Muhammad bin Ibrahim: Creating an inclusive, sustainable and prosperous Labuan

Speech by Mr Muhammad bin Ibrahim, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Labuan Industry Annual Dinner 2017, Labuan, 27 October 2017.

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It is a pleasure to speak at this dinner. Last year I spoke on the urgent need for Labuan International Business and Financial Centre (IBFC) to reinvent itself to stay relevant – in other words, for us to reinvent ourselves in order to survive in a new world reality.

In my remarks tonight, I will build on last year's theme and touch on three imperatives for change in Labuan, namely:

1. First, to ensure the local community benefits from economic activity;
2. Second, to transform the economic structure to become one that is more diversified, resilient and sustainable; and
3. Third, to rationalise and enhance tax incentives consistent with international best practices.

Ensuring the local community reaps the benefits of economic activity

Labuan has come a long way. After two and a half decades, it is now home to close to 14,000 companies, 54 banks, more than 200 insurance related entities, foundations and leasing companies, respectively.

Nonetheless, the growth of the financial sector should have more spillover benefits to the local community. Two facts illustrate this:

1. First, gains in income must be more evenly distributed across the local population. The top 20% earns more than 5 times the income of the bottom 40% household group[1]. In addition, we must improve the inequality in Labuan as measured by the Gini Index. It has to improve to at least the national level. High inequality in income affects growth, productivity and opportunities for social mobility; and
2. Second, the average unemployment rate at 5.1% in the recent years continues to be above national average in Malaysia. While this might be cyclical because of the downturn in the global oil and gas industry, we need a diversification strategy so that over reliance over certain sectors is avoided.

Further, the workforce participation rate, especially among women, is markedly lower than the national averag[2]. Both reflect a worrying trend where the labour market is not tailored to meet the needs of the local community.

This state of affairs is disappointing and cannot persist. It reveals that an improvement in the current economic operating model is warranted. A new model must be designed that can benefit the local community in a more meaningful manner. Without doubt, it is our collective duty, as an industry whether as regulators or industry players, to advance the welfare of society through a more inclusive economic development. The success or failure to achieve this will reflect on us all as a collective.

In this respect, Bank Negara Malaysia is proud to offer undergraduate scholarships to two deserving local students. This initiative to provide educational opportunities for deserving talents is very much needed and it exemplifies how one can contribute in a tangible manner to the local community. For the offshore industry in Labuan, which has benefitted significantly from Labuan since its inception, it is time to give back.

There are various ways in which the industry can assist the local population, such as innovative and creatively designed technical and industrial training that can assist in uplifting the job prospects of local talents. For example, fit-for-work programmes that leverage on online courses to complement industry supported training programmes and on-the-job training will improve the job fit of the workforce. Needless to say, strong commitment by industry captains to grant similar opportunities, apprenticeship and fit-for-work schemes will surely hasten the upskilling of the locals. The industry ought to come together to devise a scheme that give opportunities to locals to get good jobs.

As we move forward, we need to be more focused on the outcomes we want for Labuan. We want a more balanced growth. A clear step forward is to formulate clear and measurable targets, and to review them consistently. The primary performance indicators that should be applied must cover aspects such as; contribution towards Malaysia's and Labuan's GDP, quality of job creation, training and development for the local population, investment in infrastructure, access to financing by local SMEs. We must ensure that the benefits we obtain outweigh the incentives given by the government such as the revenues foregone from the notional tax incentives offered. The old adage – "You can't manage what you don't measure" – captures the essence of this idea.

Transforming the economic structure to become one that is more diversified, resilient and sustainable

Over the past few decades, the finance and oil and gas sectors have been the main economic contributors to the island's economy, representing more than half (51%) of the economy. However, the decline of oil prices since 2015 have revealed the vulnerabilities of Labuan's economy to the volatilities in the external environment. As observed, businesses across the board declined by at least 40%, with significant repercussions on the livelihood of the local community. The focus on only these two sectors has unwittingly elevated the concentration risk on the island's economy and the associated employment.

A deeper assessment on the performance of the financial sector indicates that the intended outcomes have not fully materialised. Comparing against other international financial centres, there is still a significant gap in Labuan's achievement from its counterparts. A case in point is the Mauritius International Financial Centre, which was established around the same time as the IBFC in the 1990s. Based on available data, the contribution to GDP of the Mauritius financial sector was 10.4% with an employment and tax revenue share of 4.5% and 6.5%, respectively.

Other financial centres which entered the foray much later, such as Shanghai, have moved even further ahead in terms of tax revenue generated, as well as job creation.[3] The 2017 Global Financial Centres Index ranks Shanghai at 13th with Mauritius at the 73rd position, while Labuan is currently not even ranked in the Index. What this alludes to is that continuous reinvention of financial offerings by our market players is necessary for the IBFC to build a niche and gain international prominence.

