BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

www.bnm.gov.my

Staff Insights 2017/12

Rethinking Investment Incentives

By Mohd Shazwan Shuhaimen, Nurul Hana Ahmad Ghazali, Kevin Wong Tho Foo, Loke Po Ling and Sarah Syamimi Mohd Suhaimi

Economics Department and
Foreign Exchange Administration Department

November 2017

The purpose of this paper is to assess the benefits and costs of foreign direct investment (FDI) and the effectiveness of the current investment incentives framework in attracting investments. The article also discusses potential areas for reforms that would enhance positive economic spillovers from FDI.

Bank Negara Malaysia's Staff Insights provide preliminary analysis on topical issues. Any views expressed within are solely those of the author(s) and do not necessarily reflect the position of Bank Negara Malaysia.

Rethinking Investment Incentives

Highlights

- While FDI was a game-changer in transforming the Malaysian economy in the past, there is mounting evidence that the net benefits have been narrowing in recent periods.
- The total cost of incentives used to attract FDI has been significant, and there are indications its effectiveness is waning.
- There is room to improve the existing investment incentives framework and landscape such that Malaysia continues to attract quality investments with greater economic spillovers going forward.

Introduction

Malaysia's longstanding appeal as a preferred destination for foreign direct investment (FDI) has been supported by a conducive investment climate, modern infrastructure and attractive incentives. While these investments have benefited the economy in the past, there is growing evidence to suggest that the net benefits have plateaued in recent years amid substantial costs to attract them in an increasingly competitive environment. The diminishing net benefits, together with a changing global environment necessitates a rethink of the investments that would safeguard Malaysia's future-readiness, and the incentives designed to attract these investments. This article assesses the benefits and costs of FDI and the effectiveness of the current investment incentives framework in attracting investments. The article also discusses potential areas for reforms that would enhance positive economic spillovers from FDI.

[1] A 'foreign affiliate' is defined as an enterprise operating in Malaysia with more than 50% of its equity owned by a foreign company. This concept differs from the Fifth Edition of the Balance of Payments Manual by the International Monetary Fund, which suggests a foreign equity ownership of at least 10% to be defined as FDI.

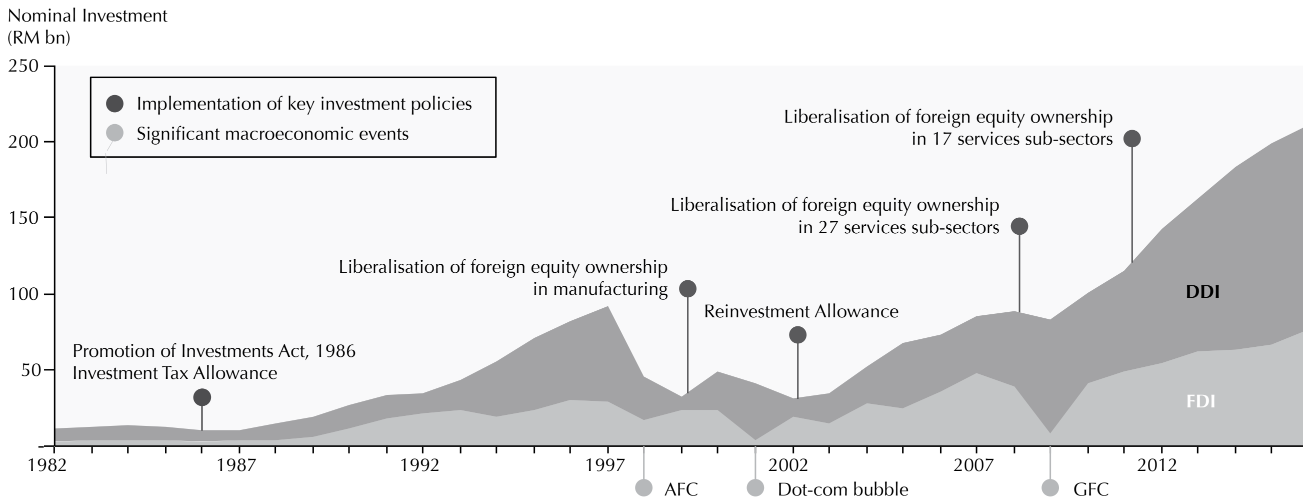
Overview of FDI in Malaysia

Investment is a key driver in expanding productive capacity for the sustainable future growth of the economy. In Malaysia, investment activity has grown by almost tenfold over the last 35 years, with foreign affiliates[1] (hereby known as FDI) playing a large role in this achievement. Between 2010 and 2015, FDI accounted for almost 40% of nominal gross fixed capital formation.

