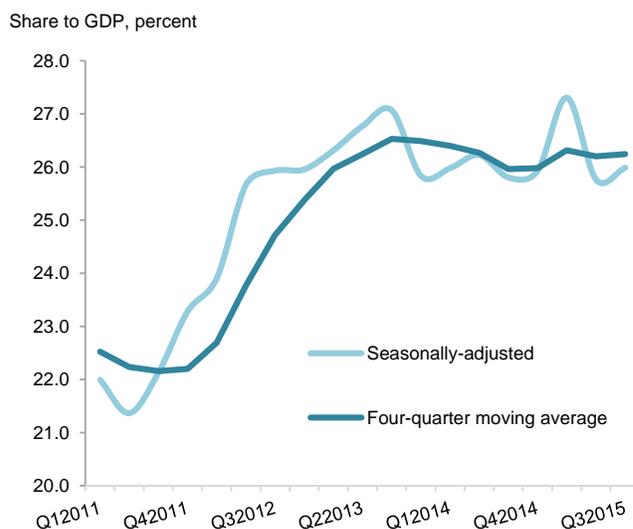
7. Public investment surged and private investment remained robust. Gross fixed capital formation (GFCF) posted a strong expansion of 19.0 percent q/q saar in Q3 2015 following a sharp decline previously (Q2: -25.9 percent q/q saar). Much of this growth was driven by a surge in public investment, which rose by 22.8 percent on a sequential basis in the third quarter (Q2: -20.9 percent q/q saar). The acceleration is linked to the ongoing delivery of infrastructure and transportation projects under the 10th Malaysia Plan and more agile disbursements of the development budget. Private investment expanded by 8.1 percent q/q saar (Q2: -8.5 percent q/q saar), partly reflecting strong foreign direct investment (FDI) growth in manufacturing, information and communications. Meanwhile, machinery and equipment investment expanded only slightly by 0.8 percent q/q saar in the third quarter following a volatile first half of 2015 (Q2: -20.2 percent q/q saar, Q1: 22.2 percent q/q saar). These movements partly reflect the slowdown in equipment-intensive investments in oil and gas in line with declines in crude oil prices. Overall, the investment-to-GDP ratio at constant prices remained largely flat throughout the first three quarters of 2015 at 26.3 percent, with roughly constant shares of private and public investment as in previous years (19 percent of GDP and 8 percent of GDP, respectively).

Figure 9: Steady fixed investment helped to offset slower private consumption



Source: CEIC, DOSM, World Bank staff calculations

Figure 10: The average investment-to-GDP ratio remained largely steady throughout 2015



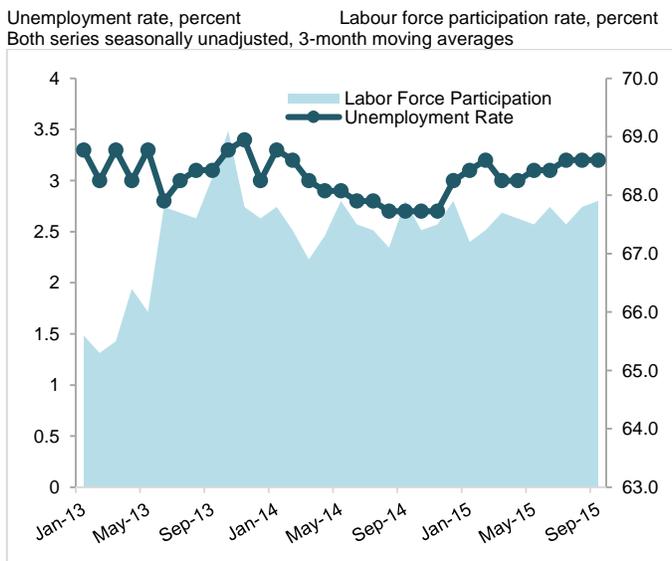
Source: CEIC, DOSM, World Bank staff calculations

Labour markets remain steady but real wage growth slows

8. Strong job creation, mainly in the services sector, kept the unemployment rate low and stable. Malaysia's economy continued its strong employment performance, generating 116,800 new jobs in the year to August 2015. This represents an increase of 0.8 percent, falling marginally short of the growing labour force that increased 1 percent over the same period. Labour force participation rate remained stable, hovering around 67 to 68 percent, slightly above the 2012-2014 average of 66.6 percent. The job market remained tight with job vacancies increasing until August 2015, mainly outside the manufacturing sector. Unemployment remained stable and low at 3.2 percent, moving within a relatively narrow band of 3.0 – 3.2 since January 2015 (Figure 11). Employment creation reflects sector specific differences and was led by the services sector. On the other hand, manufacturing employment declined 0.6 percent year-on-year in Q3 2015 as a result of sector specific job shedding, mainly driven by commodity-oriented employment which declined by 1.7 percent.

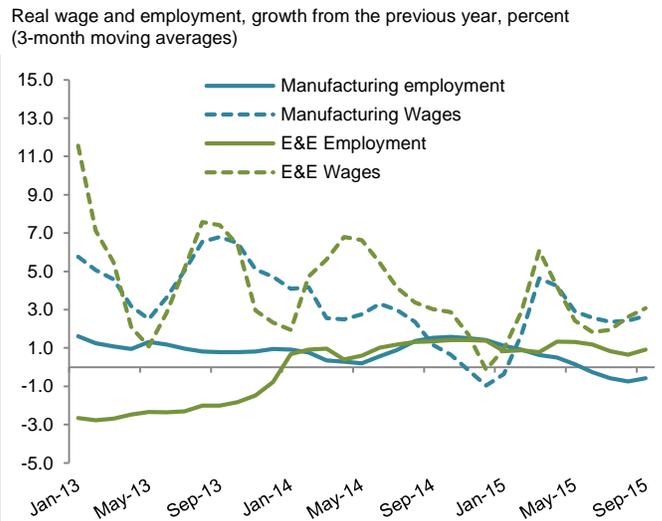
9. Growth of real wages has moderated over the year, reflecting the GST-induced increase in prices and softer employment in some sectors. Although manufacturing real wages expanded in Q1 2015 (4.6 percent y/y) along with solid domestic demand and the tight labour market, growth decelerated to 2.7 percent by September 2015 (Figure 12). This was particularly evident in the domestic oriented manufacturing sub-sector where real wage growth slowed to 1.8 percent (y/y) as employment declined by 1.2 percent. By contrast, wages grew by 3.1 percent in Q3 in the E&E sector on account of strong export performance.

Figure 11: The labour force participation remains stable and the unemployment rate remains low



Source: CEIC and World Bank staff calculations

Figure 12: Real wages and employment decelerated in manufacturing

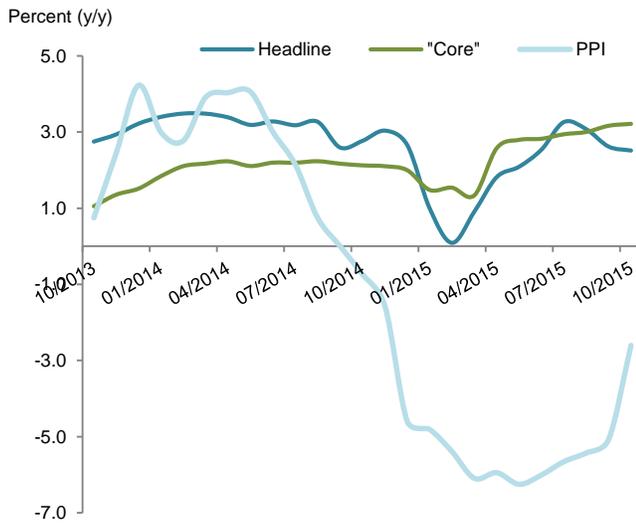


Source: CEIC and World Bank staff calculations

Inflation rose temporarily but moderated on account of lower oil prices

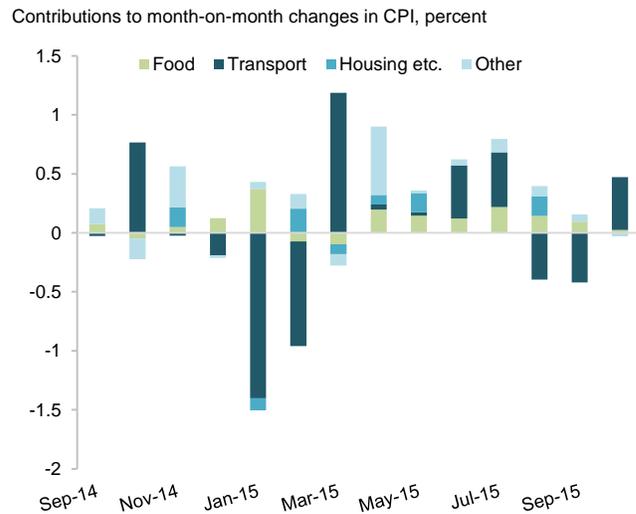
10. The introduction of the GST in April 2015 has had a temporary impact on inflation, which moderated in line with fuel prices. The broad-based impact of the introduction of the GST in April was compounded by the increase in fresh food prices resulting from adverse weather conditions. Subsequently, transport prices have dominated the overall Consumer Price Inflation (CPI) movements and the adjustment of domestic fuel pump prices in line with international oil prices has moderated annual inflation to 2.5 percent in October (year-on-year, Figure 13). At the same time, the pass-through from the latest downward movement in oil prices to consumer prices has been counteracted by the depreciation of the ringgit of nearly 20 percent between May and October. While USD price of oil declined by 25 percent during this period, the decline in ringgit terms was limited to 11 percent. Core inflation, which does not account for fuel and food products which tend to be more volatile, continues to grow moderately, reflecting also recovery in the price production index (Figure 14).

Figure 13: Core inflation increased after the introduction of GST...



Source: CEIC, DOSM, BNM and World Bank staff calculations
 Note: Core inflation is World Bank estimate

Figure 14: ...but price movements throughout 2015 are driven by transport (fuel) prices



Source: CEIC, DOSM and World Bank staff calculations

Fiscal consolidation proceeds despite declining oil related revenues

11. Despite the stern decline in oil prices, the Federal Government is expected to meet the fiscal deficit target of 3.2 percent of GDP in 2015² (2014 actual: 3.4 percent of GDP) due to greater restraint on current expenditures. Following a re-prioritization of expenditures in January 2015 in line with a lower assumption of Brent crude oil prices at USD55/bbl (vs. USD100/bbl in the original budget), the Government has largely adhered to the revised budget. Operational expenditures are expected to exceed the revised allocation by 0.4 percent (2014: 1.0 percent) despite continued overspending on personnel (Figure 15). Key to this adjustment process has been the elimination of fuel subsidies on RON95 and diesel, with savings projected to be 0.9 percent of GDP, around a third of overall subsidies. The rest of operational categories have grown moderately and below nominal GDP growth, bringing down the share of operational expenditures in GDP to 18.4 percent in 2015 (2014: 19.8 percent). Some underspending of the development budget by 2 percent (2014: 6 percent) will continue to help the fiscal position, albeit less than in previous years.

12. The introduction of the GST has been fundamental to compensate the declining collection of oil-related revenues. The sharp decline of commodity prices have had a substantial impact on oil-related public revenues that are projected to decline from 6 percent of GDP in 2014 (30 percent of total revenue) to 3.8 of GDP (19.7 percent of overall revenues) in 2015 (Figure 16), despite the RM26 billion dividends from PETRONAS on account of substantial profits in 2014. GST has been instrumental to partially compensate the foregone oil-related tax revenues and is expected to represent (together with the sales tax and service tax that were discontinued once the GST came into force) 2.3 percent of GDP or 12.1 percent of total revenues in 2015. GST implementation has outperformed expectations thanks in part to the large number of registered businesses under GST, which has broadened the tax base and raised tax compliance. Corporate tax collection, the single largest tax contributor representing around 31 percent of total public revenue, is expected to grow 4.7 percent in 2015 in line with earlier estimates, but below nominal GDP growth. Personal income tax showed significant buoyancy³, and is expected to increase by RM3.7 billion in 2015, 15.3 percent higher than in 2014, reflecting a strong labour market.

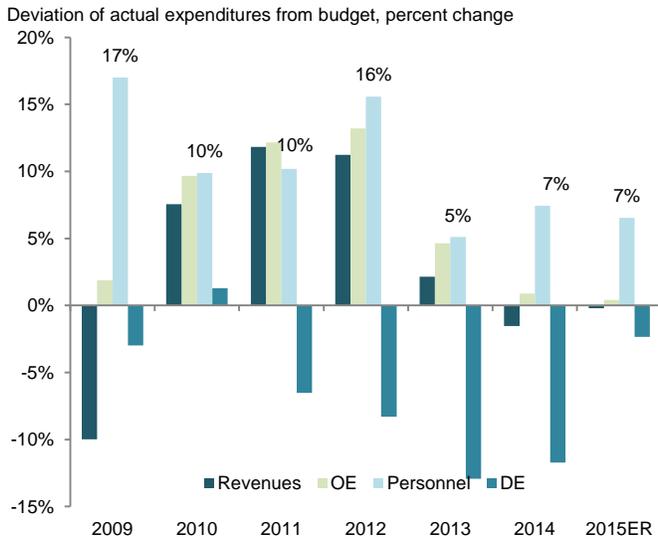
13. Non-financial public corporations increased public investment in 2015, broadening the public sector fiscal deficit. The federal development budget is projected to increase by 20 percent in 2015 after years of decline due to the increase in federal development expenditure to 4.1 percent of GDP in 2015 (2014: 3.6 percent). Development outlays grew in all categories with significant increases in the transport sector, trade and industry sector and housing programs,

² The fiscal deficit target was revised to 3.2 percent from 3.0 percent earlier in January 2015 due to lower oil prices.

³ Growth rate of income taxes exceeds the growth rate of nominal GDP.

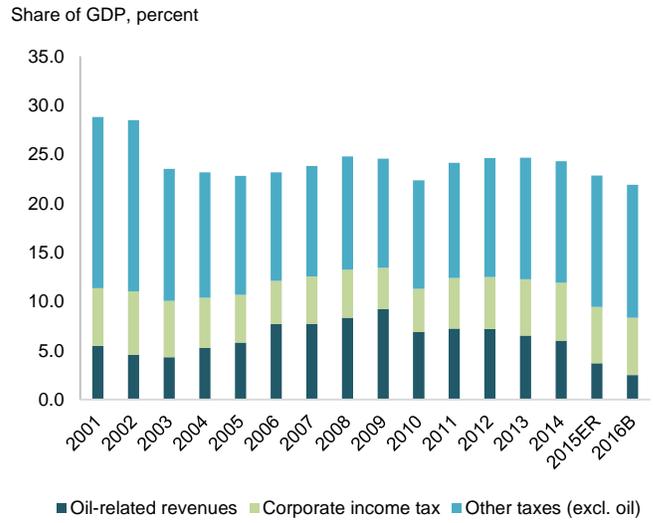
registering an increase of 41.5 percent to RM17.8 billion (2014: RM12.6 billion) or 0.4 percent of GDP. This investment effort also accelerated in State budgets and particularly, in non-financial public corporations (NFPC) outlays. The development expenditure of the State Government is expected to increase by 29.3 percent and the NFPCs by 5.4 percent in 2015. As a result, State budgets, with limited opportunities to diversify public revenues in the short term and compensate for oil-revenues foregone, moved into slight fiscal deficit. NFPCs, many of them with revenues linked to commodity goods (i.e. PETRONAS), saw their projected revenues curtailed by 15 percent in 2015. Despite intense operational cost cutting, the acceleration in capital expenditure translated into a deficit of 5.9 percent of GDP (2014: 3.4 percent).

Figure 15: Containment of operational expenditures helped to meet the fiscal target



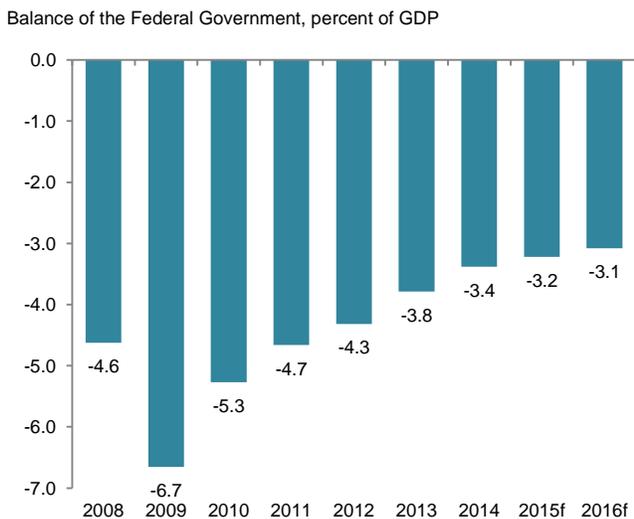
Source: CEIC, MoF and World Bank staff calculations
 Note: 'Personnel' includes emoluments, pensions and gratuities

Figure 16: The dependency on oil-related revenues continues to decline



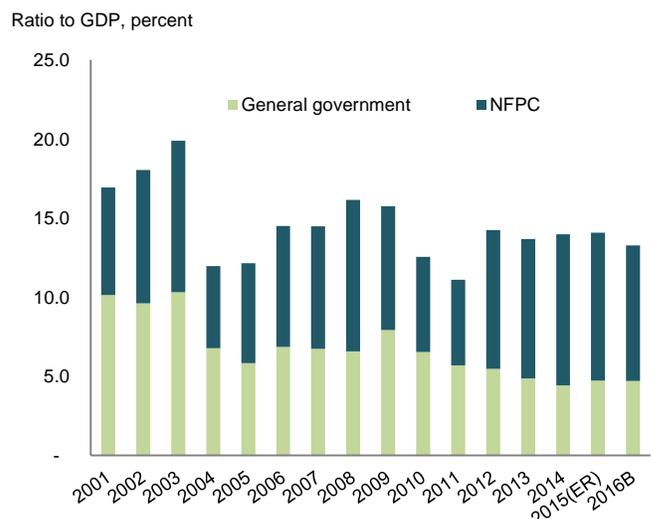
Source CEIC, MoF, and World Bank staff calculations
 Note: Oil-related revenues include Petroleum Income Tax, export duties on crude oil, petroleum royalties, the PETRONAS dividend, income from the Joint Malaysia-Thailand Development Area and petroleum permits

Figure 17: Fiscal consolidation proceeds more slowly



Source: CEIC, MoF, and World Bank staff calculations and projections

Figure 18: Non-financial public corporations continued to ramp up development spending



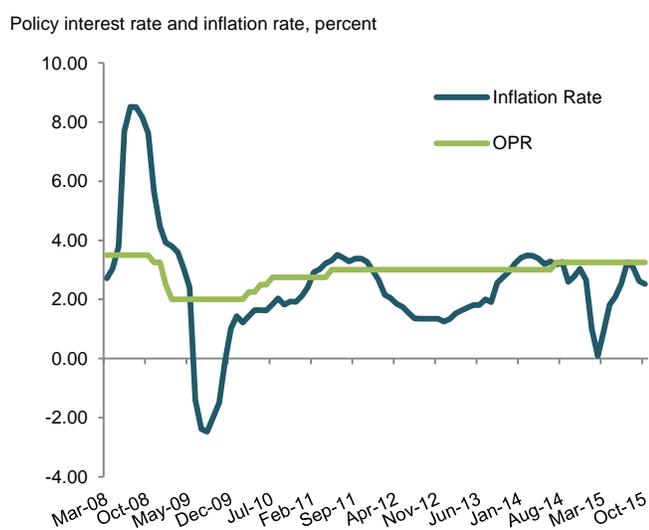
Source: CEIC, MoF, World Bank staff calculations

Growing uncertainties in domestic and external financial conditions

Monetary policy remains accommodative and watchful amid uncertainty domestic and global demand prospects

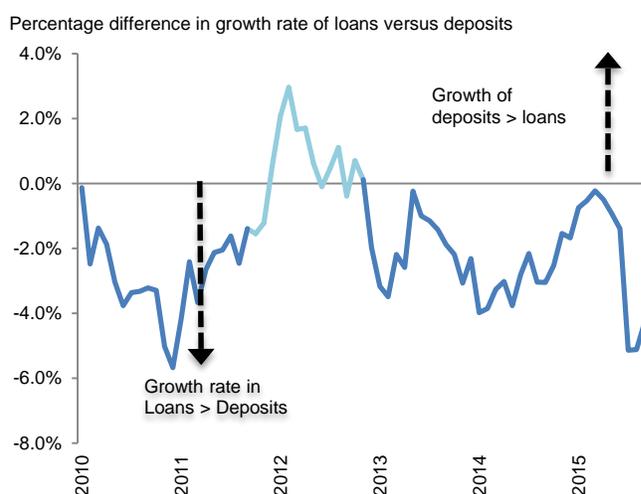
14. Monetary policy remains accommodative given subdued inflation and resilient economic growth. The Overnight Policy Rate (OPR) remains unchanged at 3.25 percent since July 2014, in line with continuing economic growth and the absence of second round effects on headline inflation since the introduction of the GST. Given the subdued inflation dynamics, uncertain external demand posed by slower-than-anticipated growth in main trading partners and deceleration of household consumption growth, monetary policy remains supportive of growth (Figure 19). In addition, despite volatility in the financial markets and the exchange rate, financial intermediation remains conducive of economic activity, with access to financing for both businesses and households uninterrupted. However, loan applications have started to show signs of deceleration (-1.8 percent y/y in September 2015) and loan approval rates declined by 15.2 percent in September 2015 compared to the same period last year, in line with Bank Negara Malaysia (BNM)'s macro-prudential measures which are helping to contain risks of financial imbalances.

Figure 19: Real policy rates have remained in positive territory since the latest hike



Source: CEIC, DOSM, BNM

Figure 20: Loans continued to expand faster than deposits



Source: CEIC, BNM, World Bank staff calculations

Credit growth to businesses remain strong while household credit moderates

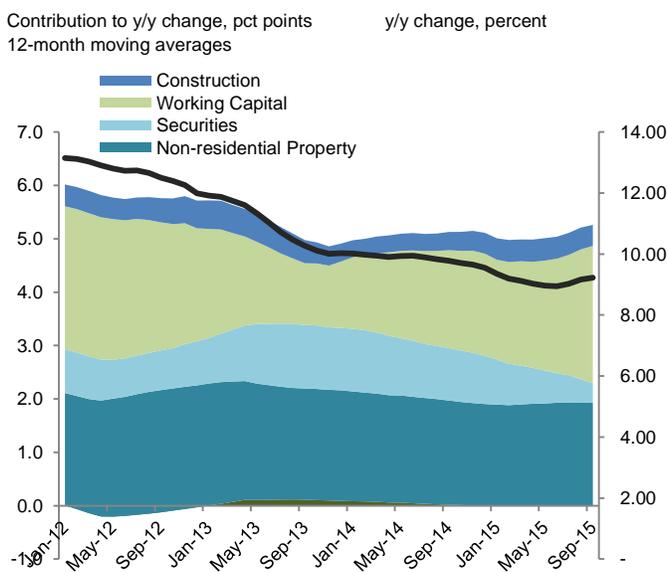
15. Despite more pronounced volatility in financial markets, liquidity conditions remain favourable and the banking sector remains well-capitalized. Broad money grew by 5.6 percent in the first ten months of 2015 compared to the same period last year, driven by increases in net claims on the Government (11.0 percent) and on the private sector (8.8 percent). Overall financing costs remained stable as reflected in the average base rate (BR) at end of Q3 2015 (3.85 percent; January 2015: 3.90 percent). Liquidity in the system remained adequate and the average overnight interbank rates have traded in the 3.05 percent to 3.19 percent range throughout the year. Although longer-term money market rates beyond the 1-month tenure were on an uptrend, this was mainly driven by the shift in preference among corporates and banks towards shorter-term placements. Meanwhile, the banking system liquidity coverage ratio (LCR) stood at 119 percent as at September 2015, with all the banks reporting LCR levels above the phased regulatory requirement of 60 percent. The loan-to-deposit-ratio increased from 86.6 percent at Q1 2015 to 90.1 percent as at Q3 2015 due to lower deposit growth, mainly of corporate deposits (Figure 20). However, this has not affected retail rates, with the average fixed deposit rates of commercial banks stable in the 3.08 - 3.31 percent range and the weighted average lending rate on outstanding loans on a relatively downward trend (5.38 percent at end of Q3 2015 versus 5.48 percent at end Q1 2015). Indicators of the banking sector show strong capital position with the common equity tier-1 capital ratio, tier-1 capital ratio and total capital ratio at end Q3 2015 well above the minimum regulatory levels at 12.1 percent, 12.8 percent and 14.8 percent, respectively. Even under a difficult scenario for the banking

system (aggressive growth in non-performing loans, capital outflows, and further ringgit depreciation), BNM estimates that potential losses to banks would well be covered by existing excess capital buffers amounting to RM100.2 billion.

16. Financing for businesses remains healthy and supportive of economic activity. Outstanding business loans in the banking system accelerated to 11.0 percent at end- Q3 2015, with the bulk of credit allocated to the manufacturing (30 percent of total loans); wholesale and retail trade, restaurants and hotels; real estate (27 percent) and finance sectors (16 percent), mainly for the purpose of working capital (Figure 21). Furthermore, financing for small-medium enterprises (SMEs) accelerated, recording an annual growth rate of 17.6 percent as at end Q3 2015, compared to 14.0 percent by end 2014. This credit acceleration in bank credit to businesses seen over Q3 2015 is consistent with the evidence from the national accounts of buoyant investment conditions.

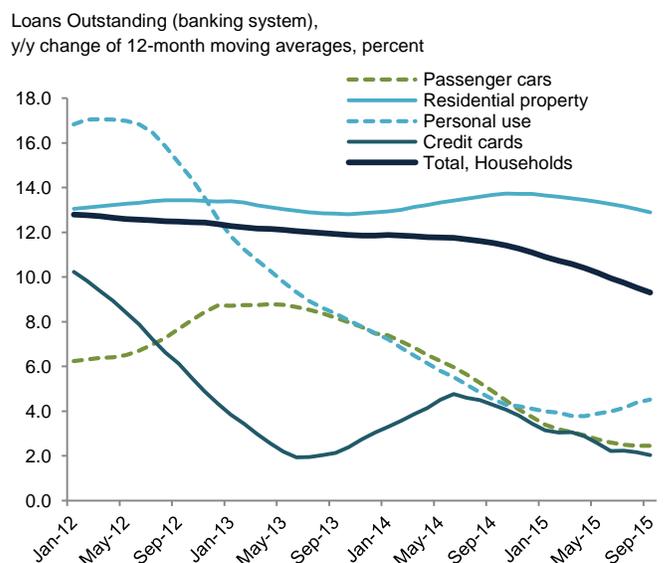
17. Household credit growth continues on a moderating trend, thanks in part to BNM macro prudential regulations. Outstanding household loans growth moderated to 7.6 percent as at Q3 2015. Within household credit, the decline in loan growth was broad-based. Of significance, unsecured borrowings by households have remained subdued, increasing by 3.4 percent in Q3 2015 (Q2: 3.7 percent), in line with BNM macro prudential measures. Similarly, the moderation was prominent in the credit extended for the purchase of securities, amid volatile financial market performance. Credit for the purchase of residential properties, which accounts for around 48 percent of household credit, remains strong at 11.3 percent in Q3 2015 compared to 12.4 percent as at end-2014 (Figure 22).

Figure 21: Growth in working capital loans continues to drive business credit expansion



Source: BNM and World Bank staff calculations

Figure 22: Household loan growth declined mainly in the riskier segments



Source: BNM and World Bank staff calculations

18. The high level of household debt calls for careful monitoring to shore up financial exposure to households' balance sheets. While the level of household debt remains one of the highest in the region at 88.4 percent of GDP as at Q3 2015 (compared to 75.0 in 2010), household debt quality appears to be improving with 80 percent of new loans recording a debt service ratio (DSR) for all outstanding debts of less than 60 percent of borrower's monthly income. Underwriting standards have not deteriorated and the quality of loans to households remains high. Impairment and delinquency levels remained stable at 1.1 percent and 1.6 percent of total household debt with the banking system, while steady income growth and supportive labour market conditions help to ensure delinquency and impairments remain low. Debt-funded speculative purchase of residential properties as proxied by the number of borrowers with three or more housing loans, remained stable and small, accounting for less than 3.0 percent of existing housing loans. Potential losses from household lending under extreme conditions remain well within banks' excess capital buffers. Total losses from all households based on BNM's stress tests are estimated at RM39.1 billion (equivalent to an impaired loan ratio of 4.8 percent). This would still be well within excess capital buffers of the banking system which stood at RM100.2 billion as at end-Sep 2015. Overall delinquencies remain low at 1.6 percent of household debt. Nonetheless, some signs of rising

late payments among highly leveraged borrowers have been observed during Q3 2015, while loans for the purchase of securities and properties have seen a slight increase in delinquencies.

19. Growth in house prices remained strong but government programs supporting access to affordable housing reduce financial risks. The slight moderation of house prices (7.8 percent y/y at end Q1 2015, compared to 8.0 percent at end-2014) was driven in part by lower transactions in the higher-end segment for properties above RM1 million. Demand for mid-range properties remain strong, but given overstretching household's balance sheet conditions, housing affordability remains a concern. To address this, the government introduced in the 2016 public budget the First Home Deposit Scheme, which contributes to affordable home buyers' deposit payments, as well as continuous effort to provide affordable housing, including 1Malaysia Housing Program (PR1MA) whereby the house prices under this scheme are approximately 20 percent below the market price. These programs support access to affordable housing while helping to contain further financial risks.

20. Equity financing conditions remained challenging, reflecting sector specific and volatile external market conditions.

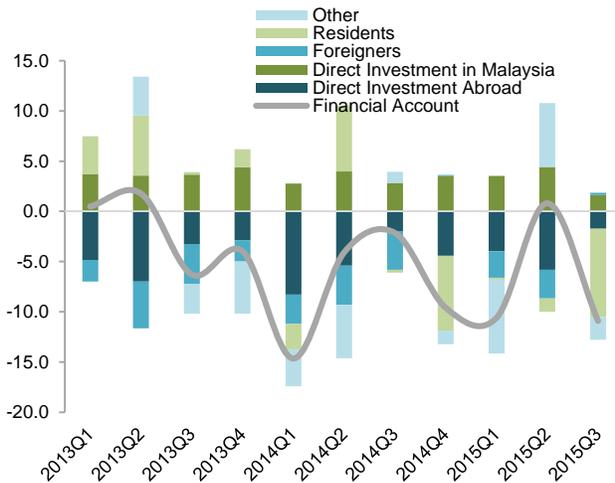
The FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI), declined 4.8 percent over the year to November 24, 2015 in line with many regional equity markets, affected by both domestic and external factors. Concerns over weak global growth, particularly from China's growth moderation have impacted equity markets across the region. Global appetite for emerging market financial assets is also subdued amidst investor concerns. Portfolio reallocations ahead of US monetary policy tightening and foreign investors' holdings in the equity market declined from 23.8 percent in May 2015 to 22.8 percent of market capitalisation in October 2015. The Government recently announced an allocation of RM20 billion to ValueCap, a government investment company, in order to help revive the equity market. In addition, weak corporate earnings, particularly from oil and gas related sectors affected by the decline in commodity prices and the financial sector have further contributed to the weakening sentiment. This explains a more cautious sentiment in private debt securities market and the equity market and lower gross private sector financing via the capital market (RM52.9 billion during the first nine months of 2015 against RM79.1 billion for the same period last year). Demand has been mainly concentrated in financial services and utilities related sectors, and most funds channelled for new activity and working capital.

