

## Low-Skilled Foreign Workers<sup>1</sup> Distortions to the Economy

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### Introduction

A prerequisite to achieving a high income and developed nation is the progression to a ‘high-productivity, high-income’ workforce. Fundamentally, Malaysia would benefit from a clear shift away from an economy that is input-based and dependent on cost suppression as a source of competitive strength, to one that competes on the quality of its labour force, technical skills and product offerings. Such a shift requires the implementation of well-aligned, coordinated and consistent public policies. These policies encompass talent development, research and development, and industrial upgrading initiatives. Importantly, these policies need to be coherent, well-communicated and mutually-reinforcing.

The vision is for Malaysia to become an economy with the know-how and competitiveness to produce sophisticated goods and services that can command a market premium. Currently, while Malaysia has made progress on several fronts, there remains a broad reliance on low-cost production models that lean on low-skilled labour while keeping a lid on wages to maintain business margins. The relative ease of obtaining low-skilled foreign workers in Malaysia contributes to these tendencies.

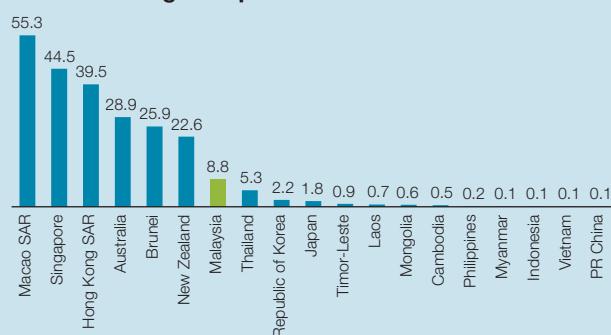
The purpose of this article is to highlight the costs of unchecked dependence on low-skilled foreign workers and how they weigh on Malaysia’s efforts to raise productivity and create higher-skilled and better-paying jobs. Several policy thrusts are highlighted to build on the progress that has been made and to ensure policy alignment with Malaysia’s long-term economic objectives.

### History and Context

Malaysia’s economy has long benefited from a supportive immigration stance. Malaysia is among the countries with a high ratio of migrants to total population in Asia Pacific (Chart 1). However, most of the migrants in Malaysia have low education attainment. Only 5.2%<sup>2</sup> of them are tertiary educated. In contrast, other economies like Australia, Singapore and Hong Kong SAR have intentionally planned to attract more skilled migrants<sup>3</sup>.

Chart 1: Share of Total Migrants to Population (%)

**Malaysia's migrant to population ratio is higher than most of its regional peers**



Source: Conference Board, United Nations, CEIC, CIA 'The World Factbook'

<sup>1</sup> This refers to the workers who are employed under the Visitor Pass (Temporary Employment). The term ‘foreigners’ used in this article refers to the ‘non-citizens’ obtained from the Labour Force Survey.

<sup>2</sup> Refers to non-citizen employed persons in Malaysia (2016 Labour Force Survey, DOSM).

<sup>3</sup> 8.8% of non-citizens working in Malaysia are high-skilled. The corresponding share for Singapore, Hong Kong SAR and Australia is 14.0%, 11.6% and 58.5% respectively.

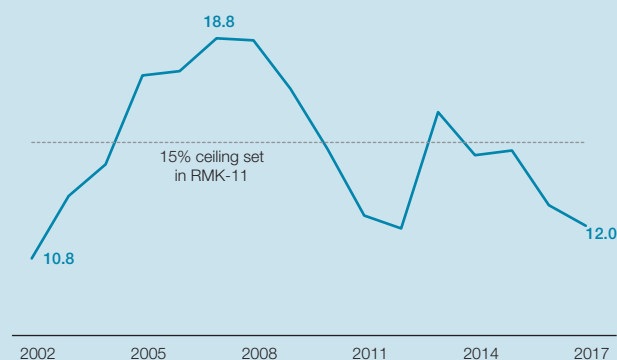
In the 1970s, foreign workers in Malaysia were mostly employed in the rural plantation and construction sectors in small numbers to meet seasonal demand. The rapid industrialisation and economic growth in the 1980s transformed a situation characterised by high unemployment in the mid-1980s to full employment by the early 1990s, with widespread labour and skill shortages, and rising wages<sup>4</sup>. This attracted both documented and undocumented foreign workers in large numbers. These workers eased production pressures and were compatible with the low value-added production of Malaysia then. However, what was initially conceived as a transitional support<sup>5</sup> to alleviate production constraints and enable firms to move up the value chain has become a more entrenched feature of the Malaysian economy.