While Malaysia has received FDI since the turn of the 20th century, the rapid industrialisation in the 1970-80s witnessed the influx of multinational corporations (MNCs) particularly in the manufacturing and mining sectors (Chart 1). Shaped by both external developments and domestic policies, such as the liberalisation of foreign equity ownership requirements in the services sector post-2008, FDI has become increasingly broad-based. There is now greater global presence in the services sector, mainly in the finance and insurance, wholesale and retail as well as transportation and communication sub-sectors (Chart 2). The presence of MNCs in the investment landscape reflects Malaysia's appeal as an attractive business destination, underpinned by pro-business policies, an educated workforce, well-developed infrastructure and an array of competitive investment incentives. In fact, Malaysia is one of the main profit centres for FDI in the region, with average returns[2] of 12.9% between 2010 and 2016 (Chart 3).

Chart 1

The Landscape of Investment in Malaysia and Policy Implementation



Note: DDI refers to investment by domestic private corporations

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

[2] Returns are measured by FDI investment income (comprising dividends, retained earnings and interest income) over the stock of outstanding FDI. For a detailed discussion on the divergence in the rate of returns between FDI and direct investment abroad by Malaysian corporations (DIA), please refer to the BNM Annual Report 2016 Box Article 'Payoffs from Going Global: Assessing the Returns from Malaysia's Direct Investment Abroad'.

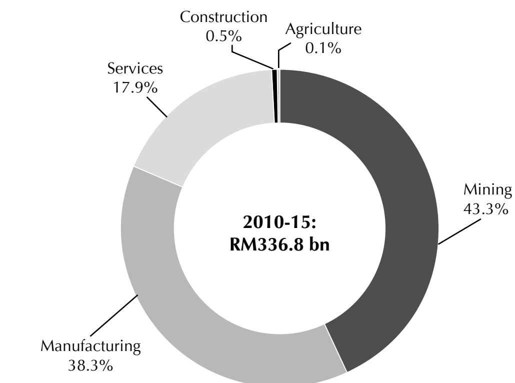
Assessing the benefits and costs of FDI

The presence of FDI was indeed a game-changer in transforming the Malaysian economy. FDI has been an important catalyst for manufactured exports, job creation and productivity. For example, the increase in FDI to 10.5% of GDP in the 1990s brought a corresponding rise in the share of manufactured exports (Chart 4). In 2015, exports generated by FDI firms amounted to RM290.2 billion or 35.5% of total exports of goods and services during the year. The rise in FDI has also been associated with greater employment opportunities, with FDI firms hiring about 848,000 workers or 5.8% of total employment in 2015 (Chart 5). Value added per worker in FDI firms is about three times higher than the national average (Chart 6).

In recent years, however, there is evidence that the net benefits have been narrowing. While FDI has helped create jobs in the economy, the dependency on foreign workers and inputs needs to be addressed. Estimates indicate that among FDI manufacturing firms, as a proportion of total employment, the hiring of locals has declined from 74% share in 2011 to 68% share in 2014 amid greater hiring of low-skilled foreign workers (Chart 7). High dependence on foreign workers erodes the benefits of FDI by substituting employment away from Malaysians and dampening wage growth, particularly affecting low-income earners (bottom 40% or B40 of households). In terms of intermediate input, growth of domestic value added in gross exports has stagnated relative to the regional economies (Chart 8). This indicates continued heavy dependence on imported inputs and foreign services (e.g. logistics), which reflects the slow development of deeper backward linkages and value creation among domestic suppliers and service providers. Further, the prevalence of labour-intensive production methods impedes adoption of technology, such as automation, and hence Malaysia's progress in moving up the production value chain. Technology transfer has plateaued, evidenced by the lower spending on R&D by the US MNCs in Malaysia relative to other countries in the region (Chart 9). The diminishing net benefits can also be observed at the firm level, based on a recent study