Ringgit depreciation accelerated as volatility in external flows picked up

21. Portfolio investment outflows accelerated in Q3 2015 as a result of extreme volatility in global financial markets. The global economy, especially emerging market economies, has experienced extreme volatility associated with the anticipation of an imminent raise in US interest rates and concerns about global economic growth. Portfolio outflows by non-residents, which amounted to RM4.2 billion in the first half of 2015 accelerated to RM25 billion in Q3 2015. While direct investment abroad remained strong during the first half of the year (RM27.6 billion) it significantly slowed down to RM5 billion in Q3 due to slower investment by the mining sector. In addition, overseas positions by domestic investors in portfolio investment, which had increased to RM15.4 billion during the first half of 2015 reversed in Q3 2015 as they repatriated funds amounting to RM0.6 billion. Although FDI to Malaysia remained strong, growing by 5.8 percent y/y until Q3 2015, it was insufficient to compensate for strong outward flow pressures which resulted in net outflows in the financial account of RM31.2 billion in Q3 2015. The overall balance remained positive at around 6 percent GDP in Q3 2015, but only due to the large errors and omissions (14.7 percent of GDP) that reflected foreign exchange revaluation effects in line with the strong ringgit depreciation.

Figure 23: The financial account deficit remained significant...

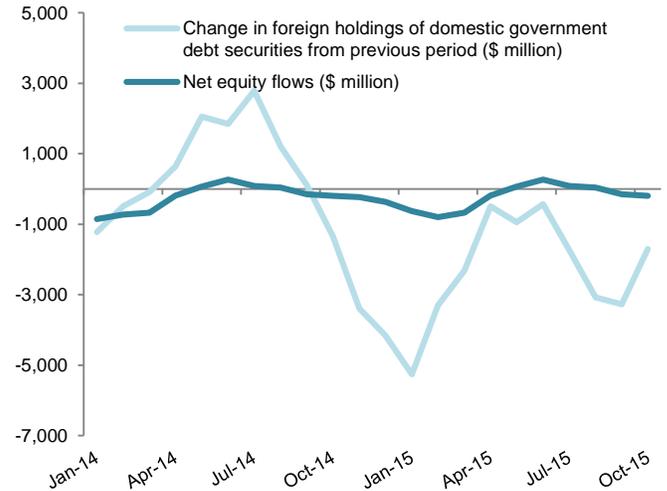
Percent of GDP (last four quarters)



Source: CEIC and World Bank staff calculations

Figure 24: ...as foreigners reduced appetite for government bonds.

Proxies for portfolio flows, USD million, -3 month moving averages



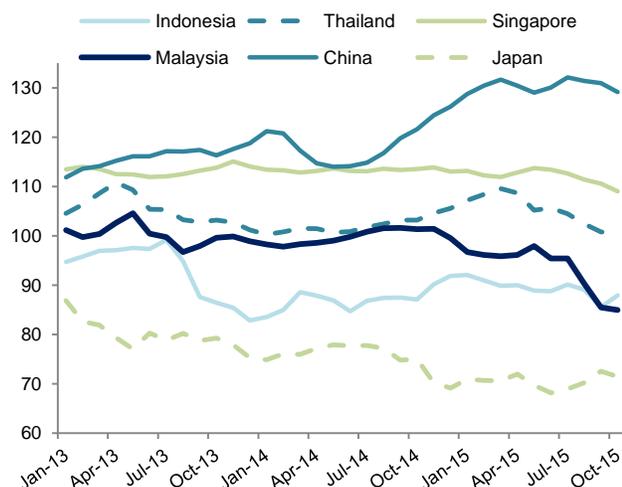
Source: CEIC, MIDF and World Bank staff calculations

22. The ringgit continued to depreciate against the US dollar as the real effective exchange rate declined more than peer countries. After depreciating by 6.5 percent against the US dollar in 2014, the ringgit further depreciated by 20.5 percent from January 1, 2015 to December 8, 2015. In line with the trend in other emerging markets, this decline was largely due to continued dollar strength, uncertainties related to the Federal Reserve’s interest rate normalization and concerns over the momentum of global growth, especially concerning China. However, the real effective exchange rate depreciated substantially during the last quarter compared to other countries in the region (Figure 25). The ongoing downward trend in global crude oil prices, significant financial outflows and political uncertainties that may have dampened investor sentiment led the ringgit depreciation to be more pronounced in Q3. Thus far, the ringgit flexibility continues to act as the main shock absorber to lower commodity prices and volatile external flows, cushioning the impact and minimizing the spillover effects to the domestic financial markets. Furthermore, the real effective depreciation against main trading partners support export growth going forward (Figure 25).

23. Large net capital outflows induced a depletion of official reserves that stabilized after August 2015. To manage the strong volatility in the forex market and moderate the steep ringgit depreciation, BNM has used USD21.9 billion of foreign reserves since end 2014 (19 percent of total reserves). Following intense volatility in forex markets in August, official reserves have stabilized to USD94.0 billion as at end October 2015 (Figure 26) – the lowest level since August 2009, but still sufficient to finance 8.7 months of retained imports and 1.1 times short-term external debt. Recognizing that ongoing global and domestic uncertainties remain high and will continue to have an impact on capital flows and the exchange rate, the Government has urged government linked companies (GLCs) to repatriate investment earnings and invest them locally, as well as review their investment and asset purchase plans, which mitigate abrupt movements in foreign flows.

Figure 25: Real effective depreciation of the ringgit intensified in Q3 compared to countries in the region

Real Effective Exchange Rate, Index, 2010=100

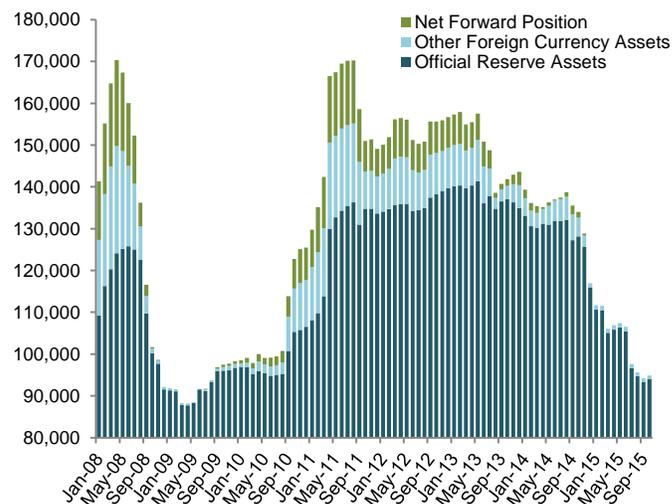


Source: Bank for International Settlements

Note: Increases in the index denote appreciation of the currency

Figure 26: Reserves further declined, but remain above the levels prior to the Euro area crisis

Reserves, USD millions



Source: BNM

Note: Net Forward Position represents aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (incl. the forward leg of currency swaps)

Continuous economic growth expected but clouded by domestic and external uncertainties

A moderation expected as the economy adjusts to the new global economic scenario

24. Malaysia's economic growth is expected to moderate in 2016 and 2017 as it adjusts to a more challenging global environment. The outlook for the Malaysian economy reflects an adjustment to a new global scenario based on: (i) normalization of US interest rates, which will reduce global liquidity and potentially increase the cost of capital; (ii) continuous growth rebalancing in China from a model mainly based on export/investment towards one more focused on consumption/services, with direct impact to the Malaysian economy and indirect effects through lower commodity prices; and (iii) slowdown in trade growth, which has not yet recovered to the levels seen before the "great recession" of 2008 (Figure 30). Furthermore, downward movements in oil prices have weakened revenue collection and limited the recourse to counter-cyclical fiscal policy as the Government is committed to maintaining the pace of fiscal consolidation.

25. Malaysia is on track to register real GDP growth of 4.7 percent year-on-year in 2015, decelerating to 4.5 percent in 2016 and 2017. These forecasts are lower than the previous projections of 4.7 percent in 2016 and 5.0 percent in 2017 (see World Bank East Asia Pacific Update, October 2015). The revised forecast is premised on three factors. First, the continuation of low oil prices poses a drag on growth, fiscal and external accounts as they impact sector investment (i.e. in the oil and gas industry), further reduce oil-related revenues and commodity exports. Second, private consumption growth is expected to moderate as consumers continue to adjust to moderating income growth and tighter fiscal policy. Third, although exports are expected to remain robust due to the strong performance of the E&E sector and the competitive exchange rate, prospects are limited due to low commodity prices and the slower growth path of Malaysia's main trading partners, particularly China. Meanwhile, fixed investment is expected to remain robust as public and private investment remain steady. Domestic demand is expected to remain the key driver of growth, contributing 4.7 percentage points to GDP growth in 2015 and 4.6 percentage points in 2016. The World Bank forecast for 2015 and 2016 is in line with median consensus estimates, which have declined over the last two quarters (Figure 27). Table 2 and Table 3 present a summary of the forecasts.

Table 2: Slower growth is expected in 2016-17 as private consumption cools...

	Year-on-Year Growth Rates, percent			
	2014	2015f	2016f	2017f
GDP	6.0	4.7	4.5	4.5
Domestic demand	5.3	5.4	5.1	5.0
Final consumption	6.4	5.1	5.0	5.1
Private sector	7.0	5.3	5.3	5.6
Public sector	4.4	4.3	4.0	3.2
GFCF	4.8	4.5	4.8	4.5
External demand	12.8	-2.2	-2.4	-1.6
Exports of G&S	5.1	0.9	3.0	3.1
Imports of G&S	4.2	1.4	3.8	3.7

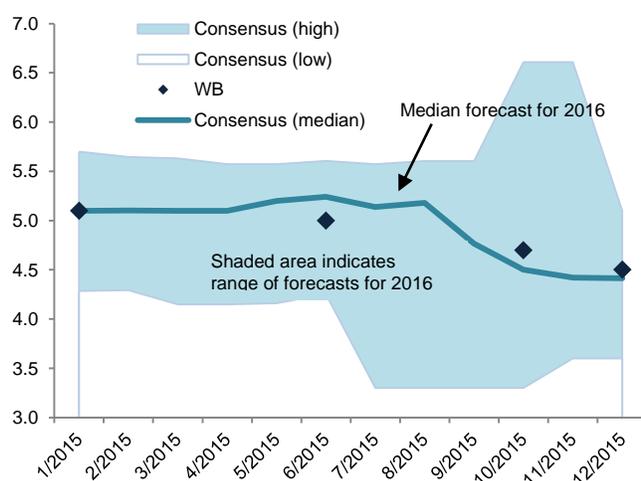
Table 3: ...and the economy adjusts to a new global economic scenario.

	Contributions to GDP Growth, percentage points			
	2014	2015f	2016f	2017f
GDP	6.0	4.7	4.5	4.5
Domestic demand	4.9	4.9	4.7	4.6
Final consumption	4.2	3.3	3.3	3.4
Private sector	3.6	2.8	2.8	2.9
Public sector	0.6	0.6	0.5	0.4
GFCF	1.3	1.2	1.3	1.2
Change in Stocks	-0.6	0.4	0.1	0.1
External demand	1.1	-0.2	-0.2	-0.1
Exports of G&S	3.9	0.7	2.2	2.3
Imports of G&S	-2.8	-0.9	-2.4	-2.4

Source: CEIC, DOSM, World Bank staff calculations and projections. Note: f=forecast; domestic demand includes change in stocks.

Figure 27: The median consensus forecasts for 2016 declined over the last two quarters

Consensus forecasts of real GDP (2016), year-on-year growth, percent



Source: Consensus Economics, World Bank staff calculations and projections

Figure 28: Inflation is expected to remain subdued as oil prices stabilize

Percent



Source: CEIC, DOSM, World Bank staff projections

26. Inflation is expected to remain subdued in the remainder of the year and in 2016 in the absence of a sharp recovery in commodity prices and global growth.

Consumer price inflation is estimated to be at 2.0 percent (y/y) at end-2015, revised downwards from the June estimate of 2.8 percent as the impact of the introduction of the GST on prices has been more contained than originally envisaged and mitigated by lower oil prices. Crude oil prices are expected to stabilize in 2016 which, combined with the base effect of the GST introduction in April, will reduce inflation pressures in 2016. In a context of moderate wage growth, raising but negative producer price index (PPI), and in the absence of a stronger momentum in international commodity prices and global growth, which could raise domestic fuel prices and boost export demand and activity in Malaysia, the 2016 inflation projection has been maintained at 2.8 percent year-on-year.

Domestic demand continues to drive growth despite headwinds

27. Private consumption is not likely to pick up substantially in the near term as consumers adjust to new economic realities.

Private consumption is expected to expand by 5.3 percent in 2016, in line with this year's growth, and

contribute 2.8 percentage points to growth (2014: 3.6 pp). These estimates are driven by the muted expansion of household spending in Q2 and Q3 2015, which suggests that consumers are adjusting more slowly and cautiously to new income and price realities in a context of heightened uncertainty. The continuation of low palm oil and rubber prices continue to limit the purchasing power of smallholder households that have a high marginal propensity to consume, while household credit growth is likely to moderate further, particularly in the riskier credit segments. Although firm labour markets, increased BR1M cash transfers and an accommodative monetary policy are likely to mitigate these effects, policy space to boost private consumption is limited as the Government continues on a fiscal consolidation path into 2016 – 2017.

28. Gross fixed capital formation is expected to remain robust as public investment ramps up and private investment remains steady. Despite a slower than expected growth in 2015, the forecasts for fixed investment continue to make an important contribution to growth. GFCF is expected to expand by 4.8 percent in 2016 and 4.5 percent in 2017. These forecasts have been lowered slightly from June 2015 due to higher than expected moderation in the oil and gas sector and further depreciations in the exchange rate, which will exert downward pressure on machinery investment. Nonetheless, public investment is expected to expand and compensate for this slowdown as the construction of new MRT lines, extension of the LRT and other infrastructure investments ramp up under the 11th Malaysia Plan (11MP).

Increased volatility in the global macroeconomic environment poses risks to growth

29. The global economic growth remains soft and subject to significant uncertainty. Purchasing Managers' Indices (PMIs) picked up slightly in the United States over Q2 2015 and across G3 economies in Q3 2015, but continued on a downward trend since October 2014 (Figure 29). Global growth remains weak and is expected to be 2.8 percent in 2015, lower than anticipated in previous projections, but growth in 2016–17 remains broadly unchanged around 3.2 percent. While US GDP growth stalled at the beginning of the year, partly due to adverse weather conditions and disruptions in port activity, growth is expected to pick up to 2.7 percent in 2015 and 2.8 percent in 2016⁴ despite the stronger dollar, driven primarily by private consumption. Prospects for the Euro area have also improved (2015: +1.5 percent y/y, 2016: 1.8 percent y/y), supported by a weakening euro, declining commodity prices and supportive monetary policy. Japan GDP growth is also expected to pick up to 1.1 percent in 2015 and 1.7 percent in 2016, supported by easing monetary and fiscal policies. Meanwhile, China's growth is projected to slow from 7.3 percent in 2014 to 6.9 percent in 2015 and 6.7 percent in 2016, in line with earlier projections.⁵ Overall, growth in developing countries is expected to slow to 4.3 in 2015 before recovering by 2017, with soft economic growth in the BRICS and increasing divergence in their growth trajectories. Prospects for ASEAN growth have also softened with GDP growth decelerating from 4.4 percent in 2014 to 4.3 percent in 2015 before accelerating to 4.7 in 2016.

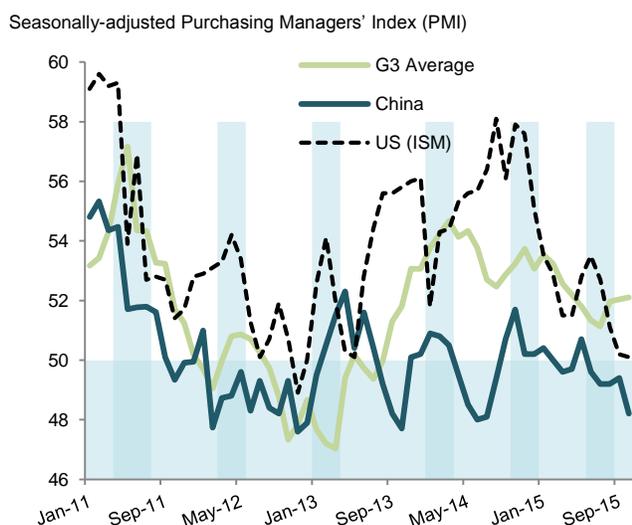
30. The outlook for exports remains modest as it hinges on the trajectories of Malaysia's main trading partners. Exports of G&S are expected to expand by 0.9 percent year-on-year in 2015, falling short of expectations on account of further declines in agricultural and hydrocarbon exports. Natural gas exports in particular dragged down growth as pass-through effects from oil price declines became more pronounced. Moving forward, exports of G&S are expected to expand by 3.0 percent in 2016 and 3.1 percent in 2017 (average growth rate in 2011–2014: 2.6 percent). Most of this growth hinges on the expectation that the strong recent performance by the E&E sector will continue to compensate for the lower contribution of commodities. As new investments come online and exports shift to higher-value-added segments, E&E exports is expected to continue contributing strongly to overall export performance. The depreciation of the ringgit, combined with an improving appetite for high-tech goods in the US and elsewhere is expected to provide a boost to Malaysian E&E exports. Exports of services, particularly tourism, also have additional potential to improve as the weaker ringgit makes Malaysia a more attractive travel destination. On the other hand, the commodity outlook remains bleak and is unlikely to make meaningful gains in the near term. Despite the prospects of stable or even rising hydrocarbon production, oil prices are not expected to recover to above USD80/bbl until 2023⁶. Palm oil production is also likely to be affected by the severe haze in Q3 and the implications of El Nino on the crops. Overall, Malaysia's exports are expected to be lower than the global trade average (Figure 30). Upsides to this forecast largely depend on the trajectory of advanced economies and on the pace with which new export-oriented investments in mining, E&E and services start to come online.

⁴ Unless noted otherwise, all GDP forecasts are from the June 2015 Global Economic Prospects (World Bank 2015).

⁵ GDP forecasts for Asian countries are from the October 2015 East Asia and Pacific Economic Update.

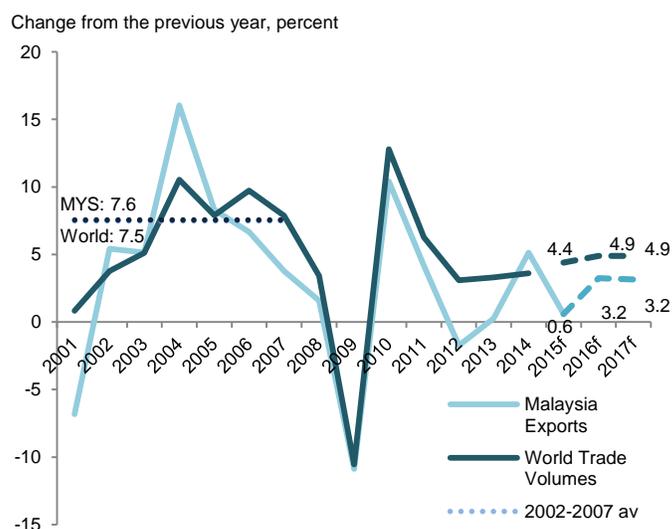
⁶ World Bank Commodity Prices Outlook, November 2015.

Figure 29: PMIs further deteriorated across the board in 2015...



Source: Markit (Japan, Euro area), Caixin (China), CEIC (US)
 Note: Simple average of PMIs for US, Euro area and Japan. Manufacturing PMI for China. Scores above 50 reflect expansion

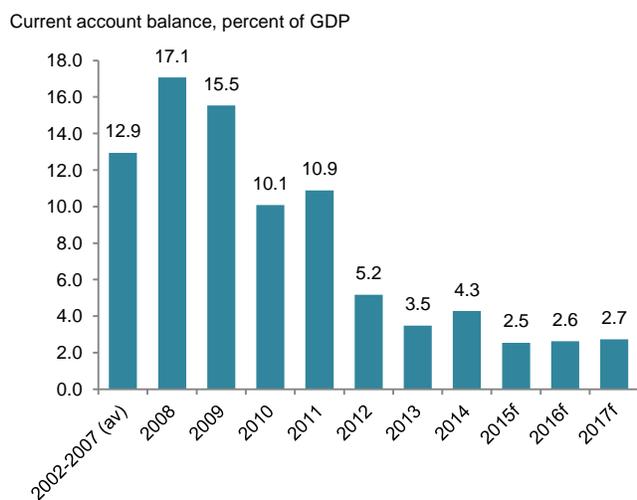
Figure 30: ...dampening the outlook for Malaysian export growth



Source: CEIC, World Bank DECPG and World Bank staff calculations
 Note: World Bank forecasts as of June 2015

31. The current account is expected to remain in a small surplus in 2016-17. The current account surplus is projected to remain at 2.5 percent of GDP this year, gradually picking up to 2.6 percent in 2016 and 2.7 percent in 2017 (Figure 31). The forecast for 2016 has been downgraded from June (+3.0 percent of GDP) due to renewed weaknesses in commodity exports and the persistence of lower oil prices. Despite slower growth in imports of consumer goods, the strong public investment pipeline is expected to demand substantial imports of capital goods and exercise pressures on the current account in 2016-17. The Government has signalled its commitment to maintain infrastructure plans such as the construction of new MRT lines and the Kuala Lumpur-Singapore high-speed rail. Other projects under the 11th Malaysia Plan will also begin to take shape, while implementation of projects under the RAPID program is expected to continue.

Figure 31: The current account is expected to remain in a small surplus.



Source: CEIC, DOSM, and World Bank staff projections

Fiscal reforms have increased resilience, but as oil related revenues remain dampened fiscal consolidation will become increasingly difficult

32. The implementation of GST and fuel subsidy cuts helped Malaysia weather the oil price shock, but Malaysia's fiscal space remains constrained in the medium-term. The Government has reaffirmed its commitment to reach a balanced budget in 2020 while maintaining substantive public investment in the short term to support economic growth and unlock infrastructure bottlenecks as part of the 11th Malaysia Plan. Key to achieving both objectives while the economy adjusts to a more challenging external economic environment will be the implementation of the medium term fiscal framework recently introduced that will anchor long term goals into short and medium term policies (Box 2).

33. Malaysia is moving towards a broader-based tax system while improving its capacity to redistribute. GST introduction has fundamentally altered the taxation system in Malaysia towards a growing reliance on indirect taxes. The GST has proved to be a powerful instrument to collect substantial revenues by broadening the tax base while keeping tax rates relatively low. The Government has also introduced other measures in the tax system that have the potential to reduce income inequality more effectively, an area where Malaysia's tax system has had limited impact so far. First, the 2016 public budget introduces additional tax exemptions and zero-rated products in the GST. To the extent that these products represent a relatively high share in the consumption basket of the most vulnerable, it improves the progressivity of the tax. However, these exceptions comes at a high price in terms of foregone revenue, making the GST less efficient and more cumbersome to administer, while limiting the resources that would be available for targeted social programs that may have more impact on income redistribution. Second, the Government has increased top earners' tax rates from 25 percent to 28 percent, which, together with last year's reduction of the tax rate between 1 percent and 3 percent for those in all other income bands, reinforce the redistributive impact of the income tax. However, the redistributive capacity and overall efficiency of the personal income tax is severely hampered by Malaysia's narrow tax base, as only around 20 percent of income earners pay personal income taxes.

34. Achieving fiscal consolidation will demand firm adherence to the 2016 public budget. The Government expects the fiscal deficit to register at 3.1 percent of GDP in 2016, a slight improvement from the projected 3.2 percent of GDP in 2015. Achieving this target will call for restraining the growth of emoluments that represent around a third of total operational expenditures. With limited policy decisions envisaged in the short term, and in a context of limited fiscal space, a renewed focus on improving value for money aspects of the public financial management systems can contribute substantially to achieving the objectives of the 11th Malaysia Plan (Box 2).

Box 2: Strengthening public financial management for better service delivery

Over the past decade, Malaysia has introduced a foundational set of systems, processes and institutions to promote disciplined and efficient use of public resources. Malaysia was a regional pioneer in introducing a performance orientation into its budget process, starting with the Modified Budget System in 1990 and continuing with the Outcomes Based Budgeting (OBB) in 2013. This performance orientation sought to increase line agencies' accountability for delivering quality public services, and to rationalize government spending in line with deficit reduction targets. Ministry activities are linked to national and ministerial key results areas and a measurable results framework, including agreed-upon targets at various levels, provide greater autonomy while raising accountability.

Malaysia introduced in the 2016 public budget a Medium Term Fiscal Framework (MTFF) with the goal of developing a medium-term perspective on resource availabilities and spending commitments. This is an important tool for strengthening fiscal discipline, supporting policy-based budgeting, and achieving technical efficiency in public spending. A recent global study by the World Bank found that the introduction of a Medium Term Expenditure Framework (MTEF) had a significant and positive effect on fiscal discipline (as measured by overall fiscal balance), as well as on allocative efficiency (as measured by volatility of both general and sector-specific government spending).⁷ For example, prior to their introduction of a MTEF in 2008, Jordan experienced significant compositional

⁷ For more details, see chapter 4 of *Beyond the Annual Budget: Global Experience with Medium Term Fiscal Frameworks*, World Bank, 2013

budget variation (15.9 percent and 12.2 percent in 2005 and 2006 respectively). Post implementation, compositional budget variation fell to approximately 5 percent between 2009/2010.⁸ Malaysia's MTFF is an opportunity for the Government to translate the fiscal framework into a set of sector allocations and spending ceilings for line agencies. Doing so will improve the ability of agencies to strategically prioritize spending by offering greater predictability of resources over the medium term, so that they can develop multi-year spending plans. This next step is particularly important in order to achieve fiscal consolidation while implementing new medium term policies as part of the 11th Malaysia Plan in a constrained fiscal space.

Malaysia has laid a strong foundation for performance in budgeting which it now has to translate into results. Improving the rigor of activity-costing, especially related to new policies, will help to maintain discipline and avoid the OBB from becoming process-oriented. Establishing incentives for performance and learning from failures will also make the OBB a tool for active management. These reforms will certainly call for capacity building across government so that civil servants can effectively deploy these different tools but would certainly pay off in terms of public sector efficiency gains. For example, South Korea instituted Performance Budgeting starting in 2008, with a particular focus on identifying and cutting expenditure for projects which perform poorly. As a result, an average of 24 percent of total projects per year are deemed "ineffective", which translated into estimated savings of USD2.5 billion between 2009 and 2013.⁹

As fiscal space shrinks the need for public sector efficiency increases, and some public sector reforms would have high impact to address targeted public governance bottlenecks. For instance, a lack of integration between capital and recurrent spending poses a significant impediment to strategic prioritization of resources, and threatens fiscal discipline when recurrent costs of new capital spending are not sufficiently accounted for. A seamless integration of capital and recurrent budgets would allow agencies to deploy resources strategically in order to meet policy objectives, rather than focusing on each component in isolation. Singapore in particular has very successfully practiced a seamless integration of capital and recurrent budgeting, under which they have been able to provide a comprehensive system of multimodal infrastructure, and have ensured that quality remains high even after years of regular use. Additionally, more strategic wage bill management would help to improve budget credibility, reducing the significant variation seen in emoluments payments in the budget over the years. Also, focusing on value for money in procurement will help improve the quality of public spending at a time when public resources are scarce. Improvements in public investment management would strengthen the quality of development expenditure in order to achieve the goals of the 11th Malaysia Plan. Improvements can be sought across the investment project cycle, reinforcing sector investment strategies, improving project screening and selection through pre-feasibility studies, adopting and consistently applying guidelines on cost-benefit analysis, establishing independent appraisal committees, and learning from ex-post project evaluation. Chile, which boasts one of the best public investment management systems in the world, undertakes a rigorous pre-screening exercise, under which 5-8 percent of projects are rejected before even moving to full appraisal – a step which saves large amounts of government resources.¹⁰ Chile also undertakes systematic ex-post evaluation of projects to ensure lessons learned are brought to bear on future efforts.

Source: Authors.

35. With crude oil prices expected to remain low in the medium term, a boost to tax collection would likely demand additional measures. As lower oil prices constrain oil-related revenues and NFPCs budget in 2016-20, reconciling the Government's consolidation efforts with the substantial infrastructure program envisaged in the 11th Malaysia Plan (RM260 billion) will demand continued expenditure consolidation and revenue-enhancing measures. Significant upsides to tax revenues are unlikely in a context of economic slowdown. Looking forward, revenue gains may be achieved by a careful consideration of tax expenditures, including exempted and zero-rated items in the GST. As a first step, publishing tax expenditure statements would serve to guide an informed discussion on their costs and benefits to support government objectives. Greater efforts to broaden the personal income tax base could have a substantial

⁸ Jordan Public Expenditure Financial Accountability assessments, 2007, 2011 (www.pefa.org)

⁹ Estimates from the Korean Ministry of Strategy and Finance, 2013

¹⁰ *The Power of Public Investment Management: Transforming Resources into Assets for Growth*, World Bank, 2014

impact in increasing tax collection. Moreover, better targeting of cash transfers and subsidies would raise the efficiency of public expenditure while protecting the most vulnerable.¹¹

36. Reprioritizing expenditures away from operational costs towards public investment will help to sustain growth. A key risk to the implementation of the 2016 budget is slower economic growth than projected, which would slowdown tax collection. Although some tax measures could boost revenue collection in the short term, a careful review of lower-priority operational expenditures would likely better serve the government to contain the fiscal deficit. Implementation of public investment will make key contributions to sustaining domestic demand at a time when growth in private consumption is softening. Investment is also likely to have a higher fiscal multiplier impact than operational expenditure and will boost the growth potential of the economy by removing infrastructure bottlenecks. Moreover, continuing efforts to improve the quality in the design, selection and implementation of the development budget would further raise its positive impact on economic growth and output potential (see Box 2).

37. Public debt is manageable but vulnerable to the uncertain global environment. Federal debt levels have increased to 54.6 percent of GDP as at end-September 2015 amid slower than expected fiscal consolidation. Gross borrowings (8.3 percent of GDP) are comfortably financed given the ample liquidity in the domestic financial system, with limited increases in borrowing cost and interest payments (2.1 percent of GDP). Foreign participation in the domestic bond market remains strong around 29 percent of government securities. Furthermore, the fact that 97 percent of federal debt is ringgit denominated and there are large number of domestic institutional borrowers (many of them public institutions) partially shield the government from sudden changes in investors' sentiments. The significant contribution that NFPCs are making towards infrastructure development and the associated increase in their deficits is also reflected in the increase of public guaranteed debt. The impact of the ringgit depreciation on public debt has been noticeable but manageable, growing almost 2 percent points to 10.3 percent of GDP. This is concentrated on foreign currency debt held by public corporations which increased to 8.7 percent of GDP in 2015 (2014: 6.9 percent). However, part of this debt is backed by substantial foreign assets as part of the diversification strategy of many public corporations, which limits exchange rate risks.

