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Towards Equitable Transition: Safeguarding Welfare Amidst Subsidy Reform in Malaysia

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The findings, interpretations, and conclusions expressed in this paper are solely those of the authors and do not necessarily reflect the policies or views of Universiti Malaya.

1. BACKGROUND

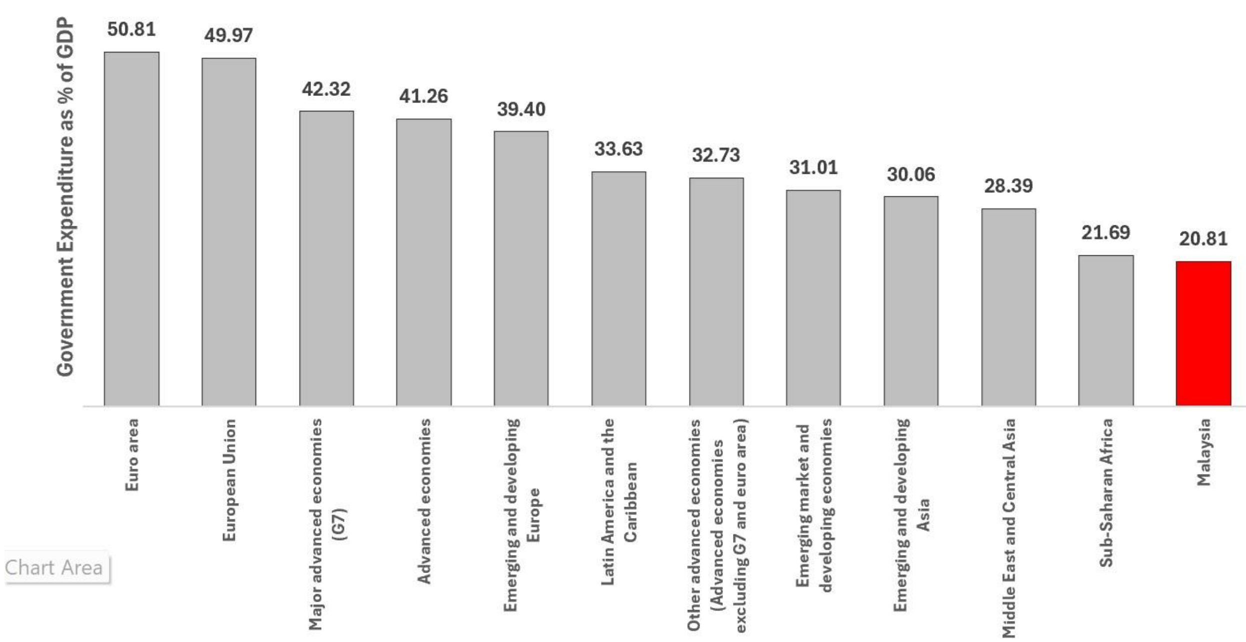
For decades, Malaysia has allocated a significant portion of its budget to providing universal price subsidies, notably for commodities like gasoline. However, this approach has led to distortions in resource allocation, hindered the transition to greener energy sources, and strained public finances. With subsidies consuming a staggering 3.12 percent of GDP in 2022 (Ministry of Finance, 2023)—more than allocation to vital sectors as health and education—the need for reform has become glaringly evident. Despite the intention of universal subsidies to benefit all citizens, evidence suggests that they disproportionately favor higher-income groups, exacerbating income inequalities.

Against this background., an examination of this distorted expenditures with focus on subsidies can yield valuable insights to formulate policy recommendations for reallocating resources, fostering efficiency, and maximizing impact.

2. PATTERNS IN PUBLIC SPENDING IN MALAYSIA

With an overall public expenditure estimated at RM 397.14 billion in 2023 (Ministry of Finance, 2023), representing only 20.81 percent of GDP for that year, Malaysia ranks among the lowest in terms of public spending relative to its level of economic development.

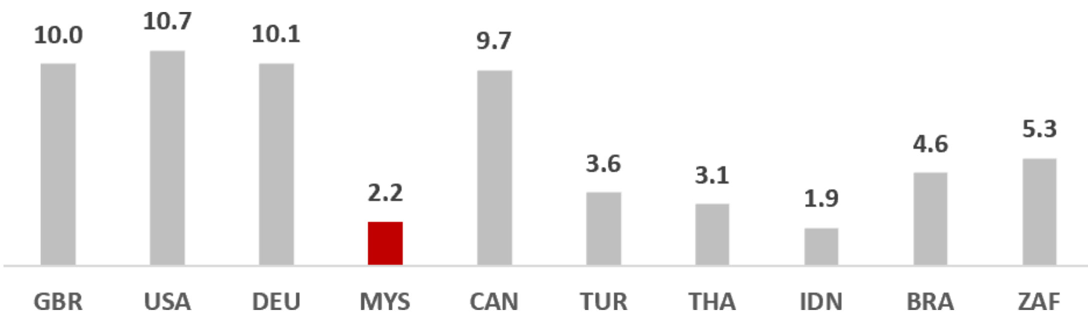
Figure 1: Public spending as a percent of GDP, Malaysia and country groups, 2023



Source: based on data from IMF (2023) and MoF (2023)

This starkly low level of public investment underscores systemic challenges in adequately funding essential sectors such as education, healthcare, and infrastructure. Insufficient allocations in these critical areas hinder the country's ability to address inequalities and promote inclusive growth. As a consequence, Malaysia faces persistent obstacles in nurturing its human capital base and achieving sustainable socio-economic development targets.

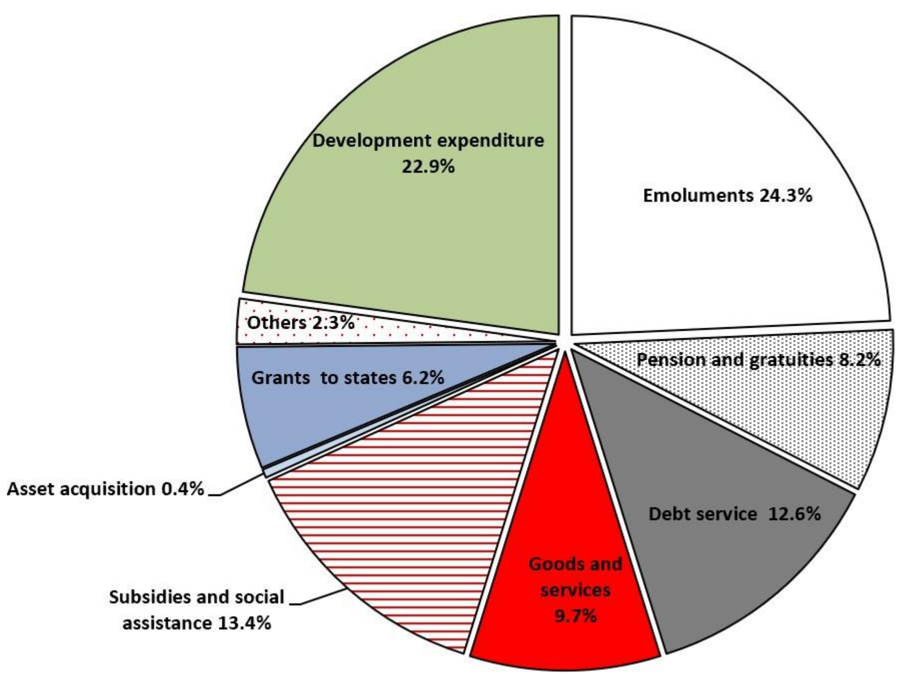
Figure 2: Public health care expenditure as a percent of GDP, selected Countries, 2020



Source: based on Data from the World Bank (2024)

A closer look at the pattern of public spending requires to ass the disaggregated spending. Below graphs shows the relative distribution of federal public spending for the budget 2024.

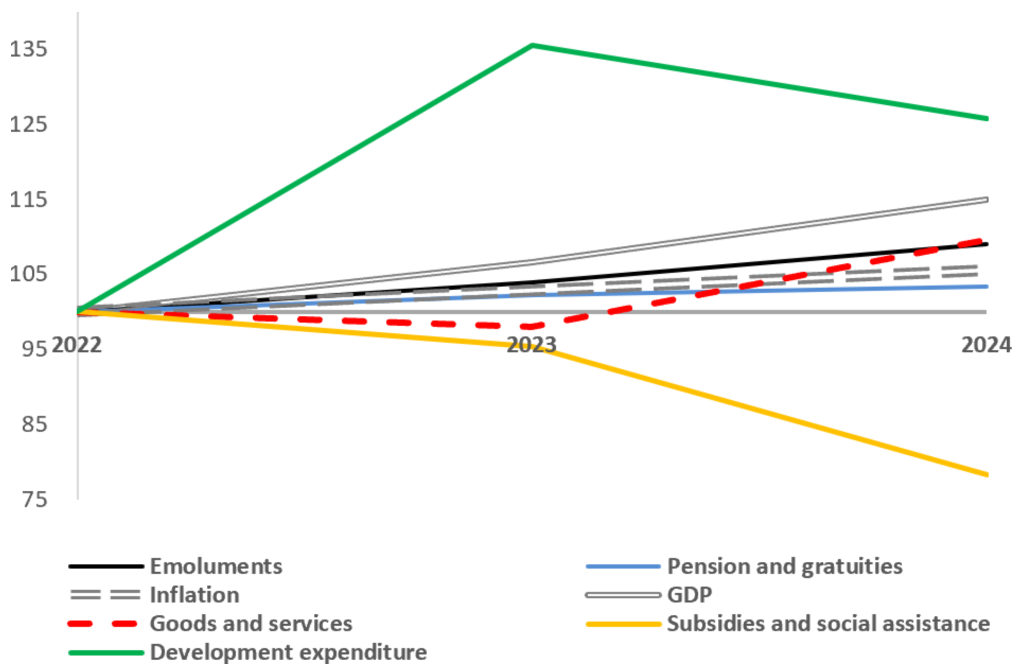
Figure 3: Economic classification of public spending as a percent of overall spending, 2024



Source: based on data from MoF (2023)

Despite this low level of public spending, the 2024 budget outlines a further reduction in overall public expenditure, projected to decrease from 20.81 percent of GDP in 2023 to 19.12 percent in 2024 (Ministry of Finance, 2023), primarily driven by the forthcoming subsidy reform. However, this reduction trend in public spending has been evident over recent years. With the exception of development expenditure, outlays in all categories have grown at a rate slower than GDP, signalling a concerted effort to curtail public spending relative to economic growth.