Chart 2

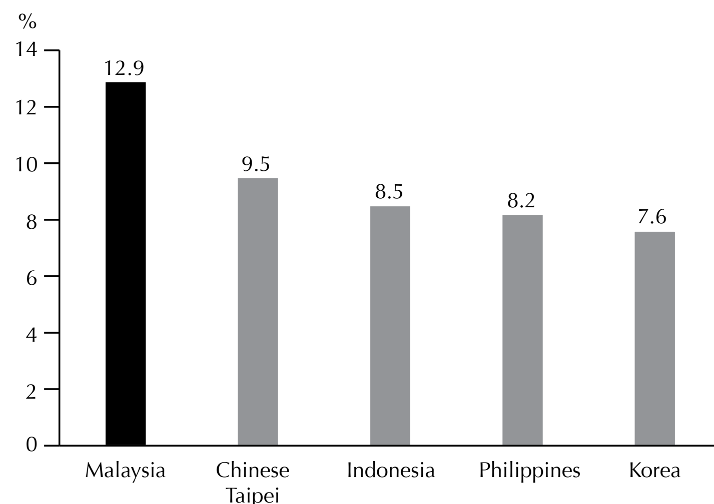
Gross Fixed Capital Formation of Foreign Affiliates (FDI) by Sector



Source: Department of Statistics, Malaysia

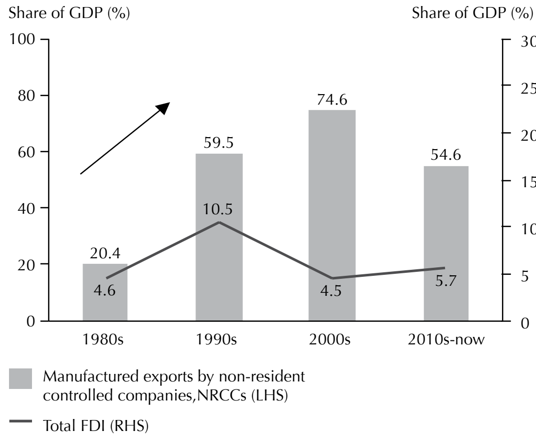
Chart 3

FDI Returns (Average: 2010-2016)



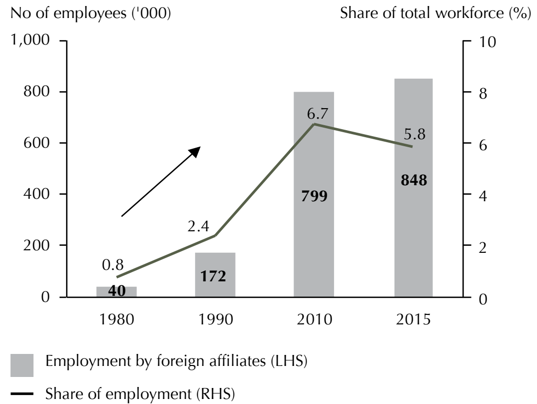
Source: Department of Statistics, Malaysia, Haver Analytics and Bank Negara Malaysia estimates

Chart 4: Manufactured Exports & FDI



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

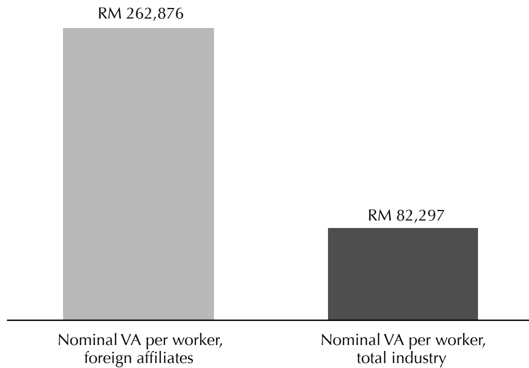
Chart 5: Employment by FDI Firms



Note: Employment by foreign affiliates was proxied for 1980 and 1990.

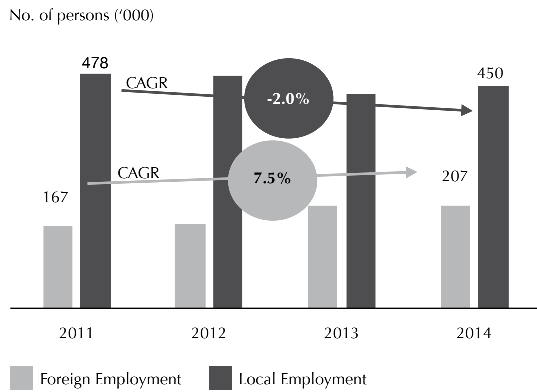
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 6: Labour Productivity: Value Added (VA) per worker (2015)