38. The banking system will face headwinds in efforts to maintain strong credit growth. Despite the review of pricing parameters to better reflect the counterpart risk, an environment of compressed financial intermediation margins¹² prevails. The growth of interest expenses between 2010 and 2014 was higher compared to interest income (+53.2 percent vs +36.4 percent). In addition, pressure in regards to operating expenses such as staff costs and overheads, has translated into a decrease of net income margin¹³. In an environment of pressures for growing interest expenses, strong competition in the marketplace and slowdown in household credit, commercial banks will be challenged to sustain their profitability levels through adequate cost and risk management.

39. Monetary policy is likely to remain accommodative of growth. In its latest Monetary Policy Statement for the year (November), BNM recognized that there are heightened uncertainties in the global economic and financial environment pose downside risks to growth, and reaffirmed that its current stance remains "accommodative and supportive of economic activity." This stance is expected to hold and monetary policy levers remain limited as interest rate differentials between Malaysia and the US are expected to narrow.

Risks to the near-term remain elevated as the global economy adjusts to new fundamentals

40. Malaysia faces a challenging year ahead as the economy transitions to a new global scenario under a volatile external environment. Uncertainty over global and domestic mid-term expectations may depress domestic demand at a time when limited space for fiscal and monetary expansion will hardly be able to provide an additional boost, given the Government's commitment to fiscal consolidation and the impending normalization of US monetary policy. The weak growth momentum in the world economy poses additional challenges as no single economy seems in position to anchor global economic growth. With overall weakness in emerging markets, and China rebalancing from

¹¹ The recently adopted decision to abolish ST15 rice subsidies (RM530 million in 2014) and explore ways to better target subsidy assistance open the avenue for careful consideration of the remaining fuel subsidies raising public expenditure efficiency while protecting the most vulnerable.

¹² Intermediation margin is equal to the difference between interest income and interest expense.

¹³ Net margin = pre-tax profit / interest income.

investment and export led growth towards consumption and services growth, risks to the relatively benign export growth outlook are significant. One bright spot may come from the Trans-Pacific Partnership, which could provide an impetus to Malaysia's reform momentum raising economic growth and export outlook in the medium term (Box 3).

41. Slower than expected economic growth in China would intensify external headwinds to growth in Malaysia. The share of Malaysia trade with China has tripled since 2000 and Malaysia's exports to China accounted for 10.4 percent of its nominal GDP in 2012-2014. Furthermore, China's slowdown would affect non-commodity exports to China, including tourism, as China has become the world's largest source of tourists, and tourist arrivals from China represent around 6 percent of total tourist arrivals in Malaysia. China was in 2014 the world's largest recipient of FDI, and the second-largest source of FDI after the United States, and accounted for 1.4 percent of total FDI in Malaysia. In addition, China's economic slowdown would have an indirect impact on Malaysia through significant regional contagion on the rest of ASEAN markets, which account for 28 percent of total Malaysian exports, as well as downward pressures on commodity prices (China consumes about half of global demand for metals, and 20 percent of global demand for primary energy). Against this backdrop, China has some fiscal and monetary leeway that would counterbalance any significant slowdown in economic growth.

42. Uncertainties about the pace of normalization of US monetary policy may generate significant volatility in Malaysian financial markets. Malaysia enjoys a large presence of foreign investors in its bond market (29 percent of total) as well as access to low-cost external funding to its banks, which supported domestic credit growth. As evidenced by portfolio outflows by non-residents (RM29.2 billion until end Q3 2015), higher US interest rates and an appreciating US dollar, along with diverging monetary policy paths across advanced economies, could further impact outflows in the short and medium term. This may have a potential impact on domestic borrowing costs, which may in turn exacerbate financial volatility and capital outflows in 2016. In this context, delivering on policy commitments such as continued fiscal consolidation would further reassure foreign investors. In addition, insofar as political events in Malaysia continue to raise concerns over transparency and institutions, this could hamper investment sentiment further.

Box 3: Potential implications of the Trans-Pacific Partnership

On October 4, 2015, 12 Pacific Rim economies – Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States, and Vietnam – concluded negotiations on the Trans-Pacific Partnership (TPP), the largest, most diverse and potentially most comprehensive regional trade agreement to date. The TPP goes beyond providing market access to goods, services and investment, to also harmonising rules and disciplines for new and emerging trade and cross-sectoral issues, such as government procurement, competition with state-owned enterprises, intellectual property rights, the digital economy, labour and environment. If well implemented, the TPP could create new opportunities and benefits for businesses, workers and consumers by providing comprehensive market access, promote innovation, productivity and competitiveness, facilitate the integration of countries' supply chains and improve regional integration.

Overall, the TPP is expected to provide a new impetus for trade and global growth. According to preliminary World Bank estimates, the TPP would raise member countries' GDP an average of 1.4 percent by 2030. The benefits of the TPP would mostly derive from the reduction in services barriers (contributing 41 percent of the total increase in GDP), followed by cuts in non-tariff barriers (37 percent) and barriers to investment (16 percent). Only 6 percent of the GDP increase would be due to tariff cuts. Larger gains are expected to occur in more protected and smaller member economies such as Malaysia and Vietnam. The World Bank estimates that by 2030, the TPP will lift Malaysia's GDP by 12 percent and Vietnam's by 7 percent as these countries lower their tariffs and become more integrated in regional supply chains.

According to a recent Government-commissioned study by PriceWaterhouseCoopers (2015), GDP would increase by USD107~211 billion over 2018-2027 (a higher GDP growth of 0.60~1.15 p.p. in 2027), assuming all tariffs are eliminated and Non-Trade Measures (NTMs) are reduced by 25~50% across the 12 prospective TPP member countries. In contrast, Malaysia's non-participation in the TPP is projected to incur a cumulative GDP loss of USD9~16 billion over 2018-2027, but could reach USD116~227 billion over the 10-year period if the cumulative opportunity cost

of non-participation in the TPP is added. Investment is also projected to increase by an additional USD136~239 billion over 2018-2027 mainly in the textiles sector, followed by the construction and distributive trade sectors. In contrast, Malaysia's non-participation in the TPP could result in a diversion of foreign investment away from Malaysia by USD7~13 billion over 2018-2027. Export growth is projected to increase mainly in textiles, but also automotive and transport equipment, and E&E. Import growth is projected to increase faster than exports, driven mainly by higher imports of intermediate and capital goods, as the reductions in import tariffs and NTMs are larger for Malaysia relative to the other TPP countries. Overall, wage growth for unskilled labour is projected to increase by 0.45~0.91 p.p. and 0.38~0.78 p.p. for skilled labour, with limited wage growth impact in the event of non-participation in the TPP.

Another recent Government-commissioned study by the Institute of Strategic and International Studies of Malaysia (2015) reports that the impact of the TPP on income distribution is more ambiguous. Although the TPP is expected to facilitate large investments and thus create jobs in sectors such as E&E, chemical, palm oil, rubber, wood, textile and automotive parts/components, there are potential job losses for low-skilled workers who may not be able to compete with semi-skilled and skilled workers. Market access obligations in government procurement are expected to negatively affect a small segment of Bumiputera suppliers with high value procurement, but over time this is expected to lead to a more equitable and efficient allocation of preferences. The study also expects positive impacts from the TPP in the areas of labour and environmental standards.

The TPP could potentially lead to trade diversion, i.e. favour less economically efficient producers from TPP members vs. more efficient ones in non-TPP members, and preference erosion (i.e. loss in preferential market access for non-TPP members vis-à-vis members). These effects are likely to be sector-specific rather than widespread but further research will be required.

Ultimately, the impact of the TPP will depend on where countries are positioned in terms of comparative advantage, existing national policies and the design and implementation of country-specific regulations required to comply with the TPP, as well as the extent to which non-participants seek to join, or implement the standards set by the TPP. Implementation of the TPP could give an impetus to domestic reforms in Malaysia by improving competition, transparency, and trade facilitation among other areas, but will call for careful policy design to meet the "21st century" standards and new regulatory compliance costs that the TPP demands.

Source: Adapted by authors from World Bank Global Economic Prospects (Forthcoming, January 2016), PriceWaterhouseCoopers (2015), and ISIS Malaysia (2015)

2. IMMIGRANT LABOUR

As Malaysia aspires to become a developed economy by 2020, there is growing attention on the role that immigration will play in that process

43. The 11th Malaysia Plan emphasizes the relevance of an efficient and inclusive labour market and a high-skilled workforce to achieve the goal of becoming a high-income country by 2020. The 11th Malaysia Plan includes the acceleration of human capital development as one of its six strategic thrusts (Economic Planning Unit 2015). Growing a skilled workforce is highlighted as key to fostering knowledge-intensive activities, gains in productivity, and investment. To this end, one of the Plan's primary areas of focus is the creation of an efficient and flexible labour market, which involves efforts to increase productivity, to enhance job matching, and to improve the management of foreign workers.

44. The 11th Malaysia Plan addresses concerns that continued reliance on immigrant labour may impact the final push to become a high-income country by 2020. Some of the concerns are long-standing and are related to the belief that low-skilled workers may hinder technological progress (Bank Negara, 2009). This, in turn, would hamper Malaysia's objective of transforming itself through innovation to become a high-income economy by 2020. The 11th Malaysia Plan addresses some of these concerns with several recommendations. Overall, the Plan calls for improvement in the management of foreign workers in a way that takes into account the needs of industry and the welfare of foreign workers. In particular, this involves a cap on foreign workers' share of the labour force of 15 percent, an improved system of levies for the entry of foreign workers, and a streamlined recruitment system.

45. This report aims to provide evidence to better assess the benefits and costs of migration in Malaysia and better harness its contribution to achieve Malaysia's objectives. The prominent role played by immigrant workers in Malaysia, as highlighted in the 11th Malaysia Plan, demands a detailed accounting of their cost and benefits. The analysis focuses on the low- and mid-skilled immigrant workers who make up 95 percent of the immigrant workforce in Malaysia. However, because of the importance of including all types of immigrant workers in a comprehensive immigration system, the analysis also includes high-skilled immigrant workers where possible. This will help illustrate how an integrated migration management system can help Malaysia leverage immigrant labour more effectively in order to meet its ambitious goals. The terminology used to refer to distinct groups of immigrants is very important in Malaysia, and worth keeping in mind when reading this report. High and mid-skilled immigrants are referred to as expatriates, whereas low and unskilled immigrants are referred to as foreign workers. Current legislation and regulations on immigrant labour make clear distinctions between these two groups.¹⁴

46. The remainder of the report is organized as follows: the next section provides an overview of the immigrant workforce in Malaysia. This is followed by a presentation of the variety of impacts of immigrant workers in Malaysia, including new research on labour market outcomes such as employment and wages. The following section examines the challenges that exist in the current approach to managing immigration. The report concludes by proposing next steps, including areas for further analysis and potential reforms for further consideration.

Immigrant labour is a crucial contributor to Malaysia's development

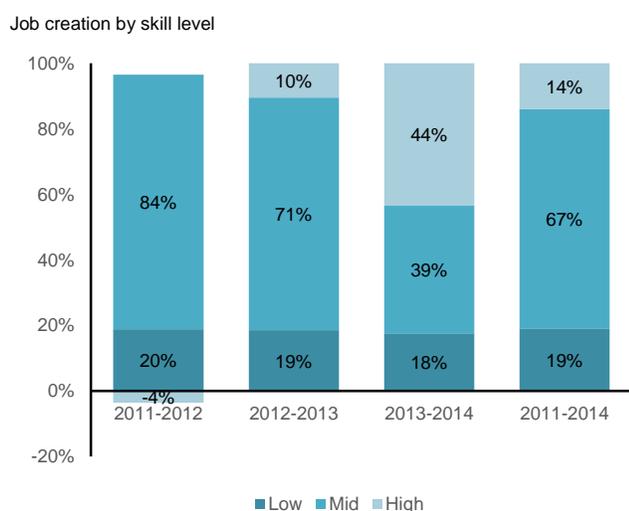
47. The Malaysian labour market is characterized by full employment, strong job creation, a growing educated local workforce, and a (slow) shift away from low-skilled occupations. Malaysia is a growing, industrializing economy with a young population which is increasingly more educated than previous generations. This is a positive outcome that reflects the country's emphasis on education and upskilling its workforce. At around 3 percent, unemployment rates are mainly frictional and low by international standards, indicating full employment and tight labour markets, in a context of relatively low but growing labour force participation. The country has had positive and strong net job creation year after year, with significant growth in higher-skilled occupational categories. In fact, the vast majority of

¹⁴ The labour force survey (LFS) does not distinguish between different types of non-citizens, i.e. permanent residency, employment pass and work permit holders are all classified as non-citizens. However, given the relatively small percentage of permanent residency holders compared to work permit/employment pass holders, in this report the definition of immigrant labour may include permanent residency holders when LFS data are used.

new jobs created between 2013 and 2014 were in high-skilled occupations¹⁵ (Figure 32), in line with a growing educated labour force.

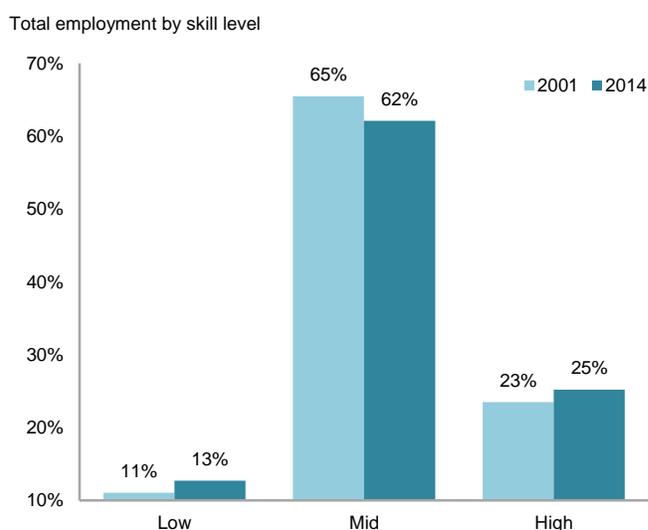
48. But low-skilled sectors remain important to the Malaysian economy, creating workforce gaps at the lower end of the skill spectrum. The development of a high-skilled workforce is a prominent goal in the 11th Malaysia Plan. Despite the recent trend toward high-skilled employment, Malaysia's economic structure is still somewhat reliant on labour-intensive and unskilled-intensive sectors such as agriculture, which made up 8 percent of GDP at the end of 2014, and lower-skilled services such as wholesale and retail, accommodations, and restaurants, which made up 19 percent of GDP. Indeed, employment remains highly concentrated in low- and mid-skilled occupations at 13 percent and 62 percent of total employment in 2014, respectively, proportions which are very similar to what they were in 2001 (Figure 33). At the same time, the educational level of Malaysians has outpaced the shift to higher-skilled employment with 71 percent of the Malaysian workforce receiving secondary education or higher in 2014 compared to just 49 percent in 2001. This mismatch between the amount and skills of jobs available in the economy and the composition of the labour force calls for foreign workers to fill the gaps.

Figure 32: More high-skilled jobs are being created...



Source: Labour Force Survey, Department of Statistics of Malaysia (DoS LFS), 2011 – 2014. World Bank staff calculations

Figure 33: ...but low- and mid-skilled jobs remain dominant.



Source: DoS LFS, 2001 and 2014. World Bank staff calculations.

49. Immigrant labour fills gaps across the entire skills spectrum. As more educated Malaysians seek out higher-skilled work, low-skilled and medium-skilled foreigners help to fill workforce gaps in occupations requiring such skill levels; about 95 percent of immigrant labour fill low and medium skill occupations. Labour force data show that about 44 percent of all immigrant labour in Malaysia works in low-skilled occupations – often in work environments that are deemed 'dirty, dangerous and difficult' (3D jobs). They are most commonly in labour-intensive sectors such as construction, agriculture and certain types of manufacturing. This is commensurate with the low education levels of most immigrant workers – three-quarters had less than secondary education in 2014. Similarly, 51 percent of the immigrant labour force is mid-skilled and tend to work in occupations such as plant and machine operators, services and sales workers and in craft and related trades. They also tend to be less educated than their Malaysian peers, and as such more highly concentrated in labour-intensive sectors and in 3D occupations. Finally, highly-skilled foreigners (only 5 percent of total immigrants) fill skills gaps in occupations requiring more specialized skills that may not be available locally. They are on average more educated than Malaysians (61 percent have a degree or higher versus 39 percent of Malaysians) and work in business services, wholesale/retail, and construction.

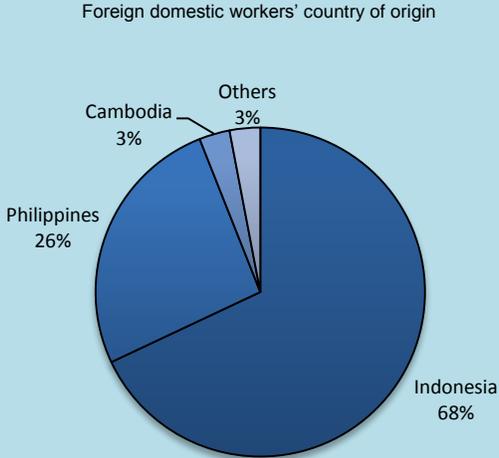
¹⁵ Categories 1 to 3 based on the Malaysia Standard of Occupational Categories (MASCO) classification refer to high-skilled occupations. These are managers; professionals; and technicians and associates. Categories 4 to 8 are mid-skilled occupations. These are plant and machine operators and assemblers; craft and related trades workers; skill agricultural, forestry, and fishery workers; services and sales workers; and clerical support workers. Category 9, elementary occupations, is low-skilled.

50. The importance of immigrant labour to the Malaysian economy is amplified by the relatively low labour force participation rate, particularly for Malaysian women, which has further contributed to labour shortages. Malaysia's relatively low labour force participation rate compared to an East Asian and Pacific (EAP) average of 70 percent according to the International Labour Organization (ILO) estimates – means that immigrant labour fills gaps created by lack of participation in the labour market. In 2014, 66 percent of all Malaysians and only 53 percent of Malaysian women participated in the labour force, with many of the latter group staying at home to care for family responsibilities. Foreign domestic workers can indeed help this group to enter the labour force, particularly for high skilled females (Box 4). Those Malaysians who are out of the labour force could also fill gaps in low- and high-skilled positions: those who are out of the labour force tend to have lower levels of education, implying that they could potentially also work in low- and mid-skilled jobs, though 27 percent have more than secondary education and could potentially fill gaps at the higher-skilled end of the spectrum. However, even increasing Malaysia's labour force participation rate to Singapore's 74 percent would only activate 1.5 million more Malaysians, fewer than the 1.8 million employed immigrants and many fewer than the total estimated immigrants (documented and undocumented) in Malaysia. Furthermore, it is unclear whether workers currently out of the labour force would seek out employment in jobs that are often dirty, dangerous, and demeaning.

Box 4: Foreign Domestic Workers and Female Labour Force Participation

Immigrant labour can promote higher labour force participation rates, particularly among women. As providers of child care and house work, immigrant labour can allow women to enter the workforce. In Hong Kong, SAR, China the extension of work permits to foreign domestic workers was associated with an increase of female labour force participation rate for mothers of young children (Cortes and Pan, 2013). In the United States and Italy, studies show that foreign domestic workers enable highly skilled American and Italian women to spend more time at work (Cortes and Tessada, 2011; Barone and Mocetti, 2010).

Figure 34: Most foreign domestic workers are from Indonesia and the Philippines



Source: Ministry of Home Affairs (MOHA), 2014

Reducing the recruitment costs for foreign maids could help women re-enter the labour market. In Malaysia, foreign domestic mainly come from neighbouring countries, mostly from Indonesia (68%) and the Philippines (26%) (Figure 34). Similarly to other countries, the evidence shows that immigration has a positive impact on the employment of Malaysia women in the services sector, especially in finance, business and real estate, insurance, health and other high value-added services (World Bank, 2012). However, the costs of hiring foreign maids are generally high for both employers and foreign workers. In particular, recruiters in sending countries can charge fees as high as RM5,000 for domestic workers from Indonesia (World Bank, 2013), thus limiting broad access to this option (see policy section for a detailed explanation of migration costs). While the government has successfully introduced

several programs to incentivise employers to hire and retain women in the labour force, and encouraging flexibility in work arrangements (World Bank, 2015c), improving access to affordable domestic services is an important additional instrument to increase labour participation among women, especially among the highly-skilled.

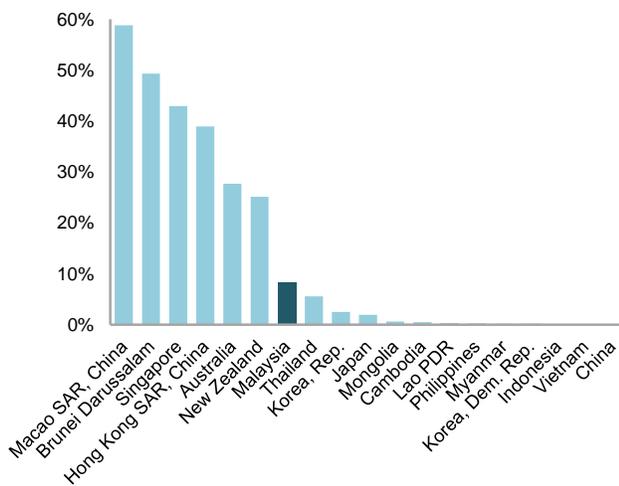
Source: Authors.

Immigration is a structural element of Malaysia's economy

51. Malaysia has one of the largest migrant stocks and one of the largest ratios of migrants to total population in East Asia and the Pacific. According to UN data, in 2013 Malaysia had the fourth-largest migrant stock in EAP¹⁶ and the seventh-highest (out of 19 countries) ratio of migrants to total population¹⁷ (Figure 35). Currently, there are 2.1 million registered immigrants in Malaysia.¹⁸ The undocumented immigrant population is also significant. While an accurate number is difficult to determine, the 6P legalization program identified 1.3 million undocumented immigrants during its first phase.¹⁹ These immigrants make up a significant portion of the Malaysian labour force; however, it is important to note that not all the undocumented are workers. Based on the Malaysian Labour Force Survey, the immigrant labour share of the workforce increased sharply between 1990 and the early 2000s from 3.5 percent to around 9.5 percent. Growth has levelled off since, but immigrant labour still accounted for about 15 percent of the labour force in 2014 (Figure 36).²⁰

Figure 35: Malaysia has one of the largest migrant stocks in East Asia and the Pacific

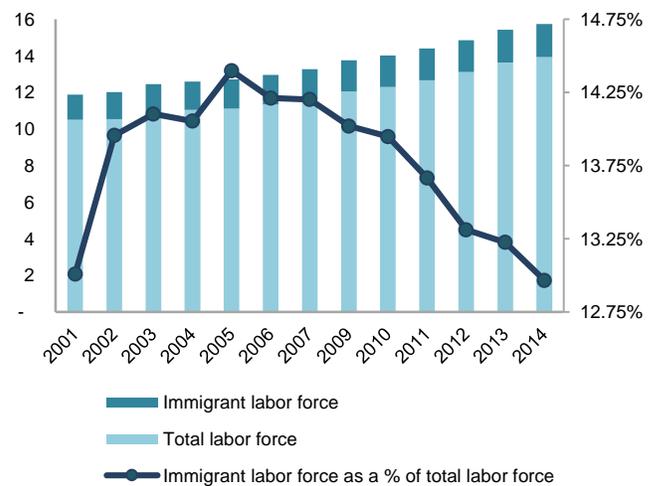
Total number of migrants as a share of the total population in East Asia and the Pacific, percent



Source: United Nations, 2013.

Figure 36: The immigrant labour share of the labour force remained in a narrow range between 2001 and 2014

Left axis: number of workers in the immigrant labour force and local labour force (millions); right axis: immigrant labour as a share of the total workforce, percent



Source: DoS LFS, 2001 and 2014. World Bank staff calculations.

52. Similar to other upper-middle and high-income countries, Malaysia's economic success makes it an important destination country for migrants. Significant wage differentials between Malaysia and neighbouring countries provide an opportunity for potential migrants in lower-income countries to increase their income. For instance, average monthly wages in Malaysia are USD609 compared to Indonesia's USD174 (ILO and ADB, 2014). Disparities in economic

¹⁶ Only Australia, Thailand and Hong Kong SAR, China have larger migrant stocks.

¹⁷ This excludes small island nations which in some cases have very high ratios of immigrants to total population.

¹⁸ This is based on the number of workers registered in the Foreign Worker Compensation Scheme in 2015.

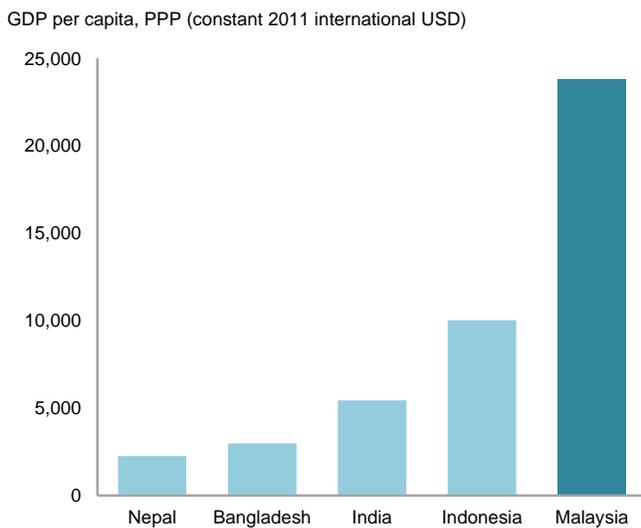
¹⁹ Press reports suggest that as of April of 2012 after two extensions of 6P a total of 3.1 million immigrant workers were registered of which two thirds were undocumented. This suggests that the total number of undocumented immigrants could be approximately 2 million.

²⁰ Data have been adjusted to account for changes in the sampling frame of the Labour Force Survey (LFS). The LFS data underestimates the number of foreign workers in the Malaysian labour market because the survey does not include communal housing where many foreign workers, particularly in key sectors such as agriculture and construction, are likely to live. On the other hand the LFS captures both regular and irregular foreign workers not captured through other official data sources.

development also drive flows. Malaysia's GDP per capita was 2 times larger than that of Indonesia, its primary origin country, and 8 and 11 times larger than that of Bangladesh and Nepal, two other major origin countries (Figure 37). These differentials offer migrants an opportunity to improve their economic standing. While catch-up growth is to be expected, these large differences will likely remain for the foreseeable future, making migration to Malaysia a long-run phenomenon.

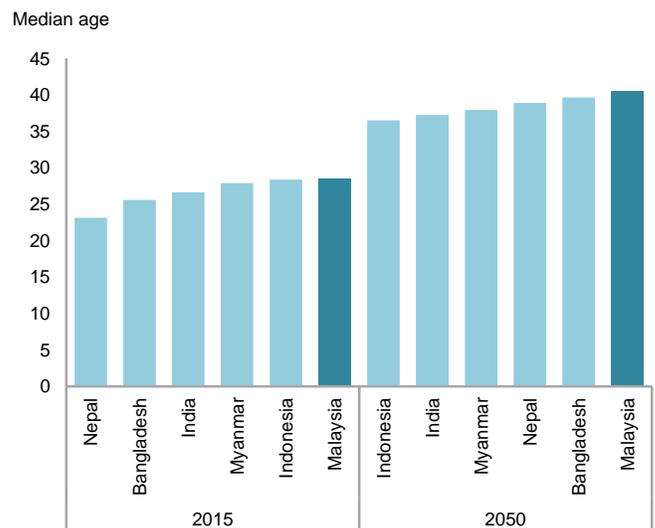
53. Population ageing may draw further migrants to Malaysia in the medium term. While still a young society, the Malaysian population is ageing, though not as quickly as other countries in East Asia. According to the United Nations (UN), the median age in Malaysia was 29 in 2015²¹, five years older than in 2000. Population ageing can have significant economic impacts with a shrinking labour force contributing to lower economic growth and a higher old-age dependency ratio straining public finances. Immigrants, who tend to be younger than Malaysians, can mitigate this ageing trend by boosting the working age population. Figure 38 shows that Malaysia's main sending countries are all younger than Malaysia. This will continue to be the case in 2050, when Malaysia's median age will be 4 years older than that of Indonesia, its main sending country. In fact, UN projections suggest that in the absence of international migration the median age in Malaysia would be 0.5 years higher in 2050 and the working age share of the population 0.5 percentage points smaller.

Figure 37: Large income disparities in the region attract migrant flows towards Malaysia



Source: World Development Indicators
 Note: Countries responsible for at least 5 percent of immigration to Malaysia are shown. Data is not available for Myanmar.

Figure 38: In the medium term, younger immigrants may further compensate for Malaysia's ageing population



Source: UN 2015
 Note: Countries responsible for at least 5 percent of immigration to Malaysia are shown. Data is not available for Myanmar.

54. The creation of the ASEAN Economic Community is expected to increase skilled immigration to Malaysia. The Association of Southeast Asian Nations (ASEAN) has committed to greater economic integration through the ASEAN Economic Community (AEC), which will promote freer movement of goods, services, capital, and skilled labour. AEC countries for now have only pledged to liberalize the movement of skilled workers, who make up a small share of intra-ASEAN migration (Martin and Abella 2014). But the AEC is expected to increase migration overall to countries, such as Malaysia, with more advanced economies, superior infrastructure, and full employment where liberalized trade will direct new investment (Martin and Abella 2014).

²¹ Data from Department of Statistics indicates a slightly lower estimate (27 years of age).

Who are the immigrants and where are they working in Malaysia?

Immigration to Malaysia has kept pace with labour force growth

55. Steady immigration flows to Malaysia are occurring in the context of a regional expansion of migration among ASEAN countries. ASEAN countries are now the origin of 8 percent and the destination for 4 percent of the world's migrants. Migration within ASEAN is increasingly important. ASEAN is one of the few global regions in which the share of intra-regional migration increased between 2000 and 2013. Indeed, Malaysia, along with Thailand and Singapore, receive many migrants from other ASEAN countries: migration to Malaysia from its main ASEAN sending countries (e.g. Indonesia, Myanmar) makes up 22 percent of all ASEAN migration, second only to Thailand's 55 percent. Most migrants within ASEAN are less educated and less-skilled – more than 90 percent of migrants from the main sending countries have less than secondary education. Most migration is driven by employment, with very low unemployment rates and very high labour force participation rates (LFPR) among these migrants. Large within-region disparities in income, education, skills, and population ageing have made migration inside of ASEAN an attractive option.

56. Most immigrants to Malaysia participate in the labour force. Based on the Labour Force Survey (LFS) which captures many formal and informal immigrants²², Malaysia had 2.2 million working-age immigrants (between 15 and 64 years old) in 2014, mostly male.²³ The majority of these (1.8 million) were in the labour force where they represent 13 percent of Malaysia's total employed people, a figure which remained relatively constant throughout the 2000s. The labour force participation rate of immigrant workers is significantly higher than that of Malaysians. In 2014, the immigrant LFPR was 83 percent compared to 67.5 percent for Malaysians (Figure 39). This is expected as the primary motivation for immigration to Malaysia is employment. Unemployment rates are very low for both Malaysian and immigrant workers, though immigrant worker rates are slightly lower (Figure 40). However, the number of migrants is difficult to measure accurately due to data/source limitations and the presence of undocumented migrants (Box 5).

Box 5: The Labour Force Survey and administrative sources provide quality data for the analysis of the impact of immigration in Malaysia

The Department of Statistics, Malaysia conducts the yearly Labour Force Survey with the primary objective to collect information on the structure and distribution of labour force in Malaysia. The LFS collects information on employment and unemployment, and includes questions about a respondent's particulars (e.g. age, gender, education level, sector and occupation of employment, employment status). From 2007, and following best practices of LFS data around the world, it began to collect wage data. Importantly, and unique among neighbouring countries, the LFS also asks for a respondent's citizenship and country of birth (del Carpio, et al., 2015). These questions about nationality and country of birth are crucial for understanding immigration into Malaysia as they permit a comparison of the immigrant labour force and the Malaysian labour force. Because immigrants and locals can be compared, the information can be used to investigate the impacts of immigration on the employment, wages, and other outcomes of Malaysians.

An additional advantage of the LFS is that it collects information about both documented and undocumented workers. This provides a more comprehensive picture than administrative records, which only cover formally documented immigrants. The LFS, however, is a household survey and as such, it does not collect data on workers living in communal or group housing. This means that immigrant workers, particularly low-skilled ones who are concentrated in the agriculture and plantations sector where such housing is commonly utilized, might be undercounted. Indeed, this is the case, especially when compared to administrative data. The LFS shows a total of 1,782,314 employed immigrants between the ages of 15 and 64 in Malaysia in 2014 versus 2,062,272 in administrative records of the Foreign Worker Compensation Scheme.

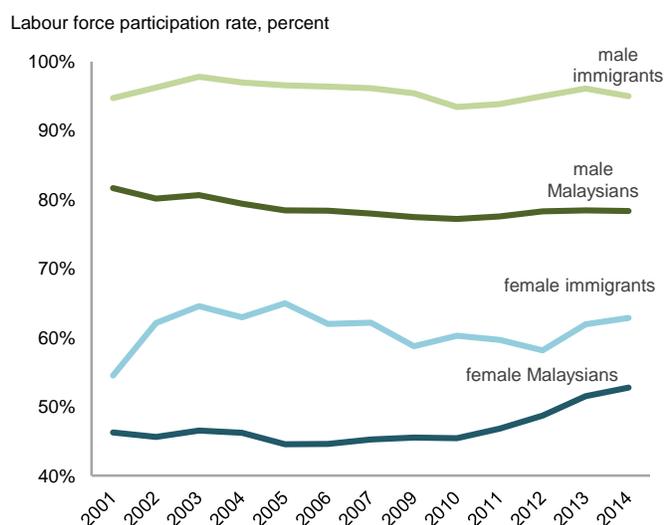
²² See Footnote 20.

²³ This is over 100,000 more than the number of immigrant workers registered in the Foreign Workers Compensation Scheme, which was 2,064,410 in 2014.

Both the LFS and administrative data have different and important uses. Administrative data provides information on the entire universe of migrants who are formally registered, whereas the LFS allows for analysis of the impacts of immigration by providing a picture of both immigrants and comparable Malaysians.

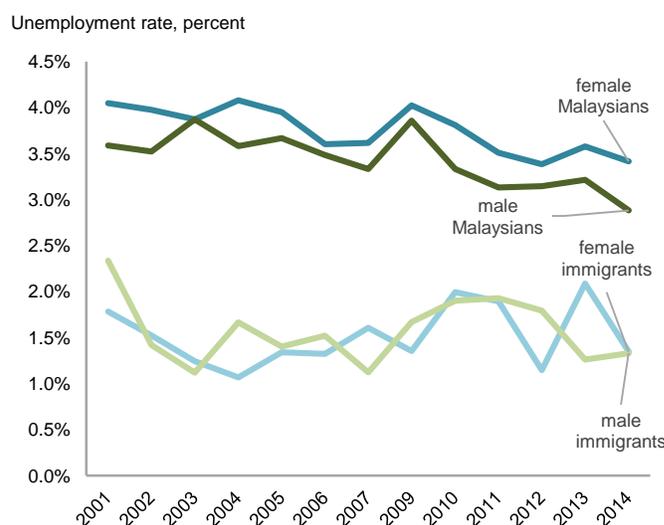
Source: Authors.

Figure 39: Labour force participation rates of male and female immigrants are much higher than those of Malaysians.



Source: DoS LFS 2001 to 2014, World Bank staff calculations.
Note: Data is not available for 2008.

Figure 40: Unemployment is low among both Malaysian and immigrant workers, but slightly lower among immigrants



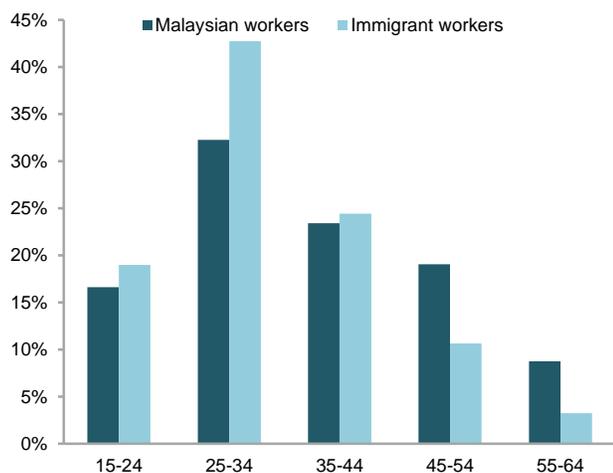
Source: DoS LFS 2001 to 2014, World Bank staff calculations.
Note: Data is not available for 2008.

Immigrant workers are younger and less-educated than Malaysians

57. Immigrant workers are significantly younger than Malaysians. 43 percent of immigrant labour is between 25 and 34 years old compared to only 32 percent of Malaysians (Figure 41). In contrast, many more Malaysian workers are 45 years of age and older than immigrant workers. This is a change from 2001 when the age distribution was much more similar and reflects the slow but increasingly ageing Malaysian population, primarily in the youngest working-age cohort (15-24 years). This trend of a younger immigrant workforce complementing an older Malaysian one is likely to continue as Malaysia ages more quickly than its primary source countries.

Figure 41: The immigrant workforce is younger than the Malaysian workforce...

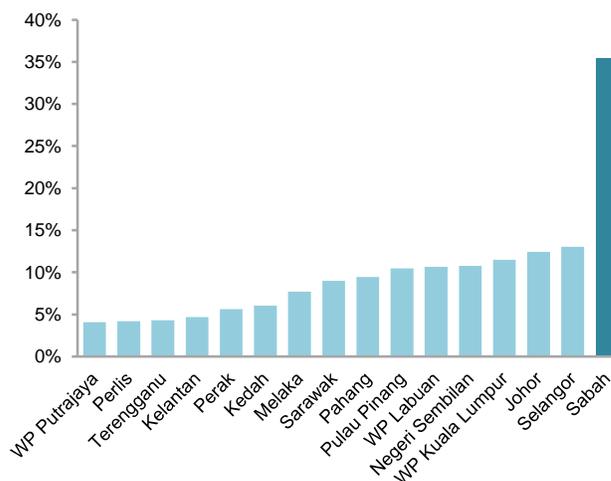
Age distribution (2014), percent of total local and immigrant labour force



Source: DoS LFS 2014, World Bank staff calculations

Figure 42: ...and is concentrated in Sabah where immigrant workers make up 35 percent of the total workforce.

Share of immigrant workers in total workforce by State, 2014



Source: DoS LFS 2014, World Bank staff calculations

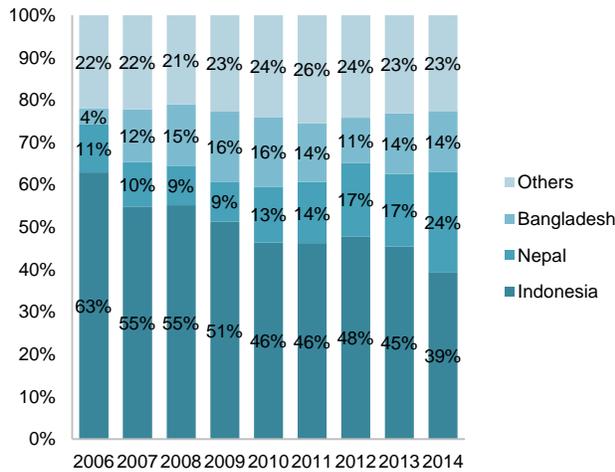
58. Two-thirds of the immigrant workforce resides in just three States. The immigrant workforce is concentrated in Sabah (33 percent), Selangor (21 percent), and Johor (11 percent). Proximity to Indonesia and the Philippines, cultural similarities with these countries, and the prominent role of agriculture have made Sabah a particularly attractive location for immigrants. Indeed, immigrant workers represent 35 percent of all workers in Sabah, significantly higher than any other State (Figure 42). Immigrants represent more than 10 percent of the workforce in Johor, Negeri Sembilan, Pulau Pinang, Selangor, Kuala Lumpur, and Labuan and are at least 4 percent of the workforce in every other state.

59. Most of the immigrant workforce is from Indonesia, although this share has declined significantly in recent years. According to the latest administrative data from the Foreign Worker Compensation Scheme,²⁴ more than a third of immigrant workers in 2015 originate from Indonesia (39 percent), followed closely by Nepal (29 percent) (Figure 43). The other main sending countries – Bangladesh, Myanmar, India, and Vietnam – have been the same since 2010. However, the share of Indonesian workers declined from two-thirds of the entire immigrant workforce in Malaysia in 2006 to about one third in 2014. This was partly due to an Indonesia-imposed ban on labour migration to Malaysia from 2009 to 2011 following human rights concerns, and tighter regulations ever since. Administrative data on immigrant workers with a Visitor's Pass (Temporary Employment)/PLKS, confirm that Indonesia sent more than 300,000 fewer immigrant workers in 2014 than in 2006. Conversely, Nepal and Bangladesh have contributed an increasing share of workers, sending 282,813 and 227,420 more immigrants respectively over the same period – a growth rate of 12 and 11 percentage points respectively. This trend reflects the sector growth in the Malaysian economy as immigrant workers from Indonesia cluster in the agricultural and construction sectors, while those from Bangladesh tend to work in the manufacturing and construction sectors, and those from Nepal in the manufacturing and service sectors, which have reported higher economic growth (Figure 44).

²⁴ These data do not capture undocumented immigrants.

Figure 43: Indonesians remain Malaysia's main immigrant group

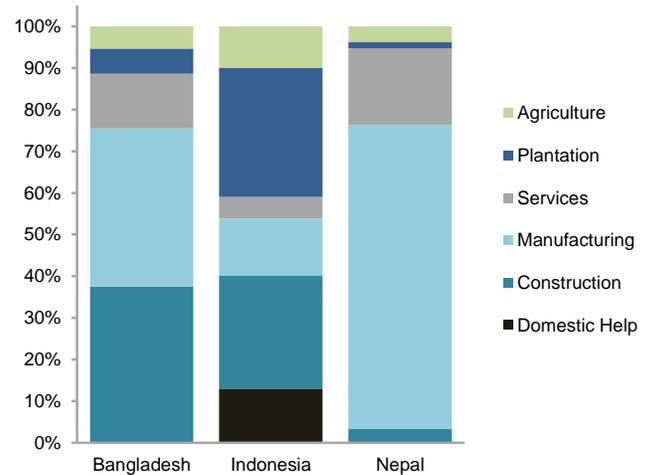
Share of total immigrants in Malaysia by country of origin, percent (2014)



Source: Immigration Department, Ministry of Home Affairs
 Note: Data refers to immigrant workers with a Visit Pass (Temporary Employment)/PLKS

Figure 44: Immigrant workers from Bangladesh and Nepal are less concentrated in plantations and agriculture

Sector of employment by country of origin, percent (2014)



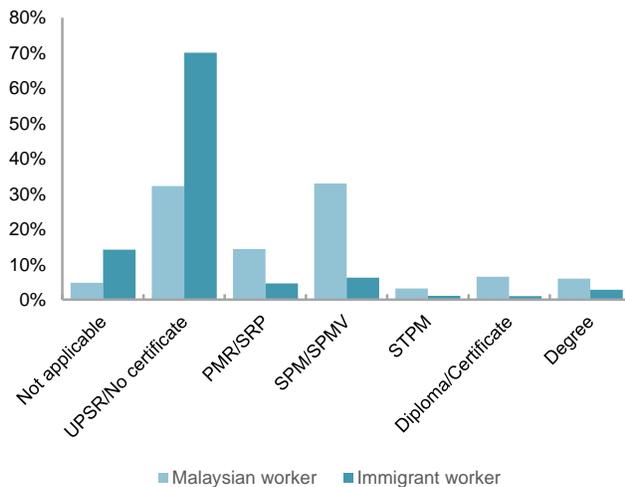
Source: Immigration Department, Ministry of Home Affairs
 Note: Data refers to immigrant workers with a Visit Pass (Temporary Employment)/PLKS

60. Malaysian workers are significantly better educated than immigrant workers, one indication that less-skilled immigrant workers complement higher-skilled Malaysians.

There has been a long-term shift towards higher education levels of the Malaysian population, a defining feature of the Malaysian workforce during the last two-and-a-half decades (World Bank 2013). The percentage of Malaysians with post-secondary education doubled from 16 percent in 2001 to 30 percent of the Malaysian workforce in 2014 (Figure 45 and Figure 46). By contrast, gains in the educational levels of immigrant workers have been concentrated at the secondary level. The share of immigrant workers with some form of post-secondary education remains low, moving from 5 percent in 2001 to 6 percent in 2014.

Figure 45: Malaysians are much better educated than immigrant workers...

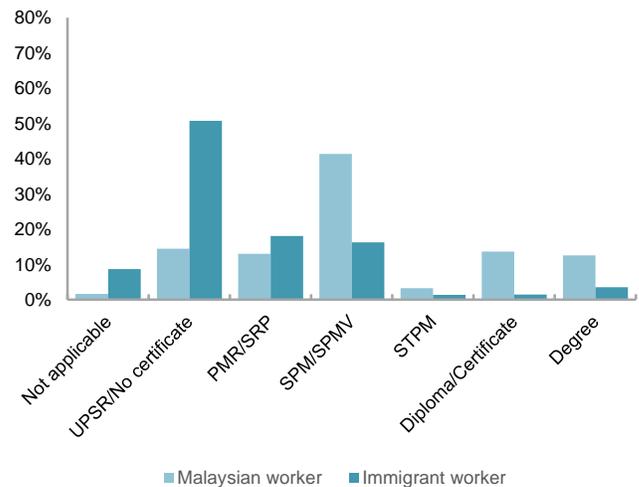
Share of workers by schooling level (percent), 2001



Source: DoS LFS 2001, World Bank staff calculations

Figure 46: ...and this educational gap has increased since 2001.

Share of workers by schooling level (percent), 2014



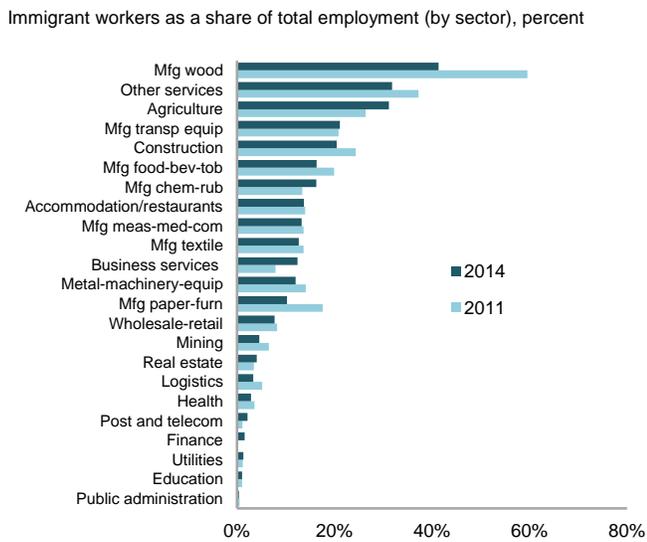
Source: DoS LFS 2014, World Bank staff calculations

61. Immigrants work mainly in sectors that require lower levels of education. While Malaysians are more evenly distributed across sectors, immigrant workers are heavily concentrated in sectors such as agriculture and construction.

43 percent of total foreign workers are employed in these sectors compared to only 18 percent of Malaysian workers. As a result, about a third of the entire agricultural workforce and one fifth of the construction workforce is an immigrant. Other sectors also show a strong immigrant presence: 40 percent of workers in wood manufacturing are immigrants; 30 percent in other services and 20 percent in transportation equipment manufacturing (Figure 47). We caution the reader that these percentages are likely to be under estimated, and the actual share is likely to be higher if immigrant workers living in communal housing (which are not captured in the LFS survey) were included in the total²⁵. Estimates show that immigrants have a relatively small presence in industries where higher skills are frequently needed such as education, finance, and health.

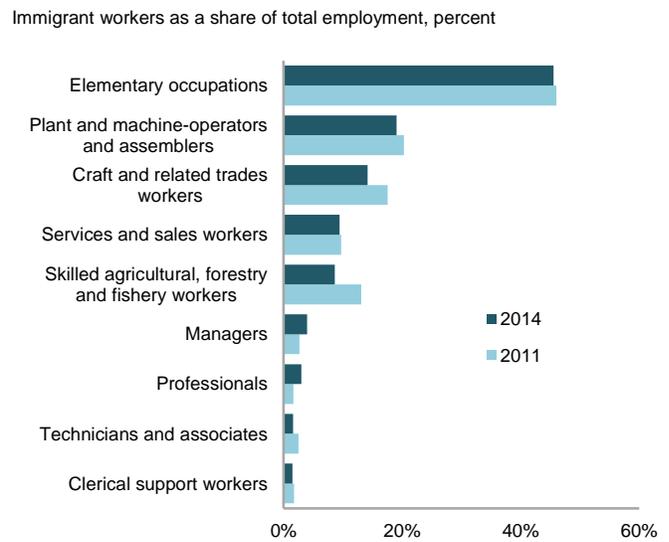
62. Foreign workers are mainly employed in low-skilled elementary occupations. 44 percent of the immigrant workforce is employed in low-skilled elementary occupations. Only 5 percent of immigrant workers are expatriates in high-skilled jobs. This contrasts with Malaysian workers, more than one quarter of whom are in high-skilled professions and only 8 percent of whom are in low-skilled ones. Immigrants have become slightly more concentrated in low-skilled jobs in the last four years: the share of foreign labour in low-skilled employment increased 4 percentage points between 2011 and 2014. Within occupations themselves, the ratio of immigrant workers to total workers in low-skilled elementary occupations was nearly fifty percent in 2014. The ratio is also high among plant and machine operators, where immigrant workers represent 19 percent of total employment and among workers in craft and related trades, where immigrant workers represent 14 percent of the total workforce.

Figure 47: Immigrant workers represent a significant share in some manufacturing and services sectors...



Source: DoS LFS, 2014, WB staff calculation

Figure 48: ...and dominate elementary occupations where they are almost half of the workforce.



Source: DoS LFS 2014, WB staff calculation

²⁵ To get the full picture of the presence of foreign labour in each distinct subsector, it is important to cross-check the information from the LFS with administrative data.

Malaysian workers tend to have a wage premium over immigrant workers

63. Malaysian workers command significantly higher wages than immigrant workers and this gap has increased in recent years. The median Malaysian worker earned RM9 an hour in 2014, RM4 more than the RM5 earned by the median immigrant worker in the same year (Figure 49). This gap has remained about steady since 2010. This earnings gap occurs across States and most sectors, reflecting the growing education, higher productivity and increasing salaries of Malaysian workers as they move to more value-added jobs. In 2014, the wage gap between foreign and local workers was largest in utilities (RM13) and finance (RM9); however, local workers earned less than their foreign counterparts in several sectors where immigrant workers tend to be highly educated such as real estate (wage gap of RM12) and post/telecommunications (wage gap of RM9).

64. Once other factors are accounted for, Malaysian workers earn more than immigrant workers in low- and mid-skilled occupations, but not in high-skilled occupations. Wages can vary significantly because of worker characteristics such as gender, education, and experience and with the occupation of employment. Once these factors are controlled for, 83 percent of Malaysian workers still have a significant wage premium over immigrant workers. Figure 50 can be interpreted as the percentage change in hourly wages due to being a Malaysian worker rather than an immigrant worker, controlling for gender, education, experience, and occupation. For instance, Malaysian workers in services and sales, the most prevalent occupation for Malaysians, earn 16 percent more than immigrant workers. The highest premium is earned by Malaysians working as plant and machine operators (32 percent). On the high-skilled end of the spectrum, expatriates who are employed as professionals and managers earn a premium over local peers, which is typical across countries as the most talented foreigners are sought for these positions.

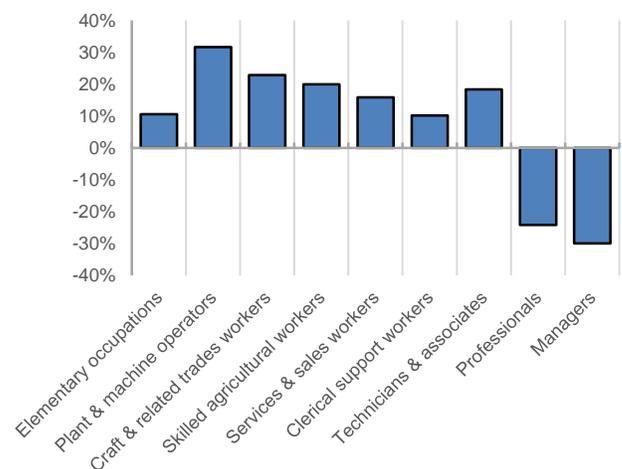
Figure 49: Malaysian workers earn significantly more than immigrant workers and this gap has grown since 2007



Source: DoS Salary and Wage Survey 2007 to 2014, World Bank staff calculations

Figure 50: Malaysian workers earn a wage premium in the occupations where most immigrants work.

Percentage change in hourly wage associated with being a citizen rather than a non-citizen, 2011 to 2014



Source: DoS Salary and Wage Survey 2011 to 2014, World Bank staff calculations

What are the economic and social costs and benefits of immigrant workers in Malaysia?

65. The economic and social impacts of migration are often the subject of significant debate especially in receiving countries. Migration is the result of economic factors such as differences in wages, demographic patterns, the structure of the labour market and employment opportunities in sending and receiving countries. Despite the contributions of migrant labour in receiving economies, there is a growing concern about the potentially negative impacts of migration on specific economic and social dimensions, especially in countries where migrants account for a significant share of the labour force. Much of this debate revolves around GDP growth and other economic dimensions such as employment, unemployment, labour force participation, wages, productivity, technological adoption,

competitiveness, prices and fiscal cost. This section tackles this debate by providing rigorous analytical evidence on the impact of migration on the aforementioned dimensions in Malaysia.

Immigration to Malaysia increases GDP

66. Econometric modelling suggests that immigration to Malaysia has direct positive impacts on GDP. Recent analysis (using a computable general equilibrium or CGE model) (Ahsan et al., 2014) finds that a 10 percent net increase in low-skilled immigrant workers increases real GDP 1.1 percent. This positive impact on GDP occurs even after taking into account impacts from remittance outflows. Low-skilled workers keep unskilled salaries low, reducing domestic prices and production costs and increasing export growth. As a result, unskilled employment increases and profits rise which increases investment and the demand for skilled employment (mainly Malaysian), which is complementary with low-skilled immigrants. This translates into salary increases for skilled workers and a boost to domestic demand which increases public revenue collection, improving the public fiscal position. This positive effect in Malaysia is reinforced by two key factors. First, the Malaysian labour market is very tight with low unemployment rates. Therefore, low-skilled immigrant labour expands employment opportunities more than it substitutes for unskilled Malaysian workers. Second, immigrants and domestic workers have complementary skills, and therefore immigration increases the demand for more-educated Malaysians.

67. The positive impact of immigration on Malaysia's GDP growth is consistent with several studies in Southeast Asia. Evidence from Thailand suggests that without migrants in the labour force GDP would fall by 0.75 percent while research on Singapore shows that immigrant labour has accounted for 37 percent of the country's GDP growth with the exception of the period after the 1997 Asian crisis. Several studies highlight that restrictive immigration policies could, in contrast, have negative implication for economic growth (Box 6).

68. Immigrant workers seem to have also relaxed key constraints to support Malaysia's economic diversification. As Malaysia expanded rapidly through the second half of the twentieth century, Malaysia's relatively open immigration policy reassured investors that they could benefit from Malaysia's infrastructure and business environment while also having access to lower-cost labour. This made Malaysia a very attractive investment destination. Migrants have allowed manufacturing to remain relatively competitive even as the commodity boom put pressure on the real effective exchange rate of many commodity exporters. Future growth will likely demand a similar combination of effective institutions and lower cost labour in addition to a highly educated local workforce.

Box 6: The trade-offs of restrictive immigration policies

Countries that implement restrictive immigration policies to tightly control immigrant populations face a trade-off. On one hand, they aim to create homogeneous populations with stronger social ties, redistribute income towards labour, incentivise higher productivity and re-engineer technological upgrading. On the other hand, they face decreased economic growth as production costs increase and certain skills are not found, as well as lower welfare overall for the local population as market size shrinks, consumer prices are higher and population ageing is not compensated.

According to Tsuda (2001), Japan remained for decades reluctant to accept unskilled foreign workers until the mid-1980s when it became evident that the growingly educated Japanese population was unable to fill the high demand for unskilled jobs. Moving forward, and although the problem has shifted from a quickly growing economy towards one that is quickly ageing, tight immigration policies continue to be implemented. The country faces a population decline estimated at 21.6 million during the next 50 years, and a trade-off between admitting 600,000 immigrants per year or an estimated 6.7% annual drop in GDP (Tsuda 2001). Also, Singapore is seeking to reduce the reliance on foreign workers to boost productivity and increase labour share in GDP. However, an International Monetary Fund (IMF) report in 2015 highlights that this restructuring is expected to entail a lower steady state growth rate in the economy. While in the long term higher capital-labour ratio and productivity growth may be achieved this process is subject to substantial transitional cost as firms suffer to fill vacancies and face lower profits (IMF 2015).

Other reports are less categorical. Kerr and Kerr (2011) surveys the economic impacts of immigration for host countries. Empirical evidence is drawn from the extensive literature regarding traditional destination countries like

the US and Canada but also emphasizes the recent experiences of Northern Europe and Scandinavia. It points out that the likelihood and magnitude of adverse labor market effects for natives from immigration are substantially weaker than often perceived. Most studies find only minor displacement effects even after very large immigrant flows. On the other hand, some more recent studies have found larger effects, and many studies note that the negative effects are concentrated on certain parts of the native population, typically the less-educated natives or the earlier immigrant cohorts, that is, those who are the closest substitutes to the new immigrant. Also, most empirical studies estimate that the impacts of immigration on public finances tend to be very small and net impact depends heavily on the migrants' age, education, and duration of stay. On average, immigrants appear to have a minor positive net fiscal effect for host countries but these benefits are not uniformly distributed across the native population and sectors of the economy.

An earlier survey by Hanson (2008) points out that research using data on the national US labor market suggests that immigration depresses wages for US workers, mainly low-skilled. The concern about this approach is that it might confound immigration with other labor market shocks that have hurt low-skilled workers, such as skill-biased technological change. However, when applying a similar approach to Canada, where immigration has been dominated by workers toward to the top end of the skill distribution, immigration is negatively correlated mainly with wages of more-educated workers. Canada is presumably subject to many of the same technology shocks as the US, it would not appear that unobserved technology shocks could explain away the wage effects of immigration in both countries.

Overall, the impact of immigration on income per capita is less clear. While finding a null impact of immigration on economic growth in the same decade, recent research presents evidence that immigration into countries with high income and/or high net inward migration, including Malaysia, has positive long-run impacts on growth in GDP per capita (Brunow, Nijkamp, and Poot 2015). Recent cross-country research finds that one percentage point increase in the immigrant share of the population results in an 6 percent increase in income per person in the long run (Ortega and Peri 2013).

Source: Authors.

69. Malaysia's highly educated workforce could mean larger positive impacts from immigration in the long run.

Countries with better educated domestic workforces experience larger benefits of immigration on income per person than countries with less-educated workers (Ortega and Peri 2013). Immigrant workers can complement locals freeing them to work in more productive jobs (Boubtane, Dumont, and Rault 2014). This seems to be the case in Malaysia where, as shown above, Malaysians have become highly educated and shifted to more skilled occupations while immigrant education levels have stagnated and their occupations have remained low-skilled.

70. Low-skilled immigrant labour has facilitated the skill upgrading of large segments of Malaysians, and has contributed to the growth of some high value-added sectors (World Bank, 2013). Between 1990 and 2014 the share of both Malaysian and immigrant workers employed in agriculture declined. But about a third of immigrant workers remained employed in agriculture in 2014 with a shift occurring from agriculture to manufacturing, construction, and business services. In contrast, in 2014 only 10 percent of Malaysians were employed in agriculture with the shift occurring from agriculture to an array of service sectors. The share of Malaysians employed in these service-type sectors²⁶ increased 15 percentage points versus 4 percentage points for immigrant workers. A similar phenomenon has occurred in the educational distribution as Malaysians have become better educated while the education levels of immigrants have stagnated and in the occupational distribution as Malaysians have become concentrated in higher-skilled occupations while immigrant workers remain concentrated in elementary occupations.

²⁶ These are business services, education, finance, health, logistics, post and telecom, real estate, utilities, wholesale and retail, and other services.

Immigration increases employment and wages for most Malaysians

71. Previous research in Malaysia found small negative impacts of immigrant workers on wages. Studying the manufacturing sector between 2000 and 2008, Athukorala and Devadasan (2012) find that an increase in the share of both immigrant workers and unskilled foreign workers results in a small decline in real wages, with a 10 percent increase²⁷ in the share of immigrant workers resulting in a 1.3 percent decline in real wages. The authors stress, however, that the magnitude of this impact is small. Yean and Siang (2014) also look at the Malaysian manufacturing sector from 2000 to 2006 and find a similarly small negative impact of immigrant workers on wages: a 1.0 percentage point increase in the share of immigrant workers translates into a 0.75 percent decline in total wages. There is also some evidence that a higher share of unskilled foreign workers in unskilled employment increases inequality, measured as the ratio of skilled worker wages to unskilled worker wages (Devadasan 2013). Jajri and Ismail (2006) show that, overall, immigrant and Malaysian workers are substitutes in manufacturing. However, when the analysis is done by skill level, immigrant and Malaysian workers can be substitutes or complements depending on the skill level and sub-industry.

72. However, the existing body of research in Malaysia may miss some important positive impacts. First, studies of the wage impact of immigrant workers have focused on the wages of all workers, obscuring the effect on Malaysians and existing immigrants. Second, most research is devoted to the manufacturing sector, which accounts for just 14 percent of Malaysians' and 18 percent of immigrant employment, respectively. To correct for this bias, this report builds on previously published research²⁸ and expands the analysis across sectors and States to determine the labour market impacts of immigration on both Malaysian and immigrant workers. See Annex 2 for a more detailed presentation of the econometric model used for this analysis.