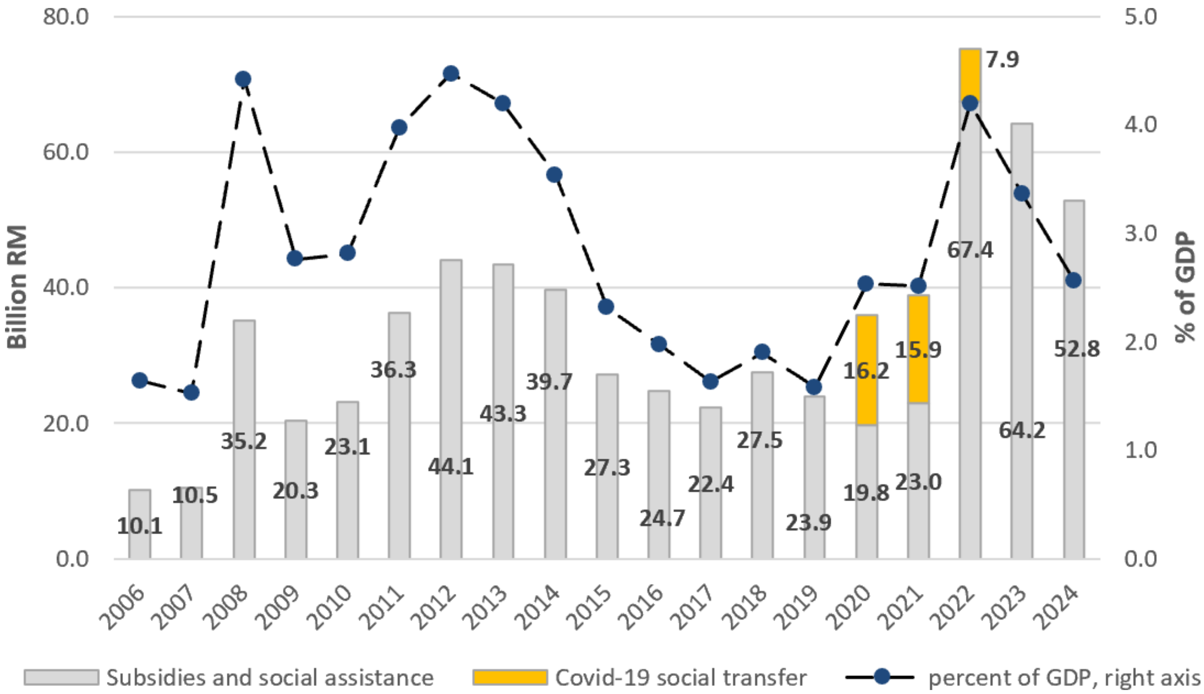
Figure 4: different public spending, inflation, and GDP growth rates (Base year is 100 in 2022)



Source: calculation is based on data from MoF (2023) and IMF (2023)

The 2024 budgeted decrease in allocation to subsidies and social assistance, prompted by a period of substantial spending escalation, characterized by expansive measures in response to the COVID-19 pandemic and a surge in the gasoline subsidy bill, marks a shift in fiscal policy.

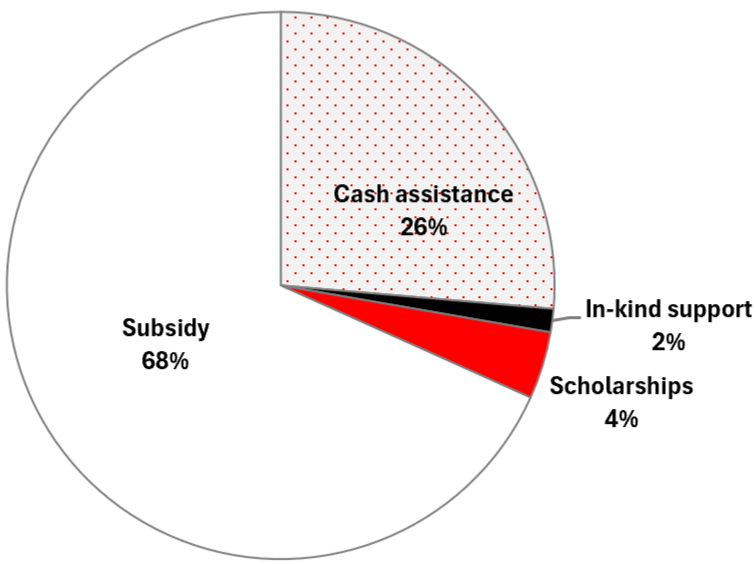
Figure 5: Public spending on subsidies and social assistance programs (RM billion) and percent of GDP (right axis), 2008 - 2022



Source: based on data from Ministry of Economy (2024). GDP data is from IMF (2023)

Disaggregating data shows that the bulk of spending on subsidies and social assistance are in the subsidy categories in comparison with spending on cash assistance.

Figure 6: Relative size of disaggregated public spending on subsidies and cash assistance, 2022

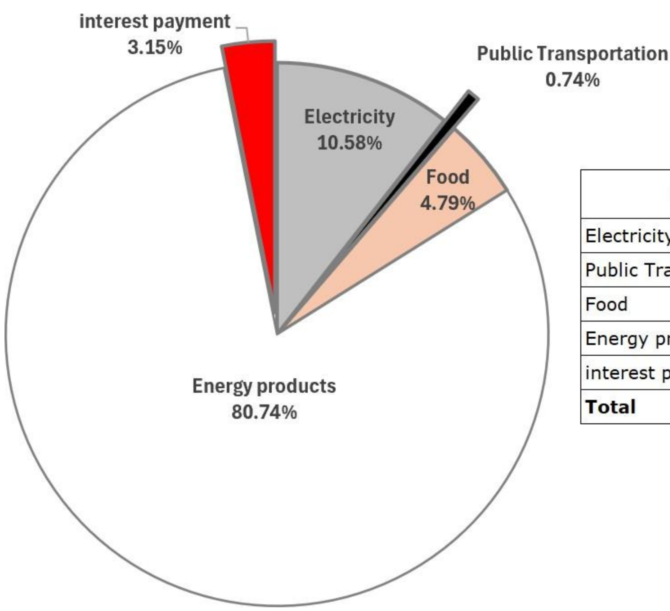


Source: based on data from MoF (2023).

3. SPENDING ON SUBSIDIES

Subsidies have been entrenched in Malaysia for decades, representing a substantial portion of government expenditure. As of 2022, a comprehensive array of 15 subsidy programs were in effect across 6 ministries, commanding a total allocation of RM55.96 billion (Ministry of Finance, 2023) (Ministry of Economy, 2024). This figure translates to a significant 3.12 percent of GDP for the corresponding year.

Figure 7: Relative size of disaggregated public spending on subsidies, 2022

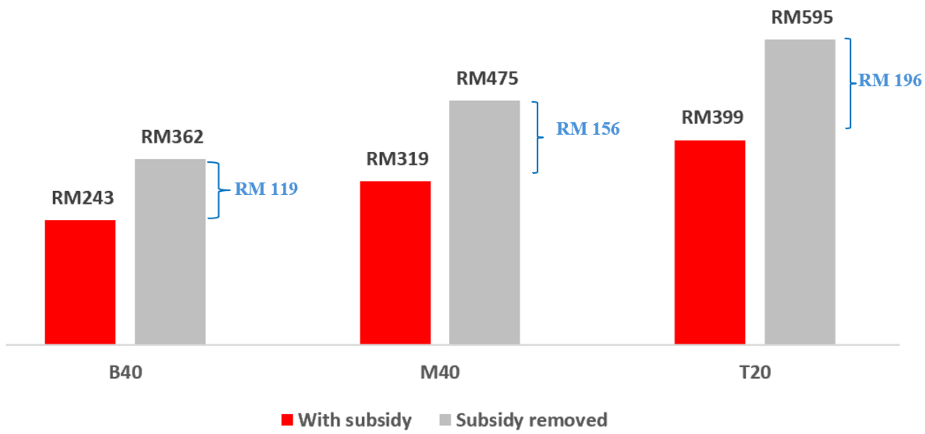


Function	No of Programs	Million RM
Electricity	2	5,918.35
Public Transportation	6	415.15
Food	5	2,681.93
Energy products	1	45,184.14
interest payment	1	1,761.11
Total	**15**	**55,960.69**

Source: based on data from MoF (2023) and Ministry of Economy (2024)

The predominance of energy products, comprising over 80 percent of the subsidy bill, is particularly alarming. Not only does it skew the price mechanism, hampering the efficient allocation of resources towards cleaner and more sustainable energy consumption patterns, but it also exacerbates socioeconomic disparities as wealthier households tend to disproportionately benefit from subsidized energy products, such as Ron 95 gasoline, in stark contrast to their less affluent counterparts.

Figure 8: Average monthly household spending on RON 95 by income groups with and without fuel subsidy, RM, 2023



Source: based on data from Ministry of Domestic Trade and Cost of Living (2023)

Furthermore, empirical evidence suggests that energy subsidies can impede economic efficiency and innovation. By artificially lowering the cost of energy, subsidies disincentivize investments in energy efficiency measures and renewable energy technologies, hindering the transition to a low-carbon economy. Research has shown that phasing out energy subsidies can spur innovation and investment in cleaner energy alternatives, leading to long-term economic and environmental benefits (Hosan, Rahman, Karmaker , & Saha, 2023).

4. THE PROPOSAL: PACKAGE SUBSIDY REMOVAL WITH CASH TRANSFERS

The announcement of subsidy reform in the budget for 2024 (Ministry of Finance, 2023) marks a positive stride. Introducing corrective measures aimed at rectifying this distortion, with the overarching goal of gradually phasing out the universal subsidy system in the short term, holds the potential to unlock substantial fiscal space. Nevertheless, the discontinuation of price subsidies is poised to provoke inflationary pressures, thereby foreseeably precipitating a welfare setback for a significant segment of households in Malaysia.

Mitigating the welfare repercussions stemming from inflationary pressures **necessitates the implementation of a well-designed and comprehensive cash assistance program, strategically tailored to target vulnerable stages of the lifecycle.**

4.1. Benefits amount and cost:

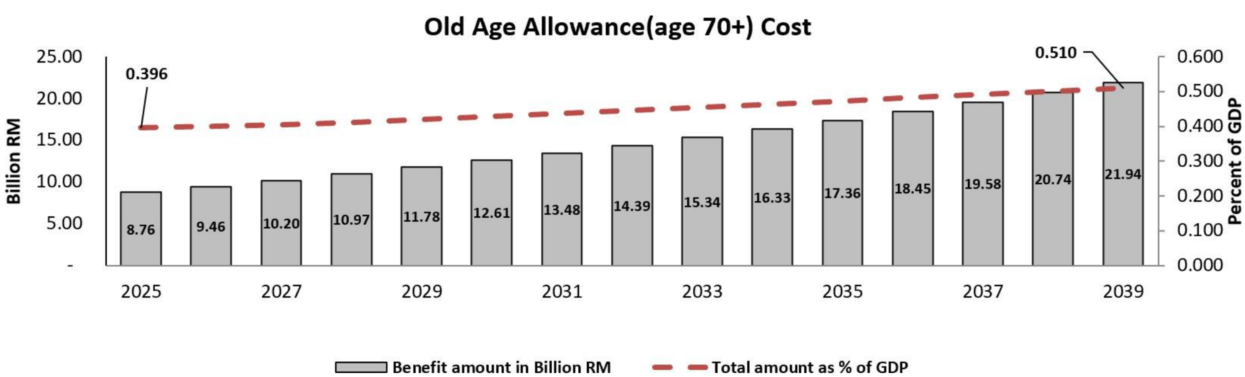
<u>Benefit amount:</u> this paper recommends prioritizing two vulnerable groups: senior citizens and children. It proposes to provide benefits of:

- RM 500 monthly to senior citizens age 70 and above; and
- RM 50 monthly to children and teens age 17 and below (under 18 years old)

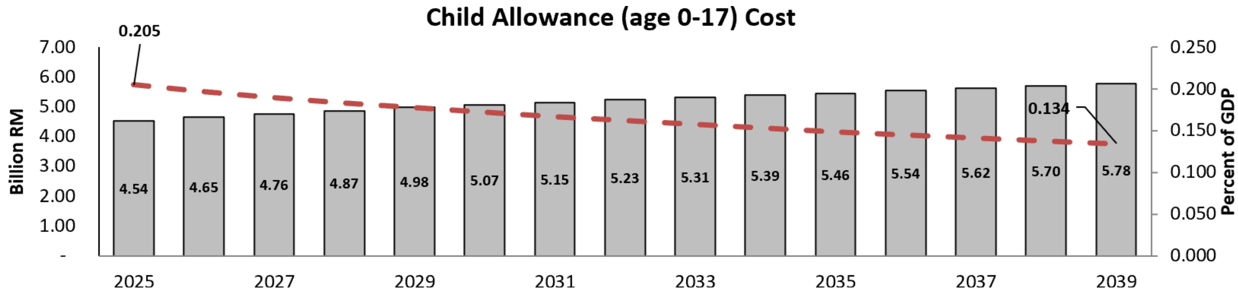
Cost: Table 1 shows the cost of the benefits proposed. Over the projection period, benefits are assumed to maintain RM real value (indexed for inflation). However, as the economy is expected to continue to grow in real terms, the benefit level will decline relative to per capita GDP or income over the projection period.