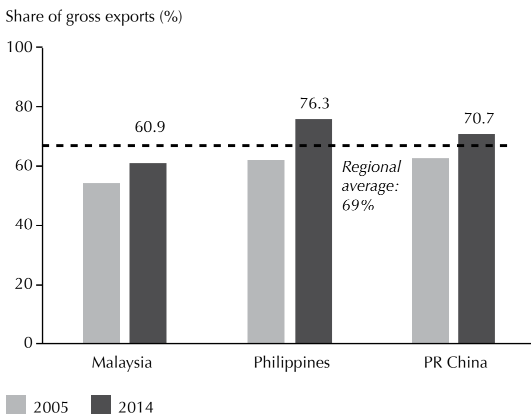
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 7: Employment in Manufacturing FDI Firms



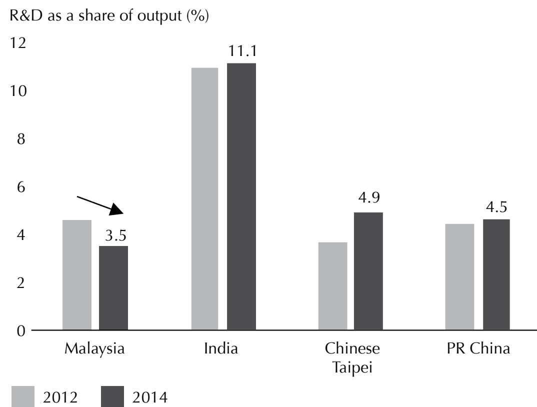
Source: Ministry of Home Affairs and Bank Negara Malaysia estimates

Chart 8: Domestic Content in Gross Exports, 2014 & 2010



Source: OECD

Chart 9: R&D Spending by US FDI Companies



Source: OECD

conducted by the Bank (Refer to Sub-Box: Case Study on Selected MNCs). Therefore, resulting distortions created by the continued heavy reliance on foreign inputs, including wage and price distortions, inhibit the efficient functioning of market mechanisms in the Malaysian economy.

There are also high costs associated with attracting investments. The Government has deployed numerous incentives to attract investments as well as to encourage certain desired economic spillovers and activities. In 2010-2015, FDI made up close to 60% of the value of manufacturing investments that were given incentives. These incentives are mainly in the form of corporate tax exemptions, tax allowances for capital expenditure and financial assistance such as training and R&D grants. As tax exemptions and allowances reduce the corporate tax paid by firms, the cost of such incentives is quantified in terms of tax foregone. Estimated by comparing the gross operating surpluses of corporates against the corporate tax revenue collected in the manufacturing sector, the cost of incentives ranged between RM10-15 billion annually over the past five years. This is equivalent to 0.8-1.3% of GDP or 6.0-8.9% of Government tax revenue.

Foreign firms have also benefitted from the liberal foreign exchange administration policies and prevailing regulations on foreign workers. Non-residents are free to invest in ringgit assets in Malaysia, and are also free to remit divestment proceeds, profits, dividends or any income arising from these investments. The Bank's estimates suggest that up to 60% of dividends declared by FDI firms have been repatriated to their home country and shareholders abroad. The resulting outflows are likely to be even higher if repatriations in other forms are incorporated, such as charges imposed by head office for inter-company lending, royalty payments and outsourcing arrangement fees.

The Bank's estimates also show that MNCs directly employ 7% of all registered foreign workers. While this is a small proportion relative to local firms, it does not take into account the induced hiring of foreign workers by the domestic suppliers and service providers that are supporting these MNCs. As a result, the overall reliance on foreign workers within the manufacturing sector has led to large remittance outflows which have doubled in the past 15 years.