The share of documented foreign workers to labour force rose sharply from 10.8% in 2002 to a peak of 18.8% in 2007 (Chart 2). It was only within the past four years that the numbers have trended downwards since 2013, although amid strong industry pushback. Foreigners hold more than a fifth of the jobs in the agriculture, construction and manufacturing sectors (Chart 3).

While this served Malaysia well previously, the transition to a high-income economy requires a major shift from labour-intensive business models to those that are driven greatly by productivity gains, technological edge and sophisticated technical know-how. The ease and availability of these low-skilled workers at a cheap cost create deep distortions that disincentivises firms to transform.

Chart 2: Share of Documented Foreign Workers (% of labour force)

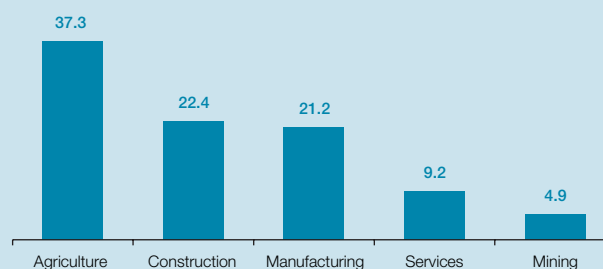
**Foreign worker share of labour force has trended downwards of late**



Source: Ministry of Home Affairs (MOHA), Department of Statistics Malaysia (DOSM)

Chart 3: Share of Foreigners\* to Employment by Sector, 2016 (%)

**Foreigners take up more than a fifth of employment in the agriculture, construction and manufacturing sectors**



\*Refers to non-citizens in the Labour Force Survey Report 2016

Source: Department of Statistics, Malaysia

## The Macroeconomic Costs of Foreign Workers

Critically, the readily available pool of cheaper low-skilled foreign workers distorts domestic factor prices, and thus discourages industrial upgrading. It makes labour relatively cheap when compared to capital, and thus weakens incentives for firms to substitute labour for technology, or for greater value adding activities from employment of higher-skilled labour. While grants and incentives for automation and technology adoption are helpful, they are by themselves insufficient to create the necessary push for firms to move up the value-chain. Since 2008, around RM8 billion has already been allocated by the Government to assist with technology adoption and commercialisation efforts.

Observations from other advanced and emerging Asian economies are illustrative of this point. While public sector support for automation and talent policies are common, the drive for more efficient and sophisticated capabilities is often accompanied by pressures of rising costs, some of which are policy induced. These factors motivated the initial wave of Japanese investments into other parts of Asia in the 1980s<sup>6</sup> and the more recent ones from PR China to Vietnam. While this was done to take advantage of the cheaper labour and land in the recipient countries,

<sup>4</sup> Kanapathy, V. 2001. International Migration and Labour Market Adjustments in Malaysia: The Role of Foreign Labour Policies.

<sup>5</sup> Carpio, X. et.al 2015. Foreign Workers in Malaysia: Labour Market and Firm-Level Analysis.

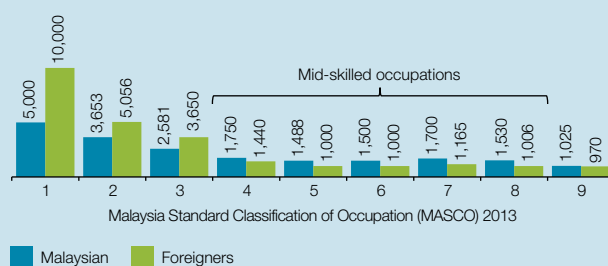
<sup>6</sup> Sheng, A. 2009. From Asian to Global Financial Crisis: An Asian Regulator's View of Unfettered Finance in the 1990s and 2000s.

the remaining business segments in both Japan and PR China were compelled to undergo sharp productivity increases and industrial upgrading to remain competitive.

Malaysia's transition to a high-income and developed nation is at risk, as long as firms are still engaged on a 'race to the bottom' in relation to labour costs and are unwilling to pay more, despite commensurable productivity gains had they adjusted. Employment of cheaper foreign workers vis-à-vis locals allows employers to keep wages low and in doing so, obviates the pressure to change the status quo. This distorts the natural wage clearing mechanisms that would have otherwise driven wages upwards. Studies<sup>7</sup> have pointed to some forms of depression on overall wages, and particularly on wages of low-skilled locals. Median wages of foreign workers are generally lower than those of locals (Chart 4), especially in mid-skilled occupations where 60.8% of locals are employed. It is entirely plausible that the very high presence of foreign workers in the private sector could widen wage differentials and deter job creation for locals. This is most evident in the Gulf Cooperation Council economies where 88% of private-sector jobs created from 2000-2010 were taken by foreign workers, of which 85% of them were low-skilled<sup>8</sup>.

Chart 4: Median Monthly Salary of Firms\* by Occupations\* and Nationality, RM

**Employment of low wage foreign workers allow employers to keep salaries low**



\*High-skilled workers: Occupations Classification 1 to 3; Midskilled: 4 to 8; Low-skilled: 9

Note: 1. Managers; 2. Professionals; 3. Technicians and associate professionals; 4. Clerical support workers; 5. Service and sales workers; 6. Skilled agricultural, forestry, livestock and fishery workers; 7. Craft and related trade workers; 8. Plant and machine operators and assemblers; 9. Elementary occupations

Source: National Employment Returns 2016

Much has been said about the reluctance of local workers in undertaking 'dirty, dangerous and difficult' (3D) jobs. While cultural factors and the inherent nature of the work do play a role in deterring local involvement, it may also be argued that it is partly due to local wage conditions. Of the approximate 200,000 daily commuters from Malaysia to Singapore, it was found that 40% were working in mid- to low-skilled jobs, motivated mainly by higher wages<sup>9</sup>. This includes occupations that are often avoided in Malaysia such as plant and machine operators and assemblers, cleaners and labourers. In other words, at a more attractive level of wages, Malaysian workers would not shun 3D jobs.

While this is a limited example, it does suggest that current wages in Malaysia may be too low to attract local workers. Employers may also be reluctant to increase them due to the presence and abundance of cheaper alternatives. In the same vein, so long as blue-collar wages continue to face downward pressures, employers will not be hard pressed to adopt productivity-enhancing measures. Consequently, Malaysia risks being trapped in a low-wage, low-skill conundrum.

This can be observed through the share of job creation by skills from 2011 to 2017. When taken with other factors, Malaysia's share of low-skilled job creation has increased to 16% from 8% in 2002 to 2010 (Chart 5). In fact, 73% of net jobs created in 2015 to 2016 went to foreigners (Chart 6), of which almost all of them had at most a secondary education.

<sup>7</sup> World Bank 2015. Malaysia Economic Monitor: Immigrant Labour; Athukorala, P. et.al 2012. 'The Impact of Foreign Labor on Host Country Wages: The Experience of a Southern Host, Malaysia'; Ismail, R. et.al 2014. The Impact of Foreign Workers on Wages: A Case Study of Malaysian Firms.

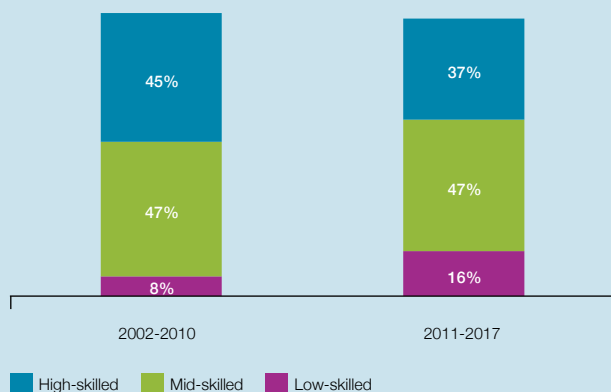
<sup>8</sup> International Monetary Fund (IMF) 2016. Economic Diversification in Oil-Exporting Arab Countries.

