

Decentralisation is the Best Pro-Growth and Pro-Poor Economic Strategy for New Malaysia

By Prof. Woo Wing Thye (Sunway University, Malaysia; University of California, USA; and Fudan University, China)

Executive Summary

- The policies for national development constructed in the twentieth century have proved incapable of pushing Malaysia out of the middle-income trap into the rank of developed countries
- Those policies relied increasingly on the centralisation of decision-making power and in many ways proved to be counter-productive where sustained economic growth is concerned
- The wish for economic reforms in the country in the wake of the change of government at the centre in 2018 makes decentralisation of power on that front necessary
- Measures needed include the following:
 1. Empower the states in order to release economic energy at the local level;
 2. Enhance competition between GLCs and private firms;
 3. Diversify the banks in terms of size and ownership; and
 4. Decentralise decision-making in the education system.

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Introduction

With the change in government in May 2018, Malaysia has once again been given the chance to re-make itself. The first comprehensive re-making of the Malaysian policy framework after Merdeka was the 1970 New Economic Policy (NEP). The most fulfilling outcome from this first national reconfiguration of public policy is that it produced a large Malay middle-class that is informed about the world, competent in the modern professions and confident about its identity.

The middle-class Malays have, however, become increasingly cognisant over the last two decades that those policies are not capable of taking Malaysia further and transforming it into a developed nation in the rank of the US, the UK and Japan. The protracted stagnation of the economy since 1996 and the continual ratcheting up of social divisions by the long-ruling coalition have caused a swing of 15-20% more Malays in West Malaysia to vote for Pakatan Harapan on May 9, 2018. The change in government that resulted from that now allows for a second re-making of the country.

To meet the aspirations of Malaysians, root-and-branch reforms are badly needed in the spheres of political governance, economic management, social interaction and environmental protection. This brief will focus on four key economic areas where reform is urgently needed and which require a common reform component – decentralisation:

1. The administrative structure inhibits innovative policymaking and prevents effective oversight because the federal government is too big compared to the state governments;
2. The crowding out of the private sector by government-linked corporations (GLCs) reduces economic dynamism, and the corruption enabled by GLCs increases income inequality;
3. The monopoly of the financial sector worsens economic performance and income inequality by suppressing the operations of small and medium enterprises (SMEs), in addition to being highly inefficient in operation (e.g. charging fees that are too high and providing service that is shoddy and sullen); and
4. The education system fails in imparting competence in the basic skills (i.e. Reading, Mathematics and Science) to the average student, and in promoting academic excellence in talented students.

Each of the above problems requires reform in several dimensions, and a common key component in each of the reform package is the decentralisation of decision-making, specifically, from the federal government to local governments, from state-owned commercial enterprises to private enterprises, from monopolies to competing firms, and from the bureaucracy to civil society.

Decentralisation is not a binary choice of 0 or 1, i.e. autocracy versus a referendum on every issue. Rather, the issue is: What is the right degree of decentralisation in decision-making for each issue?

Over-centralisation of Economic Decision-Making Power

The imbalance between the federal government and state governments is well captured in the over-centralised management of public transportation. Every aspect of the bus system in each state is controlled from Putrajaya, which decides the number of buses that operate in the state, the route for each bus line and the location of the bus stops for each route. This attitude of Putrajaya-knows-best is reflected in the huge difference in budgetary and expenditure power of the federal government compared to that of the thirteen state governments.

Only the federal government has the legal authority to impose income and sales taxes, and the state governments get their independent revenue from land-related transactions and from fees on small ticket items like hawker licenses. Furthermore, most of the provision of public services like health, education and public safety is done through branches of federal ministries operating in the state.

The size of state expenditure is determined largely by the annual fiscal allocation from the federal government to the state, with the amount of federal allocation dependent on the political considerations of the federal government. Under the Barisan Nasional (BN) government, opposition-controlled states did not only receive budgetary allocations that were proportionately much smaller than BN-controlled states, they were also often denied their rightful share of revenue collected from the exploitation of natural resources in their states, e.g. when Terengganu was governed by PAS in 1999-2004, it did not receive its legal share of taxes from oil extracted off its coast.

Given the natural proclivity of the federal ministries to hog development projects in their specialised areas, the federal government is not only biased toward minimal budgetary allocation to the states but also bans borrowing by the latter to finance development projects. The states have always been denied the ability to raise revenue to build badly-needed infrastructure to clear production bottlenecks faced by local industries. For example, the total budget (local revenue plus federal allocation) of the Penang state government in 2008 was smaller than the budget of the federal-owned university (Universiti Sains Malaysia, USM) situated in Penang.

The result of the over-centralisation of economic decision-making power in the hands of the federal government is a highly unequal pattern in regional development. The Klang Valley where the federal government sits is the recipient of the bulk of infrastructure projects – this is clearly seen in the geographical distribution of the top echelon of Malaysian public universities. Only USM, which is based in Penang, does not have major operations in the Klang Valley.