Effectiveness of current incentives landscape

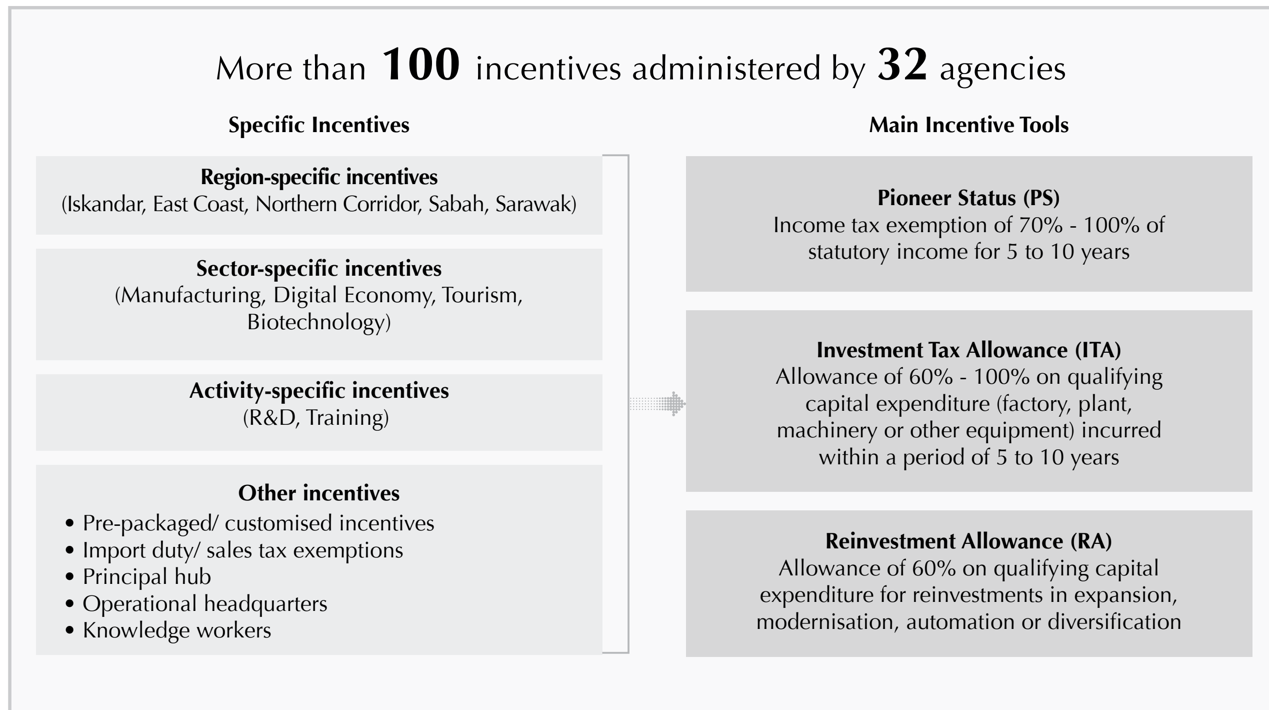
Malaysia presently offers more than 100 different types of incentives to promote investment in the economy. These are disbursed in three main forms: Pioneer Status, Investment Tax Allowance and Reinvestment Allowance. One long-established incentive is the Pioneer Status, which provides corporate tax exemption for selected activities and products as published in a 'promoted list' accompanying the Promotion of Investments Act 1986. The promoted list has since become a guidepost among Investment Promotion Agencies (IPAs) in attracting investments and offering of incentives through the fulfilment of stipulated conditions. However, given its broad scope as well as the fast-changing global environment, in its current form the list risks obsolescence and may not adequately account for new growth areas, evolving business models and activities with higher economic complexity[3].

The fragmented nature of Malaysia's investment promotion landscape is also an area that can be improved. There are presently a total of 32 IPAs operating at the national, regional and state levels, each with their own objectives and criteria in assessing prospective investments, approving incentives and monitoring the results of investments. Recognising these challenges, the Government has reaffirmed the role of the Malaysian Investment Development Authority (MIDA) as the sole agency responsible to manage investments and incentive approvals for the country as a whole. Given its vast expertise, MIDA should be entrusted and emancipated with autonomy and authority in respect of other IPAs, thereby improving coordination and consistency in the investment promotion framework, including the monitoring of economic spillovers from investments.

[3] Economic and Product Complexity Indices are as published in "The Atlas of Economic Complexity," Center for International Development at Harvard University, http://www.atlas.cid.harvard.edu. In this article, "higher economic complexity" refers to products with Product Complexity Index higher than Malaysia's 2015 Economic Complexity Index of 1.08.