Table 1: Costing Results: Number Beneficiaries in thousands, Overall Cost in in Billion RM and Percentage of GDP, 2010-2034[1]

	2025	2029	2033	2039
Demographic, 000				
Population	35,028	36,374	37,574	39,063
Children population age 0-17	9,221	9,213	9,066	8,730
Old-age population age 70+	1,780.0	2,180.4	2,618.3	3,316.8
Macroeconomic				
GDP, current prices, billion RM	2,213	2,804	3,376	4,302
Laborforce, 000	17,135	17,730	18,193	18,648
Old-age Allowance				
Beneficiaries, 000, age 70+	1,424.0	1,744.3	2,094.7	2,653.4
Total Expenditure, Billion RM	8.76	11.78	15.34	21.94
Total Expenditure,% of GDP	0.40	0.42	0.45	0.51
Child Allownce				
Beneficiaries, 000, age 0-17	7,376.8	7,370.8	7,252.6	6,983.7
Total Expenditure, Billion RM	4.54	4.98	5.31	5.78
Total Expenditure,% of GDP	0.21	0.18	0.16	0.13



[1] Calculation is based on a costing model under a set of assumptions and using data inputs from UN (2022) and IMF (2023). A more technical report on the model can be provided upon request.



4.2. Why not targeting the poor?

In theory, targeting resources to only those who need them most is the most efficient way of disbursing social transfers. However, from accumulated experience across many countries, poverty targeting tends to stigmatize the poor, be administratively challenging to manage, vulnerable to being misused, socially divisive, and politically contentious (see below). Given the level of development of Malaysia and its aspiration to reach a developed-nation status and socially inclusive society, the note argues to move away from the charity-model (poverty targeting), into a more inclusive and coherent social protection system i.e. categorial targeting (such as senior citizen and children). The selection of categories is based on their correlation with poverty and other sought developmental outcomes such as nutrition and social cohesion. For instance, poverty in Malaysia has a clear age dimension (see Figure 14).

In this regard, risks associated with the life cycle such as: childhood and old age can be targeted with social assistance programs for each of these categories. The proposed shift, from narrow poverty targeting to categorical targeting, converges with the gathering momentum for universalism, as in the intense debate on Universal Basic Income (UBI)[2]. This shift will achieve key objectives:

- Reduce exclusion errors associated with poverty targeting available data shows that STR has suffered from large exclusion errors (many deserving citizens did not receive benefits)[3].

2 While this recommendation is to provide benefits universally, it is not the same as UBI. It can be a step towards a UBI by prioritizing first key population groups i.e old age, children, etc. This is in line with the IMF suggestion 'that a gradual approach to reform would be desirable, possibly focusing first on universal coverage of subgroups of the population, such as children and the elderly.' (see IMF. 2017. IMF Fiscal Monitor: Tackling Inequality. See: Chapter 1: Tackling Inequality)

3 This is not unique to Malaysia as evidence shows that poverty targeting carries very significant exclusion error risks. For instance, Mexico's Oportunidades excluded 70 percent of the poorest 20 percent of eligible households while Brazil's Bolsa Família had an exclusion error of 59 percent (Fiszbein, Schady, & Ferreira, 2009). Exclusion and inclusion errors in Bangladesh, Indonesia, Rwanda and Sri Lanka ranged between 44 percent and 55 percent when 20 percent of the population was covered and between 57 percent and 71 percent when 10 percent was covered (Kidd & Wylde, 2011). In China's Minimum Livelihood Guarantee Scheme (also known as Diabo), cities using more targeting were less likely to reduce poverty (Ravallion, 2007).

- Administrative simplicity and efficiency: The simplicity of the categorical targeting proposed reduces the administrative burden currently placed on many agencies to verify documents and assess complex eligibility criteria. Categorical programs have little need for periodic reappraisal of eligibility, whereas poverty-targeted programs require periodic retargeting to assess ongoing eligibility, which imply more costs and complexity from an administrative perspective[4]. In addition to costs, complexity adversely affects coverage. As many vulnerable people are less educated or informed, and more likely fail to comply with the requirements of complex eligibility-determination or qualification processes, generally associated with means-tested targeted programs, they end up excluded[5]. Furthermore, fragmentation of the many different social protection programs in Malaysia covering multiple contingencies make it very difficult for beneficiaries to know which benefits they are entitled to, resulting in further exclusion of those in need while those with better access to information or better connected may benefit from many programs, including those they are ineligible for i.e. contributing to inclusion errors.

- Dignity, solidarity, and social cohesion: Programs supposed to be exclusively for the poor tend to be stigmatizing. Studies have found that the screening processes involved in determining eligibility to mean-tested, or proxy-means tested benefits tend to be stigmatizing[6.] The social ‘othering’ that occurs through targeting generates strong ‘in’ and ‘out’ group dichotomy, especially in contexts where notions of ‘deserving’ and 'undeserving' poor prevail (Roelen, 2017). In contrast, categorical targeting removes screening procedures to determine eligibility (who is ‘in’ and who is ‘out’). It further contributes to a sense of community as all the group benefits from such inclusive programs. It removes the risk of deserving low-income families excluding themselves from entitlements due to the shame of being ‘on benefits’. Further, the broad-based consensus that universal approaches help create social cohesion and a sense of citizenship and belonging. The life-cycle approach (targeting old-age and childhood vulnerable stages of the life cycle) signals a clear message from the state that all citizens have a stake in society.