<sup>9</sup> Institute of Labour Market Information and Analysis 2017. A Study on Malaysians Working in Singapore.

On the other hand, the number of graduates in Malaysia increased by around 880,000 persons over the similar period, but with a corresponding high-skilled job creation of only 650,000 persons. This translates into increasing graduate unemployment from 2011 to 2016, outstripping that of non-graduates (Chart 7).

Chart 5: Share of Job Creation\* by Skill Level

**An increasing share of net job creation is taken up by low-skilled workers in recent periods**

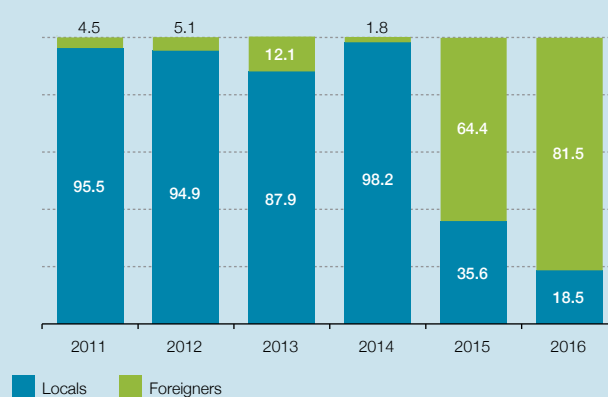


\*Defined as net change in employment

Source: Department of Statistics, Malaysia and Bank Negara Malaysia's estimates

Chart 6: Share of Job Creation\* by Citizenship (%)

**In the past two years, a large share of net jobs created went to foreigners**



\*Defined as net change in employment

Source: Bank Negara Malaysia's estimates using Department of Statistics, Malaysia's data

Chart 7: Unemployment Rate of Graduates and Non-graduates (%)

**Graduate unemployment has increased more sharply since 2011**



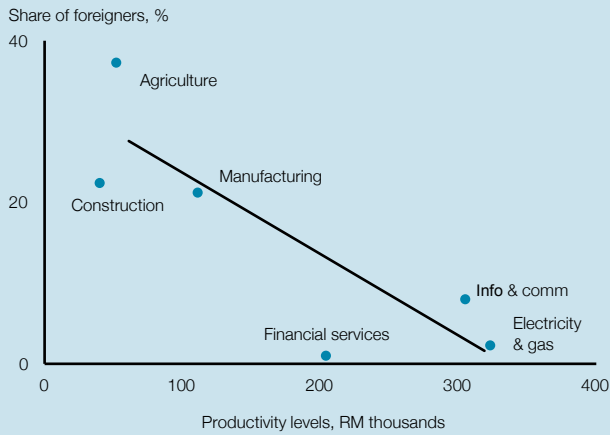
Source: Department of Statistics, Malaysia and Bank Negara Malaysia's estimates

It is also observed that industries with low productivity have a high share of low-skilled foreign workers (Chart 8), with a greater reliance on longer working hours to produce output. One study<sup>10</sup> found that South Korea increased real GDP per hour from USD4.7 in 1980 to USD25.4 in 2010, while Malaysia only registered an increase to USD7.1 in 2010 from USD5.3 in 2000. South Korea did this while reducing average weekly working hours from 49 hours to 44 hours from 2000 to 2008, while Malaysia's held steady at 49 hours. Malaysia's labour-intensive methods and longer working hours are clearly less efficient than those obtained through technological advancement and automation. This is seen through the gap between Malaysia and Asia's average usage of industrial manufacturing robots (Chart 9).

<sup>10</sup> Rasiah, R. et.al 2015. Industrialization and labour in Malaysia.

Chart 8: Productivity and Share of Foreigners<sup>11</sup> by Industries

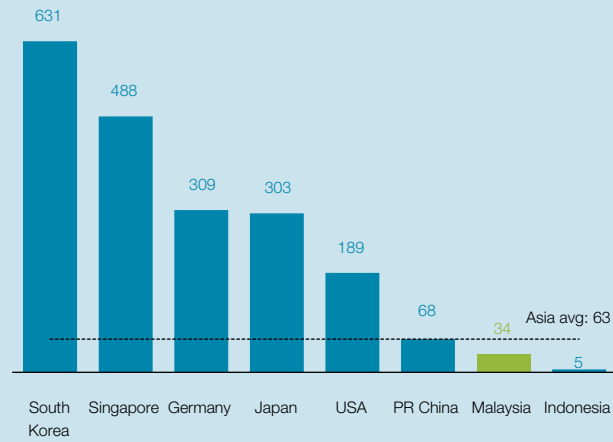
**Productivity of industries negatively correlates with share of foreigners**



Source: Department of Statistics, Malaysia and Bank Negara Malaysia's estimates

Chart 9: Robot Density\* in the Manufacturing sector (2016)

**Malaysia's robot density is below the Asian average**



\*Number of robots per 10,000 employees

Source: International Federation of Robotics

This raises an important point. With the advent of global value chains (GVCs) and the disruptive nature of technologies, two things are likely to unfold. First, competition on the low value-added and labour-intensive segments is likely to increase as more countries plug into the GVCs. Second, the fast-changing nature of technology cycles coupled with declining prices would provide more opportunities for others to leap frog and rapidly close the progress gap. In the past decade, labour costs in Asia have increased by 10% to 15%<sup>12</sup>, leading to a convergence of labour and automation costs. Every year, the amount of time it takes for a firm's investment in robots to pay off (known as the "payback period") is narrowing sharply<sup>13</sup>. Malaysia's competitors are also actively embarking on industrial upgrading. Reliance on low-wage, low-cost production methods is an untenable long-term strategy with risks of Malaysia being left behind.

Malaysia's dependence on low-skilled foreign workers adversely shapes its reputation as a labour-intensive and low-cost destination to foreign investors. Increasingly, this affects the type of initial investments that foreign investors propose to bring to Malaysia. They are likely the less complex segments of their production chain, with many seeking to primarily leverage Malaysia's relative ease of hiring foreign workers and lower labour costs. This results in foreign multinationals relocating lower value-added processes to Malaysia, while moving higher productivity and value-added processes to neighbouring economies such as Singapore and PR China. In the end, this self-reinforcing image further locks Malaysia into this low-cost bind that would require significant resources to undo. This also worsens the displacement of local talent migrating to higher-paying employment countries, culminating in a brain-drain for Malaysia.

While the hiring of more low-skilled foreign workers does create demand for local workers in mid-skilled and supervisory jobs, it is arguable as to whether this is the most desired route in achieving that outcome. Automation and the adoption of more sophisticated technologies also create their own demand for higher-skilled workers. These positions usually come with better wages and can be filled by retrained unemployed graduates.

There are also several non-economic implications that must be considered. Over-concentration of migrant workers in urban areas may pose a strain on public amenities and infrastructure as well as resulting in additional fiscal costs

<sup>11</sup> Refers to non-citizens from the Labour Force Survey (LFS) 2016. While this figure also captures high-skilled migrants, 94.6% of non-citizens have at most a secondary education, making it a useful proxy for low-skilled foreign workers. The LFS would also capture information on both documented and undocumented workers. One limitation, however, is that the LFS does not capture information of workers who are living in communal housing, which may lead to an underestimation of workers in the agriculture and plantation industries. In contrast, the data by the Ministry of Home Affairs on the number of workers with Visitor Pass (Temporary Employment) only measures the number of documented foreign workers.

<sup>12</sup> RBC Global Asset Management. Global Megatrends: Automation In Emerging Markets.

<sup>13</sup> Sirkin H. et.al 2015. The Robotics Revolution: The Next Great Leap in Manufacturing.

to governments. Many also remit a significant share of their income abroad, thus reducing domestic spillovers in the domestic economy. Total outward remittances in 2017 remain sizeable at RM35.3 billion, of which the bulk was accounted for by foreign workers.

More pressing and worrying is the presence of many undocumented migrants in Malaysia. Estimates of their numbers vary greatly<sup>14</sup>. This impedes policy discussions and underestimates the full-impact of their employment on the Malaysian economy at large. Also, undocumented migrants who avoid compulsory health screening can potentially be a source of communicable diseases<sup>15</sup>.