Diagram 1

Fragmentation of Incentives Landscape

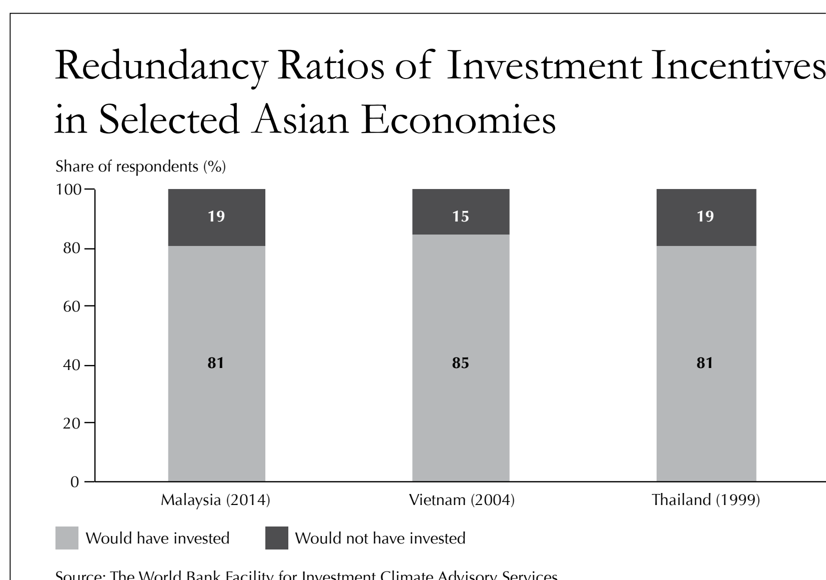


Source: MIDA, state, sectoral and regional investment promotion agencies (IPAs), PwC "Doing Business in Malaysia 2017"

At the same time, there is growing evidence to suggest that the effectiveness of the current incentive instruments in attracting FDI may be diminished by growing regional competition and reforms in the international regulatory environment. As countries compete against each to attract FDI, they tend to offer similar incentive packages. This gives MNCs the upper hand in negotiating for even more generous incentives, leading to a 'race to the bottom'. A study by the World Bank has shown that competition for investments through tax-based incentives leads to tax competition and downward pressure on tax rates among regional peers[4]. In a separate study by the World Bank, four out of five firms surveyed in Malaysia indicated they would have still invested even if incentives were not provided. Also referred to as the 'redundancy ratio', the proportion of investments that would have occurred without incentives is similarly high in the regional economies such as Thailand and Vietnam (Chart 10). Nevertheless, the study on Malaysia, which covers about 200 firms, would yield greater insights from wider sampling and more granular firm-level indicators. Furthermore, practical experience suggests that for certain industries, the competition for FDI among countries is fierce and in a number of instances, the attractiveness of incentives offered could be the deciding factor in locating investments. On a wider scale, growing awareness of base erosion and profit shifting (BEPS) places greater international scrutiny on investment incentives, with the objective of discouraging potential harmful tax practices globally.

[4] World Bank, 2015; Klemm and Van Parys, 2012.

Chart 10



Policy considerations on rethinking the investment incentives framework

The highly-dynamic global environment and emergence of global trends such as technological disruptions, rapid urbanisation and climate change necessitate a rethink of the existing investments that would prepare the Malaysian economy for the future. In particular, prospective investments should exhibit desirable characteristics that would raise overall economic complexity, create high-value jobs, deepen linkages within the domestic supply chain and create new industrial clusters. These positive spillovers should be monitored comprehensively and reported on a timely basis.

A principles-based approach would ensure a more nimble and flexible evaluation of such characteristics in prospective investments, compared to a relatively static promoted list. Principles, which may be used to assess the quality of prospective investments include, among others, investments that are 'innovation and productivity driven', generates 'quality employment' and exhibit 'high economic complexity'. In this instance, only investments that adhere to these principles would be considered for incentives. The incentives should also be time-bound and tied to performance- and outcome-based indicators, such as R&D and technological intensity, creation of skilled jobs and ranking on the Product Complexity Index (see footnote 3).

In this regard, MIDA has implemented a new cost-benefit analysis (CBA) module in the evaluation of prospective manufacturing projects. The new CBA module is more holistic as it takes into account both the quantitative and qualitative cost and benefit aspects of the investment proposal and is benchmarked against international best practices. This provides for a more comprehensive and realistic assessment of the investment's intended benefit to the economy, thereby enhancing the incentives evaluation process to become more effective and performance-driven. MIDA is also in the process of designing a new generation of the promoted list. The new list would align promotional efforts of IPAs to attract investments in new and emerging economic activities, encourage an ecosystem approach by developing the supply chain and supporting clusters within each industry as well as provide greater clarity among investors.