While life-cycle approach ostensibly covers all individuals in a category (e.g., all above age 70 receive old-age allowance, or all children receive child allowance), a form of targeting is implicitly built in:

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4 An ILO review concluded that the universal schemes reviewed had the lowest average administration costs at 2.5 percent of total program costs, whereas targeted programs averaged administration costs of 11 percent (Ortiz, Durán-Valverde, Pal, Behrendt, & Acuña-Ulate, 2017).

5 This partly explains the high exclusion 'error' among the poor as in the case of urban poor access to BR1M/BSH discussed earlier, where almost 4 out of 10 deserving beneficiaries did not receive BR1M/BSH (UNICEF, 2018).

6 In India, Thozilurappu Paddhathi (the “work guarantee scheme” or National Rural Employment Guarantee Act – NREGA) is often referred to as Thozhiluzhappu Paddhathi, the “lazy work scheme”. (Walker, 2014). Another study found that, ‘stigma or stigmatization is an important mechanism through which shame is induced’ (Roelen, 2017).

- Self-selection targeting: The modest benefit amount (a floor level benefit that can be complemented with other contributory schemes) coupled with other administrative measures to register and receive benefits, are likely to result in less than universal take up, as higher income groups may not claim the benefit.
- Categorical targeting: The lifecycle approach recognizes that deprivation and vulnerability are positively correlated with age, e.g., childhood and old-age (more details is below). As deprivation is positively correlated with the proposed categories, categorical targeting increases benefits based on household characteristics (larger and three generations household are poorer in Malaysia, and benefits proposed increases accordingly) even if non-poor households receive the same benefits.
- With the inclusion of financing mechanisms such as fuel subsidy withdrawal, the overall impact (transfer plus fuel subsidy removal) combined is a net transfer from rich households to poor households as the rich benefit more from the fuel subsidy alone.

But, if for political reasons it is thought to limit benefits only to B40 and M40, it is recommended to create a wealth threshold (for instance, those households own 3 properties or more) and exclude those above the wealth threshold without targeting the poor. In other words, **instead of targeting the poor (which we have limited to no information on their income), exclude the rich (who are more visible in existing administrative data).**

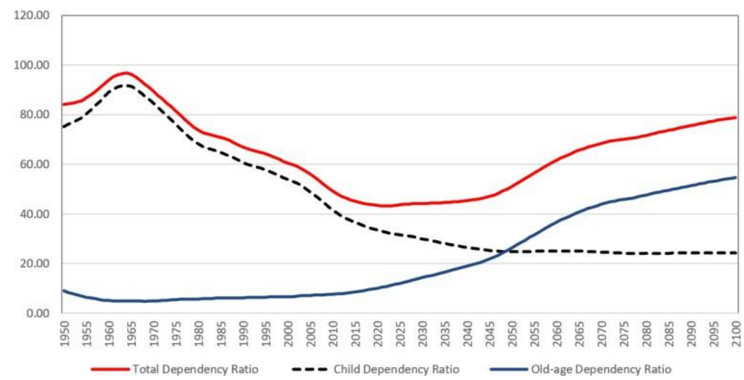
4.3. Why children and senior citizens?

The selected target groups are based on the following justifications:

a- Demographic changes: old-age pressure and the need to increase investment on smaller number of children

Malaysia has seen significant changes in its population structure. One of the notable changes is the rapid increase by the old-age dependency ratio (the ratio of elderly over 65 year-old per working-age person), which will in 2049, for the first time in Malaysia, exceed that of young dependency ratio (the ratio of pre-working population age 0-14 over 65 year-old per working-age person).

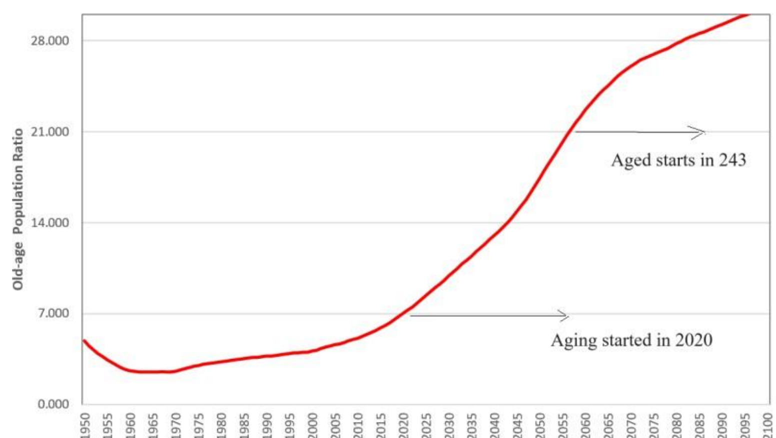
Figure 9: Number of Dependents per 100 Persons of Working Age (15-64), 1950-2100



Source: calculation is based on data from UN (2022)

Malaysia's population has been aging at a very high pace than that of other countries. The author's calculation indicates that Malaysia reached the threshold of an 'aging nation', defined when post working population (65+) constitute 7 percent of the total population, in 2020. Further, It will reach an 'aged nation, defined when post working population (65+) constitute 14 percent of the total population, by 2045. This is a rapid transition and requires to put in place instruments to provide income security for senior citizens, at the same time, ensure the young Malaysians are receiving what they need to reach their full potential as they will have to face increased burden due to this demographic situation.