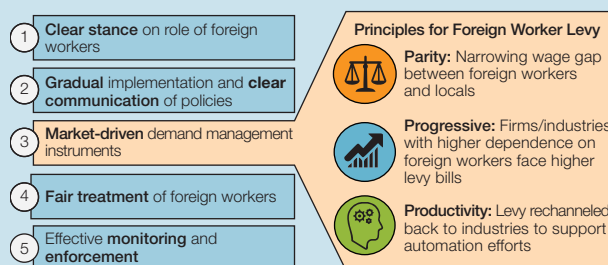
## Policy Changes

Malaysia's efforts to reign in its dependence on foreign workers began in the early 2000s with the 8<sup>th</sup> Malaysia Plan. While it may not be easy, the challenge at hand is not insurmountable. Since the 11<sup>th</sup> Malaysia Plan, there has been greater clarity and a renewed focus to resolve the issue at hand. This has resulted in the steady decline in the share of documented foreign workers from 16.1% in 2013 to 12.0% of labour force in 2017.

Going forward, more can be done to build on the progress made. The end objective is to ensure that the future foreign worker management system in Malaysia is clearly articulated, firmly implemented, and more aligned to Malaysia's economic objectives. To this end, there are five key points that are worth pursuing (Chart 10).

Chart 10: Comprehensive 5-point Action Plan

### Approach to Managing Foreign Workers:



Source: Bank Negara Malaysia

Firstly, there needs to be a clear stance on the role of low-skilled foreign workers in Malaysia's economic narrative. While these workers will continue to play an important role in supporting the Malaysian economy, there needs to be clarity as to where foreign workers are most needed and the manner in which they can be best engaged to support productivity growth and industrial upgrading. This includes clearly identified timelines for policy changes or the ease to obtaining up-to-date information on the existing framework. More importantly, policies on this front must be done in sync with other Government initiatives, be they talent development, labour market reforms, or enhancement to the existing incentives structure for attracting foreign direct investments (FDI).

Secondly, policy implementation and changes need to be gradual and clearly communicated to the industry. While reforms on foreign worker policies are necessary for Malaysia's long-term benefit, it will undoubtedly result in short-term adjustments to the economy. This will naturally result in industry pushback and eventually, the relocation of labour-intensive and low value-added goods and services production to other countries with abundant and cheaper labour. This will free up the requisite talent and fiscal resources to be redirected to more productive and complex industries. Most critically, it will allow affected industries and workers to prepare ahead for the incoming changes. This reduces the risks of policy reversals and aids policymakers in managing this delicate transition.

<sup>14</sup> Figures vary from official estimates of 600,000 persons by Jabatan Imigresen (2017) to alternative sources such as the 1.3 million undocumented workers registered under the 6P programme in 2013 (excluding East Malaysia and unregistered foreign workers) and 1.7 million persons indicated by the Malaysian Employers Federation (MEF) in 2017.

<sup>15</sup> Kanapathy, V. 2004. International Migration and Labour Market Adjustments in Malaysia: Economic Recovery, The Labour Market, and Migrant Workers in Malaysia.

Frequent policy reversals have complicated enforcement and increased business uncertainties. One example involves the several changes to the rules in foreign worker levy with regards to the party who should bear the cost – whether the employers or the workers themselves. Since the introduction of the levy in 1992, Malaysia has changed its stance on the matter three times within the last 10 years. The recent re-imposition of the levy on employers through the Employers Undertaking (effective 1 January 2018) is a step in right direction. This is in line with the Government's objective to develop a more effective means to manage demand for foreign labour and to encourage productivity gains among firms. Imposing the levy on workers does little in contributing to this outcome.

Thirdly, existing demand-management tools (such as quotas, dependency ceilings and levies) can be reformed to be more market-driven, while incentivising the outcomes that are in line with Malaysia's economic objectives. These tools should respond to evidenced-based labour and skills shortages as per Australia and Canada that rely on a mix of metrics to inform the recalibration of their immigration policies. Some foreign worker measures, such as the existing dependency ceilings, are argued to be either arbitrary, not sufficiently binding or simply hard to implement and enforce (Table 1).

Table 1

#### Selected Dependency Ceiling\* by Industries

Industry	Quota determinants	Determinants	No. of foreign workers
Restaurants	Number of chairs	70-139 chairs	11 kitchen assistants, 12 helpers
		140-250 chairs	12 kitchen assistants, 20 helpers
		> 250 chairs	20 kitchen assistants, 30 helpers
Agriculture	Hectares	Oil palm: 8 hectares	1
		Rubber: 4 hectares	1
		Cocoa: 3.7 hectares	1

\*Sets the upper limit for foreign worker intake by industry

Source: Ministry of Home Affairs (MOHA)

Reforms on the existing levy system can help disincentivise low-cost operations and prod firms to reduce dependence on foreign workers over time. There are three ways in which reforms can do so. The first would involve narrowing the wage per hour gap between local and foreign workers, arising from statutory exemptions. Internal estimates suggest that the average cost of hiring foreign workers on a per hourly basis is 30% lower than that of a local. While the upfront costs (e.g. compulsory medical check-ups, travel) of hiring the former may appear sizeable, it is important to note that these workers are usually subjected to longer working hours and that they do not enjoy the usual statutory benefits (e.g. Employer's EPF and SOCSO contributions) that locals do. In effect, the lower cost structure increases the appeal of foreign workers to employers over locals. Embedding the statutory costs in the levy calculations will help reduce this gap towards parity.

This can then be followed by making the levy system more progressive, so that industries or firms that are more dependent on foreign workers will face a higher total levy cost. The calculations can be made more nuanced, factoring the automation possibilities, wage growth and productivity improvements of each industry. The upcoming implementation of the multi-tiered levy in 2019 is a welcomed development, as it allows for a more differentiated deterrent mechanism depending on the firms' workforce profile. In line with best practices, the levy that is collected should be rechannelled back to the industry to support automation efforts.

Fourthly, there is room to ensure better treatment of foreign workers, be it improvements in working conditions or ensuring that foreign workers are paid as agreed. The questionable living and working conditions of foreign workers in certain industries do not merely raise concerns on workers' welfare but are symptomatic of the unhealthy business drive of certain unscrupulous employers to improve cost competitiveness. There are ongoing efforts by the Government to broaden the enforcement of minimum housing and amenities standards, from workers in the mining

and estate industries to all relevant sectors. Additionally, the 2018 Budget announcement to ensure payment of foreign workers' salary through bank accounts will better leverage technology to prevent employers from withholding wages or make unfair deductions from their salaries.

Lastly, it is also important to note that these proposed reforms must be complemented with effective monitoring and enforcement on the ground, particularly with respect to undocumented foreign workers. Without addressing this challenge, any additional tightening in foreign worker policies will only penalise law-abiding employers. It may also lead to greater risks of corruption and employers circumventing existing regulations by resorting to the available pool of undocumented foreign workers.

## Conclusion

While Malaysia has clearly benefitted from the presence of foreign workers in the past, the role that foreign workers play in the Malaysian economy must keep up with the times. Future foreign worker management policies, if poorly designed and inconsistently applied, will only detract from the progress that has been made to gradually wean Malaysia's dependence on foreign workers.

A high-dependence on them, if left unabated, will weaken the case for automation, suppress overall wages, and deter adoption of productivity-enhancing efforts. It will also hinder the creation of high-skilled jobs and adversely shapes Malaysia's reputation as a low-skilled, labour-intensive investment destination. When taken together, these factors trap Malaysia in a low-wage, low-productivity bind. The prevalence of large segments of undocumented workers in Malaysia compound the socio-economic costs.

While this challenge may seem daunting, critical reforms are very much within Malaysia's reach. Clear communication and firm implementation will help reduce the risks of policy reversals, and will aid Malaysia's transition into a high-income economy. If history were to serve as a guide, Malaysia's current economic strength is a result of bold reforms taken at the most critical junctures. Malaysia should seize the opportunity now to set itself on a more productive, sophisticated and sustainable economic growth path going forward.

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