There is further scope to review the type of instruments through which incentives are disbursed to ensure that benefits from investments materialise. A recent study by the World Bank states that incentives which lower the cost of investment (such as capital allowances) are less prone to profit shifting strategies as they are not contingent upon profitability[5], as compared to profit-based incentives (such as corporate income tax exemptions). At the same time, incentive instruments should also cater towards changing investor preferences, beyond tax considerations. Pivoting away from tax-based instruments, existing incentives may be complemented with lower personal income tax for highly-skilled knowledge workers, higher R&D and automation grants, and greater access to technology parks and co-working spaces.

Regardless, investment incentives should complement and should not detract from the importance of ensuring that the fundamental investment climate in Malaysia is attractive to quality investments. A conducive investment ecosystem includes elements beyond investment incentives. These include having world-class infrastructure and connectivity, efficient public service delivery and a dynamic education system which would produce a skilled workforce that is capable of undertaking high value-added activities.

Conclusion

A holistic review of the investment promotion strategy, instruments and landscape is critical in attracting quality investments going forward. More targeted, relevant and effective incentive instruments would ensure that the desired investments are attracted to Malaysia and that positive economic spillovers from these investments are maximised. It should be acknowledged, however, that investment incentives are one part of the investment landscape, and the review of incentives should be complemented with the enhancement of business enablers, such as infrastructure, public service delivery and talent. With all these in place, it is envisaged that Malaysia would stand the best chance to become a future-ready economy, and maximise the intended benefits for all Malaysians.

[5] World Bank, 2017.

Sub-Box: Case Study on Selected MNCs

Bank Negara Malaysia conducted a study on a sample of six MNCs in the E&E industry, which are also recipients of investment incentives, to assess their contributions to the domestic economy. These MNCs are among the largest manufacturers in Malaysia, with a combined revenue averaging RM63 billion per annum (9.7% of total manufacturing sales)[6]. The study shows that while these investments have generated benefits on an aggregate basis, the extent of positive spillovers have been offset by leakages at various stages of production. These leakages include the use of imported inputs, employment of foreign labour and tax foregone. The following are the key findings from the study:

1. **On an aggregate basis, the MNCs contributed positively to the domestic economy.** In the period 2013-2015, the six MNCs invested RM1.2 billion per year and generated average annual exports of RM46 billion (6.1% of total gross exports). After taking into account gross imports, these MNCs registered a trade surplus of RM16.5 billion (USD4.8 billion). These MNCs employed around 48,000 Malaysians, with a total wage bill of RM3.3 billion per year. They also collectively engaged with about 5,700 local suppliers, resulting in an overall spending on domestic inputs and services amounting to RM13.3 billion per annum.

2. **However, these positive spillovers have been offset by leakages and the degree of net benefits varies across firms.** Despite significant contributions to the gross exports of the country, spillovers generated by the sample MNCs to the domestic economy are limited by their high dependence on imported inputs and foreign services, which averages RM40 billion per annum. Consequently, net conversion of foreign currency into ringgit arising from trade only accounts for 36% of trade surplus at RM6.0 billion (USD1.75 billion). In addition, some of these MNCs register much lower net conversion of foreign currency into ringgit than the industry average[7].

3. While some firms have transitioned towards higher value added activity, **many continued to focus on low-cost business models with limited innovation capabilities.**
   - The six MNCs directly employ about 12,000 foreign workers, representing 20% of their total workforce, resulting in remittance outflows of RM0.8 billion[8] per year. Among the assembly operators, the share of foreign workers was as high as 48% of their workforce.
   - Jobs that are skewed towards the low-paying, lower-skill categories comprises 37% of total workforce. Among the assembly operators, this category could be as high as 60% share.
   - R&D intensity[9] is also relatively low, with most firms spending less than 2% of their revenue on R&D activity. Only one firm reported an R&D intensity of above 30%.

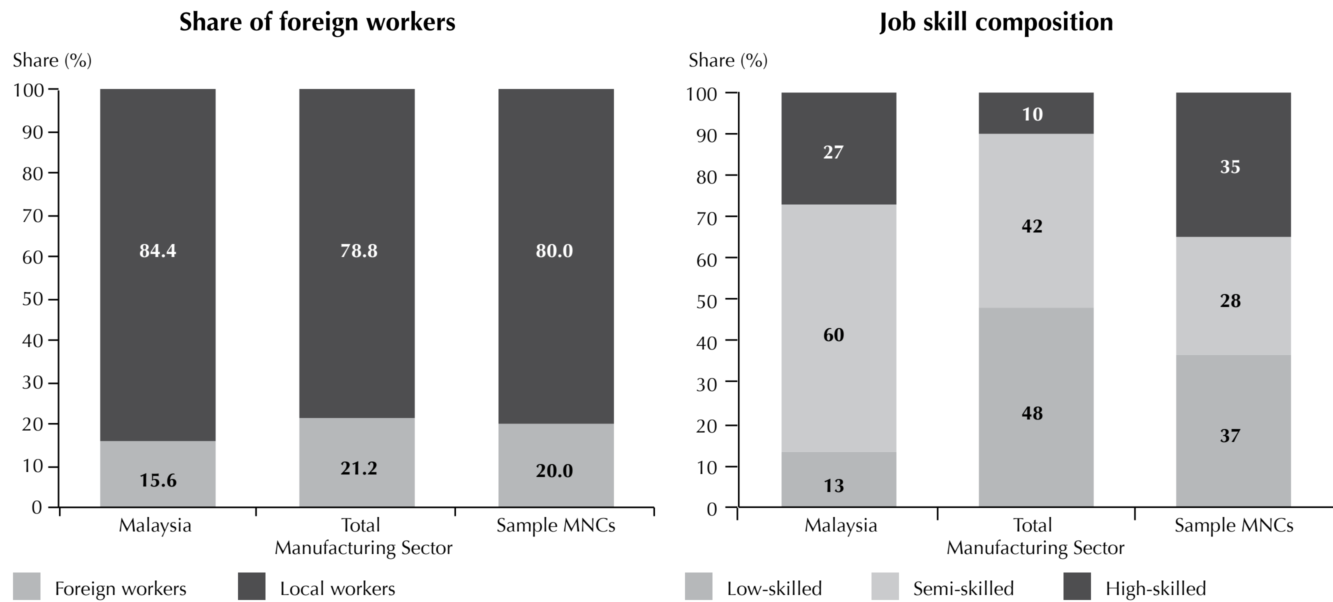
4. **The cost of investment incentives provided to the surveyed MNCs, in the form of tax foregone, is sizeable at an average of RM0.6 billion per annum.** This is equivalent to about 0.4% of Government tax revenue. Due to the incentives, these MNCs enjoy an average effective tax rate of 7.4%, significantly lower than the national corporate tax rate of 25% in 2015. This does not include other fiscal costs in the form of customs and duty exemptions, as well as subsidised rates for domestic resources[10].

It is important to note that while these findings should not be generalised to represent the E&E industry as whole, evidence does suggest that for some firms, the intended benefits are not commensurate with the associated leakages.

[6] Data is based on 3-year average (2013-2015) to take into account data availability for all firms at the time of the survey.
[7] Refers to net foreign currency flows over net exports. The average net conversion for a group of 184 E&E companies is 56% of trade surplus.
[8] Upper limit based on assumptions that 20% of wages accrue to foreign workers, in line with proportion of employment, and that wages are fully repatriated.
[9] R&D intensity is estimated using R&D spending as a proportion of value added. As a global benchmark, R&D intensity among electronics manufacturers is 25%-35% (McKinsey, 2012).
[10] Subsidised domestic resources include electricity tariff, basic food necessities and transportation. Since May 1997, the Government, through PETRONAS, subsidised a cumulative amount of RM241.4 billion in terms of revenue foregone from the supply of gas to Peninsular Malaysia's power and non-power sectors (PETRONAS, 2016).

Chart 11

Composition of Employment in Surveyed MNCs



Source: Annual Manufacturing Survey (2015) Department of Statistics, Malaysia and firm-level survey

References

James S. (2014), "Effectiveness of Investment Incentives in Developing Countries: Evidence and Policy Implications", Investment Climate Advisory Services, World Bank

Klemm, A., and S. Van Parys (2012), "Empirical Evidence on the Effects of Tax Incentives." International Tax and Public Finance 19 (3): 393–423

McKinsey Global Institute (2012) "Manufacturing the future: The next era of global growth and innovation", November

PETRONAS (2016), Annual Report 2016

PwC Malaysia (2017), "Doing business in Malaysia 2017"

World Bank (2015), East Asia and Pacific Economic Update, October

World Bank (2017), Global Investment Competitiveness Report 2017/2018, October

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Bank Negara Malaysia
Jalan Dato' Onn
50480 Kuala Lumpur
Malaysia

Tel: +(603) 2698 8044
Fax: +(603) 2693 6919

www.bnm.gov.my