73. Econometric modelling indicates that immigrant workers complement the majority of Malaysian workers. More specifically, increased migration to a state and/or sector leads to increased employment of Malaysian workers in that sector and state. For every 10 new migrant workers in a sector in a state, there are 5.2 additional Malaysians employed (4.4 full-time and 0.8 part-time jobs), and 2 of these workers are women (Figure 51). This econometric results indicate that immigrants and Malaysian workers, on average, are complements rather than substitutes, and immigrant workers do not displace Malaysian workers. It should be noted that these are state-sector, not nationwide effects. Since the Malaysian economy operates at a very low level of unemployment, the overall nationwide effect manifests itself as reallocation of Malaysian workers from states-sectors with low migrant presence to states-sectors with high immigrant presence. In terms of job creation, under reasonable assumptions on labour supply elasticities, it can be shown that 10 new migrant workers create between 0.3 and 0.5 new jobs nationwide.

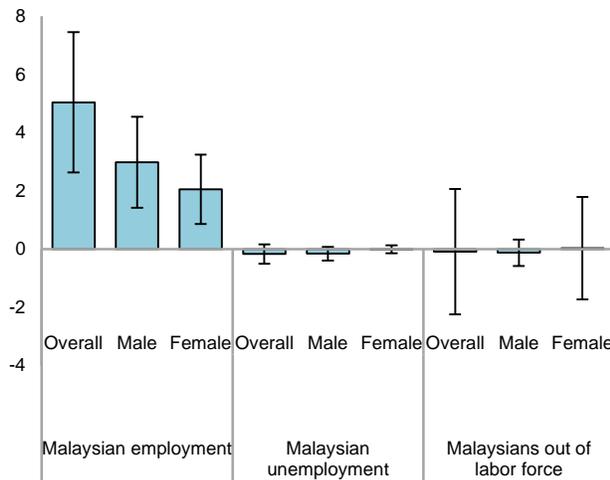
74. According to econometric analysis, immigration has expanded employment opportunities for young and relatively educated Malaysian workers. While there is complementarity between immigrant and Malaysian workers, there are some differences across ages and education levels. According to the econometric results presence of immigrants in a sector in a state attracts Malaysians between the ages of 20 and 49, with the largest impact for those ages 20 and 29 (Figure 52), and among more educated workers with upper secondary and a university degree who better complement unskilled foreign workers. There is no statistically significant impact on workers with primary or no formal education. These results suggest that even if a substitution effect exists between Malaysian and immigrant workers it is offset by expansions in output that benefit Malaysian workers at large. Only Malaysian workers between 50 and 64 years of age and with no formal or at most primary education see no benefit or substitution from the presence of immigrant workers.

²⁷ This would represent an increase of the immigrant worker share of employment from 16.2 percent in 2014 to 17.8 percent in 2015 and a decline of average wages of RM29 from RM2231 in 2014 to RM2202 in 2015.

²⁸ This includes Del Carpio et al. (2015), Özden and Wagner (2014), and Del Carpio et al. (2015b).

Figure 51: Immigrants do not affect local unemployment and labour force participation rates, but increase employment for Malaysians...

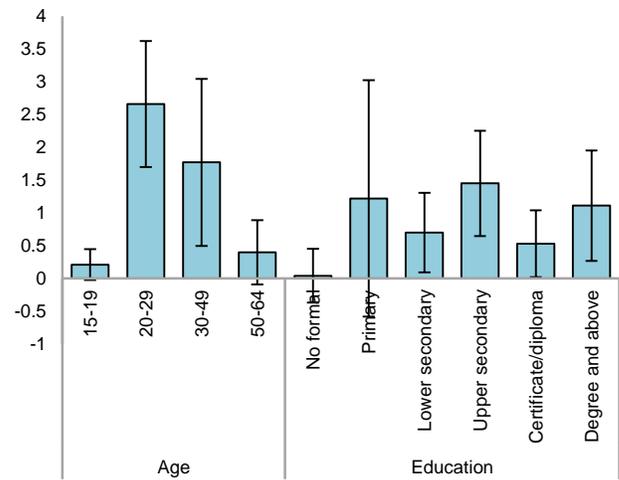
Change in Malaysians employed, unemployed, and out of labour force due to 10 additional immigrants



Source: DoS LFS 1990 to 2014, World Bank staff calculations

Figure 52: ...especially for Malaysians aged 20-49 years old and those with more education.

Change in Malaysians employed due to 10 additional immigrants



Source: DoS LFS 1990 to 2014, World Bank staff calculations

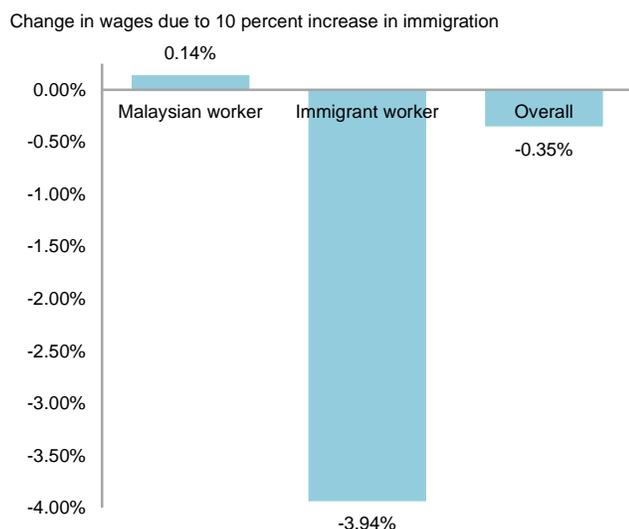
75. Using econometric models the impact of immigration on wages of Malaysian workers is estimated to be positive, though small. Recent research shows that immigration has a small positive effect on the relative wages of Malaysian workers: increasing immigration by 1 percent results in an increase in Malaysian wages of 0.14 percent (Özden and Wagner 2014) (Figure 53). In contrast, the same increase in immigration reduces the wages of immigrant workers by 3.9 percent.

76. Econometric modelling suggests that immigrant workers increase Malaysian employment, particularly for the more highly educated, by reducing the cost of production and expanding output. While the substitution effect of immigrant workers is often emphasized – that is, the potential for immigrant workers to replace locals with similar skills – the expansion in output which results from lower production costs associated with immigrant labour can offset this substitution effect, causing the employment of Malaysians to increase. This seems to be the case in Malaysia where immigration reduced the wages of immigrant workers, thereby reducing the cost of production and enabling expansions in output, which in turn expanded employment for more highly educated Malaysians. Thus, immigration has expanded output in such a way that lower-skilled migrants facilitate the ability of Malaysians to work in mid-skilled occupations, such as foreman or mid-level managers.

77. Malaysian workers with at least some secondary education benefit most from the presence of immigrant workers by, for example, working as their employers and supervisors. Wages of those with both lower and completed secondary education increase 0.38 and 0.26 percent, respectively, while the effect on highly educated workers' wages is very small (-0.02 and -0.09 percent for those with a certificate or diploma and for those with a degree or more, respectively). Higher-skilled Malaysian workers such as managers benefit only indirectly because their tasks and/or occupations and sectors rarely overlap with those of immigrant workers, limiting the possibility for complementarities. This explains the negligible wage effects of immigration on Malaysian workers with a university degree.

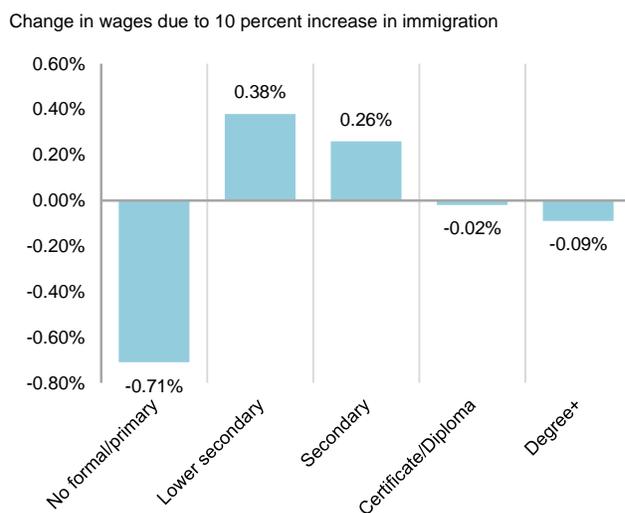
78. However, the wages of less-educated Malaysians are negatively impacted by immigration. A 10 percent increase in immigrants in a sector and State is associated with a 0.71 percent decline in the wages of Malaysians with at most primary education (Özden and Wagner 2014) (Figure 54). This suggests that immigration could have negative implications for inequality, as less-educated Malaysians earn less and more-educated Malaysians earn more because of immigration. Nonetheless, this group represents a small and shrinking share of the labour force, comprising only 14 percent of the total labour force in 2014, down from 32 percent in 2001.

Figure 53: Immigration causes a small increase in the wages of Malaysians but a large decline in those of immigrant workers.



Source: Özden and Wagner (2014)

Figure 54: The impact of immigration on the wages of Malaysians differs based on their educational background



Source: Özden and Wagner (2014)

79. Furthermore, immigrant workers significantly increase the skill premium of education. Immigrant labour in fact incentivise Malaysians to invest in education by increasing the skill premium, which contributes to Malaysia's efforts to transition to a high-skilled economy. For example, the wages of a worker with completed secondary education were 49 percent higher than those with at most primary education in the period 2007-2010; however, without immigration this premium would have been only 38 percent (Özden and Wagner 2014).

Additional analytical work would serve to better understand the impact of immigration on competitiveness in Malaysia

Box 7: Understanding the impact of immigrant workers on competitiveness

There are several channels through which immigration could affect productivity and competitiveness in Malaysia. First, immigration could improve productivity by facilitating task specialization of Malaysians and immigrant workers. Second, immigration – especially of high skilled workers – could stimulate innovation through the interaction of workers with complementary skills. Third, immigration could reduce production costs and increase profitability, thus allowing firms to invest in more productive technologies. Fourth, immigration could reduce the incentives of employers to invest in more technologically advanced production models and induce over-reliance on labour-intensive less productive technologies. Finally, immigration could reduce productivity if immigrants are employed in jobs that require skills that they lack (Ahmed, 2014).

Immigrants may promote competitiveness and increase productivity by encouraging occupational upgrading, stimulating innovation, and promoting firm creation (Peri 2014), which in turn might explain the generally minimal effects of immigration on the wages of locals. Still, evidence is not conclusive and much research remains to be done to determine whether immigration works through any or more than one of these channels.

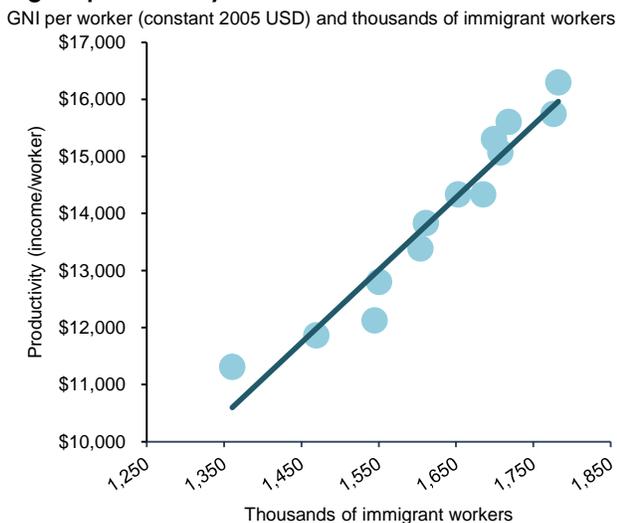
High-skilled immigration can also affect several other aspects of competitiveness, including entrepreneurship and innovation. Research in these areas, which is dominated by work in the United States and Europe, has found that skilled migration, including the diversity of the workforce, generally has a positive impact on competitiveness (see Nathan (2014) for a review). The presence of skilled migrants seems to stimulate innovation, measured primarily by patenting activity, though the impact of migrants at the firm level and on local innovators is mixed. Research on

entrepreneurship is even more limited, especially outside of the United States, but does find associations between the presence of entrepreneurs and firm formation.

Source: Authors.

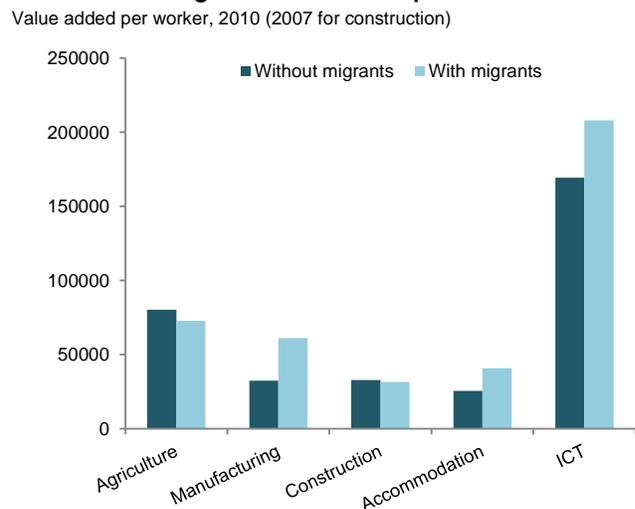
80. Research on immigration's impact on competitiveness in Malaysia is very limited. The number of immigrant workers in Malaysia is generally associated with higher productivity measured as income per worker, though this does not by any means demonstrate a causal relationship and calls for further research (Figure 55). Overall, Malaysian firms which employ immigrant workers are more productive than or as productive as those which do not, with the exception of the plantation sector (Figure 56). This is true for large firms in manufacturing, construction, accommodations and ICT. Smaller firms which employ immigrant workers in these sectors have more mixed results, while firms of all sizes which employ immigrant workers in the plantations sector have lower value-added (World Bank, 2013). This does not imply that immigrants have caused improved productivity; it may be the case that large firms that are already highly productive hire more foreign workers. Still, a recent study of the Malaysian manufacturing sector between 1972 and 2005 found that a 1 percent increase of immigrant labour was associated with a 0.172 percent increase in value-added per worker (Noor, Said, and Jalil 2011).

Figure 55: More immigrant workers are associated with higher productivity...



Source: DoS LFS 2001 to 2014 and WDI
Notes: Data is not available for 2008

Figure 56: ... and generally firms with immigrant workers have higher value-added per worker



Source: World Bank (2013)

Box 8: The importance of the Economic Census for studying the productivity impacts of immigration

The Economic Census is the primary tool for collecting information about Malaysian firms and offers the most promising data for analysing the impact of immigration on productivity. The Economic Census collects data for most sectors and sub-sectors and did so in 2000, 2005, and 2010, with the next one coming in 2015. Unlike the LFS, the Census only records immigrant labour employed in formal firms but does records those living in communal housing (del Carpio, et al., 2015).

The Census is potentially a powerful tool for studying productivity in general and immigration's impact on productivity in particular. Given the prevalence of evidence that immigration does not have large negative effects on the wages and employment of locals, recent research has sought to explain these results by looking at the productivity impacts of immigration. For example, immigration is associated with productivity growth, with a larger effect on the less-educated. This could be explained because immigrants and locals efficiently specialize in manual- and communication-intensive tasks, respectively (Acemoglu, 2002; Peri, 2012).

Indeed, several recent studies have analysed the productivity impact of immigration from the firm perspective, bringing the analysis at the level where decisions about employment (for example, of Malaysians or immigrant workers), investment, and expansion are made. Indeed, the firm is one of the next important frontiers of research to assess the impact of immigration. Ensuring that the Economic Census in Malaysia is built around panel data, would allow researchers to track firms over time broadening the research horizon on productivity.

Source: Authors.

81. There is limited evidence of the impact of immigration on competitiveness and labour productivity. This increase in profitability, in turn, raises the prospect of productivity improvements in the longer run as firms invest their higher profits. In a study of more than 2,300 manufacturing firms in Malaysia between 2000 and 2006, a 1 percent increase in the share of immigrant workers resulted in a decrease in labour productivity of 0.6 percent on average (driven by immigrant clerical workers) (Ahsan et al., 2014). However, firm competitiveness increased as unit labour costs declined 0.2 percent (driven by technicians and plant and machine operators). Similar studies from other East Asian countries show mixed results. While providing some evidence of productivity declines due to unskilled immigrants, research on manufacturing firms in Thailand is generally inconclusive. Research on small and medium businesses in Korea shows positive impacts of unskilled immigrants on firm profitability and no evidence of a productivity effect. Finally, evidence from China suggests that migration within China is associated with accelerated growth in wages, productivity, and investment (Ahsan et al., 2014).

82. There is concern that the presence of low-skilled migrants hinders the adoption of technology, but evidence is very limited and inconclusive. There is some evidence that immigrants cause a decline in the capital-to-labour ratio in Malaysia and other East Asian countries (Ahsan et al., 2014). However, one study of the Malaysian manufacturing sector shows that unskilled immigrant workers do not impact skill upgrading (Devadason, 2009). Other work from Thailand shows that labour-intensive sectors have not increased relative to skill-intensive sectors despite additional less-educated workers (Ahsan et al., 2014).

83. The educational, sectoral, and occupational distribution of immigrant and Malaysian workers suggests that skills upgrading has occurred. Between 1990 and 2014 the share of both Malaysian and immigrant workers employed in agriculture declined. But about a third of immigrant workers remained employed in agriculture in 2014 with a shift occurring from agriculture to manufacturing, construction, and business services. In contrast, in 2014 only 10 percent of Malaysians were employed in agriculture with the shift occurring from agriculture to an array of service sectors. The share of Malaysians employed in these service-type sectors²⁹ increased 15 percentage points versus 4 percentage points for immigrant workers. A similar phenomenon has occurred in the educational distribution as Malaysians have become better educated while the education levels of immigrants have stagnated and in the occupational distribution as Malaysians have become concentrated in higher-skilled occupations while immigrant workers remain concentrated in elementary occupations. Much more work remains to be done to establish the impact of immigration on productivity, competitiveness, and technological upgrading.

The fiscal impacts of immigration are likely to be small

84. The fiscal impact of immigration depends largely on the composition of immigration and the public services that they receive. Concerns that immigrant demand for public services strains both service providers and public budgets often overlook the positive fiscal impact that immigrants can have either directly (e.g. taxes) or indirectly (e.g. expanded GDP). Thus, the net impact of immigration on fiscal cost depends largely on the generosity of the welfare state – more specifically, how generous the welfare state is to immigrants – and on immigrants' direct and indirect contributions (Ratha, Mohapatra, and Scheja 2011; OECD 2013). Most studies have found that the fiscal impact of immigration is not large, ranging between plus and minus 1 percent of GDP (UNDP 2009). A recent study of the fiscal impact of immigration in OECD countries finds that the net fiscal impact of immigrants is -0.3 percent of GDP on average but with large disparities across countries (Figure 57). Impacts are more favourable in countries where labour migration dominates – particularly where immigrants have higher employment rates – and where immigrant populations are

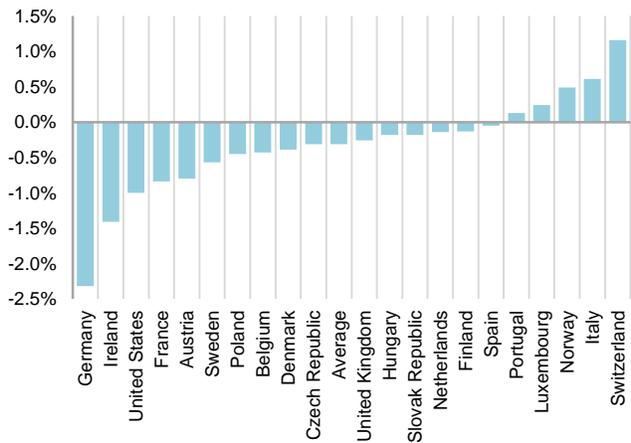
²⁹ These are business services, education, finance, health, logistics, post and telecom, real estate, utilities, wholesale and retail, and other services.

relatively young (OECD 2013). This is because younger migrants tend to be healthier and use fewer services and employed migrants tend to use fewer services. Net fiscal impacts are higher when immigrants pay taxes and social security. Additional cost may arise from the demands placed by immigrants on service providers, frequently at the local level, and the resources immigrants contribute via taxes (or levies), frequently at the national level.

85. The fiscal contribution of documented immigrants in Malaysia is likely to be positive. Low-skilled immigrants in Malaysia do not pay personal income tax but levies on foreign workers raised RM2.6 billion in 2014, representing approximately 1.2 percent of all federal public revenues and 0.24 percent of GDP (Figure 58). Furthermore, immigration enhances GDP, employment creation and wage growth of Malaysians which, in turn, contribute to public revenues. Immigrants are younger than Malaysians (62 percent of working age immigrants were younger than 35 in 2014 compared to 53 percent of Malaysians) and have close to 100 percent employment rate in 2014, factors that correlate with lower use of public services. The government's exposure to social welfare costs associated with documented immigrant workers is low because of health insurance and the workplace compensation scheme. Employers are mandated to insure immigrant workers against various liabilities which may be incurred by the immigrant worker and documented workers also have health insurance, which limit public cost associated with accidental death and temporary or permanent disablement of workers, as well as exposure of unpaid bills in public hospitals by these workers (World Bank 2013). Unlike local workers, immigrants are not mandated to contribute to the Employees Provident Fund (EPF) and an employer's matching contribution is capped at RM5, but workplace compensation to immigrant workers is significantly limited compared to those of local workers.

Figure 57: Immigrants have a small fiscal impact in OECD countries

Net fiscal impact of immigrants

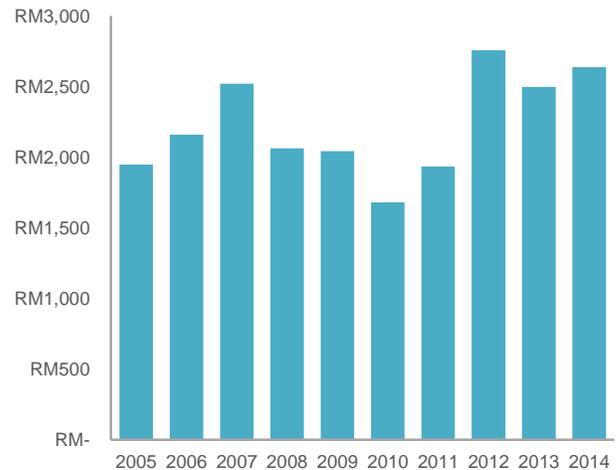


Source: OECD (2013)

Notes: Includes collectively accrued items but not defence

Figure 58: In Malaysia, the levy on foreign workers currently raises RM2.6 billion or 0.24 percent of GDP

Revenue from foreign worker levy in real terms, 2014 (RM million)



Source: Ministry of Finance 2007 to 2014, World Bank staff calculations

86. Undocumented immigrants impose fiscal costs. Unlike for documented immigrant workers, employers do not pay levies for undocumented workers or employment-related fees which cover them in case of accidents or health-related issues. Thus, most of the negative fiscal costs reported are associated with undocumented migrants, and there are anecdotal evidences of additional fiscal costs associated with the screening and follow-up health measures incurred due to the re-emergence of hitherto eradicated infectious diseases, such as tuberculosis. Other costs imposed by undocumented migrants relate to incarceration and deportation. Ministry of Home Affairs (MOHA) reports that expenditures associated to detention, food and deportation of undocumented people were around RM26 million in 2015 (about 0.01 percent of federal expenditures).

Remittance outflows from Malaysia are significant but efforts to minimize them would have undesirable effects

87. Remittances have been growing in line with an increasing immigrant population. Bank Negara Malaysia (BNM) values remittances at RM32.14 billion as at end 2014 (USD9.8 billion or 3.8 percent of GDP) and shows that remittance outflows more than doubled in real terms from approximately RM15.68 billion as at end 2011 (USD4.5 billion or 2 percent of GDP) (Bank Negara Malaysia 2015). According to BNM, this increase is attributable to public awareness about legal remittance channels, mobile and internet remittance services, and the continued importance of non-bank remittance service providers (Bank Negara Malaysia, 2015). When using internationally comparable data from the IMF, remittance outflows from Malaysia were estimated at USD2.7 billion³⁰ in 2013. This represents on average about USD125 per immigrant worker per month³¹, or 40 percent of the median migrant wage. Remittances have increased 40 percent from 2010 and now represent 0.8 percent of Malaysia's GDP about the same than in Thailand (0.8 percent of GDP) but much higher than in Indonesia and the Philippines. According to World Bank estimates Malaysia also received USD1.6 billion, or 0.5 percent of GDP in remittance inflows in 2014 with 65 percent coming from Singapore and 12 percent from Bangladesh.³²

88. The recent pressure on the ringgit has prompted concerns about financial outflows and called for measures to curb remittances, which may have potential negative impacts. Measures to reduce remittances, such as taxes, are likely to drive funds into informal channels, limiting BNM's efforts to formalize the money transfer industry, while likely failing to effectively curb outflows, as evidenced by analytical work in taxes on remittances (Freund and Spatafora, 2005; Mohapatra, Moreno-Dodson, and Ratha, 2012). Also, it would play against the Sustainable Development Goal of reducing the transaction costs of sending remittances (6-9% for banks and 4-9% for non-banks in 2015), in line with BNM's efforts (Damodaran, 2015). Furthermore, they would undermine ASEAN community's efforts to create a common market, and could trigger similar measures by other ASEAN countries on Malaysian migrants. Overall, taxes on remittance outflows are extremely rare.

Box 9: Impact of Immigrant Labour on Crime

Immigration can affect overall crime rates in several ways. First, immigrants may have a different likelihood of committing crime because their economic, social, and cultural characteristics are different from the local population. Second, immigration may alter the opportunities faced by the local population and so make crime more or less attractive. Third, immigration may change the composition of the local population by attracting people to a State who are more or less likely to commit crimes. As they are for the local population, labour market outcomes are a key consideration in the choice between legal and illegal activity for immigrants. Where labour market outcomes are better, immigrants are likely less prone to commit crimes because the benefits of legal activity (from employment) are high while the risk of loss from illegal activity (incarceration and deportation) is substantial.

Several recent studies find that immigration has no effect on violent crime and no or a small effect on property crime, though the availability of labour market opportunities is an important factor (Bell 2014). Bell, Fasani and Machin (2013) find that two waves of immigration to the UK did not affect violent crime, but that asylum seekers, generally prevented from seeking employment, increased property crime slightly while 2004 EU accession immigrants, mainly motivated by employment, decreased property crime slightly. A study of Italian provinces finds no statistically significant effect of immigration on crime (Bianchi, Buonanno, and Pinotti 2012). Finally, a study in the US finds no effect on violent crime but does show that immigration increases property crime, though only for immigrants known to have poor labour market outcomes (Spenkuch 2013).

³⁰ Compared to BNM data (from MSBR department): RM25.13 billion in 2013. IMF and World Bank data is used for comparability across countries. All currency is expressed in real 2014 USD or real 2014 RM in the remittances section unless otherwise stated. Remittances are defined as personal transfers and compensation of employees as in the sixth edition of the IMF's Balance of Payments Manual.

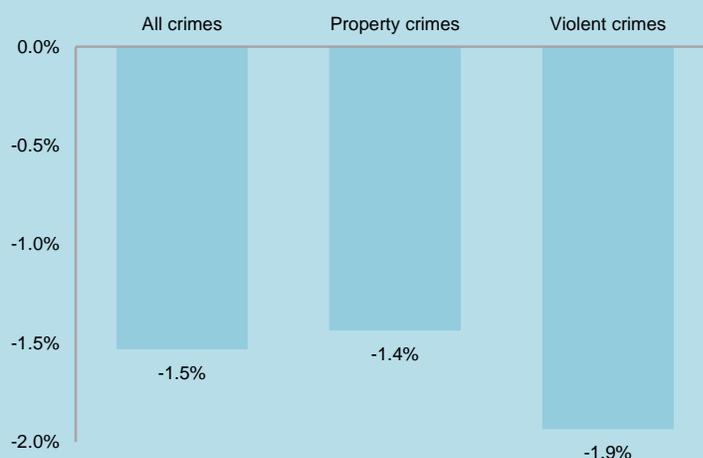
³¹ Compared to BNM data (from MSBR department): RM1,119 per immigrant worker per transaction (for year 2014).

³² World Bank estimates are taken from the Bilateral Remittance Matrices. The IMF does not have data on remittance inflows for Malaysia. Bank Negara estimates 2014 inflows at RM10.79 billion (USD3.2 billion) or 1.2 percent of GDP (Bank Negara Malaysia 2015).

Similar to the impact when immigration is motivated primarily by employment, recent evidence shows that economic immigrants reduce crime in Malaysia. Econometric analysis of the causal impact of immigration on crime finds that the presence of economic immigrants in Malaysia reduces property and violent crime (Özden, Testaverde, and Wagner 2015). An increase of 100,000 additional immigrants to a State is found to reduce the total number of crimes committed by 1.5 percent (Figure 59). These findings are consistent with the literature because most immigrants are economically active in Malaysia. Thus, most of the immigration-related reduction in crime is due to improved socioeconomic outcomes associated with immigration; among these positive outcomes are increased employment rates among Malaysians, reductions in low education (male) Malaysian workers³³. These results are robust to various econometric approaches; however, there are several limitations on the crime data used (namely its aggregate nature), which may affect the comprehensiveness of the results. Going forward, this is an important policy area that calls for further research.

Figure 59: Economic immigration reduces both property and violent crime statistics.

Percentage change in number of crimes for 100,000 additional immigrants to a State



Source: Özden, Testaverde, and Wagner (2015)

Source: Authors.

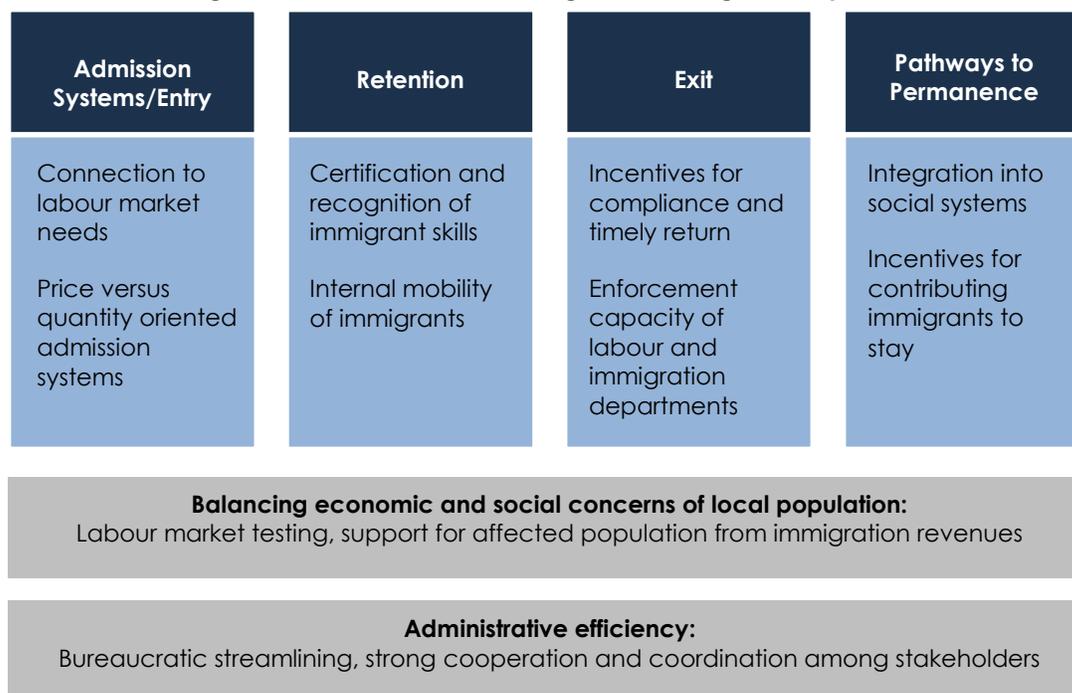
Significant challenges exist in Malaysia's current approach to migration

89. The management of immigration is a crucial determinant of its impact on sending and receiving societies. Where admissions systems are simple and efficient, employers of foreign labour are monitored, and incentives to discourage informality and non-compliance are strong, the benefits of immigration can be maximized and its costs minimized. Migration management systems are responsible for overseeing the admission, entry, stay and departure of migrants. The systems consist of the actors responsible for overseeing migration, the policies which shape migration flows, the actions of migrants and their hosts, and the tools used to implement these policies (Figure 60). The interaction of these elements is a key determinant of the role of immigrants in a host economy, as well as how this role is perceived by the public. The better aligned these elements are, the more likely desired economic outcomes will be achieved.