The virtuous growth cycle of the Klang Valley has counterparts in vicious growth cycles in the poorer states. The flow of human talent, private capital and public taxes from poorer states like Kelantan and Perak to the Klang Valley in turn requires more public infrastructure investment in the latter to cope with its over-congestion.

Economic Reforms

Initiating local economic developments by empowering the states

Malaysia needs to learn from post-1978 China that sustained overall growth requires that state governments be empowered to formulate and implement their own development strategies. Local governments understand the growth barriers in their local economies better than Putrajaya and because there will now be 13 centres of policy initiatives besides the Economic Planning Unit, a variety of innovative development strategies will be pursued by the states. Economic growth will be enhanced because the state governments will learn the best practices from each other's experiments, and from foreign experiences instead of having to blindly obey orders from their Putrajaya paymasters.

Effective administrative and budgetary decentralisation will require that (1) each state has its own state civil service (something that the formerly Unfederated States already have); (2) the states receive greatly increased shares of tax revenue according to a transparent formula that takes into account factors like the developmental stage of the state and its contribution to tax revenue; and (3) significant responsibilities of the federal ministries be transferred to the state agencies.

Furthermore, the states should be allowed to undertake borrowing to finance local infrastructure investment with the commitment that there will be no bailouts by the federal government. Private financial houses will not extend loans to state governments to implement economically non-viable projects because the bankruptcy procedures will punish them for their mistakes.

Institutionalising more equal competition between GLCs and private firms

GLC reform is the second key task in the economic reform. GLCs can perform well in theory, but not in practice because governments inevitably find it convenient to use them for political patronage and personal corruption. The large-scale rock concert in which top managers of the largest GLCs sang "Hebatkan Malaysia" (the election slogan of BN) just before the May 2018 election reveals clearly the nature of the incentives which GLC managers operate under. GLCs are presently political creatures, not economic instruments.

The competition between GLCs and private firms is intrinsically unfair, and always harmful for overall growth. No matter how inefficient the GLCs are, they can always count on being bailed out by taxes that the government levies on the latter. GLCs have also been undermining economic dynamism by buying up their more efficient private competitors. Worse yet, the GLCs have been holding back the development of a dynamic Malay business community by pulling capable Malay entrepreneurs away from starting private businesses into cozy lifetime GLC jobs, thereby inhibiting the narrowing of the Malay-Chinese income gap.

Downsizing of the GLC sector by privatisation is necessary for economic efficiency, political accountability and income equality. The amount of the bid in privatisation sales and the promotion of competition within the industry should be the only two considerations in picking the buyer. A well-prepared transparent privatisation process for the GLCs is the top priority, and not their speedy privatisation.

Diversifying the banks in terms of size and ownership

The third key economic reform is the diversification and expansion of the banking system. The 1997 Asian Financial Crisis convinced the Malaysian government that the banking system would be less prone to crisis if the regulators could monitor them easier. The result of this belief was the forced consolidation of the banks into ten big banks to enable easier prudential oversight.

This consolidation of banks made state investment companies the controlling shareholders in most of the commercial banks, turning them effectively into a state-owned banking monopoly. State control of the largest banks combined with the small number of banks have made banks slow in adopting technological upgrades in payment practices, slow in providing new financial products, shoddy in their treatment of small retail customers, and biased in lending toward GLCs.

One serious defect of the bank consolidation in 2000 was that SMEs in Malaysia began experiencing great difficulties in getting working capital (not to mention investment capital) from the large banks. This outcome is nothing unusual. Large banks all over the world prefer to make one big loan rather than a bunch of small loans because the cost of processing each loan is about the same. The international experience is that small and medium banks (where they are allowed to exist) constitute the primary funding source for SMEs.

The Malaysian government has responded to the financing difficulties of the SMEs by establishing the state-owned SME Bank in 2005. The general assessment, however, is that the SME Bank has not succeeded in meeting the capital needs of the SME sector. The only notable achievement of the SME Bank is that it has the highest non-performing loan ratio in the banking industry. The retarded growth of the SME sector is very unfortunate because it means that the formation of new Bumiputera businesses has been reduced and the overall distribution of income worsened.

Reforming the banking sector will mean (1) increasing the number of bank licenses to create private medium-sized banks; (2) reducing the government's holding of bank shares; and (3) removing restrictions on the number of foreign banks and on the range of their activities.

Decentralisation of decision-making in the education system

A key sector that needs urgent drastic reform in order to ensure sustained dynamic growth is the education system. Malaysia's education system is unnaturally low in quality according to the Organisation for Economic Co-operation and Development's (OECD) cross-country surveys on the scores of primary and secondary school students in Mathematics, Reading and Science.