Figure 10: Post-Working Population as Percent of Total Population, 1950-2100



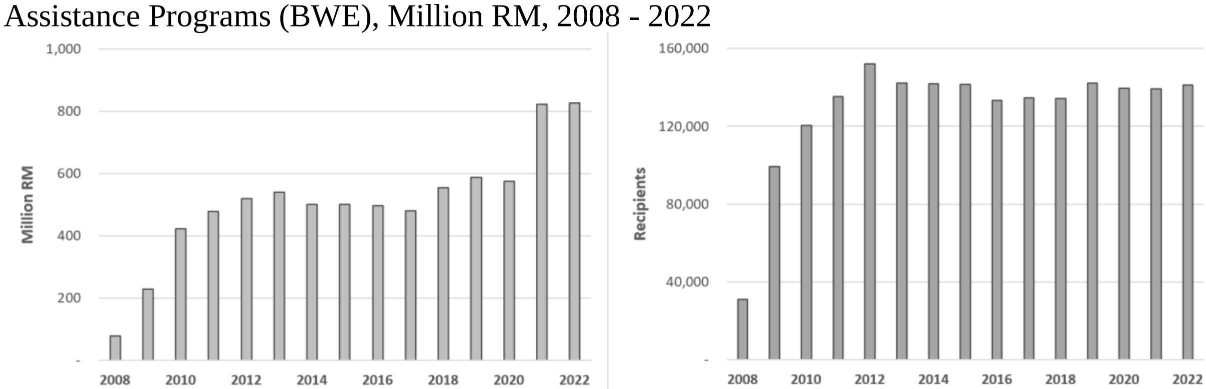
Source: calculation is based on data from UN (2022)

The demographic dynamics in Malaysia highlights productivity as the main driver for long-term growth path towards the convergence with high-income economies. To unleash productivity potential, investments in children is a key. The period of greatest vulnerability for the survival and development of the child is from pre-birth to five-years, and within that the period as a foetus and the first two years (UNICEF, 2011). But vulnerability is positively correlated with age groups e.g. childhood. Targeting this group injects income to the households' budget and supports reduction of vulnerability. More importantly, to break the cycle of becoming academically and economically disadvantaged later in life, investing in a child's early years through a preventative approach reduces the risk of poverty and social exclusion in the long run. Research has shown that school-age children who suffered from an episode of severe acute malnutrition in the first few years of life had poorer IQ levels, cognitive function, and school achievement, as well as greater behavioral problems compared to matched controls or siblings who were never malnourished (Prado & Dewey, 2012). Currently in Malaysia, the prevalence of stunting and wasting are high among children. From a development's perspective, both the prevalence of stunting and wasting results in a significant loss in terms of productivity. In one estimate, undernutrition was found to reduce a nation's economic advancement by at least 8 percent because of direct productivity losses, losses via poorer cognition, and losses via reduced schooling (Black, 2013, pp. 9-10).

b- <u>Weak Old-age protection arrangements in Malaysia</u>

The lack of comprehensive Income security system for old-age citizens has placed a significant pressure on the existing social assistance programs. Specifically, the MWFCD's social assistance programs for senior citizens, the Buntuan Warga Emas (BWE), registered a very large increase (4.55 folds between 2008-2022) and currently covers a total of 141,114 old-age recipients (MWCFD, 2023). Parallel to the increase in covered population, allocation to BWE program increased by 10.6 folds between 2008 and 2022, which constituted 33.35 percent of MWCFD's social assistance budget in 2022.

Figure 11: Expenditure (left graph) and Recipients (right graph) of MWCFD's Old-Age Social Assistance Programs (BWE), Million RM, 2008 - 2022



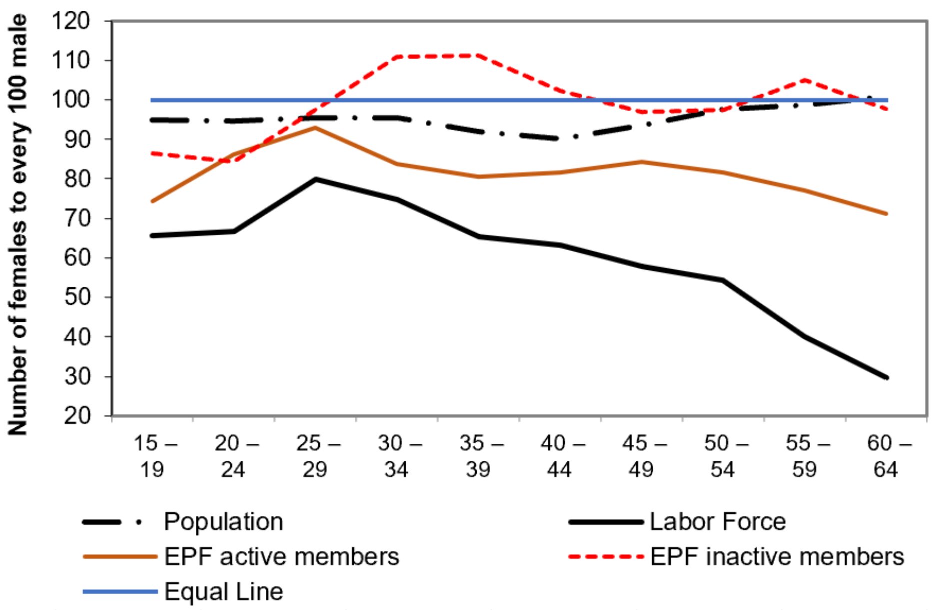
Source: based on data from (MWCFD, 2023).

Similarly, EPF statistics shows that half of EPF members age 54 (just before withdrawal year at age 50) have less than RM 50,000 (EPF, 2023). In addition to the inadequate benefit amount accumulated, early age of withdrawal, currently at 55, and the lump sum withdrawal result in old-age vulnerability (as seen in Figure 14).

c- <u>Old-age Allowance can correct the gender dimension to old-age protection</u>

EPF is employment-related old-age protection. Therefore, participation in the labor market is a key determinant whether an individual is protected or not. This is an inherent problem from the labor market in Malaysia where there are participation rates differentials between male and female working-age populations. Latest administrative statistics in Malaysia shows that EPF's active membership mirrors the general labor force pattern where the sex ratio (female to male) peaks at age 25 before it started declining.

Figure 12: Number of Women to 100 Men by Labor Force Status, 2022.

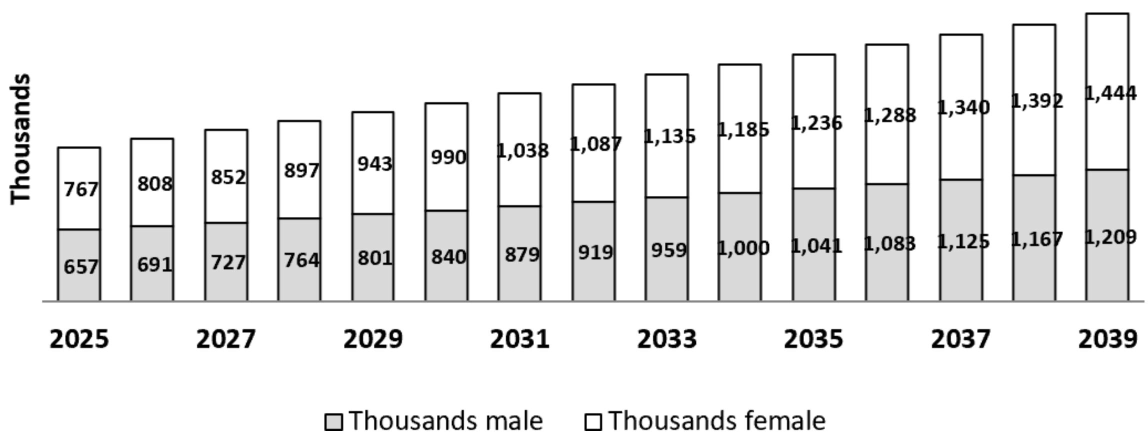


Source: calculation is based on data from (EPF, 2023), (Department of Statistics Malaysia, 2023) and (UN, 2022).

This figure shows that coverage gap starts widening between males and females starting age 25 and remains throughout the labor productive years. Low female labor force participation rates, as discussed earlier, is one reason for this, but the overreliance on insurance model (which is based on participation in the labor market) without any government intervention results naturally in a bias in the system against the female population, who has lower labor participation rates, have discontinued contributory record, and engaged more in the informal labor market. Not surprisingly, women reached age of retirement with much lower coverage as compared to men, leaving them more vulnerable to old-age income insecurity.

Therefore, an intervention by the government, such as the proposed old-age allowance, will correct for the discriminatory labor market and results in protection in old age for all citizens. In fact, as women live longer, the old-age allowance proposed will benefit women more than men as seen in below graph.

Figure 13: Coverage by Gender of Proposed Old-age Allowance, thousands of beneficiaries, 2025-2039.

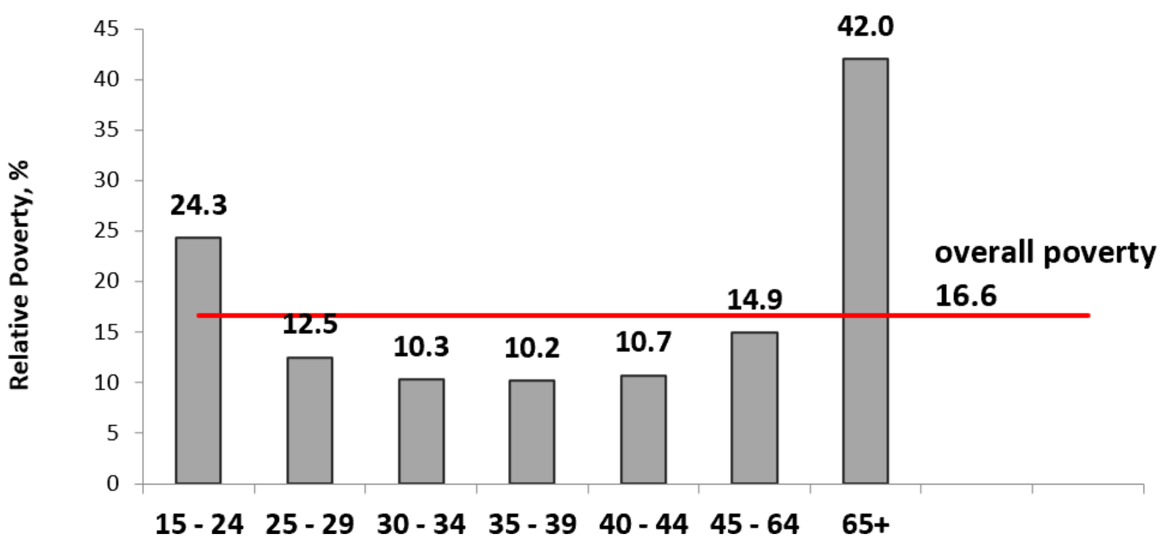


Source: Study calculations, technical note can be provided on projection model

d- <u>Old-age Poverty in Malaysia is alarming.</u>

Not surprisingly, and due to the weak old-age protection system discussed earlier, poverty in Malaysia has an age dimension with senior citizens are particularly vulnerable. Households survey data showed that relative poverty among senior citizens is the highest and stands at more than 2.5 times higher than the national average (Department of Statistics Malaysia, 2023).

Figure 14: Incidence of relative poverty by age group of head of household, Malaysia, 2022



Source: based on data from DOSM (2023).

4.4. Using MyKad to transfer allowance to seniors/ caregivers of children

Malaysia has fragmented social protection arrangements. Consequently, fragmented information management systems across many agencies have proliferated in Malaysia to meet the specific needs of each programme. Running these parallel systems are costly, besides being sub-optimal data topography. For the disbursement of periodic allowances to senior citizens and caregivers of children, we propose to use MyKad. MyKad's built-in chip can store and retrieve program specific data and link it to other biometric data already stored. MyKad provides the age information necessary to identify beneficiaries and their dependents. Another key advantage is its functionality as a payment method (Touch n Go), which can facilitate disbursement of benefits without the need to open a bank account. Such simplicity will save banking fees for low-income groups and can fully reach rural communities.

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