90. While Malaysia's immigration management system has made strides towards becoming a better functioning system in recent years, challenges remain. In recent years, the Government of Malaysia has taken many steps to improve the efficiency and effectiveness of its migration management system. These steps include the introduction of online processing portals for all classes of immigrants, review of existing laws and regulations governing migration, and deploying new technologies and policies to streamline the process. However, there are still challenges to be addressed. This section of the report identifies these challenges and draw on international experience to point a potential way forward.

³³ Men with at most primary education tend to commit the most crimes. Del Carpio et al. (2015) show that immigration leads to an influx of higher-skilled workers into a State, thereby causing a reduction in the share of low-educated men (Özden, Testaverde, and Wagner 2015).

Figure 60: Fundamentals of Immigration Management Systems



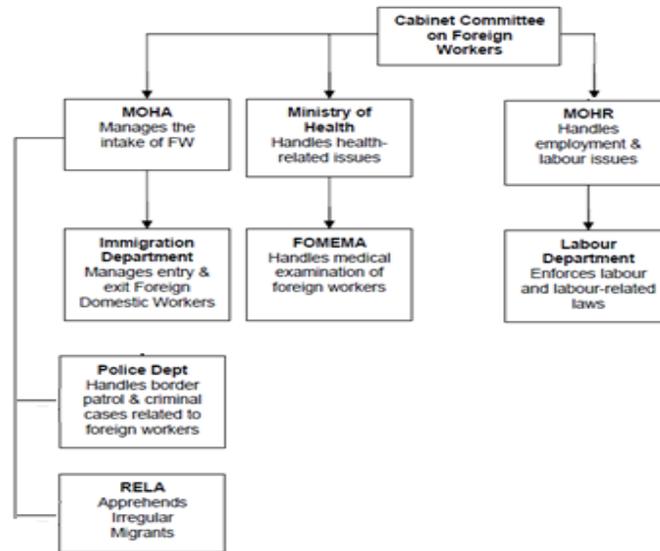
Source: Authors' illustration

Fragmentation and lack of coordination has hampered efforts to control illegal immigration

91. Many actors are responsible for the management of immigrants in Malaysia. Malaysia has a complex ecosystem overseeing migration management, ranging from a cabinet committee and several joint committees to more than ten different ministries and overlapping tools and departments within these ministries. Additionally, there are separate migration systems within Malaysia, with Sabah and Sarawak each having their own system governing migration into their respective regions. Such a complex structure may create confusion among employers and immigrants as to where responsibility lies for various parts of the migration process. This problem is exacerbated by limited coordination between these numerous actors, resulting in frequent duplication of functions and contradictions in policy implementation.

92. The Ministry of Human Resources (MOHR) and the Ministry of Home Affairs (MOHA) are the leading agencies overseeing many actors in the admission of foreign workers. The three main actors in the Malaysian immigration system are The Cabinet Committee on Foreign Workers and Illegal Immigrants (JKKPA/PATI), the Ministry of Human Resources (MOHR), and the Ministry of Home Affairs (MOHA). JKKPA/PATI is comprised of 19 cabinet ministers and is responsible for determining policy on immigrant workers. The Deputy Prime Minister chairs the committee with the Chief Secretary of the Ministry of Home Affairs as the secretariat. MOHR is responsible for the implementation of labour laws. Through its Department of Labour, the Ministry handles issues related to worker welfare and the terms and conditions of employment. It also assesses employers' applications for recruiting immigrants (both foreign workers and expatriates). Finally, MOHR is responsible for reviewing and approving labour contracts and licensing and monitoring private employment agencies (PEAs). MOHA houses the Department of Immigration, which manages the number of immigrants to Malaysia and the duration of their stay; the Foreign Worker Management Division, which is responsible for immigrant applications (quota); and the police department, which handles border patrol and criminal cases involving foreign workers. The Ministry of Health is responsible for conducting health screenings of immigrants (FOMEMA) and the Foreign Workers Health Insurance Protection Scheme (SPIKPA, which was made mandatory in 2010 to reduce the strain on the public healthcare system of unpaid hospitalization bills of uninsured (Figure 61).

Figure 61: Overview of Malaysia's Migration Management System



Source: MOHA

93. The oversight body and process is different for expatriates than for foreign workers. MOHA is responsible for formulating policy with regards to expatriates (mid- and high-skilled workers), while the Expatriate Services Division (ESD) within the Immigration Department of MOHA collaborates TalentCorp on the Expatriate Talent Service Centre (MYXpats Centre). Through this centre, Employment Pass applications are processed. Assessment for the hiring of expatriates is under the purview of the Expatriate Committee, chaired by MOHA and comprising various ministries, departments and agencies.

94. A fragmented migration system with duplicative roles undermines efforts to get the right number and profile of immigrant labour and to control irregular immigration. Current problems related to the demand and supply of immigrant labour in Malaysia can be attributed to the absence of coordination in determining the profiles of workers that the economy demands. The focus has been on the quantity of foreign labour needed in each sector rather than on the suitability of the worker to fill market demands. As a result, agencies have been forced to act in silos, which in turn contributes to the oversupply and undersupply of immigrant labour in different sectors of the economy. One of the best ways to coordinate is to undertake joint initiatives in common areas, yet while monitoring and enforcement of labour regulations and immigration laws are tightly linked there are few joint operations between the enforcement divisions of MOHA and MOHR. The two institutions maintain separate databases on immigrants that do not necessarily coincide. This hampers further coordination and has the potential to undermine policy formulation and implementation.

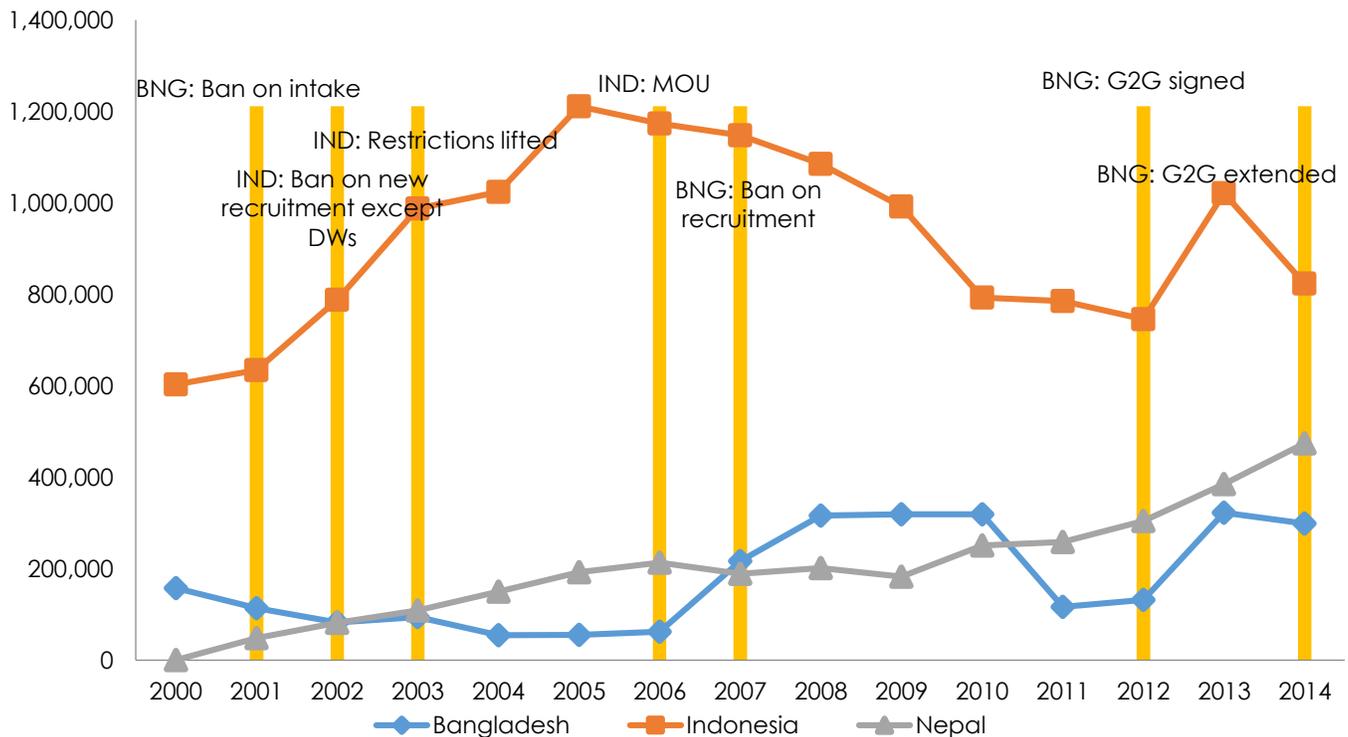
Agreements with other governments are not fully aligned with labour market needs

95. While Malaysia has many bilateral and multilateral agreements governing migration, it is not clear that they are responsive to labour market needs. Malaysia has at least nine bilateral MOUs with key sending countries: Bangladesh, China, India, Indonesia, Pakistan, the Philippines, Sri Lanka, Thailand, and Vietnam. Further, it is a signatory of important ASEAN agreements intended to achieve free movement of skilled labour by 2015. Theoretically, these types of labour agreements are responsible of shaping and structuring the inflow of immigrants into a country, generally with the objective of meeting economic or diplomatic needs. However, Malaysia's agreements do not appear to be tied directly to labour market needs. Although consultations are held with employers in advance of negotiations with sending country representatives to ensure that their requirements are reflected in the final document, consultations with employers reveal that they are rarely consulted once the final document has been signed, meaning that adjustments cannot be made to reflect needs as they emerge. By contrast, good practices in similar countries place consultations with employers at the centre of their bilateral agreements (BLA) and multilateral agreements. For instance, the Recognized Seasonal Employers scheme (RSE) in New Zealand and the Canadian Seasonal Agricultural Workers Program (SAWP) rely on close consultations with interested employers to ensure commercial viability, responsiveness to labour market needs, and beneficial outcomes for all stakeholders involved, including the workers themselves.

96. Frequent policy changes related to BLAs and MOUs and bans on immigration from specific countries limit the effectiveness of these tools to manage immigration flows from distinct countries. Malaysia has instituted multiple bans on specific sending countries. New recruitment from Bangladesh was banned in May 2001 and again in October 2007 following problems with recruiting agents in the Bangladesh-Malaysia flow (UC Davis 2001; World Bank 2013). Problems were mostly related to recruiters violating various immigration conditions, such as having an employer in Malaysia seeking to hire the worker. Each of these bans was followed by a subsequent reversal within one or two years, generally due to employers' demand. Such frequent policy changes have the potential to both strain relationships with sending country governments and create an uncertain investment climate for employers. Figure 62 compares immigrant flows across a timeline, with MOU signings and reversals.

97. New agreement structures such as government-to-government agreements (G2Gs) to manage flows between countries have been adopted with mixed results. G2Gs are intended to increase formalization of the immigration process and decrease recruitment fees charged to migrants by channelling recruitment through public employment agencies (as opposed to broader MOUs which may use a variety of channels of recruitment). The first of these agreements in Malaysia was the G2G with Bangladesh, signed in 2012 to fill vacancies on plantations. Employers, the Government of Bangladesh, and the Government of Malaysia currently have different views about the scheme's success. Partners in Bangladesh as well as employers in Malaysia point to long processing times and limited uptake as signs of design flaws. Malaysian officials highlight improved employer verification and decreased recruitment costs as signs of success. Undeniably, both governments recognize that the previous system, which involved private agents, led to an oversupply of workers (and other negative outcomes). Thus, a second scheme called G2G Plus is being considered. The new scheme would open access to other sectors for Bangladeshi workers via the G2G mechanism. The Governments of Malaysia and Indonesia are also in ongoing discussions about introducing a G2G for the recruitment of domestic workers. Such direct forms of recruitment have strong potential to eliminate the role of third-party recruiters and costs of recruitment, thus, it would be important to place more emphasis on making these arrangements work. Lessons could be drawn from the successful agreement between Canada and Mexico for temporary seasonal workers, a model which is potentially being expanded to the US.

Figure 62: The number of registered foreign workers from Indonesia declined substantially after the signing of the MOU between the two countries



Source: Immigration Department, Ministry of Home Affairs
 Note: Data refers to immigrant workers with a Visit Pass (Temporary Employment)/PLKS

The current immigration admission system does not respond well to market needs

98. Malaysia employs a hybrid system to manage immigration flows, combining quantity-oriented dependency ceilings and price-oriented levies. Quantity-oriented instruments such as quotas and dependency ceilings establish upper limits on the number of foreign nationals. Price-oriented interventions include visa fees or levies paid by employers or foreign workers for the opportunity to work. Price-oriented mechanisms help shape the incentives facing employers and migrants as they make hiring and migration decisions, while also potentially raising revenues. To hire an expat in Malaysia, an employer has to first apply for approval after meeting eligibility requirements via Department of Immigration (DOI) under MOHA. To hire a foreign worker, employers have to get approval from the One Stop Centre under MOHA. Eligibility requirements are set by controlling agencies and endorsed through JKKPA-PATI. The approval is based on the number of slots available to the employer, as determined by a dependency ceiling based on the ratio of foreign workers to Malaysian nationals working in a given firm. A relatively static price (levy) that applies sector-wide is then enforced. Levies were first established in 1992 with increases in 1995, 1998, 2005, and 2012. Levies rise with the dependency ceiling to dis-incentivize overdependence on immigrants. Expatriates are not subject to levies, so that the levy is regressive on income levels but designed to encourage the inflow of skilled workers (see Annex 1 for details of levies, by year and sector).

99. Dependency ceilings in Malaysia do not seem to be based on objective (current)³⁴ indicators of labour market shortages. The dependency ceilings vary by industry but are generally related to firm size or output (Table 4). The ceilings are not based on evidence of labour shortages or skills gaps, and an Malaysian Employers Federations (MEF) report states that there is no transparency in how the dependency ceilings are set. Best practices indicate that migration management systems benefit from combining labour market data with employer input to match immigrant labour to market demand. Countries like Singapore, Australia, UK and Canada use a variety of approaches to ensure that their immigration system fills labour shortages. For example, the system used in the United Kingdom identifies labour shortages based on objective data from a variety of sources, which then feeds their skill-tiered immigration system. Malaysia's current system, in contrast, demand the employers to offer proof that they have tried to recruit locals to fill these positions through the JobsMalaysia jobs portal, a process which can delay the hiring process up to 28 days.³⁵

Table 4: Factors used to calculate the dependency ceiling at the firm level

Industry	Dependency Ceiling Determinants
Restaurants	Number of chairs
Oil Palm	Hectares
Construction	Value and time span of projects
Manufacturing	Number of local workers

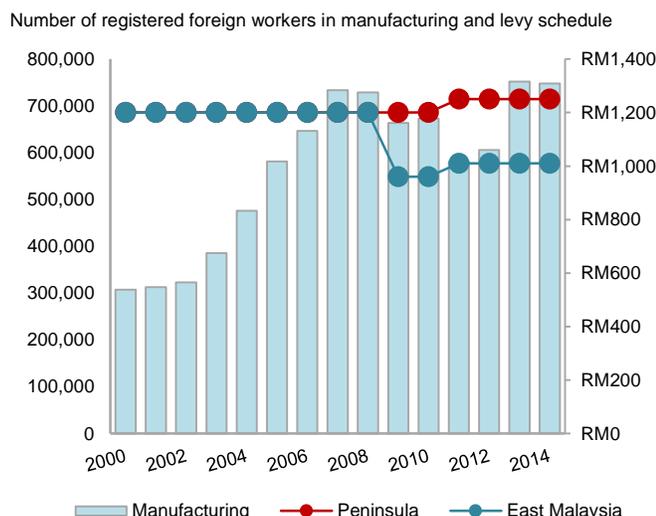
Source: MOHR.

100. Changes in the levies on foreign workers are not based on market conditions, which severely undermine their effectiveness. In some instances, levies were increased during economic downturns (see Annex 1) to incentivise the employment of Malaysian locals but were quickly lowered after employers' complaints. Comparing the levels of immigrant populations by Malaysian regions with levy changes (Figure 63 and Figure 64) suggests that frequent revisions of the levy have not deterred employers from hiring immigrants, implying that such levies are not an effective incentive in the hiring process. Responsibility for paying the cost of the levies has also shifted several times, implying a lack of consensus about the purpose of the levies, which were originally implemented to tax foreign workers for the use of public goods. The 2009 adjustment switched the burden to employers to dis-incentivize them from hiring foreign workers, only to switch back to foreign workers in 2013 to ease the impact of the new minimum wage requirements on employers. Frequent changes in both the level of the levy and responsibility for it make the system unpredictable, making it difficult for employers to make sound investment and hiring decisions. Incorporating labour market information into decisions about levy rates, as Singapore does (Box 10), would make the Malaysian system more responsive to actual labour market needs.

³⁴ Indicators based on labour market data, and data obtained from real-time vacancies using web-scraping methodology.

³⁵ Each position has to be posted twice on JobsMalaysia for 14 days each time.

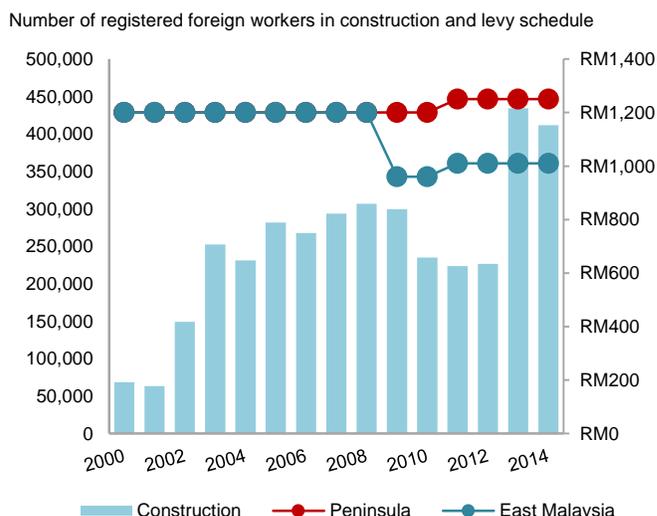
Figure 63: Decreasing the levy levels does not increase the number of foreign workers in manufacturing...



Source: Immigration Department, Ministry of Home Affairs. World Bank staff calculations.

Note: Data refers to immigrant workers with a 'Visit Pass' (Temporary Employment)/PLKS

Figure 64: ...nor is it effective in the construction sector



Source: Immigration Department, Ministry of Home Affairs. World Bank staff calculations.

Box 10: Singapore's management of levy rates

Singapore combines levies and dependency ceilings to regulate entry of foreign nationals into its labour market. Each of these mechanisms is adjusted based on market demand and worker characteristics (skill level, sending country, permit duration, and sector of work), making Singapore's system highly responsive to changes in employment and productivity levels in a given sector.

For example, in 2015 the adjustments in the construction sector reflected low productivity growth, so levies were adapted to encourage employers to hire and retain higher-skilled workers and to discourage the heavy use of lower-skilled foreign workers. On the other hand, levies were frozen for 2015-2016 in the manufacturing sector where productivity improved significantly. The key to Singapore's ability to build such a dynamic system is an intensively evidence-based approach involving frequent review of its mechanisms and the status of each sector.

Another important feature of the Singaporean system is the online publication of guidelines for employers of foreign workers; which are also directed to them via various communication forms. Such guidelines aim to help employers calculate their levy bills and understand how the Ministry of Manpower calculates dependency ceilings. The final goal of this tool is to support employers in making informed business decisions.

Source: Authors.

Admission of foreign workers relies on arbitrary cut-offs which can be easily violated

101. Malaysia has separate admission systems for immigrants depending on their skill levels, using mainly wage level cut-offs to determine the tier to which the immigrant belongs. Malaysia uses monthly salaries to distinguish unskilled and low-skilled workers (foreign workers) from mid-skilled and high-skilled foreigners (referred to as expatriates). The various systems are described in Table 5.

102. The complex administration of VP(TE)s makes the hiring process for foreign workers administratively difficult. Three different visas are issued to the same foreign worker in the process of obtaining a VP(TE). When a foreign worker first

arrives in Malaysia, s/he carries a calling visa (VDR – visa with reference). The calling visa, along with the worker's passport, the original approval letter from MOHA, and receipts showing payments of all related fees, are all submitted to the State Immigration Office. The Immigration Office then issues a temporary employment sticker which is valid for 30 days, during which time the worker is brought for medical examinations at a FOMEMA registered clinic. After the worker is found fit to work, the actual work permit is finally issued. This convoluted process is of particular concern as complex, time-consuming procedures for renewing visas can push authorized workers into illegal status even if they are eligible for a legal visa (MPI 2014).

103. Thresholds for hiring expatriates create incentives for employers to manipulate salaries in order to access preferable immigration terms. While the wage thresholds establishing different expatriate tiers are straightforward for employers and potential workers to understand, these thresholds create incentives for employers' misreporting. In the construction sector, for example, employers appear to be adjusting the wages of immigrant workers to meet the Tier 3 threshold. Figure 65 shows that the number of immigrant workers making slightly above RM2,500 increased significantly after 2012 just before Tier 3 was implemented, but stayed stable for those earning just under the threshold. The wage distribution confirms this, though the peak occurs before reaching RM2,500 – thus, showing potential gaming around the threshold to make workers qualify for a particular category. There also seems to be bunching at the RM5,000 threshold; this may not only be to qualify workers for better permit conditions but also to avoid paying the levy, which is not imposed on expatriates. Based on data from the Expatriate Services Division (ESD) Online system, 24 percent of expatriates are paid exactly RM5,000 per month. Instead of this system, Malaysia could differentiate immigrant workers by a combination of occupation and wages, which would create a system that is more capable of responding to workforce shortages and skills gaps as they arise while making artificial inflation of salaries more difficult. The UK Border Agency Codes of Practice lists occupations and their relevant pay thresholds, which are sorted into visa tiers that reflect the skill levels of these occupations. Each skill tier can be opened and closed for immigration as needed based on market conditions. Such an approach makes it more difficult for employers to misclassify a worker, to meet at more beneficial threshold, and then pay them less than the salary that is expected for the worker's profile.

Table 5: Categories of foreign worker and expatriate passes

Group	Type of pass	Requirements	Validity	Renewability
Foreign workers (unskilled/low-skilled) Subject to levy	Visit Pass (Temporary Employment), or VP (TE)	Abide with minimum salary requirement. Only for selected source countries ³⁶ and allowed to work in the 5 main formal sectors ³⁷	12 months per endorsement	The maximum renewal allowed is up to 10 years, after which the worker has to return to the country of origin. Shorter periods may be set in certain sectors in case of requirements.
Expatriates (mid- and high-skilled) No Levy paid	Tier 1 employment pass	≥ RM5,000 per month and a contract of ≥ 2 years	Up to 60 months per endorsement (pending approval by the approving authority)	No restrictions
	Tier 2 employment pass	≥ RM5,000 per month and a contract of < 2 years	Up to 60 months per endorsement (pending approval by the approving authority)	No restrictions
	Tier 3 employment pass	Between ≥RM2,500 and <RM5,000. Subject to additional conditions ³⁸	12 months per endorsement	Renewable twice only

Source: Authors. Illustration based on information from MOHA and TalentCorp

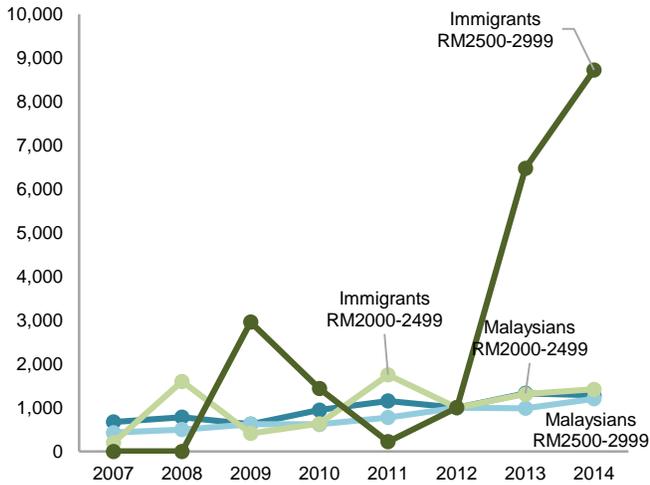
³⁶ Indonesia, Thailand, Vietnam, Cambodia, Philippines, Laos, Nepal, Sri Lanka, India, Bangladesh, China, Pakistan, Turkmenistan, Kazakhstan and Uzbekistan.

³⁷ Manufacturing, construction, plantations, agriculture, domestic work and services.

³⁸ A recent EC decision, April 2015, imposes new conditionalities on Tier 3 workers. They may be asked for a medical check-up and bring no dependents.

Figure 65: The Tier 3 threshold seems to have an effect on wages in the construction sector...

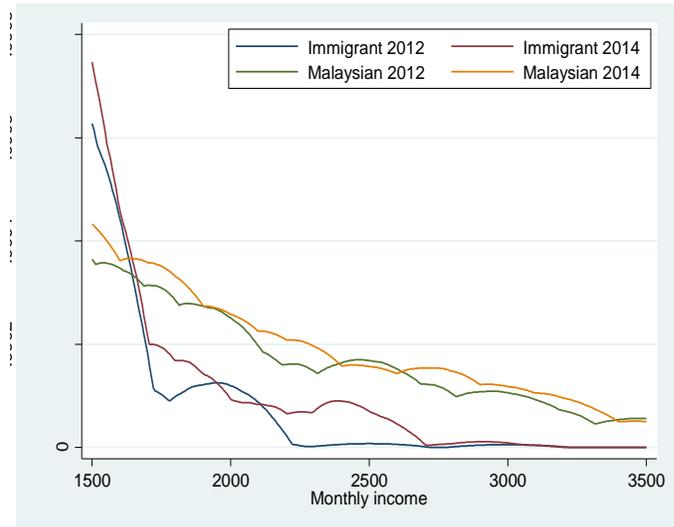
Number of immigrants and Malaysians in each basic salary range, normalized to 2012



Source: DoS LFS 2007 to 2014, World Bank staff calculations

Figure 66: ...and there is some evidence of a peak in the distribution of wages around the lower RM2,500 threshold

Wage distribution around the low Tier 3 threshold



Source: DoS LFS 2012 and 2014, World Bank staff calculations

104. Employer efforts to evade Tier 3 renewal restrictions may indicate that there is longer term demand for Tier 3 immigrants. While taking steps to prevent misreporting of wages is important, it would be relevant to place more attention on understanding the reasons behind the non-compliance. The bunching at RM5,000 per month suggests that there is real demand from employers to retain Tier 3 workers beyond the available three years allowed by the Tier 3 pass. As a result, employers put them in tier 2 (with a floor of RM5,000), which has less time and renewal restrictions. More flexibility in categories for expatriate passes can help absorb demand from employers for Tier 3-type workers. Indeed, the UK system for estimating labour shortages provides evidence against rigid time limits on passes for shortage occupations. The reasoning is that regular review or a time limit with an opportunity to appeal against removal would result in better outcomes for the economy.

105. Given that foreign workers and expatriates are admitted through distinct channels, and online systems are not synchronized, there is limited information sharing between agencies to monitor compliance across the skill spectrum. While applications for employment of foreign workers and expatriates are both processed through online portals, these portals are maintained by separate agencies. While foreign workers are approved via the Foreign Worker Centralized Management System hosted in MOHA, expatriates have to submit the Employment Pass through the ESD online system housed under MOHA; these are separate systems which are not synchronized. The upside of having such a differentiated approach is that it allows for a differentiated set of rules to be imposed on expats and foreign workers, and for more suitable services to be provided to each category. However, the down side is that if the systems are not synchronized, enforcement agencies and those assessing risk for non-compliance are unable to do comprehensive analysis, tracking, monitoring and enforcement.

The sourcing and recruitment process for immigrant workers is lengthy and does not accord the necessary protection to workers

106. The current process for sourcing immigrant workers is complex and costly for the worker. Until 2011, there were three methods through which migrant workers were formally sourced. The three methods were: (i) direct employment by a company (or individual in the case of foreign domestic helpers); (ii) indirect employment by a company or individual through a recruitment agency or private employment agency (PEA), or third-party employment agents; and (iii) through outsourcing companies (OCs). Currently, only the first two methods listed are valid for new recruitment; however, there are still thousands of workers in Malaysia who were recruited by OCs in the recent past. The recruitment process takes months to complete. Direct recruitment by the employer takes approximately 5 months, not including the initial 28 days of job search of locals on JobsMalaysia. In recent years, One-Stop-Centres have been established to

ease employer's application on the recruitment process and procedures³⁹. Apart from the steps shown below, employers have to make the levy payment within 30 days of the approval, or else the application is forfeited.

107. Business to business recruitment remains central in the immigration process despite continual reports of illicit behaviour and labour (and human rights) related violations. The modality of recruitment by private agents (or third-parties) is often referred to as a business to business (or B2B) approach. Outsourcing companies (OC) are distinct from private employment agencies (PEA) in that the OC remains the employer of the worker throughout the duration of his/her contract, while a PEA transfer workers to the primary employer upon initiation of the contract. There are currently over 1,000 private employment agencies (PEA) registered with the Ministry of Human Resources, and about 280 outsourcing companies that manage around 80,000 foreign workers. As per the PEA Act of 1981, recruitment fees are capped at 15 percent of the initial month's pay for the placement of an immigrant with sanctions for infringement. Further, PEAs often work with recruiting agents and their sub-agents in the source country, driving the cost of recruitment to the worker even higher as these agents also charge fees which are passed along by employers. Various studies find that third-party agents do not abide by regulations; in many instances they impose exorbitant costs and mislead immigrant workers in terms of employment agreements. A recent study in the electronics sector found that 32 percent of foreign workers surveyed (employed in 500 firms) reported being in situation of forced labour. Recruitment related fees demanded by third-party agents were in excess of what is legally allowed; and such indebtedness to recruiters forced immigrants to: work excessive hours, experience severe mobility constraints (by having to forego their passports to employers or agents), and be subjected to poor living conditions (unsafe and crowded housing) (Verite, 2014).

108. Using outsourcing companies to supply foreign workers can distance employers from liability for immigrant workers. In April of 2012, an amendment in the Employment Act of 1955 introduced the notion of a "contractor for labour," which officially legitimized the role of labour contractors, suppliers, and employment agents in sourcing and supplying workers to employers. The change was made because under the initial EA 1955, an employee was mandated to enter a contract of service with an employer in order to receive access to rights and protections. Because OCs acted as a third party, there is no direct contract between the worker and the employer; rather there are two contracts – one between the employee and the OC and one between the OC and the employer. OCs are not allowed to source new workers, and the Ministry of Human Resources is pursuing the phasing out of OCs by 2020. Under this arrangement, the OC, rather than the employer, is responsible for negotiating contracts, arranging workers' visas, paying workers, and providing food, accommodation, and insurance. Thus, this extended mandate blurs the line between a recruiter and an outsourcing company. Moreover, OCs are now also the sole party authorized by MOHA to have a worker's work permit renewed or cancelled, making it directly responsible for the worker's legal status. This means that employers are not directly responsible for the working conditions or even the legal status of the workers they employ and are fully removed of any liability. As such, employers can simply claim no knowledge of any violations that occur at the work site and avoid any sanctions.

The current B2B recruitment process imposes high costs on immigrant workers, which yields perverse incentives for immigrants to become undocumented

109. The process of migrating to Malaysia is costly for foreign workers and generates gains that mostly favour third-party intermediaries. The third party agent modality (recruiters, outsourcers, labour intermediaries) often involves several agents in the recruitment process. Typically, workers are identified by subagents in the source countries who charge a referral fee to be linked to a larger agent. Fees imposed by subagents are unregulated. The larger agent also charges fees to process the worker for departure, and in many cases, the receiving agent charges additional fees to place them into a job. Foreign workers who come to Malaysia face high costs of migration potentially ranging from approximately RM9,000 to RM14,000, depending on sector of employment and country of origin. These costs include the foreign worker levy, recruitment costs, medical check-ups, immigration processing fees, visa and bond, and travel expenses. The cost of the levy is currently borne by the foreign worker and varies by sector. Given the complexity of the recruitment process, costs in the source country vary widely by position and country of origin (World Bank 2013). While costs set in the MOU are generally much lower than these levels, the real costs are much higher because they are not legally binding. For example, while the MOU set the total recruitment costs in Indonesia at RM 3,070, the actual cost

³⁹ The members of the One-Stop-Center (OSC) includes the lead agencies and other related agencies such as Ministry of Plantation Industry and Commodity (MPIC), Ministry of Tourism and Culture (MOTAC), Ministry of Agriculture (MOA), Ministry of Works (MOW) and other related agencies.

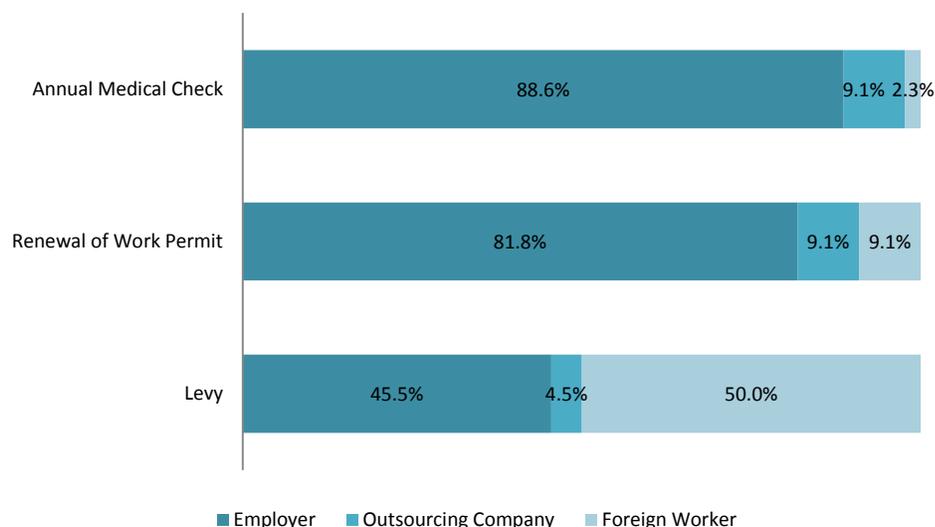
can be more than double that amount. If a foreign worker is hired through an OC, the employer likely pays some fees associated with its services. An OC may charge the user company about RM40 to RM50 (USD12–15) per worker per day, while an outsourced (foreign) worker often receives around RM20 per day.

110. The high fixed costs for foreigners who intend to migrate to Malaysia increase incentives for immigrants to become undocumented. For immigrant workers, the costs involved in migrating affect both the decision to migrate to a new labour market and how long they stay after they have arrived. The higher the cost borne by the immigrant to get to a new country, the longer they have to stay abroad to recoup their investment to get there. Most foreign workers have limited resources in their home countries and see immigration as a way to improve their income (and overall economic conditions). But having to pay high fees often incentivizes perverse behaviours such as overstaying, in the case of documented workers, or entering the country illegally to avoid paying fees altogether. Debt is often acquired by immigrant workers to pay for high fees, which are often above legal limits set by sending countries and Malaysia. To pay the debt (and interest accrued) and eventually benefit from the investment, workers seek to stay in Malaysia for long periods; often times beyond the period that is legally allowed. This leads them to overstay their work permit and become undocumented. In some cases foreign workers flee their employer (and third-party agent) to change their labour market conditions. The reasons for fleeing vary widely, but evidence shows that foreign workers who flee typically do so to escape bad labour conditions imposed on them by employers and/or agents.

111. Employers legally have to pay the minimum wage, but other labour costs between locals and foreign workers differ. Employers are mandated to pay for accommodations for foreign workers, estimated to be RM4,800, but are permitted to deduct RM50 per month from the worker's salary towards this expense. Immigrants are covered under the Workman's Compensation Act, which costs the employer RM82 annually, whereas Malaysian workers are covered under social security (SOCSO) which costs the employer RM200 annually. Malaysian employers are also mandated to contribute between 11 and 13 percent of a Malaysian worker's annual salary to the Employer's Provident Fund, whereas they are not mandated to contribute on behalf of foreign workers. Finally, health insurance (SPIKPA) is borne by the foreign worker. For maximum coverage of RM10,000 annually the compulsory premium is RM120. In some cases, employers are also mandated to pay for one trip home to the country of origin in a year.

112. Employers often pass costs on to immigrants in the form of salary deductions; some deductions are legally allowed, but not all are. Current MOUs state that employers are responsible for all costs generated after the worker arrives in Malaysia, while the worker is responsible for all costs in the source country. However, employers often pass off their costs to workers by deducting it from their salary. For example, in a recent Malaysian Employers Federation (MEF) survey, 20 percent responded that the fees were deducted from the foreign worker's salary. Employers also make deductions for accommodations (up to RM50 per month, or above with the permission of the Director General of Labour) and levies. Figure 67 below depicts employer responses to an MEF survey on who pays for the levy, work permit renewal, and annual medical checks. Employers report that while foreign workers are being paid the minimum wage, these deductions (and the fact that foreign workers work longer hours, likely because they live on-site, and have less agency than locals) make foreign workers cheaper than Malaysian workers. According to Malaysian American Electronics Industry (MAEI) the average cost of hiring a local worker in manufacturing sector is RM1,319.97 as compared to RM1,652.21 for an Indonesian migrant worker. This may be explained by the fact that foreign workers may be a more stable labour force than Malaysian workers as foreign workers are committed for at least two years, and generally have lower turnover, especially once they are well-trained (World Bank 2013). It could also reflect that employers are passing off more costs to the foreign workers than statutorily allowed, which make them cheaper to employ than Malaysian workers.

Figure 67: Percent of costs paid by employers, outsourcing companies and foreign workers



Source: MEF, 2014

Note: Costs are incurred annually

Current enforcement efforts focus largely on punishing workers rather than on non-compliant employers

113. Malaysia currently faces a large flow of undocumented immigrants which could undermine Malaysia's ability to shape migrant inflows to meet its economic objectives. According to MOHA, 1 out of 4 immigrants is undocumented. MOHR estimates that there are approximately 2 million undocumented workers in Malaysia (MOHR, 2015). These workers generally fall into one of five categories: those who (a) entered and remain in Malaysia without permission or through a non-gazetted entry point; (b) remain in Malaysia upon expiry or cancelation of immigration pass; (c) abused the entry permit, pass, or travel documents through alteration or forgery; (d) violated the conditions of the permit as set under the laws of Malaysia; or (e) are in possession of UNHCR refugee cards (not undocumented under immigration law) which do not allow them to work. While admission policies and labour regulations are crucial to shaping the role of migration in an economy, a migration management system cannot achieve its objectives without including tools for addressing undocumented migration, particularly when flows are as large as they are in Malaysia.

114. Sanctions for violating immigration law are currently enforced more on the undocumented immigrant rather than on the employer. Irregular migrants have no legal protection under the law and if arrested, they face detention in migrant detention depots⁴⁰. In addition, they face prosecution for violating the Immigration Act 1959/63 as well as deportation (World Bank 2013). Malaysia has amended the Immigration Act 1957/63 and Passport Act 1966 to include a higher penalty for undocumented immigration. Sections 55A, 55B, 55D, and 55E make the employment, trafficking and protection of undocumented immigrants an offence. They also make the possession and production of false official documents an offence. But these amendments still punish the worker severely, and employers, landlords, labour suppliers, or recruitment agents are rarely arrested and charged. In 2015, about 56,000 undocumented people were arrested; the vast majority (77 percent) were without legal pass or permit, and 12 percent overstayed their permits (MOHA, 2015). Current immigration Act 1959/63 outlines penalties for immigration related offences on employers such as employing undocumented migrants, permitting undocumented migrants to enter and remain in the premises and harbouring migrants. Further changes to the regulation have been made to strengthen the effectiveness of compliance among employers in 2002 (Act 353). MOHA reports that in 2015 about 728 employers have been arrested, though few of them were charged⁴¹; of these 88 percent are Malaysian nationals, and the vast majority (64 percent) of all violations

⁴⁰ There are 14 such depots throughout Malaysia with the capacity to accommodate about 11,000 inmates.

⁴¹ From January to September of 2015, 625 employer were arrested under the Immigration Act. Of the total, 123 were freed, 379 were compounded and only 143 charged. Out of 143, 25 were sentenced for imprisonment and fined, 26 were sentenced for imprisonment, and the rest are still under trial. So less than 20 percent of a small number of employer are actually charged.

are related to harbouring immigrants (MOHA, 2015). Despite having the number of arrests, it is unclear whether the new Act is actively and systematically enforced on employers.

115. Violations of labour regulation on the part of employers, against foreign workers, are not uncommon. A document published by the Malaysian Employers Federation in 2014 acknowledges that employers do not necessarily adhere to some labour laws when it comes to immigrant labour, especially those related to “recruitment fees, employment contracts, withholding of personal documents, working hours, deduction of wages, provision of benefits such as annual leave, public holidays and paid sick leave, access to grievance procedures and redress mechanisms, accommodation and work environments, and restriction of freedom of association and movement”. Recent reports have found that many foreign workers who had accrued large debts to pay for high immigration costs had been asked to sign labour contracts that were written in a language that they did not understand, had their passports withheld, were forced to work excessive hours and to work and live in precarious conditions, and prohibited them from forming labour unions (Bormann et.al. 2010; SOMO, 2013).

Table 6: Percentage of respondents who do not comply with labour laws

Labour Law	Percentage of non-compliance (%)
Trade Union Act	46.7
Anti-Trafficking Act in Persons and Smuggling of Migrants 2007	23.9
Industrial Relations Act 1967	11.1
Immigration Act 1959/63	10.7
Workman Compensation Act 1952	7.3
National Wages Consultative Council Act 2012	8.9

Source: MEF, 2014

116. Enforcement is further undermined by frequent policy reversals. Retrenchments, deportations, and migration bans have often been quickly followed by return migration and lifting of bans within short periods of time as employers bemoan labour shortages. This results in serious disruptions of various sectors and concern on the part of investors. The reversals also contribute to the rise of undocumented workers as they overstay their visas, remain on fraudulent visas, or switch employers to avoid detection.

117. The effectiveness of detection and detention programs, and enforcement operations to crack down on undocumented migrants, is unclear. The presence of many undocumented migrants has prompted Malaysia to identify and deport or regularize these migrants on a regular basis. Since 1992, Malaysia has implemented two ongoing programs referred to as Ops Nyah 1 and Ops Nyah 2. Ops Nyah 1 used the police force to curtail illegal entry into Malaysia by patrolling land and sea borders. Ops Nyah 2 targeted irregular immigrants already in the country through detection, detention, and deportation. A total of 1.2 million undocumented immigrants were identified under Ops Nyah 1 and Ops Nyah 2 between 1993 and 1997, while almost one million irregular immigrants were legalized through regularization exercises in the Peninsula in 1996 and in Sabah in 1997. Since then, operations targeted at specific groups of undocumented migrants have been carried out annually. The recent program launched by the immigration department, named Ops Hari-Hari, throughout Malaysia has managed to capture nearly 56,000 undocumented people. Like previous programs or enforcement campaigns, it is unclear whether assessments of these efforts were undertaken to ascertain the effectiveness of the efforts and to obtain lessons which can be valuable to subsequent efforts.

118. Similar to enforcement programs, it is unclear whether programs to regularize undocumented immigrants (e.g., amnesty programs) have been effective. The Cabinet Committee on Foreign Workers and Illegal Migrants (JKKPA-PATI) decided to adopt the 6P amnesty program to register undocumented immigrants in the country (Box 11). In 2014, a Voluntary Return Program for Illegal Immigrants (3+1 program) was implemented to encourage undocumented immigrants to voluntarily return to their country of origin; the main benefit of the program was to exempt immigrants from impeachment and from paying any fees for exiting. To date, approximately 270,000 have left Malaysia as a result of this program (MOHA 2015). Beyond having the number of people who have been registered through these programs, it is not clear whether MOHA or other agencies involved have properly assessed the effectiveness of the programs (e.g. effectiveness of outreach and self-targeting mechanisms, appropriateness of incentives). It is also not

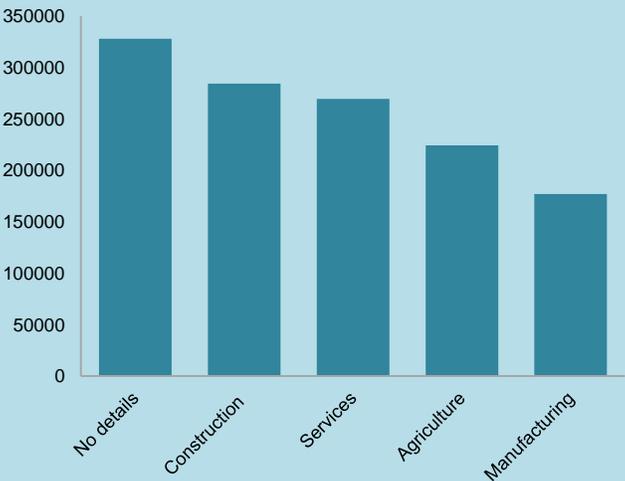
clear whether lessons from previous programs have been adopted into follow up efforts. The persistently large number of undocumented people indicates that these programs may have been less effective than intended.

Box 11: Results of the 6P program

The 6P program was implemented in 2011 to register undocumented immigrants and reduce the number of undocumented people in the country. The 6P program resulted in the registration of at least 1.3 million undocumented immigrants; such a large number of registrants gives some indication of success. During the first phase of the 6P program in July and August of 2012, 2.3 million immigrants were registered, of whom 1.3 million were undocumented. Approximately 500,000 of these undocumented immigrants received legalization approval to work in Malaysia with many of these ultimately repatriated. Apart from the large number of registrations obtained through the program, the government was also able to obtain information on the particulars of these individuals, and the sector of the economy where they were employed. Such information is useful for ascertaining risk of non-compliance in these sectors. Also, biometric information collected has been used to improve monitoring and enforcement of immigration law, and identify falsification of identities and travel documents; having such information has helped to strengthen national security.

Interestingly, most undocumented people registered in the 6P program worked in unidentified sectors. This reflects the recognition during the legalization phase of 6P of several new job categories and service sub-sectors such as laundry, barbers, and welfare homes. The predominance of undocumented workers in these categories suggests that there may be demand for immigrant workers to work in low-skilled subsectors, particularly in the services, where formal channels are insufficient (World Bank, 2013).

Figure 68: Most undocumented people legalized in the 6P program worked in unidentified sectors



Source: World Bank, 2013

Source: Authors.

119. Uneven capacity between MOHA and MOHR and differences in labour regulations between foreign and Malaysian workers have hampered regulation enforcement. While the ILO recommends one labour inspector per 10,000 workers in developed market economies and one inspector per 20,000 in transition economies, Department of Labour (JTK), the enforcement arm of MOHR, has less than 500 inspectors (in Peninsula) and similar number in Sabah and Sarawak combined. These inspectors are charged with enforcing labour regulations in a workforce of 14 million, and in an economy with over 800,000 premises (and over 1000 estates) and other types of non-traditional locales. Each inspector can handle 10-15 cases per month. By these benchmarks, JTK is severely underequipped to monitor and enforce regulations on Malaysia's workforce of 14 million. Further indicating an overburdened enforcement division, inspections in the manufacturing sector have declined by 45 percent from 2006 to 2007 and a further 78 percent from 2007 to 2008

(Devadson, 2011). On the other hand, the enforcement arm of MOHA has much higher capacity with a total of 3,000 officers to enforce immigration law. MOHA also receives assistance from the army, the General Operation Force (GOF), the Marine Operation Force, the Malaysian Maritime Enforcement Agency (MMEA), the police, and the National Registration Department (NRD). MOHA also relies on a citizen volunteer force (RELA) which has on occasion been mobilized to identify irregular migrants, assist and cooperate with security forces⁴². This is of some concern as any Malaysian citizen can join RELA and there are no specific training or eligibility requirements (World Bank 2013). The only joint operations between MOHA and MOHR on enforcement are related to human trafficking⁴³. However, given that labour and immigration violations are closely related and often found in the same situations, systematic coordination could improve burden sharing and increase enforcement capacity for both ministries. In the US, the Department of Homeland Security (through its Immigration and Customs and Enforcement arm) and the Department of Labour have created a joint Workforce Enforcement Coordination Committee to address similar problems, and have published a Memorandum of Understanding detailing the responsibilities of each party (DOL 2011).

120. The job of inspectors is made more difficult by differences in the labour regulations covering Malaysians and immigrant workers. This means that already-overburdened labour inspectors have to be versed in two separate systems when reviewing an employer. Several provisions outlined in the specified labour legislations (e.g., Employment Act 1955, Industrial Relations Act 1967, and Trade Unions Act 1959), though having adequate protection for local workers, do not extend the same protection to migrant workers in reality (World Bank 2013). Further, some areas of labour regulation are covered by different laws entirely. For instance, foreign nationals are covered by the Workman's Compensation Act and Malaysian workers are covered by the Employees Social Security Act of 1969.

Malaysia's repatriation policies is not well balanced between stakeholders

121. In the current system, much of the repatriation responsibility is on the employer or outsourcing company, which may contribute to the large incidence of irregularity. Current law states that the foreign worker has to be repatriated to the country of origin upon completion of work or dismissal, upon expiration or revocation of the VP(TE), or when the foreign worker has failed to obtain a clean bill of health. In any of these cases, the employer is responsible for making arrangements for and bearing the cost of repatriation. The employer is also responsible for notifying the Director General of the Department of Immigration within 30 days of the immigrant's repatriation. Upon providing proof that the worker has successfully left Malaysia, the employer may claim the deposit/bond paid when the worker arrived. This policy is intended to incentivise the employer's cooperation in returning the worker to their home country. However, this process is cumbersome for employers, and as such the cost-benefit calculation of not complying often favours non-compliance.

122. Foreign workers in Malaysia do not accrue any benefits upon successful repatriation, which limits their incentive for exiting Malaysia. Without monetary incentives for workers to repatriate, only sanctions are available to enforce repatriation. International experience suggests that immigrants are more likely to repatriate voluntarily at the end of their tenure if they have the ability to return to the host country and if they have access to portable benefits. Malaysia currently allows foreign workers to return after a three month cooling period, and if they fit all the characteristics (age criteria, medical fitness, and no criminal history). By leaving the door open to future return, rather than having strict limits on how long an immigrant may work in the host country, appears to have a significant effect on how likely migrants are to overstay. However, it is important to note that returning migrants have to go through the entire immigration process again; thus, incurring high costs a second time, which likely disincentives some workers from leaving at all. One of the best practices across the world is Korea's Employment Permit System (EPS), where employers have to subscribe to Departure Guarantee Insurance while EPS workers have to subscribe to Return Cost Insurance and Casualty Insurance. Employers make a monthly deposit of 8.3 percent of the worker's salary into Departure Guarantee Insurance. This amount can be claimed by the worker only just prior to his/her departure from Korea or when changing employers. Return Cost Insurance covers the cost of return to the worker's home country and represents an incentive for the workers to go back upon completion of the EPS instead of overstaying his/her work permit. Another example is Canada's Seasonal Agriculture Workers Program, through which workers participate in a compulsory saving scheme through

⁴² RELA is not permitted to act on its own, only to support law enforcement agents.

⁴³ Anti-Trafficking in Persons (Amendment) Act 2010, Trafficking in Persons means all actions involved in acquiring or maintaining the labour or services of a person through coercion and includes the act of recruiting, conveying, transferring, harbouring, providing or receiving a person for the purposes of this Act. There were 431 arrests for trafficking in 2014 and 2015, combined (MOHA, 2015).

which 25 percent of their gross earnings are withheld: 5 percent as a contribution to the salaries of Jamaican Liaison Officers and 20 percent in savings accounts which can only be claimed upon return to the country of origin.

Leveraging immigrant labour to boost growth – policy considerations for Malaysia

123. Malaysia's labour market and economy continues to benefit from the contribution of immigrant labour.

Recognition of the contribution of immigrant labour to the country's continued growth is a key element to the immigration reform process. In fact, previous sections of this report show concrete evidence that the availability of foreign labour have had positive impacts on the economy, and helped fuel economic sectors which create jobs for local workers. Thus, it can be expected that progress towards the ambitious goal of becoming a high-income economy in 2020 will continue to involve migrant labour.

124. This section builds on the evidence presented and on lessons learned from international experience. Lessons from the immigration systems in Canada, the United Kingdom, Singapore, Australia, and Japan, among others, can serve Malaysia in its reform process. This report adapts them to the local context so that reforms are implementable and aligned with Malaysia's development objectives. These countries have established policies, institutions, and metrics to ensure that their employment-based immigration systems facilitate immigration where needed while ensuring that costs and control measures prevent overutilization. Future reform of Malaysia's immigration system would benefit of a similar approach. This is a departure from Malaysia's current approach to immigration which has been overly rigid in some sectors and overly flexible in others, headed by many instead of a single empowered agency, and overburdened by a complex legal structure which is not easily enforceable.

Align the economic immigration system with broader development objectives

125. From a macro perspective, a key challenge is to design an employment oriented immigration system to guide policies and actors. The result of not having a strategic vision for immigration policy has been the *ad hoc* introduction of new immigration policies which have sometimes been reversed, immigration quotas and caps that are not based on labour market needs, and overlapping institutional mandates. The piecemeal immigration system which has emerged has managed to resolve immediate problems. As the section on the impacts of immigration in Malaysia shows, this system has allowed the country to benefit in important ways from immigration. However, the current system has also resulted in an increasing number of undocumented people and endemic non-compliance with immigration and labour regulation by employers. These issues are highlighted in the previous section.

126. Based on international experience, three guiding principles can guide policymakers in Malaysia to make meaningful improvements to the economic immigration management approach:

- **Market-driven:** Immigration flows better aligned with labour market demands, recognizing that there is a long-term role for immigrant workers, and with overall economic/social objectives.
- **Comprehensive:** A comprehensive immigration system which recognizes the need for immigrants of all types but also differentiates among these types.
- **Balanced:** Maximize the employment of Malaysians and minimize the negative impacts of immigration on Malaysian workers while also protecting immigrant workers from abuse.

Each principle guides the policy proposals and specific actions outlined in Figure 69. The first three make the economic immigration system more market-driven by proposing distinct options to convert the current approach to an approach that is responsive to market needs. The fourth proposal aims to keep the system comprehensive of all categories of immigrant labour needed in Malaysia's economy. The fifth and sixth policy proposals aim to keep the immigration approach balanced by encouraging strict enforcement and proposing strategies to reduce over-dependence on immigrant labour. Many policies and actions proposed in this document have been presented by international experts in the past, are currently being considered by the government, are in the planning stage, or are slowly getting underway. This section attempts to present those that can yield positive outcomes in the immediate term (within two years). Figure 69 outline policy proposals and relevant actions for the government of Malaysia to consider.

Figure 69: Policy proposals and relevant actions for Malaysia to consider

I: Revising employment immigration policies to be aligned with Malaysia's new human resource strategy rather than with security priorities

- Reduce fragmentation by assigning a leading institution to assess economic needs for migrants.
- Establish the mandate of the employment-based immigration system in an institution charged with HR-labour policy rather than one with security objectives.
- Update immigration legislative framework to reflect the long-term role of immigrant labour in the economy resources strategy.

II. Scaling up Malaysia's existing evidence-based system for identifying labour shortages in the full economy to identify which occupations immigrants are allowed to fill

- Scale up existing labour shortage identification system to the full economy.
- Expand the mandate of the Critical Skills Monitoring Committee to manage the system.
- Outputs from the labour shortage system can guide the admission process.

III. Phasing out static quotas by restructuring the levy system to serve as a pricing mechanism that controls migrant inflows and keeps immigration aligned with evolving genuine labour market needs

- Pricing mechanism linked to the evidence based system rather than static quotas.
- Pricing mechanism encourage employers to consider alternatives to fulfill labour needs through the pricing mechanism.
- Enforce full costs of employing immigrants to limit immigration to genuine needs.

IV. Determining distinct immigrant categories with a set of criteria focused on productivity and value-added for Malaysia (e.g. education-skill level, age, experience) instead of wage-cut-offs. Managing each category distinctly to meet economic goals

- Move from wage cut-offs to a comprehensive approach (e.g. education, experience, age) to determine distinct migrant categories.
- Manage each immigrant category distinctly.
- High-skill: Simplify admission process to attract them and improve in-country migration services to ease their retention.
- Mid-skill: To migrants to fill labour shortages until they can be filled with local labour.
- Low-unskilled: Agreements between governments to replace the role of intermediaries in the recruitment process. Single window initiative to facilitate direct recruitment.

V. Establishing risk-based systems to target enforcement efforts. Pursuing joint enforcement of immigration and labour regulation to prevent a culture of non-compliance among employers and third-party intermediaries. Applying penalties for non-compliance in a consistent manner

- Establish a risk-based monitoring system to guide physical enforcement and joint-enforcement.
- Leverage technology-based tools for joint-enforcement.
- Establish an internet-based employment verification system, cross checked with biometric data.
- Ensure consistency in the issuance of sanctions on employers and intermediaries for violations
- Enforce labour standards equally to all--local and foreign--workers.
- Include rules for sending countries to actively encourage repatriation.
- Open a new window of a revamped amnesty (6P) programme.

VI. Using levy-revenues for strengthening local workers' skills to fill medium-high skill jobs and for easing conditions for firms to adopt productivity-enhancing technology (where available and cost-effective)

- Create a retraining and experience enhancing fund, using migrant levy revenues, to upskill/rightskill local workers to fill medium and high skill jobs facing shortages.
- Ease constraints (e.g. access capital, information, capacity training) for firms to undertake technological upgrading, and make training related investments.

Making the immigration system market-driven

Policy Proposal I: Revising employment immigration policies to be aligned with Malaysia's new human resource strategy rather than with security priorities

127. Consider reducing fragmentation in the immigration system by assigning a leading government institution with the economic need for immigrant labour. Evidence shows that countries with successful systems have a single agency leading migration matters (Australia) or a lead agency (UK and Singapore) which coordinates a system with support from various agencies. In Malaysia, unlike in various benchmark countries, the ministry in charge of human resources does not play a leading role in determining the profile of immigrants that are needed to fill labour shortages. Instead, the determination of economic need for immigrant labour, and admission function is spread across agencies. Such an approach has exacerbated fragmentation of functions and contributed to misalignments between labour market shortages and migration inflows.

128. Consider establishing the primary mandate for the employment-based system with the institution in charge of human resources and labour policy. International experience shows that employment-based immigration systems are more effective when the mandate for determining the demand for immigrant labour falls within the institution responsible for human resource and labour policy. Lessons from benchmark countries show that better alignment between workers needed and workers admitted can be obtained when the focus is on economic goals rather than security objectives. This is especially important in the context of changing labour market needs where non-economic institutions are not equipped to adapt quickly. Going forward, the government may consider mandating the human resource ministry with the leadership role in determining economic needs, while having the enforcement support of immigration law from the Ministry of Home Affairs. Supporting agencies, which currently play a role in the approval process (e.g. MPIC, MOTAC, MOA, MIDA, CIDB, MDeC, CIDB, TalentCorp), would be best suited to provide sector-economy-related intelligence in support of MOHR as a lead agency.

129. Consider updating the immigration legislative framework to reflect the long-term role of immigrant labour in the economy and as a core part of the human resources strategy. Despite the contribution of immigrant labour in the economy, immigration policy and regulation have not evolved to respond to changing needs. Changes to the legislative framework to align immigration laws with the human resources strategy would further facilitate enforcement of both immigration and labour regulation. For instance, updates to the Workers' Minimum Standards of Housing and Amenities Act 1990 could be considered to ensure that concerns about worker conditions are addressed. Also, implementation and enforcement of the Private Employment Agency Act 2014, which repeals the Private Employment Agencies Act 1981 (Act 246) might be useful to strengthen enforcement activities. A full assessment of the legislative framework that pertains to immigrant labour can help identify amendments that clarify mandates of distinct institutions, and enable responsible agencies to recruit professional personnel to fulfil distinct mandates.

Policy Proposal II: Scaling up Malaysia's existing evidence-based system for identifying labour shortages in the full economy to identify which occupations immigrants are allowed to fill

130. Consider relying on an evidence based approach to identify labour shortages. Countries such as Australia, Canada and the United Kingdom use a data based system to identify labour shortages on a regular basis and make immigration and other human capital and workforce decisions. Malaysia is starting to pilot a similar approach (see next paragraph), and it can be leveraged to fit a broader objective. For instance, it can serve to assess whether labour demand in given sectors and occupations can be met with local workers now or in the near term, and if not, it can guide other agencies to seek international workforce to fill shortages. A clear contribution of this approach is that it ensures that foreign labour is complementary to rather than substitute for local workers. It can also eliminate the quotas by sector, which can impose constraints on sectors which are in high demand of workers who are not locally available. Although laws and regulations currently mandate that local employers limit international recruitment to occupations in short supply of local workers, there is no validation system in place to ensure that the shortage is genuine (apart from having to demonstrate that a job vacancy has gone unfilled for a period of time). The evidence based labour shortage identification system can also strengthen the enforcement of the local-first hiring requirement by validating the authenticity of labour market shortages.

131. Consider scaling up the labour shortage identification system, currently piloted for high skilled occupations, to facilitate responsiveness to broad labour market shortages. MOHR and TalentCorp, are currently jointly experimenting with a similar approach (focused only on skilled categories). When the pilot phase is completed, lessons obtained can serve to adapt the approach to analyse labour shortages across the economy (and skill spectrum), so that the evidence based labour shortage system can be scaled up. The resulting list of occupations facing labour shortages covering the entire economy, can guide all agencies involved in the admission process. The system depends on two critical inputs: comprehensive quantitative data (from various sources), and a thorough validation approach with stakeholders. Its effectiveness depends on the quality of these inputs, and on having a systematic process that updates the occupational shortage list regularly. The UK has an innovative approach which can serve as a model. It uses a top-down approach which relies on national data and a bottom up approach which relies on industry and experts to validate the list. The methodology is broadly accepted by all stakeholders involved in the immigration process because it is not narrowly focused on identifying jobs which are hard to fill. Instead, the methodology also takes into account broader economic and social objectives and questions whether alternative measures to addressing workforce gaps can be used, such as whether technological and managerial changes can be made to upgrade the firm's technology or whether unemployed workers can be trained or incentivized to fill open posts.

132. Consider expanding the mandate of the Critical Skills Monitoring Committee to lead the implementation of the evidence-based labour shortage identification system. An effective employment-based immigration system relies on having a professional body that can undertake the precise measurement of labour market needs and advise the institution with the human resource mandate on immigration demand. The 11th Malaysia Plan established a Critical Skills Monitoring Committee (CSC)—jointly led by MOHR's Institute of Labour Market Information and Analysis (ILMIA) and TalentCorp—to serve a similar function. One of the roles of the CSC is to construct an evidence-based labour shortage system to facilitate better identification of immigration needs and facilitate coordination between actors on policy interventions related to immigration, upskilling, scholarships, higher education and TVET. Like in other benchmark countries, the mandate of the CSC could be expanded to fulfil the function of being the central source for determining immigrant labour demand across the economy.

133. Once a labour shortage in a specific occupation is established, all institutions involved in the processing of immigrant labour can fulfil labour shortages. Immigrant labour coming to Malaysia varies widely in terms of skills and profiles. As such, each migrant group benefits from distinct admission processes which are suitable to the group's profile. By focusing on fulfilling the labour shortages identified through the unified system, fragmentation and duplication of functions across institutions will likely be reduced. And all supporting institutions can focus their efforts on improving their core activities, including processing immigrants from the relevant categories identified to be in demand. With all institutions responding to a unified labour shortage identification system migrant inflows will likely change; downward in sectors where genuine demand is not valid, and upwards where labour shortages are genuinely present. For instance, the ongoing pilot phase of the evidence-based labour shortage system has identified that there is a genuine shortage of specialized and experienced ICT managers and professionals. Based on this and other information, institutions which presently support these knowledge workers could obtain the green light to help them during the regular admission process. The Multimedia Development Corporation (MDeC), through its MSC e-Xpats⁴⁴ Centre can facilitate entry and retention of immigrant workers that fill these occupations facing shortages, and focus its efforts to improve its core functions to facilitate the transition of these immigrants to work in the country and to streamline its immigration processing approach. Another set up with a similar approach to manage high-skilled workers is the MYXpats Centre, a joint effort between the Department of Immigration and TalentCorp. Like MDeC, the MYXpats Centre can focus on improving its functions to better serve high-skilled immigrants and incentivise retention.

Policy Proposal III: Phasing out static quotas by restructuring the levy system to serve as a pricing mechanism that controls migrant inflows and keeps immigration aligned with evolving genuine labour market needs

134. Consider moving away from the use of quotas and restructuring the current levy system to serve as a price mechanism to control migrant inflows and keep them in-line with genuine market needs. Quotas are static and do not respond to market needs. They are intended to control the flow of immigration but fail to do so because they are often bypassed and difficult to lower once established. Indeed, many countries are moving away from aggregate quantity

⁴⁴ MSC stands for Multimedia Super Corridor.

targets and toward more finely tuned policies in which costs are designed for each sector and occupation separately. Adjustments through costs and price mechanisms are more effective and efficient for the Government compared to adjusting quotas which can only be implemented with a lag. Malaysia's current goal is to keep the share of foreign labour in the total workforce at or below 15 percent. The goal is designed to push industry to adapt in order to demand fewer immigrant workers. However, a strict quantity goal does not reflect economic needs and may be counterproductive to growth. The labour shortage system on the other hand, can serve to transform the existing levy system into a responsive mechanism for controlling immigrant flows and eliminating the need for quotas. Having a live-levy system will enable the government to appropriately price immigrant workers, based on whether the occupation is in shortage or not, without limiting the ability of industry to fulfil its workforce needs.

135. Incentivise stakeholders to consider all alternatives to fulfil labour needs before importing labour through the pricing mechanism (or live-levy system). The live-levy structure can be structured to take also into account government objectives', such as fostering labour productivity and higher wages. Thus, the levy which is ultimately assigned to each job category can help prevent wage depression, underinvestment in technology, forestalling of mechanization, or use of migrant labour in cases in which local workers can be skilled up or technology can be adopted. Levies can also encourage devoting resources to institutions providing education, training, and business-related support in order to upgrade worker skills, provide workers with opportunities to obtain job-related experience, and ease the conditions for firms to undergo technological upgrading.

136. Enforcement of the full costs of employing immigrant workers is important for the levy system to work effectively and to limit the employment of immigrant labour to genuine needs. If some employers are able to avoid certain legally mandated costs, the incentive structure of the live-levy system will not function appropriately. As the regulation is revised, consider regulation that enforces that the full cost of hiring an immigrant worker is borne by employers. Also, consider clarifying that employers cannot legally pass-on immigration-related costs, and the cost of health insurance to immigrant labour. Also, consider better enforcement of legislation that mandates that transport and quality housing guidelines (e.g. construction quality, overall safety, and sanitary conditions) for low- and unskilled workers are followed.

Making the immigration system comprehensive

Policy Proposal IV: Determining distinct immigrant categories with a set of criteria focused on productivity and value-added for Malaysia (e.g. education-skill level, age, experience) instead of wage-cut-offs. Managing each category distinctly to meet economic goals

137. Consider moving from wage cut-offs to determine immigrant categories to a more comprehensive determination approach that curtails perverse incentives on the part of employers and intermediaries. Evidence from countries such as Australia and the US show that wages are often misreported in order to game the system when wages cut-offs are used on their own to differentiate immigrant categories. This occurs when employers pay highly qualified migrants entry-level wages to fit the criteria of their respective work visa programs (H-1B in the United States and 457 in Australia). These artificially low wages indirectly affected the average wage in the occupations in which foreigners were hired. This may also be the case in Malaysia where wage cut-offs could potentially contribute to depression of wages if employers recruit immigrant workers and pay them at the cut-off points in order to access different tiers of the immigration system. See Box 12 for details of each category.

Box 12: Main tiers of migrant labour

Important factors to determine an immigrant's categories include: 1) formal educational qualifications; 2) specialized training; 3) current earnings; 4) years of relevant experience; and 5) the occupational category of the relevant experience. These factors create a much more nuanced picture of immigrant workers which can be used to fill workforce gaps more effectively. Each tier can then be weighted according to the results of the evidence-based labour shortage system. An updated classification of foreign workers which better reflects this more holistic assessment would group these workers into at least 4 categories: High-Skilled, Medium-Skilled, Low-Skilled and Unskilled.

High-skilled and talented foreign labour

High-skilled international workers often command large salaries and incentive packages to be attracted to a new labour market. These workers are almost always classified in the first (1) or second (2) group of the Malaysia standard of occupational categories (MASCO). In the Malaysian terminology, this category is referred to as expatriates. Their specialization and overall contribution to employers usually more than compensates for their total costs. Thus, employers are willing to pay for the fees associated with their recruitment. Workers in these occupational categories have substantial years of relevant experience and typically have higher educational qualifications (university degree or above). The combination of experience and education makes them experts in their field.

Medium-skilled foreign labour

Medium-skilled workers, which typically include occupations in the third (3) occupational category of MASCO, command a broad range of wages (as shown in part II). In the Malaysian terminology, this category is also currently referred to as expatriates. As has been shown, the skills sets and experience required to perform the tasks in these occupations are more easily found, and replicated, in the local labour market. Educational qualifications can range from technical certifications to university degrees; and their job relevant experience is well documented. Thus, the live levy-system will likely have to be adjusted (upwards) more regularly, as the local workforce obtains the necessary experience to fill jobs in demand in these occupational categories. Improved data over time would also serve as a reliable input for regular monitoring.

Low-skilled foreign labour

Low-skilled workers are classified in occupational categories four (4), five (5), seven (7) and eight (8) of MASCO. In the Malaysian terminology, this category is referred to as foreign workers. As shown, these are workers with work experience in the relevant occupation, and education levels that range broadly. Much like the medium skill category, the job profiles of these workers are common among Malaysian workers. However, availability of local workers to fill these jobs is sometimes limited for various reasons, which include monotonous work processes, working conditions and salaries which are not attractive to local workers, and limited opportunities for career advancement. Many of the occupations require tasks to be performed which can presently (or in the near future will) be performed by machinery. Thus, some jobs in these occupational categories can be substituted by technology rather than immigrant workers. Firms seeking to hire immigrants to fill these posts can be encouraged (and assisted where relevant) to adopt technology instead.

Unskilled foreign labour

Unskilled workers are encompassed in occupational categories six (6) and nine (9). In the Malaysian terminology, this category is referred to as foreign workers. These are jobs that require physical strength and willingness to work in 3D conditions or undertake tasks which are monotonous. They are undesirable jobs from the point of view of an increasingly educated population. As stated before, Malaysian workers are very likely to be unwilling to fill these occupational categories unless it is for self-employment in rural areas or near fishing locations. Thus, these jobs are heavily reliant on foreign workers. Unless technological adoption is possible (in terms of availability and affordability) reliance on foreign labour will continue.

Source: Authors.

138. Once occupations facing labour shortages are identified, consider managing each immigrant category distinctly in order to meet broad economic objectives (e.g. legislation, admission and retention). Few firms rely on only one type of worker. Rather, they demand a range of skills across both occupational categories and skill levels; and skills needed can range from minimal competency levels to very sophisticated competencies. Technological advancement at the firm level also calls for continuous adjustment of the type of workers and skills needed over time. Although the current immigration system reflects this need with separate mechanisms to identify labour shortages and to evaluate the admission of foreign workers and expatriates, the fragmented system has led to overlaps, duplications, and inefficiencies. In the previous section we highlight the importance of having a single system for identifying labour shortages; however, each category not only has relevant legislation but also has distinct approaches to recruitment, admission and retention/repatriation.

For talent and high-skilled migrant labour....

139. Actively attract and retain high-skilled and talented foreign labour to Malaysia by facilitating the admission process and improving immigration related services when they are in country. There is broad recognition that the Malaysian labour market has benefited from the presence of international industry leaders and professionals that help firms remain globally competitive. For this category of workers, employers recruit global workers from abroad using direct channels, talent search firms, and global head hunters and by moving labour within the company across borders. To obtain the best candidates, the admission process works better when it is kept simple and support services responsive to avoid deferring applicants in the occupational categories facing shortages. MDeC's MSC Malaysia e-Xpats Centre, as well as the MYXpats Centre (jointly managed by the Department of Immigration and Talencorp) offers one-stop centres to provide support services for expatriates. Continuous evaluation of these centres can help improve their effectiveness.

140. Malaysia's current approach to retain talent has been effective but can be strengthened to further attract the best global talent. Many high skilled immigrants working in Malaysia possess specialized skills and expertise which make them attractive to employers. Incentive programs for such talented workers are offered by TalentCorp through its Residence Pass-Talent (RP-T). A recent evaluation shows that the program is effective in retaining talent in Malaysia (World Bank, 2015). However, the program only aims to retain talent, not attract new talent. Given that the new employment-based approach may identify labour shortages at the top end of the skill spectrum, a revised approach may consider expanding eligibility beyond talent already in Malaysia to those applying from abroad. By doing so, a broader pool of applicants can fill labour shortages in highly skilled occupations.

For medium skilled migrant labour....

141. Consider continuing to allow immigrants to fill mid-skill occupational categories facing labour shortages until the shortage can be filled by local workers. Shortages of labour across all skill categories can cause disruptions to the production process, and impose unnecessary costs. Therefore, in the near term, foreign medium-skilled workers who can fill jobs which cannot be filled locally will continue to be in demand by industry. But to prevent long-term dependency on foreign labour in medium-skilled occupations, which could be filled with local workers in the near term, measures to upskill (or right-skill) local workers can be undertaken (see policy area VI for details). But apart from upskilling programs, firms could be encouraged to establish mentor programs to pair local and immigrant workers to gain direct practical experience. The labour shortage system can include sunset clauses in the use of immigrant labour in certain occupations in a given period of time to incentivise employers to prepare local workers. For instance, the UK removes occupations from the shortage list after a given period to discourage complacency and over-reliance on migrant labour among employers. This also motivates employers to train and up-skill resident workers and alerts education providers and governing bodies to the efficacy of their attempts to address skill shortages.

For lower and unskilled workers...

142. Agreements between governments can replace intermediaries in the recruitment process. The 11MP cites the phasing out of intermediaries in the recruitment process for unskilled and low-skilled labour. Specifically, since 2010 the Government has ceased to issue licenses for outsourcing companies to recruit and by 2018 these firms are expected to be phased out. In the meantime, joint liability between employer and outsourcing companies are being reinforced in the legislation to ensure that both parties are accountable for foreign workers hired through an outsourcer. While these intermediaries are phased out, other intermediaries (recruiters) remain actively engaged in bringing foreign labour. As stated in the previous section, such B-to-B approaches often work counter to the government's objectives. As such, the government is strengthening its G-to-G approach instead. Such an approach is more cost effective for all (including immigrants), less vulnerable to corruption and aligned with government objectives. Going forward, Malaysia can consider scaling-up this approach so that it can serve as the primary channel for the recruitment of foreign workers. In terms of costs, G-to-G agreements reduce the costs of immigration from approximately RM14,000 when using third-party recruiters to as low as RM1,400⁴⁵. Such a decrease in costs benefits workers and employers alike. But for G-to-G agreements to work effectively, it would be ideal to have them reflect labour market needs rather than serve as broad (largely diplomatic) agreements. In other words, requirements would be better aligned with the labour shortage identification system, reflecting both top-down indicators and bottom-up consultations.

⁴⁵ These are rough amounts derived by government stakeholders during the consultation process.

143. The introduction of the Single Window Initiative can facilitate direct recruitment, bypassing third-party intermediaries. In 2015, the Government announced the development of a Single Window Initiative to combine existing processes for management of foreign workers. Employers will be able to recruit pre-approved workers directly through the online portal, limiting the role of recruiting agents and responding to private sector demands to better integrate existing systems. Similar ongoing reforms in the US may provide guidance for developing a single window for migration management. A roadmap in the US was created and translated into intuitive electronic tools to provide immigrants and employers with a single dashboard which guides them through the entire immigration process from application to departure. Such an easing of administrative requirements and costs can reduce incentives to immigrate through illicit channels (MPI 2014).

144. Strengthening the oversight of recruiters, outsourcing companies and employers using these services to ensure compliance with immigration and labour regulation. To deter non-compliance, Third-party recruiters, and outsourcing companies may be subject to more stringent oversight and enforcement. For instance, Australia requires private employment services to register with the Office of Migration Agents Registration Authority (OMARA). OMARA is charged with registering complaints about PEAs, overseeing the suitability of PEAs, assisting migrants with finding a PEA, and advising immigrants about the fees agents can charge, among other responsibilities.

145. Consider establishing social protection programs for immigrant workers to boost workers' savings and incentivise their exit. Many countries such as Japan, Spain and others have used incentives to encourage immigrant workers to return (mostly during periods of economic downturn). These are commonly referred to as pay-to-go programs. In Malaysia, similar incentives could be provided through savings accounts. A fund similar to the employment provident fund (EPF) could be established for immigrants so that employers pay contributions on their behalf. The law currently forbids foreigners who contribute to EPF from withdrawing these funds while they are employed in the country. In the same spirit, savings can incentivise foreign workers to leave Malaysia by allowing them to withdraw only when they are in their country of origin or outside Malaysia. Like EPF, such an account can be portable to ensure that workers can continue contributing to the account even if they switch employers. In Canada's Seasonal Agriculture Workers Program, for example, to encourage workers to return to their home country, workers participate in a compulsory saving scheme through which 25 percent of their gross earnings are withheld, mostly in savings accounts which can be claimed only upon return to the country of origin.

Making the immigration system balanced

Policy Proposal V: Establishing risk-based systems to target enforcement efforts. Pursuing joint enforcement of immigration and labour regulation to prevent a culture of non-compliance among employers and third-party intermediaries. Applying penalties for non-compliance in a consistent manner.

146. Risk-based monitoring could be established to guide physical enforcement and facilitate joint-efforts for enforcement in sectors and firms more prone to hire irregular workers and violate labour regulations. Large scale physical enforcement on establishments is costly, especially if immigration and labour inspectors have to visit sites. A joint (MOHR and MOHA) risk-based system—using various data sources and risk-assessment tools—can be established to guide physical enforcement efforts. But to balance the inspection capacity of both MOHR and MOHA, it may be necessary to also balance the size of the labour and work related immigration inspectorate staff. If regular joint enforcement is not possible, joint-enforcement efforts could be considered in higher-risk sectors. But such an effort can be established as a core function and funded to succeed. It may also be favourable to increase the capacity of labour and immigration inspectors to identify and process any type of violations committed by employers or third-party intermediaries. A joint-enforcement fund could be created and funded with proceeds from levies to support increased enforcement of labour regulation among the immigrant population.

147. Enforcement can also be streamlined by implementing a programme that rewards employers who regularly comply. A fair and well-enforced admission rules and procedures will reduce violations, and reward those employers who play by the rules (Papademetriou and Sumption, 2011b). As part of a screening and incentive system, employers who consistently stick to the admission rules and provide adequate work conditions could receive accreditation and/or be rewarded with simplified admission procedures that shortens processing times and reduces costs by lowering processing fees. In the US, the Department of Homeland Security has a pilot program called “Known Employer”, which

streamlines the adjudication of certain types of immigration benefits and petitions filed by employers meeting strict criteria of good corporate citizenship and compliance with immigration laws. The initiative incentivises compliance on the part of employers and reduces administrative costs (for all) by making the application process less costly for those who comply with immigration law and labour regulations. In Malaysia employers can be profiled based on compliance and risk (see subsequent paragraph on risk-based systems) to break the law. This would not only reduce costs but also enhance preventive enforcement by permitting comprehensive analysis of the risk posed by individual employers.

148. Leverage existing automated technology to facilitate joint enforcement between MOHA, MOHR and others. Malaysia has invested a substantial amount in technology-based tools. However, it is not leveraging these tools to their maximum potential by cross-checking the information collected and using it for monitoring and enforcement. Going forward, systematically cross-checking databases within and across institutions would strengthen compliance with labour regulations as well as immigration law. MOHR and MOHA together can take the lead on this endeavour given that most tools are under their purview. For instance, agencies could cross-check the Biometric Data System, MyIMMs, and the Identification card or I-Card (MOHA), the e-application system (e-PPM), e-worker compensation system (e-Pampasam), e-Compensation Labour Market Database (LMD), Electronic Labour Exchange (ELX) (MOHR), FOMEMA (Ministry of Health) and data from the Income Tax Authority. Such combined data can help assess the risk for non-compliance of firms in real time as well as predict future non-compliance among employers which exhibit certain risk patterns. By cross-checking data on wages and taxes, the monitoring agent can ascertain how much foreign labour is paid, and compare it to the types of work visas held by the company.

149. An internet-based employment verification system, which is cross checked with biometric information, and made mandatory to all employers may increase compliance with immigration regulation. It may be important to have an electronic system of verification, which is accompanied by training and information programs (with special support to small businesses with limited online capabilities) to alert all employers (and workers) about it can facilitate monitoring of non-compliance when workers move across employers. Such a system can prevent businesses from knowingly employing undocumented workers who may have left another employer or entered the country through illegal channels, and holds companies accountable for full compliance. For instance, in the United States a similar system (E-Verify) ensures that employers hire foreign workers who are legally authorized to work in the country in the appropriate occupational category. To prevent the use of fraudulent documents, information in the system can be cross-checked with biometric information. The system is more likely to be widely adopted if it is easy-to-use for all employer types, and if implementation is accompanied by information and training for employers to use it. Once fully operational, more severe penalties for hiring undocumented workers can be applied to reinforce incentives to comply with it.

150. Good practices on immigration management impose sanctions which are pertinent to the violation and apply them in a consistent and transparent manner to non-complying employer to align their incentives with legal requirements. Regulations that punish employers for non-compliance of immigration and labour law are not actively imposed. In fact, Work Act 1968 (Act 353), which imposes the principle of strict liability, has been dormant. This Act could be activated and enhanced to ensure more severe punishment of all violations, including hiring undocumented workers. Penalties in benchmark countries include high fines as well as imprisonment, and they are applied consistently and transparently to all non-complying employers. Penalties can also include revocation of the work permit on the part of the worker and a prohibition on employing immigrant workers on the part of the employers. These sanctions are more effective when paired with information campaigns to educate employers and migrants about the penalties of infringing on employment rules and regulations. Singapore provides various good practices; it pairs sanctions on irregular migrants with severe penalties on their employers and those who facilitate their undocumented status such as smugglers.

151. Compliance with labour standards is more effective when enforced equally on local and foreign workers. Equal enforcement curtails informality and improves labour working conditions overall. Monitoring and oversight of labour standards applied to foreign workers are key to ensuring that they are enforced in order to prevent foreign workers from depressing domestic wages and working conditions. In 2014, Qatar announced that employers would be required to pay workers' wages automatically by electronic bank transfer. To this end, it developed a Wages Protection System (WPS), which is a comprehensive electronic system initiated by the Ministry of Labour and Social Affairs to monitor and document the process of worker wage payment in order to ensure that wages are paid systematically and in a timely

manner. This ensures that employers are neither withholding wages nor making excessive deductions from workers' salaries. This is just one area in which technology can improve enforcement.

152. Sending countries could have a more active role in the exit strategy process, through incentives and conditions. It is important to strengthen clauses on returning home in the MOU or BLA process. Sending countries are often exempted from an active role in the enforcement of immigration law in the receiving countries. However, evidence shows that when migration policies are unilaterally enforced, rather than shared, effectiveness in the receiving country is weakened. On the other hand, international evidence shows that when two countries have clear roles and responsibilities, established in legal contracts, both countries have an interest to enforce the rules. Malaysia can establish incentives for sending countries in G-to-G agreements to set up mechanisms to incentivise workers to return, before departure, and to be more careful in their screening process to raise compliance. Agreement between countries can be evaluated regularly based on compliance with exiting among other factors.

153. A new window of the 6P program could be opened once the previous ones have been assessed for effectiveness and reformed as needed. Amnesty programmes ease the government's ability to register the remaining immigrants with undocumented status and to count (and determine the occupational profile of) all undocumented foreign labour in Malaysia. A new window could be considered, incorporating lessons from past waves to increase its effectiveness. For instance, if previous programs failed to successfully reach immigrants, the new program may consider advertising along with the incentives which are offered for people to adjust their status: registration can be followed by assistance to re-enter the formal labour force for all those fitting the profile of occupations or sectors in shortage. Also, apart from exemption of fees, other incentives to leave Malaysia may be considered; for instance, transport costs, and vouchers to be redeemed upon arrival. The punishment for not registering in the amnesty can be made clear through various information channels, and become more severe over time.

Policy Proposal VI: Using levy-revenues for strengthening local workers' skills to fill medium-high skill jobs and for easing conditions for firms to adopt productivity-enhancing technology (where available and cost-effective)

154. Consider using levy revenues to upskill Malaysian workers who are currently employed in low-skilled occupations and face competition from migrant labour as well as to right skill local workers to fill medium and high skill occupations facing shortages. Few Malaysians compete with foreign workers in low-skilled occupations. However, those who are still active in those jobs would benefit from upskilling and re-employment services to mitigate negative labour market outcomes. There are a range of upskilling programs available in Malaysia, which could be better targeted to less-skilled workers and disadvantaged populations. Many of the countries with employment-based migration approaches enhance the upskilling of the local population to leverage the presence of migrant labour while reducing competition between local and immigrant workers. Consider establishing a retraining and experience enhancement (REE) fund to prepare local workers to fill medium and high skilled occupations in high demand and short supply. The fund could be rolled into the budget of the Human Resources Development Fund (HRDF), given its experience in managing worker retraining programmes, and formal education centres for longer term specialised retraining. Special programs can be established for people who require basic or vocational upskilling, and at risk of significant displacement.

155. Consider easing the legal and financial burden for firms to undertake technological upgrading, and make training related investments. Malaysia regularly assesses its business environment to improve the business climate and ease firms' ability to grow and create jobs. As such, it will be important to assess what constrains firms from adopting available technology which can reduce the use of low-skilled labour. Various public institutions are charged with helping firms improve their production processes, including technology adoption. Conditions which prevent firms from adopting technology can be eased such as constraints on access to private capital. Efforts can also focus on ensuring that the workforce is properly trained to manage new technologies. Existing SME programs, such as tax incentives for automation, can be enhanced. Programs which provide access to advisory support can be targeted to firms in sectors where labour-saving technology is available.

Overarching Principle: Continue filling knowledge gaps to guide the reform process.

156. Consider investing resources to fill knowledge gaps while reforming the immigration system, and evaluating effectiveness in the medium-and-long term. Immigration systems involve many actors and the impact of reforms is not

always clear. To successfully address the inefficiencies in the immigration system, important questions—analytical and practical—will have to be tackled. As previously mentioned, many of the policy options and actions outlined in this document have been presented by international experts in the past, are currently being considered, are in the planning stage, or are slowly getting underway. Previous work in the Migration Lab of 2010, a previous World Bank report in 2013, and in follow-up assessments done by various institutions and Ministries have proposed recommendations which align with those presented here. Still many questions remain, and merit further research in order to build on these recommendations and to enhance their implementation. Some examples are listed here: 1) what are the impacts of immigration on firm productivity? What is the relation between the availability of low-skilled labour and technological upgrading? 2) What is the effect of immigrant labour on welfare? In addition to investigating the important questions that remain unanswered, consider monitoring and evaluating the effectiveness of initiatives and reforms undertaken so that lessons learned can guide improvements.

157. Consider establishing a new or expanding the mandate of an existing inter-agency working group to comprehensively assess the effectiveness of the reform process. This inter-agency working group can identify knowledge and capacity gaps which have to be filled to increase the success of the reform process. The group can commission studies and request technical assistance from experts to increase the likelihood of success of all initiatives undertaken. The group can ensure that the lessons from the studies and assessments are incorporated into the practices of the agencies involved.

Section	Offense	Penalty
55B	Employing a person who is not in possession of a valid pass ⁷⁰	Not less than RM10,000 (USD 3,092) or imprisonment not more than 12 months or both for each such employee
	Employing more than 5 persons who are not in possession of a valid pass	Not less than RM10,000 (USD3,092) or imprisonment not less than 6 months but not more than 12 months and liable to whipping of not more than 6 strokes
55E	Permitting irregular immigrant to enter or remain at premises	Not less than RM5,000 (USD1,546) and not more than RM30,000 (USD 9,277) or imprisonment not more than 12 months or both for each illegal immigrant found at the premises
56 (1)(d)	Harbouring any person whom he knows or has reasonable grounds for believing to have acted in contravention of Immigration Act 1959/63	Not more than RM10,000 (USD3,092) or imprisonment

Table 7: Historical Overview of Malaysia's MOUs

Year	Event
1984	Medan Agreement with Indonesia – for agri-plantation and domestic workers. Signing of the MOU between Malaysia and the Philippines – for domestic workers
1985-86	Permission given for employers to recruit workers from Bangladesh and Thailand for the plantation and construction sectors; Signing of MOU between Malaysia and the Philippines for Domestic Workers
1987	Legalized the use of Indonesian workers in the plantation sector.
Jun 1992 Jul 1992	Permission given for employers to recruit workers from Indonesia, Thailand, Philippines, Bangladesh and Pakistan for manufacturing and services sectors.
Apr 1993-Jan 94	Ban on unskilled worker recruitment. Ban lifted for manufacturing sector. Ban re-implemented on unskilled and semi-skilled workers for all sectors.
Feb 1999 Oct 1999	New hiring's of mostly Indonesian workers. Recruitment of Sri Lankans in the manufacturing sector.
May 2001	Ban on Intake of Bangladeshi workers
2002	Ban on new recruitment of Indonesian workers in all sectors, except for domestic services. Increase in the number of source countries to reduce dependency on Indonesian workers. Recruitment of Cambodians in the agriculture, plantation, manufacturing and construction sectors.
Jan 2003 Apr 2003	Restrictions lifted on Indonesian workers in the manufacturing and construction sectors. Freeze on hiring of migrant workers from SARS related countries.
August 2003	MOU with Sri Lanka
September 2003	MOU with China
October 2003	MOUs with Thailand, and Bangladesh
December 2003	MOU with Vietnam
May 2004	MOU with Indonesia
March 2005	MOU with Pakistan
November 2006	MOU with Indonesia
October 2007	Ban on intake of new Bangladeshi workers
May 2010	Signing of a Letter of Intent between Indonesia and Malaysia
Nov 2010	Stopped renewal of work permits for Bangladeshi migrants.
2012	G2G with Bangladesh signed

Annex 2: Estimating the causal Impact of Immigration on Economic and Social Outcomes

Proper econometric analysis aims to separate the pull and push factors to identify the effects of immigration on labour market and social outcomes in destination countries. In statistical terms, it is crucial to separate correlation from causation. The analysis relies on the use of standard econometric techniques such as regression analysis and instrumental variables in order to isolate the effect of immigration from other factors that could also affect the economic and social outcomes of interest, such as wages, employment and crime.

This box explains the exact estimation process used for analysing the impact on key variables. The worker estimation regresses the relevant economic variable, (which will be denoted as y_{it} for simplicity) on the immigration level (denoted as m_{it}) as well as a range of additional explanatory variables (denoted as x_{it}). In this context, i denotes the state in Malaysia and t denotes the year. The variables that are of interest are: employment, unemployment, labour force participation, wages and crime. The range of explanatory variables would normally include various years, and state specific economic and social indicators. However, the richness of the data permits the use of various fixed effects to control for all of these additional factors, including other potential variables for which there are no data. This method allows us to focus on the impact of migration (in state i in year t) on the labour market and social variables listed earlier. The simplest regression equation can be written as:

$$y_{it} = \alpha m_{it} + \beta x_{it} + \varepsilon_{it}$$

where α is the main coefficient of interest and ε is the error term.

The econometric specification above has some drawbacks because it cannot properly isolate how the presence of foreign workers influences labour market outcomes, as opposed to how labour market conditions affect migration decisions of foreign workers. The proper method to address issues of causality (endogeneity) is to perform an instrumental variables regression where the migration variable (m_{it}) is first regressed on factors that are exogenous to unaccounted factors affecting the labour market (z_{it}). These factors are constructed from additional data sources and are based on the demographic data from sending countries as well as time invariant region-specific labour demand levels in Malaysia. These variables, in essence, capture the push factors discussed earlier. This is done in stages. Once this first stage is completed, the regression above is performed on a modified migration variable (m^*_{it}) that is stripped off other effects and is thus able to capture the net effect of migration on labour market and social outcomes.

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