In the 2012 OECD sample of 65 countries, Malaysia's rank for Mathematics, Reading and Science was 52, 59 and 53 respectively. Malaysia's scores were comparable to those of Thailand (50, 48 and 49), Chile (51, 48 and 47), and Mexico (53, 51 and 55). The government expenditure on education per capita in 2011 (measured in PPP 2011 international \$) was 1,307 for Malaysia, 701 for Thailand, 860 for Chile, and 832 for Mexico. This huge gap between what Malaysia spends and what Thailand, Chile and Mexico spend indicates some very severe problems in Malaysia's education system.

There is the problem of accountability and competence of teachers in the Malaysian education system because of the absence of performance-based pay and the guarantee of lifelong employment. Then there is the problem of the school curriculum - that is imposed by the central government on all government-aided schools - being set at a low academic level, resulting in an upward trend in the number of students receiving perfect scores in the annual national examinations.

There is also the problem that, because the state-set curriculum requires many courses that cater to political demands, there is simply not enough time and resources to teach Mathematics, Reading and Science well. For example, students in some schools are required to learn three languages, receive religious instruction, and study many courses on Malaysian history and society that are designed to promote acceptance of the BN-sanctioned master narrative about the optimal type of socio-economic-political arrangements (*Ketuanan Melayu*) for Malaysia.

It should be emphasised that these politically-motivated courses promote recitation by students of state-set viewpoints, rather than critical examination by students of these viewpoints. This politicisation of the school curriculum means that the overall tone in Malaysian schools is in conformity to orthodoxy, rather than creative thinking about society's choices.

The education system has undergone numerous drastic systemic reforms in the 60-plus years of BN rule. Every reform was a highly contentious affair and every reform failed to improve the academic performance of the average student. What usually went up after each systemic reform was the quantity of students in the education system, but never the quality of the education.

Successful school reform requires acknowledgement that different parents have different objectives that they want the schools to achieve for their children. To respect the wishes of the parents, Malaysia must have diversity in the curricula of publicly-funded schools. This needed diversity within the curriculum can be achieved only with decentralisation in the three following areas:

First, all schools (publicly-funded or otherwise) must share a common academic core that is allocated enough time and resources to be taught well, and each school is allowed the choice on what subjects it offers in the remaining time. For example, the Ministry of Education requires the teaching of a common core curriculum of Bahasa Malaysia, Mathematics, Reading (Literature) and Science in all schools, and each school in consultation with the local community decides on the relative proportion of courses on subjects like Malaysian history, world history, religion, civics, and geography for each school.

Second, the oversight of schools should be transferred to the state governments which can introduce incentive pay for teachers, allow a diversified range of public schools, and conduct experiments on different pedagogical approaches.

Third, the funding of public education should also be decentralised. Every school-age child could receive an education voucher from the government annually, and the parents of the child could redeem the voucher at the school with the curriculum that they think is best for their child.

As mentioned earlier, success in reforming anyone of the important sectors requires a reform package, and not just a single reform measure. Decentralisation in the above three areas (in order to depoliticise the school curriculum, increase accountability, and meet diverse parental demands) is only one of the fundamental reforms that must be implemented in raising the quality of education at public schools.

Other fundamental reforms include:

- A pay and promotion structure that rewards good teaching and innovative management of schools;
- Effective training and inspiration of teachers;
- Well-run boarding schools during weekdays for children from remote areas;
- Nutritious meal programmes for poor students; and
- Easing of restrictions on the establishment of privately-funded schools to enable them to be an easy benchmark to judge the performance of public schools.

The NEP was designed to produce a large quantity of middle-class jobs for twentieth century industries and not to entrench excellence into the socio-economic institutions of Malaysia. It is incapable of bringing Malaysia beyond the middle-income trap level into the rank of developed countries like the US, the UK and Japan because it cannot:

- Create a critical mass of world-class talents for key economic pillars of the twenty-first century (e.g. research universities, information industries, artificial intelligence, and carbon-free energy generation) where economic growth is knowledge-led and not capital-led;
- Mobilise the entire brain-power of Malaysia for knowledge creation; and
- Establish Malaysia as an important regional centre in the international network of knowledge generation, which requires being able to attract world-class talents to relocate to Malaysia.

For Malaysia to get out of the middle-income trap, the pro-Malay public policy framework must be replaced by a Pro-Growth, Pro-Poor public policy framework.

In summary, decentralisation of decision-making in the economic sphere takes different forms in four different economic areas: (a) empowerment of the 13 states in initiating local economic development; (b) institutionalisation of more equal competition between GLCs and private firms; (c) diversification of banks in terms of size and ownership; and (d) decentralisation of decision-making on school curriculum, on oversight of school operation, and on funding of students.

In each case, economic growth is enhanced and socio-economic inequality is decreased, thereby helping to wrench Malaysia out of the middle-income trap and to spread more of the fruits of economic growth to the poorer segment of the population and to the poorer regions of the country.

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