Empirical evidence suggests long-term economic resilience can only be secured by adopting a broad-based economic development strategy. In other words, Labuan needs to horizontally diversify its economic base beyond financial services and oil and gas. Financial services might be a driver, but it will not be the main one. Unquestionably, the way forward requires a refined model that also gives equal weight, if not more, to inclusive and sustainable development of the economy.

Another imperative for long term development is the issue of infrastructure. As with any other island economy, Labuan's growth prospects are very much influenced by the availability of hard and soft infrastructure which are critical enablers for better connectivity and livability. Connectivity is also an important imperative. Frequency of flights to Labuan would attract talent and visitors to the island. Labuan can also be positioned as the 'halfway point' between tourism in Sabah and Sarawak. Travelling time can be potentially reduced with the Pan Borneo Highway and physical connection between the island to mainland Sabah.

All in all, the effort to transform the economy through identifying new areas of economic potential and fulfilling infrastructure needs is a difficult but not insurmountable task. We may refer to the story of our country's development for inspiration. Within six decades, our economy moved from being a commodity-dependent nation to one that is successfully transformed. We subsequently elevated ourselves to where we are today, an economy that is open, diversified and competitive. This is only possible because of continuous investments in infrastructure over many decades.

Rationalising tax incentives to be in line with international practices

On the global regulatory front, as we had witnessed, the unfolding of the global financial crisis revealed the significant vulnerability of international financial markets to market dislocations. Calls for greater regulatory harmonisation and the adoption of international best practices have gathered speed, blurring the distinction between onshore and offshore regulatory requirements. Offshore financial centres which remain mired in the old model and thinking are set to become part of a sunset industry.

There have also been significant advancements with respect to international taxation practices. Authorities are now more proactive in seeking to mitigate the distortionary effects of harmful tax competition on the allocation of resources and its negative implications on national tax bases.

Malaysia, until early this year, has been an observer of the OECD's Inclusive Framework on Base Erosion Profit Shifting (BEPS). Since January 2017, we have agreed to become a participating member in the Inclusive Framework.

This will allow Malaysia to participate in the BEPS related work on equal footing with other OECD and G20 countries. We will also be able to provide direct inputs to shape the content of the BEPS related standards.

In addition to that, work has commenced on reviewing respective jurisdictions' preferential tax regimes against the standards outlined, to combat harmful tax practices. The standar[4], which forms one of the four BEPS minimum standards, will require authorities to step up on transparency and substance rules for geographically-mobile activities, such as financial services. It seeks, for one, to prohibit the shifting away of income into preferential tax regimes where businesses have little or no economic activity. Such international developments will directly influence IBFC's business model going forward.

The world that we live in, since the creation of offshore Labuan in the 1990s, has drastically changed. What was relevant then is no more relevant now. We have no choice but to change with it. It is an opportune time for us to review of the current tax framework for Labuan.

The purpose of this review is not only to ensure alignment with international best practices, but to confirm the continued relevance of such incentives in catalysing new growth areas. Tax incentives for businesses which have become irrelevant should be rationalised. The allocation of any preferential tax treatment must be supported by clear value propositions that are systematically measured across the qualifying period.

Businesses that enjoy tax incentives will be benchmarked against the performance indicators that quantify economics and financial benefits. This is not meant to be onerous. It is a necessary tool to ensure that the economy grows in an inclusive and sustainable way and the public policies implemented bear the intended benefits. Specific to financial industry players, such preferential treatment must be coupled with clear business strategy that integrates the desired expected outcomes of contributing positively to the national and the local economy.

The intended outcome of the revised tax structure would enhance the economy of Labuan with balanced development. The revised tax regime should also improve regulation, compliance and prevent tax leakages.

There will be greater and closer cooperation between the authorities to address any regulatory arbitrage. The enhancement is also consistent with our continued commitment in advocating strong transparency and promoting greater fiscal sustainability. The review of tax incentives is also to preserve the IBFC's reputation and competitiveness.

Conclusion

The outcome that we seek is for an inclusive, sustainable and prosperous Labuan. All must benefit from the financial activities in Labuan. How we will get there is by design, by determination and the courage to institute reform. Leonardo da Vinci once said "Knowing is not enough; we must apply. Being willing is not enough, we must do".

It is not an option for us to remain where we are. We must embrace the new reality, change course and design a new strategy for our industry. Or else we will perish. We are in this as a community.

As I said last year, we need to swim, or we will sink, together.

Thank you.

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1 RM15,328 vs RM3,654

2 Lower participation rate in Labuan (66.5%) vs national (67.7%). Among women this is even more stark (47.8% in Labuan vs 54.3% at the national level).

3 Shanghai financial centre was incepted in 2009. Latest available data shows that the share of employment and tax revenue collected was 5% and 9.6%, respectively.

4 Refers to the BEPS Action 5 – Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance