THE MALAYSIAN ECONOMY BEYOND 1990

International and Domestic Perspectives

Editors

Lee Kiong Hock
Shyamala Nagaraj

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PREFACE

This book contains papers and commentaries presented at the Tenth Economic Convention of the Persatuan Ekonomi Malaysia held from 7-9 August 1989 in Kuala Lumpur. The theme of the Convention, "The Malaysian Economy Beyond 1990: An International and Domestic Perspective", was intended to generate debate and ideas about Malaysian economic policy for the 1990s. The issue was timely: there was a good deal of uncertainty about the form of the policy that would replace the New Economic Policy, the time frame for which ended in 1990.

This mood is reflected in most of the papers, which also provide several suggestions for the future. The papers on the Malaysian economy discuss the issues at stake, whether in finance, labour or industry. These are complemented by discussion on the international setting within which the Malaysian economy operates. At the time of publication, the Second Outline Perspective Plan and the Sixth Malaysia Plan have been released. It is to the credit of the paperwriters that some of their suggestions have been considered in these documents.

We would like to place on record our gratitude to the many individuals who helped in the publication of this book. The authors have been very cooperative in responding to editing queries. The editing process has been relatively smooth with the help of Kwek Kian Teng, Don Miller, Liew San Yee, Huzir Sulaiman, Roslinah and Jeanette. We are especially grateful to Foo Ah Hiang who has most patiently worked at our erratic pace to finalize layout.

On behalf of the PEM, we take this opportunity to express our deepest sympathy to the family of Mr. Shiew Wan Shing, whose paper on "The Manufacturing Sector: Malaysian Experience and Outlook" appears in this volume, on his untimely demise last year. Mr. Shiew was a frequent contributor and participant in PEM's varied activities. The PEM has lost a member and a friend.

Lee Kiong Hock
Shyamala Nagaraj

NOTES ON CONTRIBUTORS

Dato' Ali Abul Hassan is the Director General of the Economic Planning Unit in the Prime Minister's Department.

Dr. Fong Chan Onn is the Honorable Deputy Minister in the Ministry of Education.

Dr. Homi Kharas is the Principal Economist, Asia Region at the World Bank.

Datuk Dr. Kamal Salih is the Executive Director of the Malaysian Institute of Economic Research.

Prof. Wolfgang Kasper is Professor of Economics and Head of Department of Economics and Management at the University of New South Wales.

Mr. Martin Khor is the Research Director at the Consumers Association of Penang.

Dr. Flemming Larsen is the Chief of the Current Studies Division in the Research Department at the International Monetary Fund.

Dr. Lee Kiong Hock is an Associate Professor at the Faculty of Economics and Administration, University of Malaya.

Dr. Lim Lin Lean is an Associate Professor at the Faculty of Economics and Administration, University of Malaya.

Tan Sri Dato' Dr Lin See Yan is the Deputy Governor of Bank Negara Malaysia, and President of the Persatuan Ekonomi Malaysia.

Dato' Malek Merican is the Managing Director of Arab-Malaysian Merchant Bank, and Deputy President of the Persatuan Ekonomi Malaysia.

Dato' Mohd Sheriff Mohd Kassim is the Secretary General at the Ministry of Finance, and a Vice-President of the Persatuan Ekonomi Malaysia.

Prof. Mokhtar Tamin is Professor of Rural Economics in the Faculty of Economics and Administration, University of Malaya.

Dato' N. Sadasivan is the Director General of the Malaysian Industrial Development Authority.

Dr. Shahid Yusuf is Principal Economist at the World Bank.

Mr. Shiew Wan Shing was the Group Managing Director, UMW Corporation, and Vice-President of the Federation of Malaysian Manufacturers.

Dr. Guy Standing is the Coordinator of Labour Market Research at the Employment Planning and Population Branch, International Labour Office.

Dr. Alan A. Tait is the Deputy Director of the Fiscal Affairs Department at the International Monetary Fund.

Dr. Tan Tat Wai is the Chief Executive Director of Southern Iron & Steel Works Sdn Bhd.

Dr. R. Thillainathan is the Director of Finance of Genting Berhad and a Vice-President of the Persatuan Ekonomi Malaysia.

Mr. Yong Poh Kon is the Managing Director of Selangor Pewter, and Chairman of the Institute for Strategic Analysis and Policy Research.

Encik Zain Majid is the Executive Director of the Malaysian Employers Federation.

Dr. Zainal Aznam Yusof is the Adviser to Bank Negara Malaysia.

INTRODUCTION

Unlike Rivlin's political wizards (Rivlin 1975) who do not ask, the question of income distribution has become the focal point of much of Malaysian economic policy. No serious discussion on the Malaysian economy and its potential can therefore be complete without a discussion of the New Economic Policy (NEP). In 1970 Malaysia launched its NEP, the substantive content of which is embodied in the Second Malaysia Plan. Briefly, within the context of Malaysia's pluralism, the NEP, which spans across two decades, contains two basic policy goals:

a) the reduction and elimination of poverty irrespective of race, and
b) the restructuring of society so as to reduce and eventually eliminate the identification of race with economic function.

These two policy goals serve as means toward a third, more abstract but higher, goal — national unity in the midst of diversity.

Even though economists of the past generation have, as Rivlin notes, abandoned the notion that interpersonal utility comparisons were possible and rejected the notion that redistribution of income from the rich to the poor generally enhances total welfare, one's gut feeling is that the common sense notion is correct (Rivlin 1975 p. 3). Few would therefore question the policy goals of the NEP though one might, like Rivlin, question whether half-formed policy proposals have been picked-up and implemented too hard and too fast (Rivlin 1975 p. 14).

As Malaysia approaches the official 1990 deadline of the NEP, it is imperative for the nation's economists and non-economists — the man in business and industry, in government, and indeed in virtually all walks of life — to reconsider afresh the NEP. There are two ways to do so, and there is no time for respite for the NEP affects not only the coffers of the Federal Treasury but, more importantly, the lives of the present and future generations of Malaysians. Furthermore, for the rest of the world, the NEP may be likened to a window into an extensive affirmative programme of income redistribution and the restructuring of society.

The NEP may be reconsidered afresh by reminiscing or by cogitating the future. The former is likely to be controversial and likely to remain so for a long time to come. Reminiscing may also lead to a detraction from the future of the nation. The latter, on the other hand, may be less controversial if by it is meant the adaptation of existing NEP instruments to an alternative, though not mutually exclusive, policy.

There is no denying that adaptation is possible for there is more than one way to redistribute income. Equalization could, for instance, be achieved through taxes and transfers, though economists seem noncommittal on the costs. Alternatively, equalization could be achieved through an equalization of opportunity. Economists, as Rivlin notes, do feel far more comfortable with the goal of equalizing opportunity. At least theoretically, by giving naturally productive people a chance rather than a handicap, total output might increase (Rivlin 1975 p. 7).

Within this framework, economists can chart new grounds for the future of the nation; laying new concrete goals for the nation as it enters an increasingly competitive world environment. The NEP can be interwoven into a fabric of new concrete policy goals for the 1990s. This is the approach adopted at the Tenth Economic Convention of the Malaysian Economic Association.

If at all there is a non-controversial lesson from reminiscing, it is that a small open economy such as Malaysia can ill afford to ignore changes on the international scene. As a small open economy which is a primary commodity exporter, Malaysia has experienced wide variations in its commodity prices and an adverse trend in its terms of trade. These long term pressures from the international environment have recently been amplified by developments in the industrial countries, such as protective reactions to rapid market penetration by the newly industrialized countries (NICs), a protective response to solving the deficit problem in the United States, and threats of retreats into bilateralism. Malaysia has, within this context, been forced to change its policy orientation from increasing emphasis on societal restructuring to poverty eradication.

In this context, the principal issues for Malaysia are: what is happening in the world economic scene, and how should a small, multi-ethnic country pose itself in order to achieve sustained economic growth and development without jeopardizing the goals of income redistribution and societal restructuring.

It would be extremely difficult for a single individual to deal with these issues. Rightly then, the Tenth Economic Convention of the Malaysian Economic Association has brought together economists and other professionals, from across four continents and from widely varied backgrounds and interests, to discuss issues which are important not only for Malaysia but also for the rest of the watching world. If, then, the proceedings of the Tenth Economic Convention are a farrago, that is a strength. Minds that are not closed stand to gain from this apparent farrago.

As Halberstadt and Culyer (1977 p. 9) note, even a farrago need not be a complete hodge-podge. The Tenth Economic Convention has, accordingly, grouped the papers presented by subject matter. Part I deals with alternative scenarios of the world economy in the 1990s and the implications for Malaysia. Part II is devoted to the manufacturing sector, taking lessons from the experiences of the East-Asian NICs and then looking at Malaysia's experiences and the outlook for the 1990s. Parts III to VI, respectively, examine various fiscal, labour market, capital market, and distributional reforms which are thought essential to propel Malaysia through the 1990s in the most efficient way possible.

Part I: The World and Malaysian Economy in the 1990s

As a highly open economy, Malaysia is vulnerable to the vagaries of the world economy. No discussion of the Malaysian economy in the 1990s can therefore be complete without a discussion of the external environment. The latter is deftly dealt with by Flemming Larsen, Chief of the Current Studies Division at the International Monetary Fund.

Larsen's approach revolves around the fundamental belief that "...the economic linkages that bind countries together... have increased significantly over time... (hence) policy-makers can under no circumstances disregard economic trends in the rest of the world". In line with this, Larsen's paper begins with a look at some of the most important economic developments since the twilight of Maddison's "Golden Age" (Maddison 1982). In particular, Larsen summarizes the most important economic developments over the past twenty years, giving particular emphasis to those structural changes in the world economy which set the scene for the 1990s. Next, he examines three new policy initiatives which are likely to influence the structure of the world economy. He gives particular emphasis to further structural reforms, regional integration (particularly in the form of the Canadian-US free trade agreement, and the European Community), and the future international monetary system. Larsen then discusses the major challenges that will need to be addressed in the 1990s if world growth is to be sustained at a satisfactory pace. The challenges which must be addressed are the need to restore adequate growth in the heavily indebted developing countries, protectionism, the economic aspects of environmental policies, and current contrasting demographic developments in the industrial and developing countries. Larsen concludes with sketches of alternative scenarios for the 1990s which will undoubtedly have a bearing on the Malaysian economy.

Kamal Salih, Executive Director of the Malaysian Institute of Economic Research, in the next paper, begins where Larsen leaves off. In addition to Larsen's three new policy initiatives which are likely to influence the structure of the world economy, Kamal cites the current imbalances of the US economy and the emergence of the Asian-Pacific rim. Kamal then focuses attention on the Malaysian economy giving particular emphasis to changes which have taken place following from the aftermath of the 1985 recession, the resurgence of direct foreign investment and the trend toward domestic-led growth. Clearly, the prospects for the period beyond 1990 depend not only on the external environment but also on domestic policies. Within this context, Kamal advocates the adoption of an "Income Doubling and Distribution Plan" as a replacement for the New Economic Policy. Kamal then examines three alternative scenarios for the Malaysian economy in the 1990s. Of these, only one would enable the targets of the "Income Doubling and Distribution Plan" to be realized.

Part II: Focus on the Manufacturing Sector

Whatever the shape of Malaysia's post-1990 economic policy, the manufacturing sector should be accorded a prominent role. However, the prospects for realizing this role will depend crucially on the economic order of the day.

Wolfgang Kasper, Professor of Economics at University College, University of New South Wales, and formerly advisor to the Malaysian Treasury, examines the elements essential for rapid and sustained industrial growth by drawing on recent developments in evolutionary economics, oligopolistic competition and public-choice theory. In particular, he applies these to an East-Asian model of industrialization and draws out fundamental lessons for Malaysia. Kasper argues that if Malaysia wants to emulate the extraordinary industrial performance of the four East-Asian NICs it must give priority to efficiency growth, open up the economy to international competition, and expose the producers in the public and quasi-public sector to genuine, open competition.

Shiew Wan Shing, Vice-President of the Federation of Malaysian Manufacturers, affirms the role that must be accorded to the manufacturing sector by examining the consequences of an underdeveloped manufacturing sector. He then outlines three phases in the development of the Malaysian manufacturing sector giving prominence to the forces that shape the pattern of development. In so doing, Shiew reinforces Kasper's underlying belief that the pattern of industrial development depends crucially on the economic order of the day. Next, Shiew discusses some of the problems that need to be addressed if Malaysia is to achieve rapid and sustained industrial growth. Here, Shiew elaborates, in some detail, steps which are implicit in Kasper's arguments for efficiency growth.

Part III: Fiscal Reforms

While Larsen's central scenario for the world economy in the 1990s is fairly optimistic, Kamal's "Income Doubling and Distribution Plan" calls for a faster economic growth rate than has been realized in the 1980s. For the latter to be realized, there is, as Kasper and Shiew argue, a need to give higher priority to efficiency growth which in turn calls for reforms in the current economic order. Reforms in the current economic order can come from various quarters. The Tenth Economic Convention of the Malaysian Economic Association focuses on fiscal, labour market, distribution, and financial and capital market reforms.

In terms of fiscal reforms, attention was given to the Value Added Tax (VAT) and privatization, both of which are in vogue as policy instruments. Alan Tait, Deputy Director of Fiscal Affairs Department at the International Monetary Fund and author of a book on VAT (Tait 1988), examines the growing popularity of the VAT, and then discusses some issues relevant to Malaysia even as the country contemplates its introduction. The issues include the rate of VAT, exemptions in relation to food, capital goods, and financial services, and the administration of the VAT, including a "typical" timetable for its introduction. Tait ends with a cautionary note. The VAT, he states, "is not a tax to be introduced in a hurry. As the timetables show, a careful logical sequence should be followed."

Mohamad Sheriff Mohamad Kassim, then Director General of the Economic Planning Unit at the Prime Minister's Department, looks at the issue of privatization. Mohd Sheriff begins by reviewing the achievements made under Malaysia's privatization programme. The review discusses the criteria for the selection of projects for privatization, the methods of privatization and the criteria by which the success or failure of the privatization programme may be judged. Next, Mohamad discusses some of the practical problems encountered in Malaysia's privatization programme and how some of these were resolved. Finally, Mohamad takes a peek into the Privatization Master Plan which, *inter alia*, will address various implementation problems and recommend guidelines for action needed to enhance the nation's privatization programme. The Master Plan, as Mohamad reveals, goes yet one step further in that it will also contain a "plan for action" based on an analysis of over four hundred Government-owned enterprises.

Part IV: Labour Market Reforms

Both the VAT and the privatization programme are being promoted for various reasons including efficiency growth. However, no change to the economic order of the day towards efficiency growth can possibly succeed if it ignores one of the most fundamental of inputs in the production process, that is, labour or the nation's human resource. Labour market flexibility, for instance, is viewed by many as a necessity for structural adjustments toward greater efficiency and economic growth.

Guy Standing, Senior Economist at the Employment Planning and Population Branch of the International Labour Office, adroitly handles the issue of labour market flexibility. The core of his argument is the need to strike a balance between the arguments for labour flexibility, on the one hand, and the arguments for social equity, on the other. These two arguments present a dilemma for policy-makers, and in particular for those who shape labour market policies. He observes a movement towards more labour flexibility in Malaysia. Standing then goes into an extended discussion of the structural adjustment (cum labour market flexibility) model and the social adjustment (cum labour security) model. This is followed by a discussion of labour market flexibility in Malaysia based on the recent Manufacturing Labour Flexibility Survey. The findings in general lend support to his observations pertaining to the move towards labour flexibility and the need to provide adequate security to the worker. Standing concludes with an argument for a regulatory framework coupling worker security with labour flexibility in which the overall utilization, development and replenishment of skills can be ensured.

Zain Majid, Executive Director of the Malaysian Employers' Federation, takes a closer look at one aspect of the overall issue of labour market flexibility by focusing on wage reforms. Zain begins with a discussion of some of the principal deficiencies of the existing wage system, highlighting in particular its detachment from productivity. Zain then argues for a new wage system for Malaysia based primarily on the concepts of flexibility and productivity.

Part V: Capital Market Reforms

Within the context of efficiency growth, Malaysia's growth strategy is likely to focus on the development of the manufacturing sector. This calls for sustained investment. An important question is whether domestic savings mobilization efforts are adequate. Homi Kharas, Country Economist for Malaysia at the World Bank, examines this issue. Homi reviews the determinants of savings and their intermediation in Malaysia to see whether intervention in the savings process can support the nation's long-term growth. Homi in fact addresses five specific questions. First, are current high savings levels cyclical or do they reflect long-term savings propensities? Second, will rapid growth give rise to an adequate level of domestic savings? Third, what is the role of a contractual savings scheme? Fourth, how will changes in income distribution affect the level and composition of domestic savings? Fifth, what role does the process of financial intermediation have on the allocation and efficiency of investment? As Homi examines each of these issues it is clear that changes are needed if the manufacturing-oriented growth strategy is to prove successful. Homi makes some pertinent recommendations.

Sustained growth also calls for an effective capital market. Without an effective capital market there will be no proper mechanism to ensure that capital is allocated where its marginal productivity is highest. Lin See Yan, Deputy Governor of Bank Negara Malaysia and President of the Malaysian Economic Association, recounts the reasons why Malaysia should develop its capital market. After providing a back-drop to Malaysia's capital market, Lin makes an evaluation of the performance of the capital market, giving emphasis to secondary trading activities. Lin goes on to outline recent reforms in the government securities market and then offers some suggestions on how the existing system can be improved. Next, he discusses the essential ingredients for the establishment of a financial futures market in Malaysia, and follows with a discussion of the nature, role and importance of venture capital business in Malaysia. Lin concludes by restating the five major areas which need to be developed further.

Part VI: Distribution Reforms

We come finally to the core of Malaysia's policy orientation for the last two decades: which is poverty and redistribution. As stated earlier, the objective at the Tenth Economic Convention is not so much reminiscing the past as it is to rethink the future. This is achieved by stepping back to learn from the experiences of other nations and then stepping forward with new ideas and new ways to look at an old problem.

Shahid Yusof, Principal Economist at the World Bank and formerly Country Economist for Malaysia, takes a look at the many faces of poverty and redistribution from an international perspective. Shahid is quick to point out that over the last thirty years several strategies have been implemented and much experience has been accumulated. Shahid argues that world opinion has shifted away from redistribution through planning and controls as the economic crises and turbulence of the first fifteen years brought into sharper focus the trade-off between redistribution and growth. Next, he assesses the contribution of five categories of forces that influence the extent of poverty and distribution, namely the evolving structure of the economy, the level of economic activity, reforms in agriculture and industry, social and institutional factors pertaining to the labour market, and transfer and welfare programmes. Finally, Shahid discusses policy choices for the nineties for developing countries.

Given the nature of his paper, Shahid does not give more than passing mention to Malaysia's experience in poverty eradication and redistribution. The task of documenting the Malaysian experience in greater detail is left to Zainal Aznam, Deputy Director of the Malaysian Institute of Economic Research. Zainal begins by putting the New Economic Policy (NEP) within its historical perspective. Next he documents the achievements and shortfalls in poverty eradication, ethnic restructuring of employment and wealth ownership, and income redistribution. Zainal then discusses the strategies and programmes designed and implemented to achieve the NEP goals. He concludes with an astute caution that there is no guarantee that high growth, low poverty and narrowing of ethnic inequalities will enable Malaysia to achieve the paramount goal of its NEP — national unity.

As the old adage goes, the ends do not justify the means. In the Malaysian setting, the means can be just as important as if not more important than the ends, for they can affect the attainment of the paramount goal of the NEP. Following the philosophy underlying the Convention, Yong Poh Kon, Chairman of the Institute for Strategic Analysis and Policy Research (INSAP), and Lim Lin Lean, Associate Professor at the Faculty of Economics and Administration, University of Malaya, examine the means that may be adopted for the period beyond 1990.

Yong and Lim begin by making an important distinction between opportunities and outcomes. While existing policies generally interpret equity in terms of outcomes, Yong and Lim argue for an interpretation in terms of opportunities. Both opportunities and outcomes are, they argue, affected by personal and environmental factors of which the NEP is but one. Yong and Lim bring all these factors together in a matrix of options. Deliberate attempts to manipulate the environment, such as the implementation of the NEP, can either move the country toward or away from equality. With the matrix of options, Yong and Lim succinctly illustrate the point with pertinent examples. They conclude by calling for the establishment of an independent commission to help determine and monitor the types of activities and policies that enter into the different quadrants of the matrix.

Concluding Remarks

The Tenth Economic Convention of the Malaysian Economic Association has illuminated several important aspects for further deliberation as Malaysia enters the 1990s. Overall, the consensus is that the economic order of the day, which depends so much on domestic policies, will affect Malaysia's economic performance and the attainment of the NEP goals or alternative goals which may emerge after 1990. Whatever the post-1990 goals, the challenge before the nation appears to be the need for greater efficiency in the manufacturing sector, in fiscal management, in the labour market, and in the capital market. In terms of redistribution, we are back where we started. As Rivlin argued, economists appear to be more comfortable with the equalization of opportunities.

As a final word, the Tenth Economic Convention has also brought together a notable panel of commentators to comment on each part of the deliberations. The comments add flavour to an already commendable collection of papers.

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THE WORLD ECONOMY IN THE 1990s

Flemming Larsen*

The objective of this paper is to outline some possible scenarios for the external environment the Malaysian economy will be confronted with during the 1990s. The paper begins by summarizing the most important developments during the past 20 years, with particular emphasis on structural changes: these structural changes set the scene for the 1990s. The paper then identifies some important policy premises and policy challenges for the next decade, discussing, in turn, domestic policy objectives, the international monetary system, the need to restore growth in the heavily indebted countries, protectionism, economic aspects of environmental policies, and demographic developments.

The central scenario for the 1990s is quite optimistic, and is characterized by a less cyclical world economy, and by stronger growth than in the 1980s. But there are many risks and challenges that could result in alternative outcomes. If policy-makers deal effectively with these challenges, the 1990s could be a period of very strong growth. But if policies are not sufficiently responsive, a low growth scenario cannot be ruled out.

1. Introduction and Overview

In inviting a representative from the International Monetary Fund to outline some possible scenarios for the world economy for the decade ahead, the organizers of this conference have rightly sought to stress the role the external environment is likely to play for the future performance of the Malaysian economy. History has shown us very few, if indeed any, examples where a country has successfully managed to buck the trend — to insulate its economy from major external trends or disturbances. True, domestic policies are crucial in determining the nature and

*The author is indebted to Michael Artis and several International Monetary Fund colleagues for valuable comments and suggestions. The views expressed are those of the author and should not be attributed to the Fund's staff, the Fund's Executive Director, or their national authorities.

extent of any domestic repercussions from negative external shocks and in reinforcing the positive effects of favourable influences. But policy-makers can under no circumstances disregard economic trends in the rest of the world.

Experience has also shown that the economic linkages that bind countries together, be it through merchandise trade, services or financial flows and conditions, have increased significantly over time as a steadily growing proportion of world output is being consumed or invested in countries that are different from the country of production. In the 1950s and 1960s, economic integration was synonymous with trade liberalization, which contributed so much to the prosperity of the post-war era. More recent efforts to liberalize and integrate world capital markets constitute a further significant increase in economic interdependence of national economies, which may help to release additional productivity reserves, just like the tariff reductions did in the 1950s and 1960s. The increased integration of world capital markets is one of the most crucial changes in the world economy in recent years, and in many respects may be worthy of the characterization "regime change."

A period as long as a decade is a very long time in economics and it would not be very productive to seek to quantify the economic prospects for the 1990s in great detail. In delineating several possible scenarios or sketches for the 1990s, the paper will therefore concentrate on the qualitative aspects of the economic trends that may materialize. Specifically, the discussion will focus on issues such as cyclical variability, the inflation proneness of the system, the interaction between structural reform and traditional macro-economic policies, the importance of the trade regime, the economic implications of environmental measures, and the role of demographic factors.

The paper will first summarize some of the most important economic developments over the past 20 years, with particular emphasis on structural changes in the world economy: these structural changes largely set the scene for the 1990s. Having set the scene in terms of the evolving structure of the world economy the paper will outline some of the most important policy premises and policy challenges for the next decade: which kind of domestic policies will be pursued? What will the international monetary system look like? What will it take to restore growth in the heavily indebted countries? And so forth.

The central scenario for the 1990s is fairly optimistic. It is characterized by a less cyclical world economy, by stronger growth than experienced in the 1980s, by rapid growth of world trade, and by a recovery of growth in the highly indebted developing countries. However, there are many risks that could influence world economic performance during the period ahead: if we manage to adapt the system to deal effectively with these challenges, there is no reason to rule out that the 1990s could be a period of very strong growth. On the other hand, if policies are not sufficiently responsive, a low-growth scenario, with a combination of lower trend growth and more cyclical variability, cannot be ruled out either.

2. Setting the Scene: The World Economy in the 1970s and 1980s

The past two decades have been extraordinarily rich in economic upheavals. The world economy has experienced a series of fundamental economic problems and major disturbances: large fluctuations in prices of oil and raw material; the emergence of protracted inflation problems in both industrial and developing countries; the persistence of large external imbalances and debt problems; and significant misalignment of important currencies. We have also witnessed a series of quite fundamental systemic changes in the form of the demise of the Bretton Woods system and the gradual emergence of a new international monetary system; a marked strengthening of policy coordination among the major industrial countries; and a shift in policy orientation from preoccupation with short-term stabilization to much more emphasis on medium-term and even long-term objectives.

Considerable costs in the form of unemployed resources in both labour and product markets were incurred during the 1970s and 1980s as old policies were rejected and new ones put in place. With the benefit of hindsight these costs were probably larger than they needed to have been. But the experience was nonetheless rewarding because we have learned so much about the importance of preserving a high degree of flexibility in the economic system, about the interaction of supply and demand, and about the types of policy responses that may be appropriate for different countries in different circumstances. Policy-makers therefore stand much better prepared to deal with economic change here at the end of the 1980s than they did, for example, when oil prices suddenly quadrupled in 1973-74.

2.1 Policy Developments

The shift in policy orientation began to gain momentum towards the end of the 1970s. The background for the growing emphasis on medium-term objectives was the following. *First*, sharp increases in commodity prices and oil prices in the early 1970s had deeply affected the supply side of the industrial world as relative price shifts accelerated the obsolescence of part of the capital stock and reduced the warranted level of real wages — the level of real wages that is consistent with full employment. As a result, structural unemployment increased dramatically, particularly in European countries where, in the face of these supply-side disturbances, labour markets proved more inflexible than in North America. Cyclical unemployment also increased, reflecting the sudden increase in the world's saving propensity as income was transferred to oil producing countries faster than these countries could raise domestic absorption. However, during the second half of the 1970s it gradually became clear that the cyclical component of unemployment was relatively small and that non-cyclical or structural unemployment had increased substantially. The crucial implication of this development was that the rate of unemployment consistent with stable inflation (the NAIRU) had increased, which largely eroded the potency of demand management measures as an instrument to control unemployment.[1] Several attempts continued to be made in the late 1970s and early 1980s to use fiscal policy to stimulate demand. However, confronted with this largely novel type of unemployment, most of these attempts had at best temporary effects on output, leaving more substantial scars on countries' inflation performance.

The *second* reason for reconsidering the priorities for domestic policies was related to the first but had its roots in the period of rapid growth of the late 1960s and early 1970s. This was the realization that underlying inflationary pressures appeared to be intensifying and that each cyclical peak was associated with higher inflation than the previous one. This ratcheting-up of inflation was partly attributable to growing rigidities in labour markets in the form of widespread indexation clauses, statutory minimum wages, social security taxes, etc. However, another reason for the worsening of inflation was the extremely rapid growth of money supply in many of the industrial countries in the early 1970s. The need to control money growth was eventually recognized by most of the major countries. The operational consequence was the introduction of monetary targets as a guide for monetary management. The pursuit of relatively low growth targets for the monetary aggregates subsequently played a key role in the disinflation of the early 1980s. As is well known, however, difficulties associated with the impact of financial deregulation on the stability of demand for money relationships have recently forced Central Banks in most industrial countries to adopt a more pragmatic approach to monetary management.

A *third* factor was the feeling in many countries that the rapid growth of the public sector's share of national income needed to slow down, or even to be brought to a standstill. This objective should be seen in the light of rising budget deficits caused by the failure of tax revenue to keep up with the growth in outlays (due to sluggish economic growth) as well as a growing uneasiness about the longer-term economic consequences of large public sectors, particularly on inflation, external competitiveness, saving and capital formation. Whatever the reason in specific cases, the need to limit the growth of public expenditure and to reduce the risk of crowding out business investment became a serious constraint on the use of fiscal policy for demand stabilization purposes throughout the industrial countries.

A *fourth* element in the shift in policy was less well understood in the 1970s but has since been broadly accepted. This is the evidence that the rate of growth of productivity and, hence, of potential output in the industrial countries slowed significantly after the early 1970s, not only because of the impact of rising commodity prices but also because of the cessation of some of the favourable

[1]These issues are discussed in Bruno and Sachs (1985); see also Coe (1985) and Adams, Fenton and Larsen (1986).

influences that had contributed to the historically very high growth rates of the 1950s and 1960s. With the recognition that underlying or potential growth had slowed, policy-makers generally lowered their levels of ambition.[2]

2.2 Growth Trends

The 1970s and 1980s present a very mixed picture in terms of conventional growth indicators. Growth was highly cyclical; the period comprises two significant growth recessions, 1974-75 and 1981-82; it has also been highly uneven among countries, largely reflecting the poor performance of the highly indebted developing countries (Table 1). To the extent any clear trends are discernible, most regions (with the notable exception of Asia) have also experienced weaker growth in the 1970s and 1980s than in the preceding two decades, even though growth in the industrial countries has been roughly in line with the long-term trend prevailing over the past 100 years (Table 2).[3]

Trends or averages for the past two decades are not particularly helpful as a guide to the future, however. Because this period was characterized by a number of serious and probably unique disturbances that affected economic performance, the average growth performance over the past twenty years may well give a downward bias to any estimates of the underlying future growth rate. Likewise, the performance during the second half of the 1980s may result in an upward bias for those countries that have experienced particularly rapid growth through the elimination of cyclical slack, and a downward bias in the underlying growth trend for countries that have experienced debt-related impediments to growth. To eliminate the noise from the underlying growth trend caused by cyclical and transitory influences, it is useful to apply a growth accounting framework.

For most of the industrial countries, 1973 marked the end of the strong post-war expansion phase.[4] There is now substantial agreement that the slow-down reflected more than the effects of a cyclical downturn in the wake of the abrupt increase in oil prices in 1973. Views still differ, however, about the relative importance of the many possible causes of the slow-down that have been suggested and about the implications for the underlying growth rate in the future.[5]

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[2]The rather slow realization that underlying growth had declined significantly may be illustrated by the relatively optimistic growth objectives outlined in the "McCracken Report" (OECD 1977). A subsequent study, the "Interfutures Report," issued only two years later (OECD 1979) raised a number of doubts about the feasibility of the high growth objectives in the McCracken report and proposed several alternative "moderate growth" scenarios that in retrospect have been closer to the mark.

[3]A long-term comparison is only possible for the industrial countries.

[4]Depending on the statistical technique used, there is some evidence that GNP growth in the United States began to slow in the late 1960s (Dennison 1979). For other major industrial countries there is no evidence of a significant slow-down in growth during the 1960s.

[5]The analysis presented here draws upon a recent background study for the Fund's *World Economic Outlook* (Adams, Fenton and Larsen 1987, updated in 1988).

Table 1
World Output Growth Rates, 1970-89

	1970-74	*1975-79*	*1980-84*	*1985-89*
World	4.6	3.7	2.2	3.3
Industrial Countries	3.5	3.1	2.0	3.4
Canada	5.2	4.2	2.2	4.1
United States	2.4	3.2	1.9	3.2
Japan	6.1	4.6	3.9	4.5
France	5.1	3.0	1.5	2.6
Germany, Fed. Rep. of	3.4	2.8	1.1	2.6
Italy	4.4	3.3	1.9	3.1
United Kingdom	2.6	2.2	0.8	3.7
Major Industrial Countries	3.4	3.3	2.1	3.4
Other Industrial Countries	4.6	2.2	1.7	3.0
of which				
European Community Countries (EC)	4.1	2.7	1.3	2.9
Developing Countries	7.1	5.0	2.6	3.8
Africa	6.6	2.4	1.3	2.7
Asia	6.1	5.9	6.6	7.4
Europe	5.9	6.0	1.7	2.4
Middle East	11.8	5.1	-0.4	1.2
Western Hemisphere	6.8	4.5	1.0	2.2
Fuel Exporters	10.5	5.0	0.4	1.4
Non-Fuel Exporters	6.0	5.0	3.6	4.9
Exporters of Manufactures	7.1	5.9	4.6	6.0
Exporters of Primary Products	4.1	2.5	0.5	2.7
Countries with Debt-Serv. Difficulties	6.3	4.5	0.8	2.5
Countries without Debt-Serv. Difficulties	6.4	5.5	6.0	6.5
Other Countries (USSR/DDR/CZ/BUL)	6.4	4.6	2.4	2.3
Malaysia	8.3	7.2	6.9	4.2

Source: IMF World Economic Outlook.

Table 2
Major Industrial Countries: Average Growth in Output, Employment and Productivity, 1870-1985
(Per cent, compound annual rates of change)

	1870-1950	*1951-73*	*1974-85*
Canada			
GDP/GNP	3.4	5.1	3.3
Employment (persons)	1.7	2.5	2.2
Hours per employee	-0.5	-0.4	-0.3
Employment (man-hours)	1.2	2.1	1.9
Productivity (output per man-hour)	2.1	3.0	1.4
United States			
GDP/GNP	3.5	3.6	2.3
Employment (persons)	2.0	1.6	1.9
Hours per employee	-0.6	-0.4	—
Employment (man-hours)	1.4	1.1	1.9
Productivity (output per man-hour)	2.3	2.6	0.4
Japan			
GDP/GNP	2.2	9.3	3.8
Employment (persons)	0.9	1.7	0.9
Hours per employee	-0.3	-0.1	-0.1
Employment (man-hours)	0.6	1.6	0.7
Productivity (output per man-hour)	1.6	8.0	3.0
France			
GDP/GNP	1.4	5.1	2.1
Employment (persons)	—	0.4	0.2
Hours per employee	-0.5	-0.4	-1.2
Employment (man-hours)	-0.5	—	-1.0
Productivity (output per man-hour)	1.9	5.1	3.2
Germany, Fed. Rep. of			
GDP/GNP	2.1	6.0	1.8
Employment (persons)	0.9	1.0	-0.2
Hours per employee	-0.3	-1.0	-0.8
Employment (man-hours)	0.6	—	-1.1
Productivity (output per man-hour)	1.5	6.0	2.9
Italy			
GDP/GNP	1.5	5.4	2.0
Employment (persons)	0.5	0.6	0.6
Hours per employee	-0.5	-0.9	-0.6
Employment (man-hours)	—	-0.3	0.1
Productivity (output per man-hour)	1.4	5.8	1.9
United Kingdom			
GDP/GNP	1.6	3.0	1.3
Employment (persons)	0.8	0.5	-0.5
Hours per employee	-0.5	-0.6	-0.7
Employment (man-hours)	0.2	-0.1	-1.1
Productivity (output per man-hour)	1.4	3.1	2.5

Sources: Maddison (1982); and Adams, Fenton and Larsen (1987).

While the unprecedented economic disturbances of the 1970s clearly contributed to the sudden and widespread slow-down of growth in the industrial countries after 1973, there is evidence that more deep-seated elements also played a major role, largely reflecting the winding down of a number of unique influences at work in the 1950s and 1960s. In particular, the completion of the period of trade liberalization and of the process whereby Europe and Japan generally made up for the effects of World War II and caught up with the level of productivity in the United States seem to have been significant factors behind the slow-down. Seen in isolation, these explanations would seem to make it unlikely that the industrial countries can return to the very high growth rates that prevailed in the 1950s and 1960s.

However, such a conclusion will need to be tempered by two considerations. *First*, some of the transitory factors behind the slow-down, most importantly the oil price increases, have been partly reversed, which should help to raise growth at least somewhat above the dismal 1975-84. *Second*, the impact of structural reform efforts affecting capital markets as well as labour and goods markets and tax policies may give a significant boost to productivity growth. Regional integration efforts and the on-going liberalization and opening of centrally planned economies may also provide a new impetus to world trade and to growth of productivity world-wide. Overall, while demographic developments may begin to constrain growth in the 1990s in large parts of the industrial world, most countries would seem to be currently experiencing underlying (or potential) growth somewhat higher than during the 1970s or early 1980s albeit probably still significantly less than during "The Golden Age"[6] from 1950 to 1973 (Table 3).[7]

The growth performance of the developing countries has also varied significantly over the past twenty years — among countries and over time. As in the case of the industrial countries, some of the reasons for these variations were of a long-term, deep-seated nature, others reflected transitory influences that had varying effects on different groups of countries.

The large fluctuations in both oil prices and non-oil commodity prices have played a major role in the developing countries' growth performance, particularly through the impact high price levels had on many countries' growth expectations and development strategies, often leading to drastic reconsideration when prices turned less favourable. The availability and terms of external borrowing during the 1970s also have strongly influenced policies and growth expectations even though the record of the developing countries has been extremely mixed in terms of their ability to translate their external borrowing into higher growth on a

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[6]The term "Golden Age" was used by Maddison (1982).

[7]The estimates in Table 3 do not reflect the potential implications of on-going regional integration efforts in Europe; the potential spillover effects of the on-going efforts to liberalize centrally planned economies also are not incorporated.

Table 3
Major Industrial Countries: Estimates of Potential Output Growth, 1966-92
(Annual percentage changes or contribution)

	1966-73	*1974-79*	*1980-87*	*1988-92*
Canada				
Potential GNP growth	4.9	3.6	3.5	2.8
Of which contributions of:				
Business sector	3.7	3.0	3.0	2.4
Capital	0.9	0.7	0.9	0.9
Labour[1]	1.1	1.4	1.0	0.8
Total factor productivity	1.7	0.9	1.1	0.7
Public sector	1.2	0.6	0.5	0.4
United States				
Potential GNP growth	3.6	2.0	2.8	2.8
Of which contributions of:				
Business Sector	2.9	1.9	2.5	2.5
Capital	0.8	0.5	0.8	0.8
Labour[1]	1.0	1.3	0.7	0.7
Total factor productivity	1.1	0.1	1.0	1.0
Public sector	0.7	0.1	0.3	0.3
Japan				
Potential GNP growth	8.6	3.5	3.9	3.9
Of which contributions of:				
Business Sector	7.9	3.3	3.6	3.5
Capital	2.3	1.0	1.3	1.6
Labour[1]	-0.3	0.7	0.3	-0.1
Total factor productivity	5.9	1.4	2.0	2.0
Public sector	0.7	0.2	0.3	0.4
France				
Potential GDP growth	5.5	2.3	2.3	2.5
Of which contributions of:				
Business sector	4.9	2.0	2.0	2.2
Capital	1.1	0.7	0.8	0.9
Labour[1]	-0.1	-1.0	-0.6	-0.5
Total factor productivity	3.9	2.3	1.8	1.8
Public sector	0.6	0.3	0.3	0.3
Germany, Fed. Rep. of				
Potential GNP growth	4.5	1.5	2.2	2.1
Of which contributions of:				
Business sector	3.9	1.2	1.9	1.8
Capital	1.0	0.5	0.7	0.7
Labour[1]	-0.8	-0.8	-0.2	-0.8
Total factor productivity	3.7	1.5	1.4	1.9
Public sector	0.6	0.3	0.3	0.3
Italy				
Potential GDP growth	5.1	1.4	3.0	2.6
Of which contributions of:				
Business sector	4.6	1.2	2.5	2.1
Capital	1.0	0.6	0.8	0.6
Labour[1]	-1.3	-0.3	-0.1	-0.4
Total factor productivity	4.9	0.9	1.8	1.5
Public sector	0.5	0.2	0.5	0.5
United Kingdom				
Potential GDP growth	2.7	1.0	2.5	2.6
Of which contributions of:				
Business sector	2.0	0.4	1.9	2.1
Capital	0.7	0.4	0.6	0.6
Labour[1]	-0.9	-0.8	-0.3	-0.2
Total factor productivity	2.2	0.8	1.6	1.7
Public sector	0.7	0.6	0.6	0.5

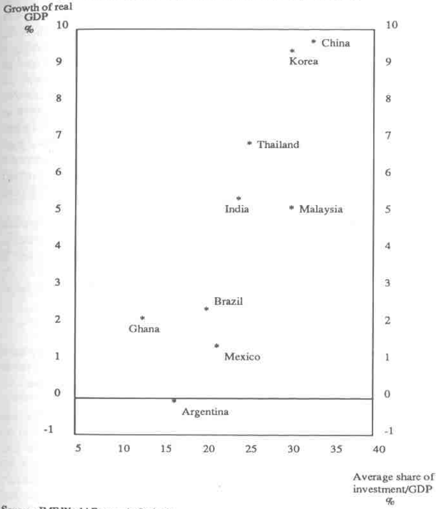
Note: [1] Man hours.
Source: Based on Adams, Fenton and Larsen (1987), updated in IMF (1988).

Table 4.
Developing Countries: Contributions to Potential GDP Growth, 1968-94
(In per cent per annum)

	1970-73[1]	1974-82[1]	1983-89	1989-94
Net debtor countries				
Potential GDP	6.3	5.1	3.7	4.6
Capital contribution	2.6	2.7	1.6	1.9
Labour contribution	1.3	1.4	1.2	1.1
Total factor productivity	2.4	0.9	0.9	1.5
By region				
Africa				
Potential GDP	8.0	3.4	1.4	2.9
Capital contribution	3.0	2.4	0.2	0.6
Labour contribution	1.8	1.8	1.7	1.7
Total factor productivity	3.2	-0.8	-0.6	0.6
Asia[2]				
Potential GDP	5.3	5.8	7.2	7.0
Capital contribution	2.1	2.8	2.9	2.8
Labour contribution	0.9	1.3	1.0	1.0
Total factor productivity	2.3	1.6	3.3	3.3
Europe				
Potential GDP	6.0	5.0	2.6	2.8
Capital contribution	3.5	2.6	1.4	1.6
Labour contribution	0.7	0.7	0.6	0.5
Total factor productivity	1.7	1.6	0.6	0.7
Middle East[2]				
Potential GDP	6.2	4.4	3.6	3.1
Capital contribution	2.7	2.9	1.1	0.9
Labour contribution	1.7	1.4	1.5	1.5
Total factor productivity	1.8	0.1	1.0	0.7
Western hemisphere				
Potential GDP	6.5	5.1	1.6	2.9
Capital contribution	2.3	2.7	1.0	1.5
Labour contribution	1.6	1.7	1.4	1.3
Total factor productivity	2.6	0.8	-0.8	0.1
Countries with debt-servicing problems				
Potential GDP	6.5	4.7	1.5	2.8
Capital contribution	2.8	2.7	0.8	1.3
National savings[3]	2.4	2.0	0.6	1.2
Foreign savings	0.4	0.7	0.2	0.1
Labour contribution	1.4	1.5	1.3	1.2
Total factor productivity	2.3	0.5	-0.6	0.3
Developing countries without debt-serving problems				
Potential GDP	5.9	5.5	6.5	6.4
Capital contribution	2.3	2.7	2.7	2.6
National savings[3]	1.9	2.4	2.5	2.6
Foreign savings	1.9	2.4	2.5	2.6
Labour contribution	1.0	1.3	1.1	1.0
Total factor productivity	2.6	1.5	2.7	2.8

Notes: [1] Excludes China.
[2] Excludes net creditor countries.
[3] Net of depreciation.
Source: IMF World Economic Outlook.

Chart 1
Selected Developing Countries: Investment and Growth, 1980-89



Source: IMF World Economic Outlook.

sustainable basis. The heavy recourse to external borrowing in the 1970s therefore constitute a major impediment to growth in the 1990s because many countries' debt-servicing burden has risen much faster than their debt-servicing capacity.

As illustrated in Table 4, the high growth rate that has been sustained in Asia over the past 15 years has partly reflected very high rates of capital formation. However, although high investment rates do set many Asian countries apart from many other developing countries (Chart 1), this is not the entire explanation. In some regions, (the Western Hemisphere, for example), a relatively large contribution from capital in the 1970s appears to have been offset by a negative contribution from total factor productivity. Since it is difficult to see why growth in the Western Hemisphere should be so much more capital-intensive than in Asia, the negative contribution from investment might be an indication of inefficiency in the allocation of investment resources. Such inefficiency can be attributed to price distortions, high inflation, and inadequate competition in economies dominated by inward-looking economic strategies as opposed to the outward-looking successful strategies pursued in large parts of Asia. The slow-down in growth as from the early 1980s was also most pronounced in the Western Hemisphere and in those countries in Europe that are classified as developing[8] — countries in which debt-servicing problems came to the fore and which experienced a sharp decline in capital formation. By contrast, Asia's growth actually increased slightly due to an acceleration in the pace of productivity gains, a development that reflected the rapid growth of the manufacturing sector.

With such diverse experiences it is difficult to extrapolate the potential growth trends for the developing country regions over the next decade. At least potentially, growth in the developing countries could strengthen significantly. However, if growth in the regions with a relatively weak performance in the 1980s is to recover to match that of Asia, profound structural changes obviously need to take place. This issue will be discussed further below.

2.3 *Inflation*

Inflation problems have been pervasive during the past twenty years; they have affected most regions at least during part of the period (Table 5) and have led to profound changes in economic policies. Among the industrial countries, the ratcheting-up of price pressures was already a cause for concern in the late 1960s. During the 1970s inflation worsened sharply, initially fuelled by excess demand and sharp increases in liquidity, which were followed by the commodity and oil price shocks of 1973-74. Contrary to expectations, the 1974-75 recession had little effect on inflationary pressures and it gradually became apparent that the lack of flexibility of many industrial economies, particularly through the failure of labour markets to adjust to the massive increases in raw materials prices and rising unemployment, contributed to give inflation a life of its own, almost independent of the general economic situation.

The re-orientation of the economic strategy in the 1980s eventually succeeded in reducing inflation in the industrial countries to the levels experienced in the early 1960s (about 3 per cent a year for the industrial countries as a group) — but the costs have been high in terms of unemployment and foregone growth.

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[8]The country classification system used here follows that of the *World Economic Outlook* (see IMF 1989, p. 117-122).

Table 5
World Inflation, 1970-89
(Average percentage, per annum)

	1970-74	1975-79	1980-84	1985-89
World	8.1	11.6	13.5	14.7
Industrial Countries	7.2	8.9	7.8	3.5
Canada	5.9	8.9	8.7	4.3
United States	6.1	8.0	7.4	3.7
Japan	10.6	7.4	3.9	1.1
France	7.7	10.1	11.1	3.6
Germany, Fed. Rep. of	5.6	4.1	4.5	1.3
Italy	9.0	15.8	16.2	6.3
United Kingdom	9.6	15.6	9.5	5.3
Major Industrial Countries	7.1	8.6	7.6	3.2
Other Industrial Countries	7.9	10.2	9.0	5.1
Of which				
European Community (EC)	7.7	10.2	9.5	4.0
Developing Countries	11.4	20.8	30.3	52.3
Africa	8.9	17.8	22.8	16.2
Asia	7.6	5.1	8.7	10.8
Europe	7.2	13.9	28.5	46.8
Middle East	8.7	15.6	14.2	17.2
Western Hemisphere	21.8	50.5	82.4	190.7
Fuel Exporters	9.3	15.6	18.2	25.0
Non-Fuel Exporters	12.1	22.9	36.1	64.7
Exporters of Manufactures	8.6	13.9	33.4	66.2
Exporters of Primary Products	25.0	73.9	67.5	115.9
Countries with Debt-Servicing Difficulties	15.1	33.1	52.9	112.0
Countries without Debt-Servicing Difficulties	7.7	8.8	12.9	11.8
Malaysia	6.8	4.1	6.0	1.7

Source: IMF World Economic Outlook.

Some important lessons have nevertheless been learned about the role of monetary policy in influencing inflationary expectations (hence the widespread use of monetary targets); about the need to promote labour market flexibility (hence the abolition of indexation and introduction of labour market reform measures in many countries); and about the adverse long-term implications of allowing inflation to get out of hand in the 1970s, which explains — and justifies — the rapidity with which monetary authorities reacted to the resurgence of inflationary pressures during 1988 and early 1989. Controlling inflation has been broadly accepted as the key to sustaining economic expansion over the medium term and avoiding excessive cyclical fluctuations.

The developing countries also faced a rise in inflationary pressures in the 1970s for much the same reasons as the industrial countries. In addition, the rise in commodity prices and the emergence of large capital inflows resulted in a substantial boost to disposable income in many countries which translated in large part into rising inflation expectations and excess demand pressures. In contrast to the anti-inflationary strategy that was pursued in the industrial countries, price performance has continued to worsen dramatically in many developing countries in the second half of the 1980s, mainly but not exclusively in countries experiencing debt-servicing difficulties. Because of the impact on confidence and investment, inflation has thus increasingly become part of the vicious circle that is impeding growth in the heavily indebted countries. However, price performance also has worsened in countries without debt-servicing difficulties as a consequence of rapid growth and, in some cases, reflecting transitional difficulties in preventing necessary shifts in relative prices from affecting the overall inflation performance. The continued failure to control inflation is clearly one of the negative factors that cloud the medium-term outlook for many developing countries.

2.4 External Developments

The past ten years have witnessed the emergence of trends on the external side that are widely regarded as unsustainable over the medium term. Addressing the external imbalances has therefore also become a major policy prerogative in both industrial and developing countries.

Among the industrial countries the problems can be traced back to the early 1980s when two major developments occurred. *First*, fiscal strategies and priorities began to differ substantially between the United States on the one hand and Japan and Germany on the other. This contributed to a marked deficiency of national savings in the United States relative to most other countries and, hence, a sharp increase in US interest rates. *Second*, the progressive liberalization of capital markets that began to gain momentum in the early 1980s led to a significant reallocation of the portfolio composition of international investors, involving a dramatic increase in demand for US dollar-denominated assets that reinforced the direct effect of high US interest rates. The result was a massive capital inflow into the United States and a sharp appreciation of the US dollar against the yen and the European currencies, the counterpart of which was a sharp widening of current account imbalances. Reflecting growing concern over these developments, a process of policy coordination was instituted among the Group of Seven countries in 1985. The policy coordination process involved a significant realignment of exchange rates together with attempts to eliminate or at least reduce the fundamental causes of these imbalances.

As is well known, the adjustment process is far from completed. After four years of intensive policy coordination among the Group of Seven the imbalances have shrunk only slightly (in nominal terms; they have narrowed more significantly in real terms) and there are signs that the adjustment process has stalled as indeed is implied by the Fund staff's most recent projections (Table 6). Much more clearly remains to be done if these large current account deficits and surpluses are to be reduced significantly. Yet, we continue to be faced with the perplexing facts that the imbalances have not prevented the present expansion from becoming the longest in the post-war period and that financial markets have remained willing to continue to finance them.

In a world of integrated capital markets this is perhaps less surprising than what most would have thought. That investors diversify their portfolios and spread their risk over many markets and economies is both a natural consequence of structural reform and one of its primary objectives. In view of the differences in investment opportunities, growth prospects and demographic factors that exist among countries, it is also quite understandable that the smoothing of consumption over time, which is the goal of saving, should result in significant net capital inflows or outflows for individual countries.

What is more worrying is the possibility that current account imbalances, while reflecting the free play of market forces, may also reflect fundamental imbalances, such as excessive fiscal deficits or structural impediments to investment that require savings in surplus countries to be invested in other countries. While relatively large current account deficits and surpluses are a natural consequence of the dismantling of structural barriers, policy still needs to be concerned about the adequacy of saving — globally as well as in each country — and about the consequences of structural distortions in markets for goods, labour and capital assets (including land). I will return to these issues in the discussion of the international monetary system below.

The external problems of the indebted developing countries have their roots in the 1970s when these countries undertook massive external borrowing. For many countries, the increase in foreign liabilities proved to be a serious economic mistake, partly because of domestic policy deficiencies but also because of a series of unexpected, largely adverse, external disturbances (including weak commodity prices during the second half of the 1970s and most of the 1980s, high international interest rates, and the 1981-82 recession in industrial countries). The domestic policy deficiencies meant that a large proportion of the external borrowing was used to finance consumption or inadequately productive investment, or led to capital flight as the sustainability of the situation became increasingly questionable.

While the adjustment efforts pursued in most of these countries since the early 1980s have succeeded in curtailing imports and reducing the requirements for new capital, many countries today remain deeply indebted with their debt-servicing burden vastly exceeding their debt-servicing capacity. As a result, the debt has kept growing as rescheduled interest arrears have been accumulated (Table 7). The strength of world trade and commodity prices in 1988 has helped to reduce the debt burden relative to these countries' export earnings but it is clear that the

Table 6
Summary of Payments Balances on Current Account, 1981-90[1]
(In billions of U.S. dollars)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*
Industrial countries	-15.8	-19.5	-18.0	-57.3	-51.1	-17.5	-44.6	-59.0	-67.0	-74.5
United States	6.9	-8.7	-46.3	-107.1	-115.1	-138.8	-154.0	-135.3	-139.3	-156.6
Japan	4.8	6.9	20.8	35.0	49.2	85.8	87.0	79.5	84.0	93.5
Germany, Fed. Rep. of	-3.6	5.1	5.3	9.9	16.6	39.3	45.0	48.5	49.7	51.2
Other industrial countries	-23.9	-22.8	2.1	4.9	-1.7	-3.8	-22.7	-51.6	-61.4	-62.6
Developing countries	-49.1	-83.4	-62.4	-31.4	-26.0	-42.2	1.4	-19.1	-19.4	-26.0
By region										
Africa	-22.1	-21.3	-12.2	-8.0	-0.6	-9.6	-5.3	-9.5	-7.8	-8.4
Asia	-18.6	-16.5	-14.2	-4.2	-14.0	3.9	21.6	10.0	8.8	5.6
Europe	-13.9	-8.0	-5.8	-3.0	-3.1	-2.0	1.0	3.5	1.4	-1.3
Middle East	48.5	5.0	-19.4	-13.7	-3.6	-17.2	-3.8	-11.7	-10.4	-6.2
Western Hemisphere	-43.0	-42.5	-10.9	-2.5	-4.7	-17.3	-12.0	-11.5	-11.5	-15.8
By analytical criteria										
Fuel exporters	33.5	-15.2	-16.9	-1.5	2.8	-31.0	-3.7	-20.4	-13.1	-9.3
Non-fuel exporters	-82.6	-68.2	-45.5	-29.8	-28.8	-11.2	5.1	1.3	-6.3	-16.7
Market borrowers	-57.7	-54.0	-16.2	-3.9	1.7	-6.7	10.2	12.1	10.3	4.4
Official borrowers	-20.0	-17.5	-11.4	-13.1	-12.4	-11.9	-11.1	-14.1	-15.7	-14.9
Countries with recent debt-servicing difficulties	-83.9	-84.5	-31.7	-15.7	-11.5	-33.2	-18.3	-20.6	-21.6	-27.5
Countries without debt-servicing difficulties	-29.8	-27.8	-29.7	-19.2	-27.3	-16.9	1.4	-0.4	-4.9	-6.9
Other countries[2]	-3.4	2.7	3.1	4.8	2.3	3.1	5.1	0.5	-	0.5
Total[3]	-68.3	-100.2	-77.3	-83.9	-74.8	-56.6	-38.1	-77.6	-86.5	-100.0

Notes: [1] Including official transfers.
[2] Covers estimated balances on current transactions only in convertible currencies of the U.S.S.R and non-member countries of Eastern Europe.
[3] Reflects errors, omissions, and asymmetries in reported balance of payments statistics on current account, plus balance of listed groups with countries not included.
Source: IMF (April 1989).

Table 7
Developing Countries: External Debt and Debt Service, 1981-90[1]
(In per cent of exports of goods and services, except where otherwise noted)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*
External debt[2]										
Developing countries	95.8	120.0	134.8	134.3	150.8	170.8	158.7	141.9	132.1	126.6
(in billions of U.S. dollars)	751.9	851.5	904.1	946.6	1023.0	1114.1	1230.9	1239.7	1279.0	1336.6
By region										
Africa	119.3	154.5	170.6	170.5	191.3	244.9	249.2	248.9	241.9	243.9
Asia	73.8	87.1	92.5	88.3	101.8	103.0	89.1	76.1	69.6	65.7
Europe	136.9	145.0	149.1	145.4	160.5	168.4	169.0	146.2	133.9	127.0
Middle East	34.6	47.6	63.6	72.0	84.9	116.3	109.8	116.8	112.3	110.7
Western Hemisphere	209.8	271.8	292.5	274.6	296.9	353.0	346.3	305.0	297.3	289.8
By financial criteria										
Net creditor countries	19.9	27.3	32.3	31.6	34.8	42.9	41.7	39.9	35.0	32.4
Net debtor countries	130.4	157.5	171.0	166.0	183.0	202.4	187.4	164.2	153.7	147.0
Market borrowers	134.1	165.4	170.2	160.8	172.3	180.8	156.3	127.9	116.3	108.3
Diversified borrowers	94.5	112.1	135.6	135.0	153.8	185.6	182.0	172.7	163.6	159.9
Official borrowers	241.9	278.1	286.9	296.4	341.2	360.6	377.7	344.6	338.0	332.3
Countries with recent debt-servicing difficulties	175.3	223.8	244.1	237.4	257.3	305.6	300.2	273.3	264.1	258.5
Countries without debt-servicing difficulties	85.0	97.4	107.0	104.7	121.2	128.7	115.7	99.9	92.1	87.2

contd.

Table 7 (continued)
Developing Countries: External Debt and Debt Service, 1981-90[1]
(In per cent of exports of goods and services, except where otherwise noted)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*
Debt service payments[3]										
Developing countries	16.2	19.7	18.6	20.0	21.3	23.0	20.3	19.6	18.9	17.5
(in billions of U.S. dollars)	127.0	140.1	125.0	140.8	144.7	150.1	157.6	171.3	182.7	185.2
By region										
Africa	17.0	21.2	22.9	26.6	29.1	29.1	25.4	28.8	29.0	26.8
Asia	9.9	12.3	11.9	12.3	14.4	14.5	14.8	11.4	10.6	9.4
Europe	21.8	22.9	20.7	21.7	23.7	26.5	25.9	25.3	23.8	21.4
Middle East	5.0	6.5	8.3	10.0	10.3	14.0	12.6	12.8	12.6	12.3
Western Hemisphere	43.9	54.0	43.3	42.7	42.1	47.2	37.0	41.6	43.2	43.0
By financial criteria										
Net creditor countries	2.8	3.5	4.2	4.7	4.4	5.9	5.4	4.6	3.8	3.4
Net debtor countries	22.3	26.3	23.7	24.7	26.0	27.2	24.0	22.9	22.2	20.6
Market borrowers	27.0	32.0	26.8	27.9	28.3	28.9	24.4	22.7	21.4	19.2
Diversified borrowers	14.6	17.9	18.4	19.3	22.3	24.1	23.1	23.0	22.5	21.3
Official borrowers	26.2	27.8	25.9	26.1	27.3	28.8	24.5	23.6	26.2	26.9
Countries with recent debt-servicing difficulties	31.3	38.0	32.6	33.8	33.9	36.7	29.6	31.9	32.4	31.7
Countries without debt-servicing difficulties	13.1	15.7	16.0	16.8	19.5	20.5	20.4	17.6	16.5	14.7

Notes: [1] Excludes debt owed, and debt service paid, to the Fund.
[2] Total debt at year-end as percentage of exports of goods and services in the year indicated.
[3] Debt service payments refer to actual payments of interest on total debt plus actual amortization payments on long-term debt. The projections incorporate the impact of exceptional financing items.

Source: IMF (April 1989).

situation remains extremely difficult as illustrated by the persistently inadequate growth performance of most of these countries and the large discounts in secondary markets for developing countries' debt.

3. Policy Premises for the 1990s

In addition to the implications that follow from the economic trends over the past two decades, the 1990s are likely to be influenced by new policy initiatives and priorities. There are at least three areas that are likely to receive prominent attention on the policy agenda for the 1990s.

3.1 Structural Reform[9]

The past twenty years have revealed the existence of numerous structural deficiencies in industrial and developing economies alike, including the centrally planned economies. Much has already been done in terms of promoting public awareness of these issues and many reform measures have been taken or are planned.

The basic rationale for structural reform is to improve economic performance over the medium term by raising potential output and by lowering the output and employment losses that may result from adverse economic disturbances. In general, potential output can be raised by improving the allocation of resources, for example, through trade liberalization and the removal of price distortions and subsidies. In addition, structural policies may raise private saving and capital formation and improve the allocation of financial resources through the removal of interest rate ceilings or other rigidities in the financial system, or through the elimination of tax distortions which may discourage private savings or raise the cost of capital. Structural measures can also remove distortions that discourage employment and inhibit incentives to work. For a given rate of growth of nominal demand, all of these measures tend to improve the split between output growth and inflation over the long run.

In addition to their impact on potential output, structural policies can influence the way in which an economy reacts to adverse disturbances — such as relative price shocks — and thereby help to reduce the costs in terms of unused resources that would be incurred as part of the adjustment process. These adjustment costs can be lowered by enhancing the "flexibility" of the economic system — that is, the extent to which (and the speed with which) prices respond to changes in market conditions, and the supply and demand for goods, services, and factors of production respond to changes in relative prices. An important example of relatively

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[9]The role of structural or micro-economic policies in industrial countries is discussed extensively in Feldman, Hernândez-Catâ, Larsen and Wattleworth (1989). Hernândez-Catâ (1989) reviews the role of fiscal and structural policies in the design of growth-oriented adjustment policies in developing countries.

inflexible price setting is that of labour markets, which in many European countries contributed to the sharp increases in unemployment during the 1970s and early 1980s. Measures that increase the flexibility of labour markets can help to lower adjustment costs and also to lower the level of unemployment consistent with stable inflation.

In general, structural measures will affect both exports and imports, and therefore their net impact on the balance of payments is often uncertain. Nevertheless, some structural policies may well have significant effects on the current account. For example, in countries with an external surplus the removal of distortions that discourage investment may help to stimulate domestic demand and imports, and thus contribute to reducing the gap between saving and investment. It is often argued that the desirability of structural measures should be assessed primarily in terms of their effects on efficiency and growth, but the consequences for external balances should also be recognized. This applies to both surplus and deficit countries.

The growing recognition of the role structural policies can and should play in policy strategies is evident from the emphasis placed on these issues in recent Communiqués by the Group of Seven, notably the intention to expand policy coordination and multilateral surveillance to encompass not just fiscal, monetary and exchange rate policies but also micro-economic reform. Among the developing countries it is also increasingly accepted that market forces need to play a larger role in the allocation of resources, and profound reforms are on the agenda virtually everywhere even though the political resistance to change remains an important constraint in many countries. The deepest reforms may occur in some of the centrally planned economies where economic liberalization efforts are just starting. With the pervasive emphasis on structural policies, the 1990s may well become the decade of "structural revolution."

3.2 *Regional Integration*

The Canadian-U.S. free trade agreement and the creation of a unified internal market in the European Community by 1992 are two prominent examples of regional integration efforts. These projects, which are likely to profoundly affect regional and world economic performance in the future, may well become models for other regions.

The European integration plans are the most ambitious, particularly when viewed in the context of the subsequent proposals to create an economic and monetary union in the European Community.[10] The operation of a vast internal European market will strengthen Europe's growth potential by the elimination of

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[10]These proposals are outlined in the "Delors Report" (*Report on Economic and Monetary Union in the European Community* (Committee for the Study of Economic and Monetary Union, April 12, 1989).

internal barriers to the free movement of goods, services, labour and capital. As a result, the efficiency of resource allocation within the Community should be greatly enhanced. At the same time, the structural reforms that are accompanying the 1992 proposals will make the European economy more flexible in the face of economic disturbances, which should make Europe less inflation-prone at the same time as it will promote growth. Finally, the process toward economic and monetary union — even though the precise timetable for the final stages of this process remain to be determined — can be expected to enhance gradually the coordination of policies within the European Community and increase the convergence of economic performance among its member countries. While the precise effects of the European integration efforts are difficult to quantify[11] it is likely that Europe's economic performance will improve substantially compared with the lacklustre performance that has characterized Europe during much of the 1970s and 1980s.

Will the improved internal performance be at the expense of the rest of the world or will other countries also benefit? This question is obviously the subject of an intense debate outside the Community where many fear that Europe is preparing to set up "fortress Europe."[12] So far there is little to suggest that Europe will attempt to raise new barriers against the rest of the world. True, the internal market will make some European producers more competitive, which will undoubtedly generate a shake-out of inefficient producers both within the community and in those cases where third-country exporters are losing their competitive edge. However, such trade diversion effects are likely to be much more than offset by trade creation effects stemming from the enhancement of Europe's growth potential. The net positive effects on the rest of the world will of course depend on other countries' ability to adjust to the challenge of the new European market — exactly as the intra-European effects will depend on the flexibility with which European producers and suppliers of labour adjust to the new situation. These positive effects could be greatly enhanced if the reform plans were extended to comprise the dismantling of Europe's protectionist barriers affecting trade in agricultural products.[13]

3.3 The International Monetary System

The breakdown of the Bretton Woods fixed parity system in the early 1970s was followed by a long period of uncertainty about international monetary arrange-

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[11]The Commission 1988 has made some illustrative calculations suggesting that the 1992 proposals might raise potential output by up to six percent over the medium term, over and above its underlying trend. Depending on the precise assumptions underlying such calculations, the range of possible effects could be quite large.

[12]See Henderson (1989) for a prominent example of this debate.

[13]For a review of the principles and consequences of the agricultural policies in the European Community, see Rosenblatt *et. al.* (1988).

ments. Freely floating exchange rates were accepted, albeit rather reluctantly, as a workable alternative to fixed rates, but only so long as exchange rate volatility did not become excessive, and perceived exchange rate misalignment did not jeopardize the attainment of other objectives such as external balance and price stability. By the mid-1980s the emergence of what was regarded as unsustainably large external imbalances among several of the major industrial countries led to the beginning of a reconsideration of the exchange rate system. Although it is probably still too early to formally announce the creation of a "new system," particularly in view of a number of unresolved issues, it is at least possible to see the contours of what may well form the basis of international monetary arrangements during the decade ahead.

Among the features of the future international monetary system that can be discerned from the experience of the past four years since the Plaza Agreement, there are three major aspects that are particularly important. The *first* element or premise is that freely floating rates are no longer acceptable to the major industrial countries because of the volatility that has been experienced and, in particular, the risk of fundamental misalignment. Several alternatives have been proposed involving more or less fixity of exchange rates. For the time being, at least, the adoption of informal (and confidential) target ranges seems to have been a reasonably successful approach although the implementation has not always been easy.[14]

The *second* element is that the authorities of the major seven industrial countries have become firmly committed to pursuing their exchange rate and other economic objectives through a process of policy coordination (multilateral surveillance) on the basis of the projected medium-term evolution of key economic indicators as well as alternative scenarios. This coordination process encompasses not only monetary and fiscal policies but also many aspects of structural policies. Adjustment of underlying policies has thus become the primary channel through which countries will seek to correct misaligned exchange rates and fundamental external imbalances.[15] In this context, considerable emphasis is being placed on symmetry in the policy adjustments in the sense that both surplus and deficit countries are supposed to share the burden of adjustment, albeit not necessarily through symmetric changes in each policy instrument.

The *third* element concerns the use of coordinated intervention in foreign exchange markets as a means to limiting the volatility of short-term fluctuations. While intervention can never substitute for the required adjustment of underlying policies, the experience from several episodes during the past few years suggests

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[14] See Crockett and Goldstein (1987) and Frenkel and Goldstein (1986).

[15] Crockett and Goldstein (1987). See also Llewellyn, Potter and Samuelson (1985) for a discussion of the need to monitor and forecast economic indicators as a basis for international policy coordination.

that it may be quite effective in containing speculative movements, partly through signalling effects.

There are still several issues that remain to be resolved. *First*, a nominal anchor for the system is probably needed. The major countries do monitor several inflation indicators, including commodity prices, in an effort to ensure that their policies do not have an inflationary or deflationary bias. However, these inflation indicators appear to play a rather informal role in the coordination process. *Second*, the need for international liquidity creation will have to be defined, which potentially includes a clearer definition of the role of the short-term deposit rate (SDR). *Third*, the currencies of the smaller countries will need to be linked to the central system of the major currencies.

A *fourth* issue that needs to be tackled concerns the consequences for the system of the increasingly closely linked domestic capital markets. During the 1980s, the globalization of financial markets encouraged a reallocation of world financial portfolios, which potentially could be of a scale not seen since the gold standard period (1870-1913). As a result, investors are now able to diversify the geographical composition of their assets so as to maximize their rate of return subject to perceived risks in individual markets. At the same time, it must be recognized that the integration of financial markets may have increased the vulnerability of the system to major shocks. The speed with which the stock market correction in October 1987 spread to virtually all countries clearly served as a warning of such linkages. While few people would advocate a return to capital controls, the potential systemic risks could probably be reduced through an appropriate system of "firewalls" and contingency plans for the provision of liquidity. The best prevention, of course, would be if the threat of potential market reactions was to reduce the risk of major policy mistakes that often are at the root of economic disturbances.

A particularly important aspect of the globalization of financial markets is that capital movements may amplify the effects of distortions in other parts of the economy as well as of specific structural characteristics of individual countries, such as the age structure, that may influence countries' saving and investment propensities. Because the structural characteristics that influence saving and investment behaviour may differ among countries, an international monetary system with closely integrated financial markets may well be characterized by relatively large net capital movements among countries, movements that may persist for a span of years. The counterpart of such net capital movements will necessarily show up as deficits and surpluses on countries' current external balances. Relatively large and persistent external imbalances may thus become difficult to avoid. To ensure the sustainability of such a development, countries with capital inflows will need to put in place policies that promote investment so that the inflow of foreign saving does not simply become a substitute for domestic saving which eventually would jeopardize countries' ability to service their external liabilities. The parallels from the experience of the heavily indebted developing countries are quite obvious.

All of these issues will not be resolved quickly. However, both those elements of the emerging "new" international monetary system that are in place, and those that remain under discussion, will be likely to influence the performance of the world economy during the period ahead.

4. Major Challenges

Notwithstanding the substantial achievements in many areas of economic performance in recent years, and the important lessons that have been learned from the turmoil of the 1970s and the early 1980s, several challenges will need to be addressed in the 1990s if world growth is to be sustained at a satisfactory pace.

4.1 Restoring Growth in Severely Indebted Developing Countries

The most important challenge facing world policy-makers is the need to restore adequate growth in the heavily indebted developing countries. Despite a few isolated success stories, the strategy that has been pursued since the early 1980s has failed to generate a sustainable improvement in economic performance of the indebted countries. The main reason for this has been the inadequate attention given to the implementation of the most important element of the strategy, the necessary adaptations of domestic policies in the indebted countries.

Repeated delays in policy implementation have meant that the debt burden has continued to grow, as interest arrears assume an ever growing role as a primary source of (involuntary) financing. At the same time, the discounts on developing country debt traded on secondary markets have widened dramatically, illustrating the growing gap between countries' perceived debt-servicing capacity and their external liabilities. This gap — which is often used as an indicator of the debt "overhang" — has increasingly been recognized as a fundamental impediment to stronger growth. Indeed, it seems likely to constitute a disincentive to potential investors, given the likelihood that the external debt-servicing obligations will eventually lead to higher taxes or increased inflation. There also is a risk that the debt overhang may reduce the incentive for governments to undertake the necessary policy reforms to the extent that the benefits of such reforms are viewed as primarily benefiting external creditors.

To break this vicious circle, major creditor countries have now accepted the need, in particularly severe cases, for a reduction of the indebted countries' debt and debt-servicing burden as a potentially desirable element on the menu of options being considered. At the same time, of course, it is recognized that debt reduction is no panacea itself and that any easing of the liquidity constraints facing a particular country will only succeed in restoring growth if it is accompanied by strong policy measures.

4.2 Protectionism

Protectionist pressures have increased substantially during the 1980s — chiefly in the form of "voluntary" export restraint arrangements (VERs) and other non-tariff measures.[16] The dangerous tendency toward increased bilateralism threatens the multilateral trading system that has played such a fundamental role in the prosperity of the post-war era. The rise in protectionism has its roots in sectoral or regional problems in individual countries and can be related to the emergence of large imbalances on current accounts. While demands for protection are always present, political resistance often weakens in the face of high unemployment, large trade deficits and highly volatile or misaligned exchange rates, which appear to lend support to claims of "unfair" competition.

Fortunately, the commitment to free trade remains strong, as illustrated by the pronouncements in the Communiqué issued after July 89's Summit in Paris, and by the Uruguay Round of Trade Negotiations which addresses several major issues that hitherto have been neglected in multilateral trade discussions (such as agriculture). The Uruguay Round also addresses several new areas (such as services) and sectors that have been subject to special restrictions (steel, automobiles, electronics). Nonetheless, the negotiations are progressing very slowly and although there are grounds for optimism, it is clear that a successful outcome will require major concessions by many of the interested parties.

Because of the strong links there are between protectionist pressures — or the leverage of the protectionist lobby — and economic performance, the problems of protection may amplify the adverse consequences of general economic disturbances. The strongest defense of the multilateral trading system may therefore lie in policy adaptations that promote sustained non-inflationary growth while reducing external imbalances and exchange rate volatility.

4.3 Economic Aspects of Environmental Policies

The extensive focus on environmental issues at the recent Summit meeting of the major industrial countries serves as a forewarning of the attention that is likely to be paid to such problems in the future. Major efforts are likely to be undertaken to arrest and reverse the environmental damage associated with deforestation, the heavy use of hydrocarbons and other forms of air pollution, and the depletion and increased pollution of water reserves. Because of externalities, these efforts will have to be based on international cooperation, involving both industrial and developing countries.

The economic aspects of enhanced efforts to arrest the deterioration of the environment basically concerns the incidence of the economic costs of such

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[16] As discussed in Kelly *et al.* (1988), the number of VERs reported by the GATT rose from 135 in September 1987 to 261 in May 1988.

policies, and the impact of such costs on consumption and investment. While such costs are difficult to assess, one can safely assume that they are likely to be of a considerable magnitude, possibly reaching several percent of world GNP. Some measures will need to involve heavy taxation of pollutants — hydrocarbons in particular — that may help to finance subsidies to development of new products. But tougher pollution standards and environmental regulations could involve substantial costs for industries and for consumers.

Such costs are economically akin to depreciation allowances for the physical capital stock. If they are not covered, the capital stock (the environment) will deteriorate, reducing future consumption possibilities. If they are made, current consumption may be reduced but future growth will be protected. It is noteworthy in this context that several countries are planning to introduce environmental considerations into their national accounts, to permit the calculation of national income net of depreciation of the physical capital stock as well as net of environmental damage.

4.4 Demographic Developments

In stark contrast to the current trend of moderating population growth in most industrial countries, and the prospective aging of the populations of Japan and Western Europe, rapid population growth continues to characterize large parts of the developing world. Paradoxically, in both industrial and developing countries, demographic factors are likely to constrain potential future growth, albeit for totally different reasons. In the industrial countries, this problem is less severe to the extent that labour scarcity may be offset by technological developments and rapid productivity growth.

In many developing countries, in contrast, rapid population growth has serious adverse implications for the growth process through its effects on saving and investment, and through the tremendous burden it involves in terms of public expenditure on health and education. These problems are particularly acute in much of Africa, in some of the low-income countries in Asia and in parts of Latin America where excessive population growth, deforestation, soil erosion, and other aspects of environmental deterioration have created a vicious circle of economic decline and increasing poverty. In some countries in Latin America, real per capita national income is now less than it was a decade ago; in many African countries it is less than it was two decades ago. While this regression is often attributed to the debt crisis and commodity price declines, there is no doubt that population pressures have reinforced the adverse effects of exogenous disturbances and inappropriate economic management. The population issue is perhaps now the biggest crisis facing much of the developing world, particularly the poorest countries. Yet the cultural and political aspects of this issue continue to cloud the prospects, and any significant change in trend may take decades to materialize. The 1990s will see, at best, a modest start on this issue.

5. Sketches of Alternative Scenarios for the 1990s

5.1 Central Scenario

It follows from the foregoing that the forces determining world economic trends over the next decade appear, on the whole, to be quite favourable. Important lessons have been learned and policy management has improved, or is in the process of improving, in both developing and industrial countries.

Among the industrial countries a growth trend of 3 per cent a year would seem to be feasible, with the United States and Europe growing by 2.5-3 per cent a year, and Japan somewhat closer to 4 per cent. This scenario is obviously predicated upon the assumptions that the policy coordination process among the major countries permits a progressive reduction of the large imbalances over the medium term and that inflation remains under control.

The developing countries should be able to register a somewhat stronger growth trend as they continue to close the productivity gap *vis-a-vis* the industrial countries. Among the developing country regions, Asia has the brightest prospects and could experience growth of 6 per cent or more; there are good chances that Africa and Latin America will experience some recovery (to growth rates of perhaps 4 per cent a year) but many of these countries will remain constrained by their debt burden, their strong population growth and the difficult adjustment problems they are facing.

5.2 High Growth Alternative

Notwithstanding the relatively optimistic trends in the central scenario, one should not lose sight of the opportunities there are for doing even better, particularly among the developing countries. A successful implementation of appropriate domestic policy changes, coupled with an adequate reduction of the debt and debt-servicing burden of the severely indebted countries should in principle be able to generate substantial improvements in confidence and economic incentives, restore credit-worthiness, and put the countries on a growth track almost as favourable as Asia's. Substantial progress in liberalizing world trade, particularly in the area of agricultural products, could also give a significant boost to the growth potential of many developing countries. And a progressive integration of centrally planned economies into the world economy might provide a major boost to trade and productivity world-wide.

5.3 Pessimistic Alternative

At the same time, a more pessimistic outcome cannot be excluded either. The challenges listed earlier may not be addressed in a timely fashion; adjustment policies in both developing countries and among the industrial countries may fail to be implemented; or protectionist barriers may intensify. In all cases, the resilience of the system would weaken, confidence would be jeopardized, growth would weaken, and financial market stability would no longer be ensured.

With the hope of triggering an interesting debate about these issues, I would assign a probability of 50 per cent to the central scenario and 25 per cent to each of the two other scenarios.

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Commentary

Mokhtar Tamin

Introduction

Mr. Larsen's paper is an extremely well written one. Coming from the International Monetary Fund, with its wealth of data and expertise, Mr. Larsen is well placed to ponder about the world economy in the past, present and the future. In attempting to sketch the world economy in the nineties, the author takes us back to the past with a view to identify major policy developments, trends and other economic phenomena that prevailed. He has dealt, quite adequately, with structural changes in the world economy, and identified a number of policy premises on which future policies may be predicated. He has also adequately identified major challenges and proposed some policies which may be pursued to overcome these challenges, and finally he has sketched the world economic landscape in the nineties. This by any standard is a very courageous deed bearing in mind that a decade is a rather long time, making predictions of probable scenarios extremely hazardous. To be fair, the author acknowledges these difficulties and therefore has opted to concentrate on the qualitative aspects of economic trends.

The World Economy in the Seventies and Eighties

In sketching the world economic record in the decades of the seventies and eighties the author has quite exhaustively identified the major disturbances and problems that have given form and character to the economic landscape. Thus he considers as major upheavals, large fluctuations in oil and primary commodity prices, protracted inflation problems in both developed and developing countries, the nagging problem of external imbalances and debt problems, and a serious misalignment of important currencies. With the benefit of hindsight nobody can take issue with these observations. The more interesting aspect of the paper, however, are the author's treatment of the array of policy tools that have been employed to remedy these major problems, and what seems to come out clear is how relatively ineffective some of these have been. Thus, policy tools used to address the unemployment problem were quite ineffective in the face of rigidities in the labour market. Fiscal measures to stimulate demand failed to reduce unemployment and instead worsened inflation.

The attempt to check inflation in industrial countries, particularly in the eighties, did work but the author is quick to point out that the costs in terms of slower growth and increasing unemployment have been rather high. The developing countries fared no better and perhaps worse for, as the author rightly pointed out, inflation has increasingly become part of a vicious circle that has tended to impede growth particularly in countries burdened with debt.

A startling revelation which the author has pointed out has been the recurrence of the longest post-war period of growth in the industrial countries despite serious external imbalances. The author quite rightly attributes it to the emergence of increasingly integrated capital markets, but also raises a warning that while current account imbalances may be attributed to a free play of market forces, large fiscal deficits may impede growth since it requires savings in surplus countries to be invested in deficit countries. This transfer is not always easy and may be subject to political impediments. If the situation in the industrial countries has not been very good, that in the developing countries has been worse on account of the huge debt burden they have had to bear. Of course, with the benefit of hindsight, one may argue that their predicament in some measure stemmed from overwillingness of the industrial countries in providing loans. For many of these countries, their debt burden far exceeds their debt-servicing capacity.

To remedy the structural deficiencies of the seventies and eighties, the author proposes structural reforms and indeed he suggests calling the decade of the nineties as the structural revolution. The rationale for structural reform, he argues, is to improve economic performance by raising potential output through improvements in allocation of resources, through trade liberalization and the removal of price distortions and subsidies. This of course is not a new approach. In fact the decade of the sixties and seventies saw the positive effects of such policies as has been manifested by the expansion of world trade. In particular he suggests structural measures to remove some of the rigidities of the labour market. He also extols the virtues of structural measures on both exports and imports through the promotion of market forces. While these may be good suggestions, the world is littered with negative evidence of the difficulty of such measures. The common market agricultural policies is a case in point. It bears to mention, at least in so far as it affects Malaysian and other vegetable oil producers, that the US call for freer trade falls on deaf ears. Thus powerful political lobbies mounted by the American Soya Bean Association can be said to have extra-territorial effects. In fact the effect may be observed at least in all the industrialized countries.

The author suggests the movement towards regional integration spearheaded by the Canadian-US free trade agreement and the European integration plans may be taken as models for other regions to promote the dismantling of barriers against free trade. While these agreements would boost intra-community movement of capital goods and services to the betterment of the community, it is a matter of debate as to whether these gains would not be at the expense of the rest of the world. All we have heard thus far is that these groupings would not erect barriers against the rest of the world. This is quite questionable. For example, the European integration is around the corner in 1992 but we have yet to see how existing barriers such as the Community Agricultural Policy (CAP) would be removed.

In so far as the international monetary system is concerned, the author suggests that the probability of a new system emerging is high. This is considered necessary to avoid extreme volatility which has manifested itself in terms of fundamental misalignment of currencies.

The author also adequately discussed the globalization of financial markets that began in the eighties and its implications, particularly its potential effect of amplifying distortions. Also, there may be a tendency for countries which benefit from the inflow of foreign savings to regard them as a substitute for domestic savings. The highly indebted countries provide good testimony of this.

Besides these, there are other challenges such as:

a) How best to address the debt problem of the severely indebted developing countries since measures initiated in the eighties have largely failed.
b) Protectionism and regional integration of Europe and the US present a trade fortress to developing nations.
c) Economic effects of environmental policies sometimes produce negative externalities which have to be reduced. Consider, for example, the emergence of the environmentalists in the European Parliament, which is a indication of concern about such matters. Another result that has implications for the Malaysian economy is the campaign against tropical hardwood.

THE MALAYSIAN ECONOMY IN THE 1990s: ALTERNATIVE SCENARIOS

Kamal Salih

Global restructuring that has been taking place since the second oil shock will likely spill over into the 1990s. While such developments in the external environment will affect Malaysia's prospects in the coming decade, developments in the domestic environment, both economic and political, will also play a pertinent role.

Recovering from the effects of the recent recession through improvements in commodity prices and the adoption of adjustment policies, the economy benefitted from liberalization measures to promote investment through new tax and monetary schemes. Debate has begun on the economic policy to be adopted in place of the existing New Economic Policy. While there are indications of a new growth-oriented policy, the particular set of development strategies adopted will significantly affect the growth path of the economy and its long-term consequences.

This paper examines the long-term outlook of the Malaysian economy in the context of the post-1990 external and domestic environments, taking into account the cyclical and trend factors, national as well as global.

1. Introduction

This paper examines the long-term outlook of the Malaysian economy in the context of the post-1990 external and domestic environment. This requires not just a forecasting exercise involving a number of critical macro-economic variables, but also a review and account of the structural trends over the past and an assessment of the key determinants of developments in the forthcoming decade. In other words, projecting the prospects of the economy over the long-term requires consideration of those cyclical and trend factors, national as well as global, that are likely to impinge on its growth and development.

The world economy has gone from crisis in the 1970s to structural adjustment in the 1980s in the spheres of trade, investment and finance. Global restructuring, which saw the decline of US economic hegemony and the rise of Japan and the

East Asian economies, reforms in the centrally-planned economies, East and West, and the emergence of new centres of growth in the rest of the world, will likely continue into the 1990s. The growing interdependence, competitiveness and uncertainty of the world economy, which were features of the 1980s, made international impulses crucial factors affecting domestic economies, especially those as open as Malaysia's. While a shift to domestic sources of growth among Asian countries are likely in the next decade, financial and other economic developments in the external environment can be expected to continue to have some influence in determining the comparative performance of economies.

As for Malaysia, its economic prospects over the long haul depend also on developments in the domestic environment. Having staged a remarkable recovery from the recession of 1985, through improvements in commodity prices and the adoption of adjustment policies relating to the government deficit, the external debt, and the exchange rate, the economy also saw measures implemented by government to liberalize the economy through new tax and monetary schemes to promote investment. Besides contributing to the recovery, these policy measures laid the basis for greater capacity enhancement and output growth. Of greater importance to economic prospects over the next decade is the economic policy to be adopted in place of the present New Economic Policy (NEP). That policy is presently being debated, the final shape depending on the consensus achieved, and will implemented by the government through a new Outline Perspective Plan (OPP). While indications are that the new policy will be growth-oriented, the particular set of development strategies adopted will greatly influence the growth path of the economy and its long-term consequences.

This paper will first examine the trends in the external environment in terms of growth prospects, aspects of global restructuring and the regional adjustments expected to take place over the next decade or so. This will be followed by a review of recent key trends in the Malaysian economy and developments in the domestic environment which are likely to affect its future growth prospects. In the final section, before concluding remarks, we present three alternative scenarios for long-term projections and discuss the implications for the Malaysian economy in the 1990s.

2. Trends in the External Environment

The major trends in the external environment that will affect Malaysia's prospects in the 1990s are associated with the global restructuring that has been taking place since the second oil shock, the impacts of which are likely to persist through the coming decade. Three dimensions of this restructuring are: first, adjustments to the US twin deficits (federal and current accounts) and the North American free trade agreement; second, the single European market agreement which comes into effect in 1992; and third, the emergence of Japan as an economic power and of Western Pacific integration.

The *current imbalances of the US economy* continue to cast a long shadow on the rest of the world and will prolong its slow growth syndrome for much of the remainder of this century. While cutting the federal deficit is an internal political matter, its persistence, however, may eventually jeopardize what is already the longest post-war economic expansion on record. The other concern is with the persistent trade deficit, which translates into a continuing threat of protectionism that will have dire consequences on world economic growth and the future performance of the Asian-Pacific economies.

The threat of protectionism in the US is closely tied with American political forces. Despite the defeat of the original Jenkins bill in 1986 and the Gephardt amendment, the call for a free but fair trade pushed the US government into strong bilateral action against its major trading partners with whom it had developed a huge deficit. This now has taken the form of Super 301. Protectionist pressures had also led to new initiatives in multilateral trade negotiations within the new GATT Uruguay Round, including in the area of trade in services. The US-Canada free trade agreement has also been seen as a trading bloc that could possibly threaten access to the world's largest market for the rest of the world. Economic adjustments in the US, which in the context of global structural shifts have an impact on the former's own competitive position and reindustrialization, have beneficial impacts on the rest of the world.

The *single European market plan* to come into effect in 1992 has created much confusion and fear in equal measure amongst the rest of the world economy. The confusion is over whether the plan means a "Fortress Europe", and the fear is over the effects this will have on extra-European trade development and investment diversion. European attempts to explain the concept have not, so far, had much impact in allaying the fears of Americans and Asians alike.

The major focus of European structural adjustment is the solution to the unemployment overhang, resulting from lowered productivity and deskilling due to the loss of its competitive edge in manufacturing to the East Asian economies. Because of the unemployment overhang and the decline of European industry, a period of relocation through direct foreign investments ensued in the 1970s as European enterprises sought to maintain their profit levels and expansion in activity. The emergence of the so-called new international division of labour as a result of the export of European capital has been the major result of this development. It has, however, also brought new pressure towards protectionism and calls for a new industrial policy in Europe.

The 1980s and 1990s could, therefore, see a reversal of this trend with the reindustrialization of Europe through technology development, and the introduction of a new social contract between labour and capital. This is supposed to be aided further by the strengthening of European economic integration with the complete liberalization of intra-European trade in 1992. However, a consolidated European economy, together with an increased role for the European Monetary System

(EMS) and greater coordination among the Group of Seven, would help to stabilize the world monetary situation and contribute to a smoother transitional path in the global restructuring process.

The emergence of *the Asian-Pacific Rim as the locus of high economic growth* during the 1980s was the result of trade patterns that had emerged among Asian-Pacific countries, and between them and the United States and the European Economic Community (EEC). This triangular Pacific trade was induced by the rapid industrialization that had taken place in the 1970s and early 1980s among the Asian countries. The increased trade flow was created by the burgeoning US market for finished products, and dominated by US-Japan trade relations. Two basic processes occurred during the period: (a) adjustments at the global economic level to the two "oil shocks" of 1973 and 1979, and the declining comparative advantage in "traditional" manufactured goods among the advanced industrialized countries, and (b) adjustments at the regional level to the rising comparative advantage of the Asian newly industrialized countries (NICs) in light manufacturing and of ASEAN in raw material exports, and an emerging division of labour amongst Japan-Asian NICs-ASEAN as a new industrial belt within the global economy.

The emergence of this belt was induced by the world-wide structural adjustments and industrial relocation that began in the 1970s. These adjustments followed the changing dynamic comparative advantage of the different countries in the Asian-Pacific region in different sectors in the industrialization process. This result has been described as conforming to a so-called "*flying geese*" pattern of development. In this industrialization process late-comers appeared to have successfully adopted a strategy of entering into sectors in which they have a rising comparative advantage in some cost terms, by importing technology from an already mature economy whose comparative advantage in that industry seems to be on the decline. The latter in turn began to invest in new industrial products using new technology and know-how for which they have the innovative edge. Such industrial restructuring and shifts in the position of the economies involved in the global specialization and division of labour are not always smooth and involve frictions in adjustment and competition.

The relative performance over the past twenty years of Japan, the Asian NICs and ASEAN in trade in the three categories of manufactured goods, namely, non-durable consumer goods, durable consumer goods and capital goods, is reflected in the trade specialization coefficients that emerged amongst the three economic entities. In this regard, Japan had become a net importer of non-durable consumer goods since 1972, while the Asian NICs reached a peak as net exporters of this product category around 1977. ASEAN, on the other hand, became a net exporter of consumer non-durable goods in the early 1970s, and is expected catch up with the Asian NICs in this category by the late 1980s. In the durable consumer goods category, however, ASEAN remains a net importer and is likely to remain so until the mid-1990s. The Asian NICs, on the other hand, became net exporters in the early 1970s and look set to challenge Japan in this category in the early 1990s. However, it is clear that Japan will remain dominant as a net exporter of capital goods for some time to come, although the Asian NICs will probably reach "self-sufficiency" by the end of this decade and become net exporters, as they are in some areas. ASEAN will continue to depend on imports of capital goods for some time to come from Japan, the Asian NICs and elsewhere.

These sectoral shifts were made possible by the global restructuring that had taken place particularly in the US and the EEC up to 1983. The pent-up demand for consumer goods in the world's largest market, rising labour costs inducing the relocation off-shore of production facilities and the availability of cheap labour in East and Southeast Asia, as well as active promotion of foreign investment through tax incentives and other reliefs, have contributed to rapid growth in manufactured exports from the Asian-Pacific Rim to the US and the EEC. The high yen and low US dollar situation stimulated Japan to relocate their production sites overseas, a process begun in earnest since 1986. This may result in the future development of the capital goods and machinery parts industries as well as other related industries in the Asian NICs, ASEAN and other countries. On the other hand, pressures on the currencies of the Asian "four tigers", as a result of their burgeoning trade surpluses and withdrawal of GSP privileges by the US, have also induced relocation and new investment from the Asian NICs to ASEAN and other developing countries in the region. Consequently, the inter-industry structure of developing countries in the region will likely become more mature and diversified.

Thus, the interdependence between intra-regional trade and investment in this region will inevitably be intensified in the 1990s. ASEAN, for example, has been much more dependent upon Japan and other developed countries than upon its own fellow members. It is expected that direct investment from the Asian NICs to ASEAN countries will also increase. As for Japan, it is inevitable that she will face increased pressure from outside for easier access to her domestic market and for more positive action for economic cooperation through increased direct investment and official assistance in the region.

In the past three years, there has been a *direct foreign investment boom* in the region, especially from Japan due to the high yen. JETRO's White Paper on World Direct Foreign Investment estimates that the world's outstanding direct investment at the end of 1986 increased 20.4 per cent over the previous year. The growth rate of outstanding investment in dollar terms was 37.5 per cent for West Germany; 34.1 per cent for the Netherlands; 32 per cent for Japan; 19.3 per cent for the UK and 13.1 per cent for the US. In fact, Japanese direct foreign investment outstanding grew at an annual rate of 20.1 per cent from 1980 through 1985. The Asian NICs have also begun from 1988 to make commitments in the ASEAN region as foreign investing countries. While the US was the major target of that investment growth in the early 1980s, direct investment in Asian countries are also increasing, accounting for 50 per cent in 1985 and 53 per cent in 1986 of the total investment in the developing countries. In 1986, Japan's investment in Asia increased 73.8 per cent over the previous year, second only to West Germany which grew by 91 per cent. The growth of Japanese direct foreign investment inflow to various Asian countries continued apace, with Thailand, South Korea and Taiwan leading the way. Malaysia's direct foreign investment inflow was 103 per cent over the first eight months of 1987, and this tripled again in 1988. Thailand absorbed a large absolute share of Taiwan direct foreign investment in 1987 and 1988, while the growth of direct foreign investment in Malaysia from Japan, Taiwan and South Korea showed a healthy turn for the same period and is rising rapidly. The rising yen over the last five years of the 1980s had also encouraged renewed growth in direct foreign investment in Asia by Japanese small- and medium-sized firms. These investment trends are likely to continue into the 1990s.

Prospects for world economic growth will surely be influenced greatly by the success of these continuing structural adjustments in the various parts of the global economy. The emergence of a multipolar economic system, along with an increasingly peaceful world, are fundamental stabilizing factors underlying these adjustments. The possibilities of greater international coordination of economic policies will promote stable paths of transition and ameliorate fluctuations in the global business cycle. The fact that the world economy is also entering the expansionary phase of the Fifth Kondratieff Cycle, which will carry into the twenty-first century, also heralds an economic uptrend that will further promote growth and restructuring. For Asia, this constitutes not only an opportunity for new technology absorption and phased regional transfer of existing technology and industrial production; but also a new building cycle that should last the better part of the 1990s, as governments seek to expand back-up infrastructure investments in order to promote further sustainable growth. The major threat to this bright picture is, of course, the converse situation in each case: rising protectionism due to the failure to solve external imbalances and the rise of trading blocs, breakdown of economic coordination, failure of initiatives such as the Brady Plan to solve the Third World debt problem, and the failure of domestic policy to adjust to the changing external and domestic environments.

3. Trends in the Domestic Economy

Weaknesses in the structure and resilience of the Malaysian economy became apparent after the recession in 1985: the narrow industrial base; the dependence on commodities that continues to be threatened by growing competition from lower-cost producers in neighbouring countries; the problem of graduate unemployment and the skills gap; the low indigenous technological development; and the problem of an over-sized public sector and an over-regulated economy.

Measures adopted to adjust the economy taken since 1985 include cutting down the government deficit; better management of the external debt; tax reform; deregulation and changes in the structure of investment incentives and tariff protection; exchange rate management and financial reform; privatization, etc. Together with the recovery of commodity prices, these structural adjustment policies produced a remarkable turnaround in Malaysia's economic fortunes that augur well for the 1990s. The longer term prospects for the Malaysian economy depend not only on the global and regional environment as described above, but also developments in the domestic environment, both economic as well as political.

Given that sound economic fundamentals prevail, the Malaysian economy has the potential to expand and develop further. To examine this question, a more detailed analysis of data on the relationship between private and public sector investment is needed. Other than the need to analyze the features of investment such as the incremental capital-output ratio (ICOR) to identify the sources of capital that have been effectively utilized, an analysis of crowding-out or crowding-in effects is also useful to ascertain whether government expenditure and investment in the 1970s and 1980s have resulted in blocking out private sector investment or helped promote it. This analysis will point to the possible direction of the respective role of the private and public sector in economic development after 1990. Such an analysis should also identify the role of foreign investment in national development. We should also examine the contribution of the "third factor" (that is, technology, entrepreneurship, innovation and efficiency) towards growth of national output.

According to the data from EPU, the ICOR, which measures efficiency in the utilization of capital, increased from 3.65 during 1971-80 to 7.21 during 1981-85 and this was anticipated to drop to 4.76 during 1986-90. The high ratios (a value of 3 is considered the average) are the result of a combination of factors: the intensity of the capital utilized, the need for economies of scale and others. The ICOR for public sector investment is much higher than for private sector investment: the data shows that the ratio for the public sector increased from an average of 6.75 during 1971-81 to an average of 15.51 per year during 1981-85. It was particularly high during 1982-86, the years which saw the implementation of the heavy industries strategy. In contrast, the private sector ICOR has increased from 2.27 to 3.87 over the same period, excluding the anomalous years of 1975 and 1985-86. The ICOR for the industrial sectors, namely manufacturing, construction, transport and communication, electricity and water supply, all have high ratios due to the capital-intensive nature of these investments. The high ICORs and the rising external debt due to this type of investment particularly in the public sector, are some of the major problems associated with the implementation of the NEP in the last two decades, and differ markedly from the experience in the newly industrialized countries. One must note also the volatility of ICOR measures, especially in the public sector.

One important cause of the high ICOR in the public sector is the expenditure pattern of the non-financial public enterprises (NFPEs) throughout the NEP period, especially in the 1980s. NFPEs in Malaysia can be defined as the production entities that are owned and/or controlled by public authorities who, in turn, market the output. On the whole, NFPEs have been used to serve a variety of socio-economic objectives, including both of the NEP objectives to eradicate poverty and restructure society. NFPEs have also been used in the establishment of heavy industries and others. Public companies, which were estimated to comprise about one third of the national economic activities, have emerged in just about every economic sector and are said to have a unique dynamic feature. It has been asserted that there is a possibility that such companies have not only contributed to the increased public debt, but through inefficiency and accumulated losses, have led to wastage of investment resources and increased the government's fiscal burden. The scope for economic expansion in the future involves the removal of this "inefficiency overhang" through write-offs and other financial reconstruction, and through privatization of these concerns, which has already been planned.

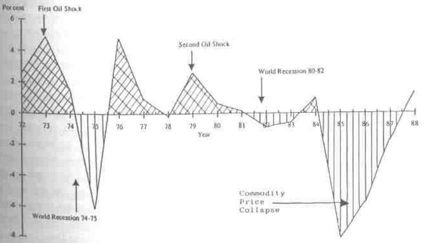
On the question of whether there is a crowding-out effect by public investment on private investment, a preliminary study by the Malaysian Institute of Economic Research (MIER) shows that, generally, this was not true either for the entire study period of 1970-88 or for the two sub-periods, 1970-79 and 1980-88. However, there was physical crowding-out in terms of production as a result of government consumption. Also, when the sources of financing are examined, there is some indication that in the 1970s, the sources of private investment were saturated due to financing of government investment through domestic mobilization. This, however, does not appear to be the case in the early 1980s because government investment then was financed through external sources. A more definitive conclusion will be forthcoming when a more detailed study is carried out later. The shift to a bigger role for the private sector, as already announced by the government, through deregulation and further liberalization in the next decade under the post-1990 economic policy, should provide the impetus for private investment to play the leading role in economic growth.

The information on contribution from the third factor that was given by the EPU (based on a World Bank Study) showed a drop in the contribution of the residual factor to national output from 28 per cent in 1970-75 to 13.7 per cent in 1975-80 and to rise again to 21.1 per cent in 1980-83. MIER's study, using a different basis for calculations, shows that technological and efficiency factors contributed between 17.6 per cent and 20.8 per cent (depending on the assumption made on the contribution from labour) for the whole NEP implementation period. The percentage contribution of the third factor to growth, a measure of efficiency, innovation, technology and skills, can be compared with the situation found in both developed countries and Asian NICs, where this factor contributes more than 60 per cent to the national growth of output. This shows how important it is that the problems of wastage, inefficient management, shortcomings in skill and manpower, and technological development, need to be addressed in the future under the post-1990 economic policy. Our calculations show that, holding the contribution of labour and capital constant, a doubling of the third set's contribution can lead to an additional 1.5-2.0 per cent increase in growth of GDP per annum. This cannot, of course, be done overnight, but the promotion of skill development, technology absorption, innovative enterprise and entrepreneurship should help improve the growth prospects for the future.

Overall, MIER's analysis of production potential (estimated as the GDP trend between 1962-1988) and index of capacity utilization (calculated as the ratio between actual national product and potential product) shows a sufficient improvement in the years of the NEP implementation (Figure 1), except in the post-1985 recovery when actual output is still below its potential. In per capita GDP terms, incomes doubled twice during the NEP years (Figure 2): the first from 1971 until about 1976; and the second between 1976 and the middle of 1981, despite the below potential national product in 1975-79 period. Problems arose after 1981. The latest world economic slow-down and problems in private investment and public spending discussed above dragged the national product below potential, especially after 1984. Per capita income fell back from the M$5,000 mark in 1984 to the 1981 level due to the 1985 recession. Only after the structural adjustments and economic recovery of 1986 did the economy rise back to its potential level, and the economy recovered its long-term historical trend

Figure 1

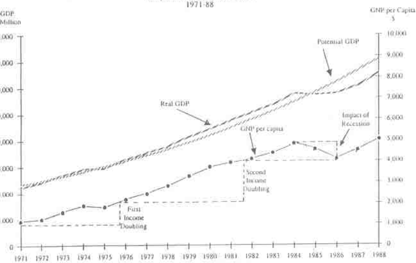
Deviation of Actual GDP from Potential GDP (1978 Base)



Source: Department of Statistics
MIER Estimates

Figure 2

Malaysia: Potential and Real GDP
1971-88



Source: Bank Negara Quarterly Bulletin
Economic Report, Ministry of Finance.

by 1988. The prognosis based on current economic trends is that per capita income will rise back to M$5,670 (US$2,100) by 1991.

A new source of growth for the 1990s is the resurgence of direct foreign investment as a consequence of developments in the global and regional economy which we have described above. The trend is clear from the middle of 1987, and by 1988 the shift from export-led growth to investment-led growth was definite. This is expected to continue into the new decade. The re-emergence of foreign investment in the economy through the relaxation of the restructuring requirements under the NEP during the post-1985 recovery, however, has caused some concern regarding the achievement of the NEP restructuring targets. While foreign investment has been considered important in achieving the present recovery and for further economic growth, suggestions have been made to ensure greater selectivity of industrial focus in order to differentiate between real estate investment, manufacturing investment and portfolio investment (stock), and diversification of sources of capital would prevent the national economy from being captive to one dominant foreign economy. In the former case, what should be encouraged is real and productive investment. We should also promote the role of new forms of investment such as management contracts, licensing and franchising, and joint ventures are also needed especially in the services sector which is anticipated to play an important role in our economic future. Such diversification of sources of capital will lead to a more balanced integration of Malaysia into the world economy. There is now also great concern over the need to promote domestic private investment as well, by treating equally foreign and local private investors.

The trend towards domestic-led growth in the 1990s, while riding on the new wave of foreign and local private investment, would be enhanced further by the new building cycle that is anticipated in the Asian region. Shinohara (1988) discovered these medium term cycles, which for Malaysia took about 8-12 years from peak-to-peak, the last one being in 1982. This study was subsequently updated by Oshima of the University of the Philippines using data for most of Monsoon Asia. From our own sources, it is apparent that the property boom reached its height in 1982, and by 1984 it had collapsed. By early 1988, the property market had bottomed-out amid signs of new construction activity beginning with low to medium-cost housing. In the first half of 1989, industrial construction began to take off, and with the lower effective ringgit, real property assets were bought, especially by foreigners seeking bargains. This new construction uptrend is expected to rise steadily to peak around 1994, with a downturn showing by 1995. The construction boom will be strengthened if not extended by government infrastructure investments in the transport and utilities sector over the same period. This infrastructure spending should boost economic growth further over the next decade.

Above all this, the Post-1990 Economic Policy, which is expected to replace the present NEP when it ends in 1990, will no doubt largely determine, whatever its shape, the direction of growth and development in the 1990s. The post-1990 economic policy is being deliberated in the National Economic Consultative Council, and recommendations are expected to be submitted to the government by the end of 1989. From pronouncements made from time to time by government leaders, and as indicated by recent policy initiatives, a refocus on growth and eradication of absolute poverty appear to be part of the consensus. Among the issues that will engage planners and politicians alike is how far to go towards deregulation and economic liberalization in order to promote growth, without jeopardizing the distribution goals, and most particularly, the restructuring objectives of the old NEP. A recent communique arising from the National Conference on the Post-1990 Economic Policy, jointly organized by the National Chamber of Commerce and Industry and MIER, pointed to a consensus on four areas: growth and distribution; human resource development; defining the respective roles of the government, private sector and the foreign sector; and the question of restructuring. In the latter case, a de-emphasis of wealth restructuring was balanced by a greater focus on the goal of creating a Bumiputera commercial and industrial community.

MIER has advocated the adoption and implementation of an Income Doubling and Distribution Plan (IDDP) as a framework for the OPP, 1991-2000. The main development objectives of the IDDP are as follows:

* A growth rate of about 9 per cent per annum

- Double the per capita income from about M$5000 in 1990 and achieve parity in Bumiputera: non-Bumiputera average household income by 2000
- Eradicate absolute poverty by 2000
- Full employment of labour force, at five per cent unemployment, through growth and efficient utilization of human resources
- Raise further the standard of living through education and through increasing access to basic services, such as health, water and electricity.

In other words, the IDDP is essentially an *accelerated* growth with distribution plan, and as will be seen below, coincides with the High Growth Scenario projections.

The IDDP in one version or another may or may not be adopted eventually by the government, but the new OPP will have to give considerable attention to many of the issues raised in the above examination of trends in the domestic economy in order to project the likely future prospects of Malaysia in the 1990s. Having considered both the key trends in the external and domestic environment, it is now possible to construct some alternative scenarios and examine their likely impact on national growth prospects and related developments.

4. The Malaysian Economy: Alternative Scenarios in the 1990s

The outlook for the Malaysian economy in the 1990s is now examined according to three alternative scenarios based on the description of key trends in the international and national environment examined above. The projections are based on Wharton Econometric Forecasting Associates's (WEFA) country monitor model for Malaysia, which is driven by exogenous forecasts of world economic growth and a set of exogenously forecast national level inputs. The former forecasts are derived from a model developed by Onishi, whose Future of the Global Interdependence (FUGI) Model contains approximately 50,000 variables covering 140 countries and country groupings, whilst the latter are obtained from various estimates as well as from the scenario analyses. The two models used for this scenario analyses are obviously not fully integrated; in addition, the WEFA country monitor model is non-behavioural. Nonetheless, the linkages are mostly generated internally once the exogenous parameters are estimated or forecast.

The assumptions and exogenously determined values are given in Table 1, while the forecasts from the FUGI model is given in Table 2. The baseline projection for Malaysia by Onishi forecasts a long-term growth rate of around 7 per cent per annum up to the year 2000, while his alternative projections ("optimistic" or "pessimistic") adds or subtracts an average of about 1 per cent from the base trend (Table 2). If Malaysia can achieve a more efficient management of the economy at the macro- and micro-levels, through reductions in the ICOR and improving the contribution of the third factor (namely, technology, innovation, skills and entrepreneurship, etc), by MIER calculations, an additional 1.5-2.0 per cent may be added to the annual growth of output as projected above, thus

Table 1
Assumptions for the Three Alternative Scenarios

	Low Growth Scenario	Baseline (Trend) Scenario	High Growth Scenario
External Environment			
World GDP growth	2%	3%	4%
US	0-1%	2%	3%
Europe	2%	3%	4%
Japan	4%	5%	6%
Import Growth	-20%	—	+20%
except Japan	—	—	+20%
Interest rates	+20%	—	-10%
DFI	-10%	—	+5%
Domestic Environment			
Growth rate	5%	7%	9%
Third factor growth	0%	x1.5%	x2%

approaching the long-term growth target of the income doubling and distribution plan. Malaysia has to undertake the necessary structural adjustments in order to achieve a higher rate of industrialization if it wants to attain this GDP growth rate by the year 2000, if not earlier, depending on the success of global restructuring and the economic and political environments during the period.

In the *Baseline Scenario*, the world economy is expected to grow at 3 per cent per annum, with the US economy growing at 2 per cent, Europe at 3 per cent and Japan at 5 per cent per annum. Interest rates are 8.2 per cent per annum between 1990-1995 and 7.6 per cent per annum between 1996-2000. Foreign investment is expected at a vigorous rate (around 10 per cent per annum), and the yen is set to approach parity with the US dollar (US$1=¥100) by the year 2000. Commodity prices are generally set only to partially recover their 1981 price levels, except for food, forest products, and other fuels and beverages which will attain or surpass their 1981 index level. Saudi Arabia crude is put at US$21 and US$23 for 1995 and 2000 respectively. The Malaysian GDP growth rate is specified as 7 per cent per annum for the Baseline Scenario, with some shifts in direction of trade to Japan and East Asia. Third factor growth improves by 50 per cent over the ten-year period.

Table 2
Projection of the Asian Pacific Economy in the Global Perspectives:
Annual Averag Growth Rates of Real GDP — 1986 to 2000

	Baseline				Deviations From the Baseline (% Changes)							
					Optimistic				Pessimistic			
	1990-95	96-2000	90-2000	86-2000	1990-95	96-2000	90-2000	86-2000	1990-95	96-2000	90-2000	86-2000
Long Term												
World	3.3	3.6	3.4	3.3	0.373	0.446	0.409	0.279	-0.753	-0.962	-0.857	-0.711
Asian-Pacific Region	3.8	4.3	4.0	3.9	0.887	0.925	0.938	0.741	-1.549	-1.873	-1.824	-1.453
World (Excl. CPES)	2.9	3.2	3.1	2.9	0.364	0.401	0.382	0.258	-0.931	-1.226	-1.078	-0.890
Dev. Market Econ. (AMES)	2.6	3.0	2.8	2.7	0.291	0.366	0.328	0.204	-1.006	-' 429	-1.217	-0.997
OECD	2.6	3.0	2.8	2.7	0.294	0.369	0.331	0.206	-1.025	-1.463	-1.244	-1.018
The Major Seven	2.6	3.0	2.8	2.7	0.324	0.400	0.363	0.221	-1.209	-1.766	-1.488	-1.204
Japan	4.1	4.8	4.4	4.1	0.959	1.173	1.065	0.669	-2.359	-3.248	-2.804	-2.151
Canada	2.5	3.3	2.9	3.0	0.040	0.164	0.102	0.030	-1.628	-2.550	-2.090	-1.780
United States	2.1	2.4	2.3	2.2	0.009	0.128	0.068	0.011	-1.460	-2.258	-1.859	-1.497
France	3.3	3.3	3.3	2.8	0.996	0.442	0.719	0.496	-0.080	-0.138	-0.109	-0.129
Germany, Fed. Rep. of	1.9	1.9	1.9	1.9	0.361	0.207	0.284	0.212	-0.298	-0.342	-0.320	-0.332
Italy	3.0	3.8	3.4	3.1	0.012	0.271	0.161	0.097	-0.201	-0.200	-0.200	-0.231
United Kingdom	2.2	2.0	2.1	2.4	0.126	0.225	0.176	0.121	-0.164	-0.204	-0.184	-0.190
Dev. Market Econ. (DMES)	4.0	4.2	4.1	4.0	0.644	0.510	0.577	0.467	-0.640	-0.495	-0.567	-0.490
Asia and Pacific	5.2	5.2	5.2	5.3	1.304	0.765	1.034	0.920	-0.813	-0.796	-0.805	-0.658
East Asia	7.6	7.6	7.6	8.2	0.989	0.434	0.710	0.812	-1.143	-1.475	-1.310	-1.108
Taiwan (Prov. of China)	6.6	7.5	7.0	7.6	0.634	0.266	0.448	0.538	-1.171	-1.490	-1.322	-1.118
Hong Kong	6.7	6.1	6.4	7.3	0.693	0.262	0.476	0.510	-0.860	-1.482	-1.173	-1.189
Korea, Republic of	8.7	8.3	8.5	8.9	1.406	0.625	1.016	1.155	-1.235	-1.459	-1.347	-1.091

contd.

Table 2 (continued)
Projection of the Asian Pacific Economy in the Global Perspectives:
Annual Averag Growth Rates of Real GDP —1986 to 2000

	Baseline				*Deviations From the Baseline (% Changes)*							
					Optimistic				*Pessimistic*			
	1990-95	*96-2000*	*90-2000*	*86-2000*	*1990-95*	*96-2000*	*90-2000*	*86-2000*	*1990-95*	*96-2000*	*90-2000*	*86-2000*
ASEAN	4.1	5.3	5.0	4.8	1.410	0.958	1.184	0.999	-0.764	-0.725	-0.744	-0.580
Singapore	4.9	5.2	5.1	5.2	1.580	0.712	1.145	0.887	-0.607	-0.655	-0.631	-0.479
Indonesia	4.1	4.8	4.4	4.2	1.258	0.680	0.969	0.775	-0.748	-0.541	-0.645	-0.507
Malaysia	6.1	6.4	6.3	5.4	0.842	0.882	0.862	0.893	-0.831	-1.078	-0.954	-0.709
Philippines	4.7	5.7	5.2	4.6	1.406	0.156	1.281	1.231	-0.953	-1.296	-1.124	-0.890
Thailand	5.3	5.1	5.2	5.4	1.902	1.320	1.610	1.277	-0.694	-0.498	-0.596	-0.471
Other Asia & Pacific	3.8	3.1	3.5	3.7	1.432	0.883	1.157	0.968	-0.588	-0.271	-0.429	-0.365
India	4.2	3.1	3.7	3.8	1.777	1.115	1.445	1.174	-0.650	-0.340	-0.495	-0.413
Middle East	2.6	3.1	2.9	2.2	0.288	0.349	0.319	0.222	-0.576	-0.519	-0.548	-0.412
Africa	3.7	3.8	3.8	3.6	0.153	0.208	0.181	0.134	-0.487	-0.241	-0.364	-0.354
Latin America & Carribbean	3.3	3.7	3.5	3.4	0.192	0.256	0.224	0.145	-0.543	-0.220	-0.381	-0.386
Centrally Planned Econ.CPES	4.5	4.7	4.6	4.7	0.400	0.603	0.502	0.352	-0.161	-0.134	-0.147	-0.115
USSR and Eastern Europe	2.4	2.5	2.4	2.7	0.350	0.678	0.514	0.355	-0.136	-0.132	-0.134	-0.103
China and Other Asian CPES	7.2	7.0	7.1	7.4	0.468	0.502	0.485	0.349	-0.194	-0.132	-0.163	-0.131
China	7.4	7.1	7.3	7.6	0.477	0.509	0.493	0.356	-0.199	-0.135	-0.167	-0.134

The figures shown above are those of baseline projections and scenario simulations using Professor Onishi's FUGI Model.

Table 3
Malaysia Projections, according to Alternative Scenarios, 1990-2000
(in current US$ million)

	Low Growth Scenario				Baseline Scenario		High Growth Scenario	
	1985	1990	1995	2000	1995	2000	1995	2000
Trade Account Balance	3672	5425	5462	5558	7827	6213	6547	5504
Merchandise Exports	15265	20261	25983	35650	30243	41712	34503	47774
Merchandise Imports	11593	14836	20522	30092	22416	35499	27957	42269
Service & Income Credits	2597	3324	4170	5469	4307	5754	4587	6227
Service & Income Debits	6907	9355	11054	13265	10392	12692	11153	14048
Net Transfers	-30	0	0	0	0	0	0	0
Current Account Balance	-668	-607	-1422	-2237	1743	-725	-20	02316
Gross Debt (end year)	16500	22887	24931	29172	22211	25969	26337	32179
Short Term	2310	2468	3414	4336	3729	5115	4651	6090
Medium and Long Term	14190	20419	21517	24836	18481	20855	21685	26089
Cent. & Dep. Bank Assets (EOY)	4912	6407	8863	12771	9681	15066	12074	17939
Change in Assets	1189	674	3130	3908	3948	5385	6341	5865
Net Debt (end year)	10354	14146	13734	13817	10196	8320	11929	11656
Servicing of M & LT Debt	1633	3323	3603	3713	3259	3191	3239	3318
Interest Payments	1106	1334	1614	1783	1270	1261	1250	1389
Principal Repayments	527	1989	1989	1939	1989	1930	1989	1930
Debt Service/Export (%)	10.7	16.4	13.9	10.4	10.8	7.6	9.4	6.9
Gross Debt/Exports (%)	103.1	113	95.9	81.8	73.4	62.3	76.3	67.4
Interest/Exports (%)	7.2	6.6	6.2	5	4.2	3	3.6	2.9
GDP, 1980 US$ bill	30.3	38.6	45.3	56.7	49.5	66.9	53.7	77.9
Population, mil.	15.6	17.3	19.5	21.8	19.5	21.8	19.5	21.8
GDP Per Capita (US)	1940	2230	2320	2600	2540	3070	2750	3570

From Table 3 it can be seen that the long-term trend forecast under the Baseline Scenario for Malaysia generates a trade surplus of US$7.8 billion by 1995, reducing to US$6.2 billion in 2000, and a current account surplus by 1995 of US$1.7 billion, but this reduces to a deficit of US$725 million by year 2000. The major factor for the reduced current account surplus is the high remittances overseas in the form of profits and dividends by foreign investors. Gross debt was projected to be at US$22.2 billion in 1995 and to increase further to US$25.9 billion by 2000. The debt-service ratio, however, reduces to 10 per cent of exports in 1995 and 7.6 per cent in 2000.

In the *"Low" Growth Scenario*, the world economy is set to grow at only 2 per cent, with imports by US and Europe reduced by 20 per cent over the period, while those by Japan remain at the trend level. Interest rates are expected to rise by 20 per cent over the 1990 level, and direct foreign investment is expected to fall by 10 per cent over the same period. The Malaysian GDP growth is projected to increase at 5 per cent per annum. There is no change in third factor contribution.

The result of this scenario projection worsens the current account deficit over the two periods 1990-1995 and 1995-2000. Net borrowing requirements also increase in comparison with the baseline scenario in order to maintain the growth rate of 5 per cent per annum with a debt service ratio of 13.9 per cent in 1995 and 10.4 per cent in 2000. Factor service repatriation also appears to have increased.

In the *High Growth Scenario*, world economic growth is set at 4 per cent with the US economy growing at 3 per cent, Europe in excess of 4 per cent and Japan at 6 per cent. Thus, all their imports from Malaysia are projected to grow by 20 per cent higher than the Baseline Scenario, whilst investments grow by 5 per cent higher than the trend, and interest rates decline by 10 per cent over the baseline level. The Malaysian economy, thus, is slated to grow at 9 per cent per annum over the period, namely at the Income Doubling Plan target rate. The contribution of third factor growth is double that of the "Low" Growth Scenario.

In this scenario, the trade surplus is expected to be US$6.5 billion in the first period and to reduce moderately to US$5.5 billion in the second. The trade surplus projection in this scenario is slightly lower than the Baseline Scenario, largely because of the sharp acceleration of import demand. Parallel to this, the current account is projected to record a small deficit in the first period and worsen further in the next period. Apart from the increase in import intensity, huge factor payments outflow also contributed to the deficit. The debt service, however, reduces to 9.4 per cent in 1995 and 6.9 per cent in 2000.

5. Conclusion

Overall, the alternative scenarios give us some indication of the combination of international and national factors which will have impacts on the growth path of the Malaysian economy. The model may not be robust enough to factor out these effects, especially to track causal paths of the key determinants which at present have not been incorporated behaviourally in the model used. This is currently being undertaken at MIER to improve on the above results.

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ACCELERATED INDUSTRIAL EVOLUTION IN EAST ASIA: LESSONS FOR MALAYSIA

Wolfgang Kasper*

The purpose of this paper is to analyze the reasons for the extraordinary, sustained industrial performance of the East Asian market economies. It draws on recent theoretical developments in evolutionary economics, oligopolistic competition and public-choice theory. These theories highlight the importance of the economic order in inducing industrialists to compete by price, innovation and quality, and in preventing them and public officials from cooperating to secure "market niches" by cartelization and lobbying.

We then list a complex combination of phenomena that make up what might be termed the "East Asian pattern of industrialization" (observed primarily in Japan and the four first-generation new industrial countries). Most notable among these are systematic policies to make the supply of production factors elastic, to attract bottle-neck supply factors from abroad, and to create a stable socio-economic order within which competitors and investors can work and plan with confidence. A performance-oriented economic order forced East Asian industries increasingly to realize economies of scale to compete in export markets (though not always at home) and has ensured small government. We show that the extraordinary East Asian success in accelerated industrial evolution owes much to an understanding of these fundamentals (and much less to market interventions on behalf of specific industries).

Malaysia shares many fundamentals for rapid industrialization with the successful East Asian economies. If it wants to emulate their industrial performance, it would have to

(a) give priority to efficiency growth over a policy of positive discrimination that tries to achieve income redistribution, and creates secure "niches" for certain groups;

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(b) *open up the economy and expose all industries to international market forces and review the intended and unintended side effects of all regulations, and*

(c) *expose producers in the public and quasi-public sectors, which have grown as "stakeholders" of Bumiputera interests, more fully to genuine, open competition by removing all patronage, possibly by privatizing or closing down state-owned firms.*

The East Asian evidence suggests that such reforms would accelerate productivity growth and raise capital efficiency (and lead to a more equitable inter-personal income distribution). The question is: will the industrial and official interest groups, which the New Economic Policy has created, allow such reforms?

"... there is no magic formula [for economic growth] — no combination of one or two or even ten or twelve policy buttons that, once pushed in the right order, will guarantee economic growth."
A.C. Harberger (1984), World Economic Growth, p. 427.

1. The Spread of Modern Industry to East Asia

The industrial age dawned in East Asia late last century when modern industry took off in Japan, Shanghai and other coastal cities of China. Early East Asian industrialization followed two different patterns that define the spectrum of East Asian industrial policies up to our time:

A. In Japan at the beginning of the Meiji Restoration (starting 1868), "...a large portion of the Japanese ruling class... took a collective decision to carry out a revolution from above... with the deliberate objective of making Japan *fukoku-kyohei*, 'rich country, strong army'" (Johnson 1983:177). A group of bureaucrats, politicians, merchants, bankers and samurai decided collectively to develop industry by systematically emulating the West, but with minimal direct foreign involvement to avoid a colonial take-over. A government department *(Kobu Sho* — Department of Industrial Matters) "served as an indispensable midwife of almost all the industrial projects" (Tsuru 1963:144). Industrialization was promoted by mobilizing all necessary production factors. Most were developed locally (except technical know-how) and often at considerable sacrifice. Industrialization began with low-skill, labour-intensive activities, but it was soon guided towards more heavy industries, partly for military reasons and partly to bias the industry structure in favour of faster industrialization (unbalanced growth).

B. In Shanghai and other treaty ports, modern industry grew organically out of entrepôt activities in the late 19th century, often with big direct foreign inputs of entrepreneurship, capital and technology. Western-owned industrial ventures soon triggered vigorous Chinese imitation. Industrial evolution was driven by market forces (including transport costs) and focussed on labour-intensive activities. In the 20th century, public intervention, government-industry collusion and war played a big role. Before 1950, there was little systematic effort to mobilize the inputs for industrial growth. Education and training, capital formation and natural-resource development received little systematic support by government. There was no cohesive development of industrial policy.[1]

Early industrialization demanded heavy sacrifices, which contributed to the political turmoil in China and Japan during the first half of the twentieth century. But politics, in turn, hampered industrial growth. Nevertheless, the East Asian industrial centres developed further, so that the bi-polar world economy of a century ago (NW Europe and NE of North America) had become a genuinely tri-polar one by 1950 with an important third industrial core in NE Asia.

After 1960, new industrial centres developed rapidly in East Asia. As had been the case sixty to eighty years earlier in Japan and the Chinese ports, the new industrial countries of the 1960s were spawned at a time of accelerated growth in the major established industrial centres (Kasper 1983a). They became what is now known as the "first-wave new industrial countries (NICs) of Asia" (Korea, Taiwan, Hong Kong, Singapore). More recently, a number of second-wave industrial countries have been following in the steps of the "Four Dragons of Asia" (Malaysia, Thailand, Guangzhou, Sichuan, Fujian,[2] as well as possibly Indonesia, the Philippines, and Vietnam).[3]

East Asian industrialization, once started, has almost invariably proceeded faster than in most other places. Though there are outstanding industrial success stories elsewhere and in earlier periods, the most spectacular industrialization performances to date can be found in the Asia-Pacific region. Over the past 20 years, five countries (Japan, Hong Kong, Taiwan, Singapore, South Korea) each have at least doubled their national output and their industrial productivity every decade, as did China in the ten years from 1978 to 1988 (which implies an annual growth rate of 7 per cent). Graph 1 places the exceptional performance in overall economic growth of the East Asian market economies in an international

[1]Eckstein1975; Perkins 1975, 1986; Perkins 1988; Chai and Leung 1987. In this paper, we will not pursue industrial development in China, because political events keep distorting the process, so that few systematic lessons can, in our view, be drawn for Malaysia.

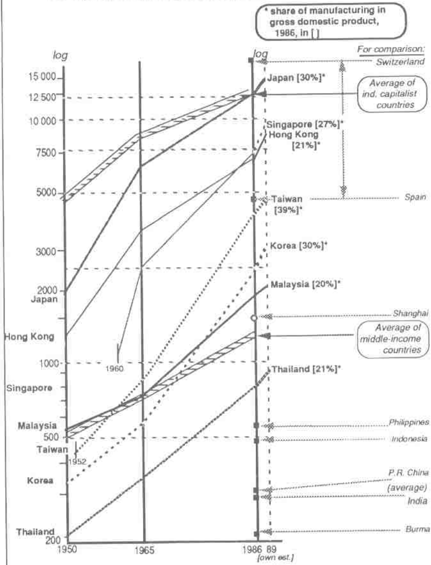
[2]It sometimes seems appropriate to treat the various provinces of China analytically as separate economies of considerable size, with differing policies, industry strategies and great differences in their levels of development. However, the totalitarian collectivism that revealed itself (again) in June 1989 is a common handicap that will stifle the market economy and growth throughout all of China.

[3]The term "new industrial country" is used here loosely to describe upper-middle income countries (per capita income in 1986 at between US$2,000 and US$7,500), whose industrial growth rates after 1960 ran for a sustained period at 7 per cent per annum or more. The term implies no advocacy of any particular industrialization or trade policy.

Graph 1

Economic Growth in East Asia

— Per capita gross national product in constant 1986 US $ [1] —



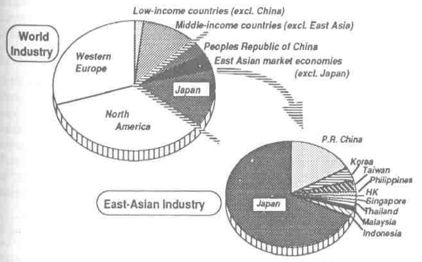
Note: [1] World bank method. 1986-89 based on various sources and forecasts.
Sources: World Development Reports; and IBRD, World Tables, various years.

perspective. Graph 2 gives an impression of East Asia's relative importance in world industry.

Milestones that highlight the recent industrial growth performance in East Asian market economies are:

- The East Asian market economies (Japan, Northeast Asia and ASEAN), which had a share in the gross world product of 6 per cent in the early 1960s, exceeded 15 per cent by the mid-1980s. This is projected to climb further to 22 per cent by the year 2000 (Drysdale 1989: 15-25).
- The growth of East Asian industrial production and exports is now rapidly changing the economic geography of the world (Graph 3). The world export share of East Asian market economies went from an already remarkable 8 per cent in the early 1960s to nearly 19 per cent in 1987 (Table 1); and the share of the four NICs went from 1.4 per cent to 7.5 per cent over the same period. More trade is now crossing the Pacific than the Atlantic.
- More recently, trade within the Asian "growth complex" has grown rapidly. There is now more intra-Asian trade than between the East Asian region and the United States (Zerby, 1989).
- In the mid-1960s, the four East Asian NICs contributed 32 per cent to the OECD market for manufactured imports from developing countries (already a sizeable share); by the mid-1980s, they have captured no less than 56 per cent of that market.

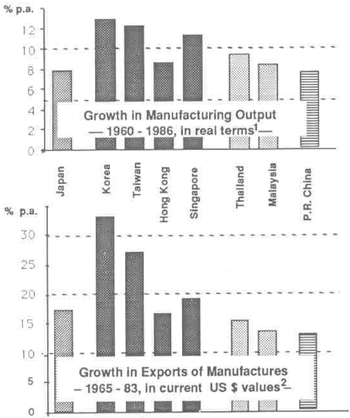
Graph 2 **Composition of World Industrial Production, 1986**



Source: IBRD, World Dev. Report

Graph 3

Manufacturing Industry: Growth in Production and Exports



1 Source: IBRD and national statistics

2 Non-oil manufactures, Source: B. Fischer - D. Spinanger, Kiel Institute of World Economics, Working Paper No. 259.

Table 1
Leading East Asian Exporters

	1973		1987		1986
Country	Rank	% share of world exports	Rank	% share of world exports	% share of mfg. in merchandise trade
Japan	3	6.4	3	9.3	97
Taiwan	28	0.8	11	2.2	91
Hong Kong	24	0.9	12	1.9	91
Rep. of Korea	39	0.6	13	1.9	92
P.R. China	20	1.0	16	1.6	44
Singapore	34	0.6	18	1.2	59
Malaysia	42	0.5	30	0.7	37
Total of above	—	10.8	—	18.8	—

Source: GATT, *International Trade 1987-88*, Vol. II, Geneva: Gatt, 1988, pp. 7 and 66-67.

2. A Theory of Sustained Industrial Evolution

These developments have challenged the international economic "pecking order" and can offer important lessons. A theoretical framework is needed to interpret the exceptional East Asian growth record and to identify which aspects of industrial evolution were critical. Only on the basis of a cohesive theory can we attempt to offer the lessons from the East Asian experience to the latest vintage of fast-industrializing nations, including Malaysia.

2.1 Resource Mobilization and Entrepreneurship

Modern growth (in industry and elsewhere) occurs when production factors — labour, capital, skills, technology, natural resources — are mobilized and combined with each other to produce output that is valued more highly than the production costs. It is not so much a matter of allocating known, given resources, but of uncovering new resources, as Joseph Schumpeter had pointed out before the war. This view of industrial growth is highlighted by the currently fast growing school of "Schumpeterian (or evolutionary) economics".[4] Developing new knowledge takes time and requires the presence of a catalyst, entrepreneurship. Entrepreneurs

[4]Schumpeter 1912. See also: Hayek 1945, 1978; Baumol 1968; Drucker 1981, 1985; Nelson and Winter 1982; Freeman 1982; Scherer 1984; Clark and Juma 1987; Hanusch 1988. Two important new journals, *The Journal of Evolutionary Economics* and *Structural Change and Economic Dynamics*, mark the ascendancy of this branch of economics.

— who are the main agents of change — explore the unknown when they try out new combinations of production factors (innovations) or set up shop in new locations. To use economic jargon: they push the production possibility frontier outwards.

The relevant knowledge that entrepreneurs uncover and test in markets often consists of petty, but complex know-how. It is frequently not technical knowledge, but often petty commercial and managerial know-how. It has to be constantly adapted to changing conditions: how to cope with a price increase, how best to design a specific product or process, how to motivate people, how to train new skills, where to obtain inputs, (most importantly!) how to keep expensive machines in good repair and operating without interruption, how to manage a speedy production flow and economize on stocks-in-trade, how to package and transport, or how to develop a new market, and how to utilize feedback from customers. Much of this know-how evolves constantly, in a dynamic process. The analysis of how useful know-how evolves cannot be undertaken within the economics of comparative static equilibria, which resemble the elegant determinism of celestial physics. The established neo-classical consensus economics of comparative static equilibria and conventional fixed-parameter econometrics are not very useful in analyzing these problems. The appropriate analytical framework for the problem of how new knowledge is found and tested is provided by evolutionary disequilibrium economics, whose approach is more akin to open biological growth processes. This has been increasingly realized in the 1980s, as the influence of "evolutionary economics" spreads. But the evolutionary economics approach is sometimes being resisted by academic teachers who are reluctant to write off some of their intellectual capital.

Industrial evolution, experimentation, dynamic change and entrepreneurship require mental attitudes which often conflict with the personal and social conditions that prevail in static, traditional societies (Kilby 1971; also Hagen 1962; Steinhoff 1980; Berger 1986: 140-171). Traditional societies often value loyalty, harmony and patronage, rather than the impersonal, self-seeking mode of individual or group competition. Entrepreneurship is therefore often the bottleneck in the early stages of development and industrialization. It is scarce because the social climate and traditional forms of government, which were attuned to static societies, do not favour *genuine* entrepreneurs. Profit incentives to entrepreneurs are often suppressed and social obstacles inhibit entrepreneurship. The most critical task of industrial development is therefore to nurture the elusive production factor entrepreneurship.

Crucial production factors like entrepreneurship do not, of course, always have to be mobilized locally. They are internationally mobile and can be imported — especially capital, technical know-how (about production processes, product design and marketing), skills, and entrepreneurship. Often, these internationally mobile production factors can be attracted in bundles called "firms" (or "multinationals"). By the right policies, they can be made to interact with locally available production factors to generate wealth for local citizens and promote widespread welfare. The gains from attracting critical and scarce production factors from abroad are comparable to the familiar gains from international trade. In economic theory, international factor mobility and trade are often treated as substitutes, but in a real world with frictions — transport and communications costs, social obstacles — both may be needed for speedy industrialization.

If entrepreneurship — whether home-grown or imported — is to flourish, certain "climatic conditions" are necessary. These "climatic conditions" cover purely economic and wider social and political aspects. The key economic aspects are: making the supply of local production factors elastic by education and training, by promoting the transfer of knowledge, by facilitating access to natural resources and land, encouraging savings, and mobilizing the labour force. The environment for entrepreneurship is also influenced by taxation and the provision of an infrastructure appropriate to industry. Furthermore, profits are needed to mobilize change; and the price signals that guide entrepreneurs must not be overlaid by the "static noise" of inflation.

Entrepreneurship tends to play a changing role as industry evolves. At the early stages of industrialization the scarce production factor "entrepreneurship" tends to concentrate on organizing and improving the production process and on training skills. At that stage, entrepreneurs in NICs tend to be successful by being able to respond quickly and efficiently to demand from overseas customers or overseas divisions within multinationals. As industry evolves further, entrepreneurs have to learn new tasks, in particular marketing (creating favourable demand) and innovation (design; fine-tuning of product variations and production processes). Entrepreneurship has to turn from being reactive to market forces (as nineteenth century entrepreneurs typically were in Europe) to being active, market-creating and innovative (as the twentieth century economist Schumpeter described). Schumpeterian entrepreneurs cultivate on-going producer-customer relationships and continually modify given production functions. So far, relatively few enterprises in the East Asian NICs have made that transition (possibly because close-by domestic markets have not been fully competitive due to import substitution policies). For future industrial performance, much will depend on whether industrialists learn to be fully fledged Schumpeterian entrepreneurs.

The "climatic" conditions that matter for the development of entrepreneurship also cover wider socio-political matters: law and order, peace, the securing of property rights (including against intrusive and erratic regulations, administrative arbitrariness and political income redistribution efforts), political and social stability, and the fostering and maintenance of genuine market competition.[5]

[5]In recent years, the crucial importance of political and wider social factors to economic development have been stressed, amongst others, by Reynolds (1985) and Harberger (1984).

Hayek has pointed out that the rule of the law and the absence of arbitrary decisions are essential ingredients in the underlying economic order.[6] They have hard-to-track, but nevertheless, powerful effects on whether people behave entrepreneurially in their economic decisions or whether they are deterred by legal insecurity. A simple, transparent law which treats all as equals and which constrains influential citizens and administrative arbitrariness, is essential to a sustained growth of industrial performance. In other words: if you want Swiss levels of manufacturing productivity, you need Swiss ethics in public life!

Even mere threats of changes in the climate can have deleterious effects on entrepreneurship (and other internationally mobile resources). In the early phases of industrialization, entrepreneurship is a tender plant. It may simply vanish or move elsewhere. Rarely will people who decide not to act entrepreneurially publicize the fact or offer reasons why. The only visible result is that there is eventually lesser growth and lower capital productivity than in countries with more favourable climates for entrepreneurship and resource mobilization. Much used to be made of psychological, anthropological and sociological factors for entrepreneurship a generation ago. But the more recent evidence focuses on economic incentives: where it pays to be entrepreneurial, we get entrepreneurs!

The social and economic order has to count as an essential production factor in industrialization because it reduces transaction costs and entrepreneurial risks. A good economic and social order has the same beneficial effects on productivity growth as a good road network: it makes many profitable transactions feasible and stimulates the flow of traffic. Where the roads decay (where ethics and legality decay), traffic slows down (growth and productivity are retarded). If anti-entrepreneurial policies and market interventions raise transaction costs, there will be less spontaneous growth and hard-to-surmount ceilings to continued and sustained growth of manufacturing productivity emerge, as Latin American or Mideastern experience shows. It is then of course still possible for governments to create artificial conditions for selected investors by granting them protection, special deals and government-secured rents. However, as experiences in many less developed countries demonstrate, this leads to industrial structures which are unlikely to be internationally competitive over the longer term and which are not capable of generating self-sustained growth and an equitable distribution of economic opportunity.

2.2 *Industrial Development, Oligopolistic Competition and Rent-seeking*

Modern industrial evolution is not guided by atomistic competition (often mislabelled "perfect" competition). Instead, firms are identifiable, sizeable and few in number. Oligopolistic competitors in industry (the rivalry of the few) have the technical and financial resources for generating industrial progress. They are able

[6] Hayek 1973-79 (especially Volume 3), and 1988.

to stimulate the development and use of complex practical know-how, the training of skills, and innovation in technology and finance. They also have the incentives to pioneer new processes, products, markets and industrial locations (Schumpeter 1912; Clark 1961; Klein 1977; Blandy 1985). But the great potential benefits of oligopolistic competition are associated with the danger that oligopolistic industries may use their economic weight to forge political alliances that permit them to collude and monopolize markets at the expense of long-term growth and social harmony. The extent to which oligopolistic industries sustain competition and the extent to which they join political-economic redistribution alliances depend largely on the socio-political climate and the economic-political order (the framework of ground rules for industry). The distributions of incomes and wealth also matter. Where the richest have acquired dominant control over assets and income (as for example in Latin America or the Philippines), there tends to be more political rent-seeking — and correspondingly less genuine competition and evolution, which give everyone better opportunities to gain income (Sachs 1989).

What matters for sustained industrial performance is that suppliers keep rivalling with each other actively for market shares. In oligopolistic industrial markets, suppliers may do so firstly by engaging in *price competition* and *process innovation* to cut costs, especially when scale economies can be realized. But they often also rival each other by creating and defending a market niche (range of relatively low price elasticity) against their competitors (see Insert). Market niches can be secured

(a) by the socially desirable means of *non-price competition*, which relies on product innovation, product quality and reliability, advertising and after-sales services; and

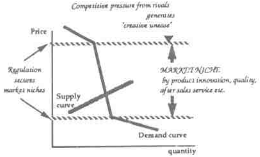
(b) by the socially harmful means of *rent-seeking* through cartels and the solicitation of government interventions.

When price and non-price competition are active, entrepreneurs can never be quite sure of their market niches; profits from innovation are temporary, and further innovation is stimulated by the insecurity, in a never-ending dynamic process of industrial evolution. Governments must appreciate the role of "creative unease" and resist the temptation of providing some businessmen with artificial security through regulation. "Creative unease" is good for the wealth of nations, but bad for the quiet life of businessmen. Businessmen will therefore often try to secure their market niches against the onslaught of competitors by colluding and by getting politicians and the bureaucracy to regulate them. Industrialists often seek the maternal protection of government and appeal to instincts of protection, cooperation and harmony in politicians. When oligopolists are patronized by government, they need not take as many entrepreneurial risks and need not control their costs all that eagerly. This is conducive to a more relaxed life, but weakens industrial performance. It is the political and social order that determines, to a

OLIGOPOLISTIC COMPETITION IN INDUSTRY

The theoretical model to explain competition amongst the few and the rent-seeking is the double-kinked oligopoly curve: over a certain price range, each of the few suppliers in an industry influences the demand each of them faces to be inelastic; this allows them to pass on cost increases if necessary ("market niches"). They normally do this by competitive and socially desirable means — product differentiation, quality improvement, provision of after-sales services, and advertising. And their rivals for market share use the same means to cut into the market niche. This dynamic rivalry for market share keeps the oligopolist alert and in "creative unease". But because this rivalry for market shares is uncomfortable, industrial suppliers seek to "fortify" their market niches by lobbying for regulations. Where the economic order tolerates patronage of industry, industrial oligopolists can abandon genuine competition and the drive to innovate, which genuine market rivalry alone motivates.

DOUBLE-KINKED DEMAND CURVE



large extent, whether industries compete or seek rents. When governments fail to keep oligopolistic competition alive, the economy and society begin to suffer from what Karl Marx (rightly) castigated as "monopoly capitalism". It is therefore incorrect to equate oligopoly with lack of competition. Instead, we must focus on government-industry collusion.

What matters is whether oligopolistic suppliers are made to engage in sustained, workable, competition. When industrialists are exposed to continuing market challenges, they strive to raise productivity and product quality by drawing on all available knowledge (cultivating technology and skills). This raises the productivity of investment and facilitates a high rate of growth for a given investment rate (part of what makes for high third-factor growth).[7]

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[7]See Kasper 1988. Refer also to Chart 1 in the paper by Flemming Larsen in this volume, which shows that Korea managed to translate the same (high) investment rate, which Malaysia marshalled, into a much higher growth rate. The Latin American countries, which have large State-enterprise sectors and have been regulated and inward-looking for longer than the East Asian countries, have done particularly poorly in getting their oligopolistic entrepreneurs to translate the "consumption sacrifices" (savings) into growing output.

In the older industrial countries, bitter historic experience has taught nations to develop rules and procedures which maximize the social benefits of oligopolistic competition in industry and which control its dangers. Western governments often see their task (at least in principle) as promoting active competition, even at times against the clamour of powerful industry groups. Trade practice laws control monopolies. The general rule of the law, open, democratic and parliamentary government, and a free press limit the scope for political-industrial collusion. In addition, relatively unimpeded international competition ensures that local industrial oligopolists are controlled by outside competitors. Micro-economic reforms (deregulation and privatization) are now increasing the scope for genuine competition and make the industrial supply apparatus more responsive to innovative challenges.

In the newer industrial countries of East Asia, many of these mechanisms are not in place, because the people have not yet learnt of the dangers to the socio-economic order and sustained common good of society when politicians and bureaucrats collude with industrial interest groups. Redistributive supplier alliances (producer cartels, trade unions, industry-trade union pressure groups) are not yet fully set up and entrenched in the NICs. But as time goes on, an active competition policy becomes a necessity. This can best be done by forcing industry to compete with overseas companies both in the home and foreign markets. If the state fails to keep genuine competition alive, oligopolistic supplier alliances gradually become strong enough with market niches durable enough to distort the basic ground rules to the advantage of powerful vested interests. Once that happens, they will challenge governments, should governments dare withdraw regulatory patronage for market niches, and this will then be at the expense of the common good or long-term sustained economic growth (and an equitable income distribution).[8]

The temptation for the rulers to make common cause with sizeable oligopolistic producers is ever present. Licensing or regulation of competition is, after all, a mutually profitable business. When a few merchants are regulated and protected by the bureaucracy or politicians, they can obtain easy and secure profits and do not have to bear the burdens and risks of industrial evolution. In exchange, regulated industries are willing to share the rents with the regulators. However, statesmen who are concerned with good government resist regulations and rent-creation.

Politicians who simply want to rule use market interventions to gain power. This age-old phenomenon — known as mercantilism or corporation rent-seeking behaviour — has been analyzed in recent years under the label "public-choice

[8]Olson 1982. Extreme examples can be found in Argentinian, Uruguayan, recent Chinese or Soviet industrial performance, but also in India, Indonesia, the Philippines, Australia or New Zealand.

economics" (Olson 1965; Tulloch 1967; Stigler 1971; Buchanan *et. al.* (eds.) 1980; Anderson and Baldwin 1987). But the phenomenon was already castigated by Adam Smith in the *Wealth of Nations* when he wrote:

> "The member of parliament who supports every proposal for strengthening monopoly is sure to acquire not only the reputation of understanding trade, but great popularity and influence.... If he opposes [the rent-seekers]... neither the most acknowledged probity nor the highest rank... can protect him from the most infamous abuse... arising from the outrage of furious and disappointed monopolists."

The economic theory of oligopolistic competition and rent-seeking (as outlined above) is validated by much historic evidence, for example:

- Sung Dynasty China was poised for industrialization, but Mandarin-led controls and centralized political influence smothered entrepreneurship. The episode ended in economic stagnation.
- Mercantilist France made a start towards modern manufacturing in the eighteenth century, but was overtaken by a liberal Britain.
- German industry caught up with the then leading industrial nation, England, by pursuing Mercantilist, Statist industry policies, but the State was ultimately "high-jacked" by powerful interest groups, which contributed to well-known political and military disasters. This was also true of Japan in the 1930s.
- In Latin America, the poor growth record and the social tensions created by industrialization have a lot to do with State patronage and close, collusive alliances between big industry and military/political/bureaucratic cliques.
- In the Philippines, a long-standing import substitution policy has produced an uncompetitive industry sector and the diversion of enterprise into rent-seeking and rent allocation amongst a closely-knit ruling class. As in Latin America, this collusion is connected with poor overall economic performance, great income inequalities and revolutionary insurgencies.

Both theory and empirical evidence demonstrate that sustained industrial performance and long-term economic growth suffer when the rent-seeking game becomes rampant. Protection and cronyism weaken genuine entrepreneurial energies because they divert genuine competitive entrepreneurship away from innovation and cost control and into securing political patronage. The beneficiaries of regulation eventually lose the incentives to help themselves. Ultimately, interventionism corrupts the entire political system and leads to social tensions and civil strife.

2.2 *Collective Entrepreneurship and Industry Policy*

The history of developing countries outside East Asia is full of examples which show that industry collusion and government protection have created stagnant "permanently retarded infant industries". Yet, the East Asian industrial experience shows that it is possible to push infant industries successfully into "teenage competition" by keeping politics and business apart. The East Asian NICs are therefore of great general interest because they appear to have succeeded better than the other developing countries in keeping innovation and creative entrepreneurship alive. The experience is doubly interesting because, in some cases, competitiveness was sustained despite a close involvement of the State. The traditional view in economics is that entrepreneurship is displayed by competing individuals or firms with drive and vision. But in East Asia, it seems that it can also be mobilized with lasting success by groups who act collectively or are public agencies (Freeman 1987; Shahid Alam 1989). We therefore have to consider two types of entrepreneurship:

(a) Individual, capitalist entrepreneurs who tend to operate between competitive factor and product markets, uncover the relevant information by trial and error and have their decisions validated and coordinated *ex-post* by profit-loss signals; and

(b) entrepreneurial initiative that is mobilized by coordinated, centralized planning processes in which relevant information is gathered, sorted and implemented (*ex-ante* coordination).

This latter approach to generating entrepreneurship was taken by central planners, Soviet-style, but the coercive variant with socialized ownership of capital is now largely discredited, even in developing countries with much state-owned industry, like India and China. Another variant is an activist, non-coercive "industry policy" which targets promising growth areas and creates artificial incentives to channel resources in support of the choices that have been made centrally (see Insert). This variant of entrepreneurship has played a considerable role in some East Asian industrial countries (early Japan and Korea in particular).

If industrial performance is to be sustained, either type of entrepreneurship has to be kept competitive over the long term (like a mother's, an entrepreneur's job is never done!). The critical question for sustained industrial development is how that can be achieved and how industrial capacities can be created that become viable without endless government support. What makes the East Asian industrial performance so remarkable is that, normally, the collective type of entrepreneurship — with direct bureaucratic involvement and shared political responsibility for resource use — is much more likely to lead to rent-seeking, mercantilism and cronyism, that has ended elsewhere in industrial stagnation. Industrialization and growth in East Asia appears, at first sight, to be a remarkable exception to that rule.

3. The General Pattern of East Asian Industrial Experience

How does the fast growth and industrialization in the East Asian market economies fit in with this theory of industrial evolution and entrepreneurship? And how did East Asian countries, which pursued activist, interventionist industry policies to

INDUSTRY POLICY

"Industry policy" is defined as a consistent set of measures by which governments, in cooperation with industry (and union) leaders, aim to influence the overall structure and growth of industry with the objective of obtaining outcomes that differ from what market competition would produce — in other words systematic government intervention in the process of industrial evolution. Industry policy relies on central *ex-ante* coordination of plans in a cohesive strategy and on collective decision imposed from above. It discriminates between industries. It is therefore neither just a series of uncoordinated, once-off measures that have coincidental side-effects on industry; nor is it simply a policy to create a generally favourable climate for all enterprises (Behrman 1984: 128; Gatti 1981; Lindbeck 1981: 391–405; Burton 1983; Irvine and Martin 1984; Kasper 1985: 1–8). The major professed objective of industry policy is to accelerate overall economic growth and job creation.

There are two sides to industry policy: to delay the decline in shrinking industries and to accelerate the growth of expanding industries by attempts to "pick the winners", the growth industries of tomorrow. It is this second aspect that is of most interest in East Asian industrialization. After all, the new industrial countries have few old, declining industries yet.

Industry policy is incompatible with the notion of economic activity as a decentralized, open-ended evolutionary (Hayekian) search process that spontaneously generates (Schumpeterian) development. In the ultimate analysis, industry-policy planners view economic activity as a static, one-dimensional optimization of given, centrally known resources.

varying degrees, manage to keep the usual rigidifying forces of industrial cartelization and political patronage at bay?

3.1 Common Features of East Asian Growth

To answer these important questions, we must first attempt to sketch a generalized picture of the key features of industrial growth in East Asia, and find out whether there were common features. Historic and international generalizations are of course always risky. Country case studies reveal many differences amongst the various nations in their approach to industrialization (Appendix). Nevertheless, a survey of the literature and of the economic history of East Asian countries shows that there has indeed been a common, particularly East Asian, pattern of industrialization.[9] As one would expect, it was a complex web of interdependent

[9]A number of excellent recent studies have described and analyzed the "East Asian model" of industrial performance. Among them are Lee 1981, Mutoh *et. al.* 1986, Scitovsky 1986, Arndt 1987a and Riedel 1988c.

developments that facilitated industrial performance. Generally, economy-wide factors often mattered more than industry-specific aspects:

- Industrialization accelerated organically, and new methods of profitable production were tested by market participants all the time. The emphasis was on getting the incentives right for individual firms to develop. For this reason, it seems appropriate to talk of "industrial evolution", evoking growth processes similar to biological evolution, and not of "industrial revolution".
- East Asian governments were not given to fashions of "development mechanics".[10] They turned their backs on Statist, mechanistic approaches to development by such abstract policies as import substitution; coercive central planning; grandiose, centralized stop-go development strategies; heavy reliance on bureaucratic, large-scale state enterprises; or forced savings. Instead, the East Asian market economies shaped and used market forces and individual economic motivation. Over time, they liberalized — not because of ideological commitments to free markets but because of experience and a pragmatic commitment to improving economic performance (Krause 1988; Berger 1986).
- The East Asian market economies gave up development aid relatively early.
- Economics and business had primacy over politics. The social objective of high economic growth was given high priority over other, competing social goals, such as national prestige, welfare spending and income distribution, or environmental protection.
- The East Asian governments concentrated their limited administrative resources on assisting the mobilization of production factors and making their nation attractive to enterprise (Giersch 1979b, Parry 1988). The East Asian market economies opted for small government and, with some exceptions, desisted from massive international borrowing by the state for consumptive purposes.
- East Asian governments have been fairly autocratic and were normally not modelled on Westminster democracy. But they safeguarded, on the whole, the basic civil and economic rights of all their citizens, certainly to a greater extent than in Africa or Latin America. They cultivated the rule of the law which, as we saw above, is an essential ingredient in entrepreneurial confidence and industrial performance. East Asian leaders often acted implicitly on the

[10] "Development mechanics" describes the abstract, Statist/collectivist macro-economic, comparative/static social-engineering approach to development advocated by authors like Prebisch, Myrdal, Streeten, and Chenery, and UN organisations, who frequently ignored basic market forces and the contribution of individual creativity. See Lal 1983 and Arndt 1987b. The fashions of "development mechanics" came under challenge from the "new orthodoxy" on development, which was promulgated by the OECD's Development Centre, the World Bank, the Kiel Institute of World Economics, the (US) National Bureau of Economic Research, and the (US) Institute for Contemporary Studies. The evidence of East Asia strongly supports the "new orthodoxy".

Confucian model which defines the place of the state and the citizen and recognizes the role of a strong state that ensures order and social harmony. Under what one might term the "neo-Confucian constitution", state and industry are cast in a master-pupil relationship, in which the master plans and monitors the progress of the pupils, consults and cooperates with them, but also has the authority to discipline them. When the master gets corrupted, prosperity suffers. Then the "Mandate of Heaven" is withdrawn. This notion of government differs greatly from the Western concept of the state representatives and public officials as the servants of the individual, ultimately sovereign citizen. A more cooperative, yet clearly defined role of state and industrialist, as well as official policies that keep industries in "creative uncertainty" and refuse the false security of permanent regulation, assist in accelerated learning and capital formation and in the evolution of a modern industrial society — once the basic market incentives have been implemented.[11] A sovereign state apparatus that is aloof of lobby groups is better able to create a stable framework of rules and laws for enterprises, which enables them to plan with confidence. It is, however, probably not correct to see Confucianism as an autonomous force of growth, but as a contributing condition for industrialization.

- Over time, state regulation of East Asian industry has, on the whole, been made simpler, and the administration of industrial matters has been non-corrupt. This was crucial for the sustained growth of manufacturing productivity beyond the low levels of labour-intensive assembly. If a country wants linkages from initial assembly operations into sustained growth, it has to remove barriers of regulation which invariably have unintended side effects, including inducing bribery. As there is no fire without polluting gasses, there is no regulation without polluting corruption! The long-term side effects of regulation are often hard to diagnose, and entrepreneurs often do not bother to raise them with the authorities. Instead, they relocate the expansion of their plants elsewhere. Two examples may illustrate the innocuous side effects of regulation:
  - — Complex computer-controlled machines are now increasingly the heart of many manufacturing operations, even in labour-intensive production. Products made with these costly machines can only compete in world markets if their down-times are kept to a minimum, that is, if they can be quickly serviced. Repair engineers typically fly in with a supply of spares and diagnostic equipment. In some countries (like Singapore or Taiwan), these engineers are quickly checked through customs. And that is the reason why many computer-controlled operations are now being installed

[11]The traditional rigid Confucian model of the state used to be seen as a cause of underdevelopment. However, external shocks (loss of the Mainland, Korean War, expulsion of Singapore from the Federation) often jolted the system to become open to technology and to shift from administrative to market-driven motivations.

there and why manufacturing productivity keeps rising to developed-country levels. By contrast, other countries have a complex customs administration that tends to delay fly-in maintenance engineers and their repair kits for hours at the airport (or that extracts bribes). No computer controlled machines, which produce for exports, are consequently installed there and manufacturing productivity runs into ceilings.

— Increasingly, international manufacturers are placing headquarters and servicing operations in the Far East. That creates many very attractive jobs and allows the nationals from the host country to learn the tricks of managing advanced productivity. Singapore and Hong Kong have become such centres. Many international companies would like to locate their headquarters or servicing centres in Kuala Lumpur, where costs are 30 per cent below Singapore, but cannot, because work permits for the overseas staff are reportedly hard to get and not securely guaranteed for the long term.

- The East Asian market economies have welcomed international journalists and researchers, even if critical. This has created a rich network of information and contacts which makes it easy for potential investors, even small ones, to inform themselves. By contrast, countries with xenophobic regulations on researchers and journalists, like Indonesia or China, are not part of such networks and find it much more costly to attract foreign investors.
- East Asian industrialization was driven by exports to the wealthy markets in North America, Europe and Japan. At least initially, it was concentrated in labour-intensive activities (such as textiles, clothing, leather goods, shoes, electronic assembly), some of which benefitted from product-life cycle dynamics (Vernon 1966). But, after the mid-1970s, concerted industry policies, wage-cost increases and imitation amongst the various East Asian countries combined with slowed demand growth and import restrictions in OECD countries to make this strategy less attractive. As a result, East Asian industrial strategies shifted towards encouragement of heavy industries along the lines of the (often wrongly) perceived model of "Japan Inc." (see Appendix). These policies were not an unmitigated success. And the more agile East Asian performers soon made pragmatic corrections. Taiwan pushed machinery and heavy industries, but soon abandoned massive government involvement in heavy industry (see Appendix). Korea's protectionist drive to capital-intensive industries after 1977 created big losses and over-indebtedness; the government was apparently not successful in picking winners. Singapore deliberately raised wages to discourage labour-intensive activities and promoted a heavy petroleum industry. Both strategies contributed greatly to a grave recession and created problems that were undone by resolute corrective action in the late 1980s (see Appendix). The initial "dream run" into labour-intensive, export-oriented industrialization came unstuck where governments became over-confident and tried to "pick new winners" (Arndt 1987b: 43-45).

Only nimble-footed, pragmatic corrections and retractions saved the day, at least where governments were forcefully committed to the common, long-term good and were not captured by special interest-groups. The resolve of governments to undo the blunders was greatly strengthened by lack of natural resources and balance-of-payments constraints. However, in some countries, like Korea, the strategy has reached a point by the end of the 1980s where critical choices will have to be made and where the entire interventionist strategy may come undone.

- The impression that exports drove growth and industrialization is in line with much suggestive evidence that national income and export growth are strongly correlated. If one takes explicit account of capital accumulation and labour-force growth (factors, which are, in reality, not independent of the pace of overall economic growth), one can find clear econometric evidence that export growth accelerated overall growth (Balassa 1978; Feder 1983; Lal and Rajapatirana 1986; DeRosa 1986; Heitger 1987).
- Exchange-rate policy was used in the bigger Asian NICs to help export growth along. Like in Germany and Japan in the 1950s and early 1960s, exchange rates were kept on the side of undervaluation. This was possible for a time, as long as it did not lead to imported inflation, and the domestic wage level remained constant. More recently, all countries have had to appreciate their currencies and have had equilibrium exchange rates, which have contributed greatly to cost and price stability.
- The support for the flexible responsiveness of the supply side was normally preceded, and accompanied by, a commitment to stability in macro-economic demand conditions (except, at times, in the Republic of Korea). Where there were "inflation accidents", these were soon corrected, so that long-term price expectations remained stable. Internal stability helped to free the East Asian "high performers" from balance-of-payments constraints, which many LDCs elsewhere created for themselves. Internal and external balance greatly helped in the mobilization of production factors and the export success. Price-level stability also made it possible for relative prices to fulfil their signalling function for efficient allocation by competing entrepreneurs. And also assisted in maintaining positive real interest rates, a key condition for voluntary, spontaneous capital formation.
- Industrial acceleration was normally preceded, and accompanied by, enhanced agricultural development (for example, Taiwan's land reforms). There were no interventionist income transfers from agriculture to the urban sector of the sort that African and Latin American countries, or India, attempted.
- Governments desisted largely from positive discrimination (for example, on grounds of race, or some welfare notion of equality of outcomes). Few could expect good personal incomes irrespective of effort. This is important because welfare policies would have created secure market niches for certain privileged

Table 2
Income Distribution and Growth
Rank Order in a Sample of 34 Developing Countries

	Rank out of sample of 34 countries			*Inc. ratio of richest 20% to poorest 20%*
	Income distribution	*Income and GDP growth*	*Income distribution and per capita growth*	
Taiwan	1	1	1	ca. 4x
Singapore	5	2	2	ca. 8x
Rep. of Korea	8	4	3	ca. 7x
Hong Kong	11	5	4	ca. 8x
Thailand	16	10	9	ca. 9x
Malaysia	26	16	14	ca. 16x

Sources: All except last columns from Riedel 1988c. The index is based on Borda's rule of rank ordering and is explained there. Last column from Sachs 1989.

groups that then would not have to make an effort to gain income. Long-lasting positive discrimination erodes the entrepreneurial capabilities of the privileged groups and gradually amounts to enfeebling protection. By contrast, lack of patronage and favouritism tends to enable the vast majority of citizens to compete and get ahead. A recent study of thirty-four developing countries showed that the four first-generation NICs achieved the highest performance in a growth and equality index (Table 2). The income equalization by markets in fast-growing LDCs is well documented (Fei, Ranis and Kuo 1979; Choo 1980; Chow and Papanek 1981; Fields 1984; Scitovski 1985). A reasonably equitable income distribution is facilitated by free competition, and this assists in successful industrial evolution (Sachs 1989).

- None of the East Asian countries tried to assume a high profile in international politics; they behaved rather like the Swiss, stressing trade and finance. They displayed few hang-ups about foreign dominance or conspiracies and did not waste much thought on regional cooperation or the international coordination of industrialization (as Comecon does, and ASEAN tried for a while). None of the East Asian market economies engaged in post-colonial grandstanding, confronting the West. Instead, they conduct themselves on the international stage as pragmatic, non-ideological grown-ups. Their comparatively well educated citizens are directly exposed to the ideas of the outside world; and their leaders have successfully cast themselves in the role of budding equals of the leaders of the rich nations. This adds to international confidence and makes the supply of production factors from abroad relatively cheap and elastic.

- Many of the East Asian nations have turned themselves into attractive locations for internationally mobile production factors from the West. Locally available production factors were often pushed to higher productivity by systematic policies to attract foreign technology and capital, and by exposing the growing industries to signals from competitive world markets. International trade competition and investment were seen as transmitters of useful productive ideas and devices to control production costs effectively.
- None of these countries had natural resources for export. The lack of resources *protected* them from specializing along the lines of comparative advantage in natural resources analyzed by David Ricardo (1817, Ch. 5), and induced them instead to develop industries that exploit Heckscher-Ohlin-type comparative advantages, which depend on low labour cost and rising labour productivity (Heckscher 1919; Ohlin 1933). More recently, Japan and the more advanced NICs began to develop comparative advantages also in innovation- and technology-intensive industries, as described by Joseph Schumpeter, shifting increasingly from "Heckscher-Ohlin" to "Schumpeter goods". This East Asian specialization pattern turned out to be favoured by world demand and hence was more profitable and conducive to rapid industrial growth than a concentration on "Ricardo goods".
- The East Asian market economies (except Hong Kong) did not pursue *laissez faire* industrial policies, but paid great attention to facilitating industrial growth by ensuring an elastic supply of production factors and by preventing firms from seeking government-protected market niches. Their policies concentrated on the supply side. What probably mattered in influencing producers was the direction of policy change towards gradual, progressive liberalization, rather than the level of intervention. Many producers in countries like Japan, Korea and Taiwan were made to expect more competition in the future. This greatly assisted in structural adjustments in the industrial supply apparatus. General functional policies were normally given preference over narrow, industry-specific policy actions. Systematic, concerted supply-side policies were focussed in particular on investment in physical and human capital. Beyond those non-discriminatory policies, policy concentrated on export incentives (Table 3), although import substitution policies varied.
- The elastic supply of capital was assisted by a systematic development of financial markets and, sometimes, direct subsidies to promote saving and industrial investment. Share markets, including those for venture capital, were developed, often appealing to the gambling instincts of small savers.
- The supply of knowledge was made elastic by numerous policies to attract overseas industrial know-how: sanctioning breaches of copyright ("reverse engineering"), licensing, favouring direct foreign investment; exchanges of experts; encouragement of overseas studies.
- Labour markets were not regulated, and trade unions, in their role as rent-

Table 3
Export Incentives

	Rep. Korea	Taiwan	Hong Kong	Singapore	Malaysia	Thailand
Financial incentives						
a. Loans/interest reductions	X	X	–	X	X	X
b. Guarantees	X	X	X	X	X	–
Fiscal incentives						
a. Tax exemption and relief	X	X	–	X	X	X
b. Depreciation of allowances	X	X	–	X	X	–
c. Exemption of customs duties	X	X	–	–	X	X
Incentives to production factors						
a. Training	–	–	–	X	–	–
b. Research and development	–	X	X	X	–	–
c. Sites, buildings, facilities	X	X	X	X	X	X

Source: Luetkenhorst 1989.

seeking organizations, were frequently opposed by governments. Despite this, real wages rose quickly. The main reason was that training and skill formation were favoured by (normally government-provided) education, and there was an eager demand from employers who needed higher skills (Stevens 1987).

- Mobilizing labour and skills for industry growth also embraced women. In East Asia, they are not treated as beasts of burden, as in Africa, or as house-bound luxury items, as in the Middle East and South America. This enhances the growth potential enormously, since the entire workforce can participate in development, a crucial factor when labour-intensive industries are launched. Development was also greatly helped in that both the nuclear and the extended families remained intact in the industrial cities and even in lower socio-economic strata (in contrast to Africa or parts of Latin America).
- What has often mattered more to success than the work effort and mere capital accumulation was the increase in total factor productivities, as measured by "third-factor growth". Whilst this measure only provides us with proximate causes of economic growth and not a proper explanation, it nevertheless indicates that the policy-makers knew how to ensure high returns on work and saving by the good use of knowledge and scale economies (Table 4).
- Great attention has been paid to quality improvement, an aspect of industrial performance which only occurs where there is genuine oligopolistic competition. Industry in Japan, and later elsewhere, implemented systematic quality controls and human-resource management techniques to raise quality. Industries tended to start with shoddy, but cheap products, and then moved up the scales of quality and value-added.

Table 4
Third-Factor Growth in Selected Countries

Country	*Period*	*Third-factor growth share in total growth (%)*
Japan	1960-73	41.3
S. Korea	1955-60	47.4
	1960-73	42.3
Taiwan	1955-60	59.5
Hong Kong	1955-60	29.1
	1960-70	47.0
Malaysia	1969-86	12.0-23.0
For comparison:		
Average of OECD	50s-70s	49.0
Average of LDCs	60s-70s	31.0

Source: Malaysia, Kasper 1988; other countries, Chenery, Robinson and Syrquin 1986, p. 20-22.

- The East Asian economies became not only rich, but unfortunately "filthy rich", with dangerously rising levels of pollution. It is possible that these external costs will lead to rising burdens on industries and will, eventually, slow down their growth.
- Accelerated industrial evolution has demanded much of the adaptability of East Asians, but they have maintained much of their identity in their culture and value systems. What has probably helped greatly is the good functioning of family units. Like in Europe, industrial development in East Asia means that cultural diversity is modified, but not given up. Instead, it now becomes evident that the diverse cultural traditions of the Japanese, Koreans, Shanghainese, Sichuanese, Cantonese or Singaporeans enrich the evolving global industrial civilization. The West is beginning to learn from the East in industrial matters.

This is a complex constellation of factors. But it is in the nature of economic growth and industrial evolution that simple models with a few variables will not do. Whilst the above factors are not unique to East Asia, their combination justifies the view that there is such a thing as a common East Asian pattern of industrialization. It has been highly successful in advancing people's living standards (and other social objectives).

3.2 Two Different Models of Industrial Evolution

Despite many common traits, industrial performance and policies to promote industry were far from uniform throughout the region. Indeed, in two important respects, East Asian market economies differed considerably from each other:

(a) In their treatment of internationally mobile production factors *other than* capital and knowledge (in particular of entrepreneurship, skills, and bundles of such production factors called "firms"), some followed in the nationalistic Japanese mould and kept foreigners out. Others developed along lines closer to the "treaty-port model". They relied heavily on attracting bottle-neck supply factors and opened their doors widely to direct foreign investment, to promote the transfer of industrial know-how and skills. They did so by relying on multinationals and skilled foreigners.

(b) Some governments influenced evolving industrial structures by comprehensive direct interventions in market processes with the aim of accelerating growth ("unbalanced growth"). Selective industry policies occurred normally where the nation was isolated from the world by language or other barriers and was normally associated with policies to restrict the direct involvement of foreign companies and with a more direct role of bureaucracies in the entrepreneurial function.[12]

Discriminatory interventionist industry policies tended to go along with more aggressive protection from import competition, probably because the market distortions by industry policy would not have been validated in open international competition.

One can therefore identify *two models of industrial growth*:

A. The open, market-oriented model of industrial development that welcomes not only capital and know-how from the outside world, but also enterprises and other production factors, and adopts a fairly liberal trade regime. In this model, government relies very heavily on general, functional policies of furthering industrial growth and limits its involvement with specific industries, be it through direct public investment or industry-specific regulation. This type of industrial country has also tended to move fairly readily from import substitution to export growth.

B. The more nationalistic model of industrial development relied on stricter restrictions of imports and engaged in more activist public policies, including collective forms of entrepreneurship, in which the state or government-sponsored groups start new industries. These countries tended to be more

[12]In this respect, the East Asian experience differs from the Latin American or African models, in which regulations are implemented to attract rent-seeking foreign multinationals with the fairly overt purpose of allowing politicians and bureaucrats to extract part of the rents they have initially allotted.

active in discriminatory industry policies and have been more reluctant to open their trade to the stimulus of international competition.

Hong Kong, Singapore, increasingly Taiwan, and important parts of Japanese industry (as well as Malaysia) have developed along the lines of Model A. Other parts of the Japanese economy, Korea and much of Chinese manufacturing are closer to prototype B.

3.3 Timing the Take-off

New industrial centres are normally spawned during times of accelerated growth in the old industrial countries. Thus, Japan and Shanghai managed their industrial take-off during the world-wide industrial expansion in the prosperity before the first world war. The first-wave NICs of East Asia took off during the global expansion of the 1950s and 1960s. Hong Kong's and Taiwan's take-off occurred in the late 1950s, whereas Singapore and the Republic of Korea followed in the mid-1960s. Malaysia might have taken off into accelerated industrial evolution in the early 1970s, when it had reached the income level of Korea and Taiwan at the time that their industrial growth accelerated. But world demand slowed down in the 1970s and, in any case, Malaysia embarked on the New Economic Policy (giving weight to equity and positive redistribution policies) and entered a resources-for-export boom. This assisted growth and external balance, but hampered job creation in the manufacturing industry.

When growth in the old industrial countries decelerates (as in the 1930s or 1970s), this does not normally induce a similar slow-down of growth in those new industrial locations that have already taken off, because the NICs can still nurture their growth process by imitating and catching up and do not have to engage in the "creative destruction" of old, superseded industrial and social structures.[13] The NICs are — so to speak — still downhill from the mountain-top craters, from which flows the "technological lava" of new industrial ideas (Giersch 1979a). But, like Malaysia, they are already well above "sea level" with regard to infrastructure, skills and capital, so that they can absorb imported technical know-how fast and effectively. Industrial performance thus benefits from continuing technical diffusion, even when world demand slows down. Also, their domestic markets have developed segments of demand that can afford to buy more expensive innovative goods, so that innovators can begin to test new products in domestic markets. During slow-downs like between the late 1960s and early 1980s, the old industrial countries are engaged in "creative destruction" which requires considerable energies and is often resisted with the help of political interventions, which in turn impede overall economic growth further. By contrast,

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[13]This is based on the theory of Kondratieff cycles. Examples of NICs of earlier eras that kept growing through Kondratieff downswings were Germany and Japan in the late nineteenth century and the Soviet Union during the 1930s downswing (Kasper 1983a).

the NIC's supply system is young and responsive, so that they tend to grow throughout such global downturns.[14] This explains the continued high growth of the East Asian NICs (as well as post-war Japan), after the 1970s/1980s slow-down of world economic growth.

One must of course assume that the future success of the "second-wave NICs" will to a considerable extent depend on the growth of demand in the old industrial countries. There appear to be first, tender signs of a renewed acceleration in the world-wide growth trend.[15] If growth in the old industrial centres picks up further into the 1990s, the new NICs will enjoy enhanced chances of rapid industrialization. In addition, however, demand growth in the "old NICs" — and indeed throughout Asia — is in future also likely to facilitate export-oriented industrialization. Intra-Asian trade has been growing fast and will continue to do so, offering market opportunities to "second wave NICs" like Malaysia. A third source of demand will be internal income growth in the "second-wave NICs" themselves. Industrialization tends to generate its own expansionary dynamics, in which high demand elasticities for manufactures, the transfer of tested technology packages from abroad and scale economies interact to generate a "virtuous circle" of growth (Abramovitz 1979). Those industries and economies that are most responsive to market opportunities and have the most elastic supply system will be among the next generation of NICs. And those who patronize, regulate, politicize and rigidify their production apparatus will fall behind. In which group a country will end up seems largely a matter of its own choosing.

4. Some Important Lessons for Policy Makers

4.1 Industry Policy and Entrepreneurship

For those who "look East" for guidance in industrial policy, it is important to note that the overall industrial performance of post-war Japan owes much to hard work, learning and high saving, and not all that much to industry-specific policies implemented by its Ministry of Trade and Industry (see Appendix). Japan had, in the early 1950s, reached Malaysia's current level of income and productivity; and it was still easy to emulate industrial successes in countries that were "higher up the development ladder". The preconditions for a high industrial growth performance (education, training, capital availability and infrastructure) had already been laid, so that firms could latch on to promising products and processes and exploit them rapidly. In post-war Japan, functional policies to enhance an elastic and secure supply of labour, capital, skills, and natural resources, as well as a stable, enterprise-oriented socio-economic climate, small government and an export orientation made it easy for firms to reap scale economies by mass

[14] J. Riedel showed recently for Hong Kong that it is not high demand growth but supply-system responsiveness which explains much of the Colony's superlative growth performance (Riedel 1988b; see also: Donges and Riedel 1977).

[15] See paper by Larsen Flemming in this volume.

production for world markets. Much evolutionary competition and innovation took place within oligopolistic enterprises of considerable size. The resulting scale economies were not so much of the static kind (larger production runs with given production functions), but more importantly of the dynamic kind (learning-by-doing, a process by which entrepreneurs shift production functions upwards). Consequently, Japanese industrial producers frequently achieved downward-sloping supply curves. Japanese industrial marketing aimed to sell innovative products at low per-unit profits, but in larger quantities. The strategy of small unit profits and high output runs was helped by overall stability and a hierarchical master-pupil relationship between government and industry. A strategy of "riding downward-sloping supply curves" is of course conducive to rapid industrial growth. But it was only pursued where government patronage did not secure *permanent* market niches by industry-specific intervention and as long as business did not have to fear cost explosions.

The first-wave NICs shifted, in the light of pragmatic lessons from experience, from failing import substitution to labour-intensive specialization and export orientation. Like in Japan, their governments focussed on mobilizing the necessary production factors. But, sooner or later, they exposed most industries to the discipline and stimulus of world-market competition. Market niches were supported by government, but were perceived to be temporary because the general trend increasingly was towards liberalization. Firms were gradually forced to attain economies of scale and to innovate constantly by competing in export markets. On the whole, governments talked to business and consulted, but assumed no co-responsibility for profitability and kept industry at arm's length. They could do so more easily because political power did not depend on elections and political fund raising.

In other respects, the first-wave NICs relied on greatly differing strategies regarding entrepreneurship. South Korea implemented a fairly interventionist industry policy and built up large-scale, capital-intensive industries (Model B of industrialization, mentioned above), more so than post-war Japan. But Korea has been, in the late 1980s, also trying to move away from concentrated, overt government patronage and towards more exposure to competitive forces. In 1989, this led to a near-crisis when one of the major conglomerates had to be bailed out by government credits of US$600 million, and when major wage increases were conceded. By contrast, Taiwan's and Singapore's strategies have been much more reliant on creating a general climate favourable to enterprise, on pursuing functional policies to favour industrial expansion, and on attracting complementary, internationally mobile resources from abroad (including foreign enterprises). But both also tried selective industry-policy interventions. However, they were prepared to make pragmatic corrections when these failed to contribute to growth. Hong Kong is located at the free market end of the spectrum, partly by choice, partly by historic and political accident, and has done equally well.

The evidence suggests that both individual and collective entrepreneurship by state-sponsored groups are capable of promoting high industrial growth. But the evidence to date also shows that direct entrepreneurial involvement by government agencies in industrial enterprise and industry-specific interventions require great administrative discipline and an overriding political commitment to the national economic goal of long-term economic growth. Confucian traditions and great social cohesion have no doubt helped greatly in limiting the inherent dangers of government involvement in industry. The dangers of corruption, rent-seeking and eventual maladjustments and rigidities in industry structures were normally controlled by exposing industries to untrammelled world-market competition. East Asian governments have, most of the time, imposed the rule of law, and to retain control, they pushed their industries into competitive world markets. Because this switch was made before rent-seeking became entrenched, industries were readily inclined to seek opportunities to control production costs by innovation and scale economies. The blocking of lobbies for government hand-outs often helped industries to switch successfully from import protection to export orientation, because there was no alternative for survival.

It is worth reiterating that collective approaches to industrial entrepreneurship — like in inter-war and early post-war Japan and post-war Korea — require great social cohesion, for they create centrifugal tensions. It is an open question whether Malaysia's multi-ethnic society could stand the pressures of a "Korean strategy", let alone whether that would be compatible with Malaysia's more open political traditions. The political turmoil in Japan during the first half of this century, the inherent corruption in present-day Japan and the present civil and industrial unrest (combined with crises in big conglomerates) in Korea have to be seen as the result of collusive alliances of industry and government. We have yet to see whether the political system will withstand the strains of long-term selective intervention in favour of big corporations. Ultimately, the anonymity of market competition and the cooperation of diverse people within firms, who are bound together by their rivalry with outside competitors, appears more conducive to social harmony and political stability than overt political patronage of industry.

It is worth underlining that *all* East Asian market economies have steadily and perceptibly moved towards market capitalism, often against the resistance of powerful industry-interest groups. They did so pragmatically because interventions led at times to costly failures, corruption, and political tensions which endangered future economic growth. Taiwan in particular is of interest in this respect because it has moved from an originally Statist, interventionist stance in the direction of what might be termed Malaysia's "Old Economic Policy" of the 1960s, namely the provision of an infrastructure and a stable economic order, together with general functional policies to enhance the supply of production factors. It is no coincidence that these policies have promoted a very equitable income distribution and offer good economic opportunities to small operators who have no "connection" with patrons in big government.

4.2 International Trade Regime and Industrial Entrepreneurship

The East Asian experience has provided much input into the intellectual battle between import substitution and export orientation. In the opinion of most economists, the battle has been clearly won by the protagonists of the latter. East Asia shows that there is no reason for the once fashionable export pessimism. If a country dislikes its terms of trade, it can change them. This takes considerable time, but entrepreneurs will shift economic structures from activities with poor long-term prospects into those with better market prospects. Manufacturing tends to offer more such opportunities than a specialization in primary industries.[16] The protectionism of the OECD countries did not impede the export-led success of the NICs, who have shown that "the bark of protectionism is clearly less than its bite". Agile NIC exporters have always found their way around many import barriers in OECD countries and continue to flourish even without the continued concession of General Preferences for imports which are granted to poor countries, but have been withdrawn from first-wave NICs (Hughes and Krueger 1984; Baldwin 1982).

Governments increasingly realized that initial import substitution imposed a deadweight burden on all potential exporters, so that industry assistance and export subsidies were used to overcome that handicap when the strategy shifted from an inward to an outward orientation. The import protection handicap that is in place in East Asian countries seems moderate by developing-country standards and helps to explain why the shift was feasible and successful (Table 5). However, some countries have raised levels of effective protection, most notably Korea and the Philippines.

There is agreement that the East Asian market economies have moved to greater export orientation. But what is not so clear is what various observers mean precisely by "export orientation". For some (including myself) it simply means free trade. But many others argue for tilting interventions towards favouring exports, normally with oligopolistic, evolutionary dynamics and scale economies in mind. However, I would conclude with Paul Krugman that "there is nothing in the theory [which takes oligopolies and technical evolution into account] so far that would restore intellectual respectability to the strategy of import substitution. [It] ...looks even worse in the new theory than it does in the standard theory" (quoted by Riedel, 1988a, p. 9).

Occasionally, the East Asian experience is adduced as an argument to support

[16] I argued this case in the early 1970s for Malaysia when I feared that FELDA and other agricultural development schemes might create the poverty ghettos of the year 2000. See Kasper 1975.

Table 5
Rates of Protection
(percentages)

	Nominal rate	Effective rate
Singapore (1967)	3	6
Taiwan (1969)	12	15
Korea (1968)	11	1
Korea (1978)	18	31
Malaysia (1978)	22	39
Thailand (1978)	27	70
Philippines (1965)	51	51
Philippines (1980)	...	70

Source: Riedel 1988c, p. 32.

the view that countries should protect "infant export industries". The argument rests on the fact that secure domestic profits and secure domestic markets are needed to enable producers to lay the foundation for scale economies and for marginal cost pricing in export markets (Westphal 1982; Pack and Westphal 1986). This amounts to the argument that (protected) domestic customers should pay artificially high prices to subsidize foreign customers and it assumes — against the theory and evidence of dynamic oligopolistic competition — that the artificial protection of market niches facilitates sustained innovation. Why should protected producers ever abandon the secure home-market profits for insecure export profits and the extra risks of implementing scale economies? Like after an initial phase of import protection, the step into the competitive world market will be difficult and will be resisted. It may easily fail because prior domestic featherbedding has induced high cost levels. The argument for "infant export industry protection" gives the impression of interventionists clutching at straws!

Most East Asian industrial countries have at one time or another tilted market signals in the direction of exporting by selective subsidies for manufactured exports. The Republic of Korea and Singapore offer, for example, selective tax subsidies (exemptions) for export earnings. But this means that other producers have to pay higher taxes to finance a given level of state activity. Also, potential loopholes are opened, and the terms of trade for the economy as a whole may deteriorate. Export subsidies bear, in principle, within them some of the same dangers to genuine entrepreneurship as import protection, in that industries are directed by administrative incentive and not by exposure to the market. But subsidized exporters at least face effective competition in world markets, whereas protected importers are shielded from effective competition. Import protection also imposes higher cost levels on the local consumers (and therefore acts like a tax on potential exporters), and normally has regressive effects on income distribution. By contrast, export subsidies do not drive up domestic price and cost levels to a similar extent, though they impose burdens on public budgets.

The drawbacks of direct export subsidies may be found acceptable if rapid export growth is seen to bring static and dynamic externalities. But that case is fairly fragile. Moreover, export subsidies may raise (justified) "beggar-thy-neighbour" objections from overseas market economies, where industrial jobs come under artificial pressure because of these interventions. In practice so far, the NICs have been largely able to get away with most such violations of free-market principles. However, the export interventionism of the East Asian NICs and countries like Brazil has contributed to the growing new protectionism in the OECD countries. This could have serious long-term consequences for the international economic order, from which the NICs have been profiting so handsomely.

In some cases, East Asian governments went beyond export subsidies and encouraged a strategy of concerted "targeting" of foreign markets to reap scale economies in innovative industries. This amounts to export cartelization which, in the longer run, tends to weaken non-price competitiveness. International competition may also become less open, and foreign markets could be dominated by certain monopolistic suppliers. This is now of concern in the West due to concerted Japanese targeting of certain industrial markets. "Targeting" amounts to a breach of the rules of free competition that is banned in most Western countries. For political reasons, "targeting" of American or European markets by East Asian industries has often been tolerated in the past. But, not surprisingly, it now leads to growing international trade conflicts and is seen as a threat to the multilateral trading system. It is unlikely that the affluent industrial countries (especially the United States and the EEC) will tolerate increasing "targeting" by more and more NICs. These would not for long get away with the asymmetry of protecting their own domestic markets whilst trading with monopolistic practices in rich-country markets (Bradshaw, Burton, Cooper and Hormats 1988). Moreover, as the practice of "targeting" is emulated by more and more NICs, excess capacities are built up, so that rates of return in "promising" industries are low. The newest crop of NICs will not be able to follow in the wake of Japanese and Korean policies, but will have to discover their own market niches by normal competitive trial and error (Park 1989). The search for such market niches is best done when enterprises enjoy a climate conducive to risk-taking and expansion. Countries that are open to the world and that favour learning and individual self-reliance will fare best in the long run.

The East Asian experience shows that lack of natural resources can be a boon for good industrial performance. Thanks to export-oriented industrialization, resource-poor Taiwan and Korea, for example, overtook Malaysia in its living standards during the 1970s, the time of the oil-and-gas boom and big public sector expansion in Malaysia. Moreover, the lack of profitable resource industries makes it impossible to "milk" the primary sector for rents and transfers to the industrial-urban sector (as has been the case in many countries like Australia, Argentina, or India). Instead, manufacturers are forced simply to compete and they can do so because the real exchange-rate is not pushed up by resource exports (and loans which mortgage the natural resources). This is not to say that resource-rich countries should not exploit their resources, but that they should not give artificial preference to these industries.

4.3 General Functional versus Specific Manufacturing Policies

Much has been said about general economic and social policies and relatively little about direct interventions on behalf of specific manufacturing industries. The reason is that general economic and social policies have been infinitely more important to the East Asian success than sector- or industry-specific policies. General, functional policies, including a stable social and economic order that gives people long-term confidence to work, learn and form capital, are by far the most important pre-conditions for good industrial performance. Specific policies — for example, tax holidays, tariff exemptions or provision of industrial estates — may delight the interventionist bureaucrat, the economic planner, or the academic economist, but such specifics were clearly of second- or third-order importance to the East Asian success. Otherwise one would not have observed the same excellent industrial performance in response to greatly differing approaches to these specifics in otherwise comparable countries, like Korea and Taiwan, or Singapore and Hong Kong. It is also worth recording that countries with successful industrialization were successful in agricultural and service-sector development because the overall framework was favourable to growth in all sectors. One important lesson therefore is that, when the fundamentals are right, specific policies probably do not matter all that much. Another major lesson from East Asia is that an enlightened, stable and strong political leadership, which stays aloof of industrial lobby groups, can do much for industrial success. Time and again, political leaders have shown the autonomy from industrial interest groups by making bold cuts in subsidies and protection, such as Japan's freeing-up of the aluminium industry or Singapore's decision not to protect car assembly. Such actions tend to send out signals to other industrialists that their market niches are not unconditionally protected by government, but have to be secured by unceasing effort.

Where selective, interventionist policies created productive capacities which failed to reach genuine competitiveness (after say, ten years), the most rational policy is to end subsidies and protection. It must be accepted that capital has, occasionally, to be written off. Different from developing countries elsewhere, where public enterprises were seen in terms of national prestige or as "milch cows" for the members of a well-organized political and bureaucratic class, the East Asian market economies have on the whole treated public as well as private, but regulated, industries in purely economic terms as business and judged them by their contribution to growth.

East Asia shows that a general, gradual liberalization of the economy can mobilize enormous creative potential. It advances entrepreneurial activity for sustained periods of time. Few would have predicted in 1955 what progress those hopeless, handicapped places like Korea, Taiwan, Hong Kong and Singapore, or even Japan, would make within a generation. This progress was only possible after the failures of Statist policies, which suggested the use of market forces and individual initiative. What mattered to keeping (oligopolistic) entrepreneurs on their toes was the gradual, but irreversible, move towards liberalization, not a given level of regulation. As long as producers were made to expect that markets were to become more contestable, they innovated and competed. The single most important, if not even the only feasible, way to ensure contestability was by international competitive pressures.

The experience also shows that a market orientation can help even the poorest segments of the population, not only because the poor benefit from faster job creation in industry, but also because competitive open markets and the absence of favouritism promote greater equality of opportunity and create incentives to acquire skills. Positive discrimination and redistribution by government intervention often fails, not in the least because it destroys entrepreneurial incentives, creates a privileged class, and politicizes and emotionalizes economic allocation.

General policies to mobilize supply factors for industry should pay great attention to controlling the cartelization of labour markets by unions, to raising savings rates (by making real interest rates attractive and limiting the claim of the state on national income) and to improving the general educational level of the population, especially in scientific and technical areas. And treating women as equals in schools and in industry is particularly important in the early, labour-intensive stages of industrialization (textiles, garments, electronics assembly) when women play a very important role in the industrial workforce.

For general policies to be effective, clarity, simplicity and stability of rules ("the economic order") are essential. Complex policies normally fail because their administration breaks down. Policies also have to be consistent over time. Activist, zigzag policies — a new national strategy with every five-year plan! — can be destructive of many potential entrepreneurial contributions to material progress. Policies also have to be consistent amongst themselves and fit within a cohesive overall strategy. This is more easily achieved where there are few initiatives. If individual measures are contradictory, they smother the spontaneous forces of industrial growth. It is not necessarily the absence of rules and regulations that matters, but their predictability and generality, combined with controls of rent- and patronage-seeking. In interpreting the record, I find myself close to the interpretations of the "new orthodox development economists" who stress the central role of prices, incentives and security. But I still see some merit in the reading of the evidence by political scientists. Robert Wade has, for example, shown that the East Asian industrial performance has been assisted by market-oriented interventions

- which combined mere trade protection with competition measures,
- which were selected according to economic rationale, not in response to lobbying, and
- which were coherent with other interventions and over time (Wade 1988; in a similar vein, see Lindblom 1977; Reynolds 1985).

It is not the total absence of regulations that matters, but their shape and spirit, as well as the trend in regulatory policy toward greater freedom of individual initiative.

5. Conclusion: Lessons for Malaysia

Compared to the very exacting standards of the East Asian high performers, Malaysia has had somewhat less overall economic growth (real per capita incomes since the early 1960s a very respectable 4 per cent per annum) and less rapid manufacturing expansion (to 25 per cent of GDP). Compared to Taiwan and other competitive economies, income distribution appears less even. But by any other international comparison, Malaysia has done well. And Malaysia now seems well placed to become a fully fledged "second-generation NIC", having reached upper-middle income status of around US$2000 per capita income. It is of course not uncontroversial to generalize the East Asian model (Cline 1982; Ranis 1985). But Malaysia shares many of the essential pre-conditions for accelerated industrial evolution with the successful East Asian market economies, namely

— a good record of education (including widespread knowledge of the "world language", English), training and attracting scarce skills from overseas;
— a fairly high degree of capital mobilization from domestic sources and the attraction of foreign capital, not least due to, on the whole, responsible macro-economic policies, a high degree of price-level stability (of around 3 per cent per annum since Independence) and reasonably liberal financial-sector policies;
— the development of a modern infrastructure;
— a reasonable degree of political stability, a functioning legal system, and — on the whole — a guarantee of basic civil and economic rights;
— a good record of mainly rational general policy making and a predominantly rational, cohesive framework of largely market-oriented economic-policy interventions;
— a reasonable degree of openness to ideas, production factors and products from other countries; and
— a traditional reliance on private initiative.

On these scores, Malaysia has, on the whole, been closer to the successful industrializing economies of East Asia than to other developing countries, including the Philippines and Indonesia.

But there have been important aspects where Malaysia, at least from the early 1970s to the mid-1980s, was increasingly at variance with the East Asian pattern:

— Whilst market interventions (including government ownership of productive assets) were scaled down all over East Asia, Malaysia introduced more and more detailed regulations for industry (such as the *dirigiste* Industrial Co-ordination Act [ICA]). More recently, the ICA has been liberalized, but Malaysia still requires the licensing of much industrial investment (which puts it at a disadvantage, for example, as against low-cost locations in Europe, like Portugal). Malaysia also greatly increased the socialized ownership of industry during the 1970s. The share of public spending in gross national expenditure has crept from a modest 22 per cent in the First Malaya Plan (1956-60) to no less than 36.6 per cent in the Fourth Malaysia Plan (1981-85). That share has been coming down a little since.

— The direction is now towards de-emphasizing reliance on the state and towards trusting more in market forces than in regulation. The expectations of industrialists would, however, be durably affected if government pursued a mix of de- and re-regulation and failed to adhere to setting a clear trend and committing themselves to a liberalization strategy.

— There have been some doubts about the legal order and civil rights, mainly in the administration of the law and in areas where there is much scope for arbitrary administration.

— Resource-richness, which Malaysia has been good at exploiting, and loans that have mortgaged reserves of resources have kept the exchange rate high and made industrial exports and job creation harder. Whilst Malaysia should of course continue to exploit its good land and mineral resources, it should not do so by artificial promotion, which would be to the detriment of industrial jobs. Caution in foreign-loan driven development will also help to maintain an exchange rate at which Malaysian industrial jobs can compete internationally.

— The trend to socialization of industry and other activities has not always promoted efficiency and growth. Many of the 700-800 active Non-Financial Public Enterprises, which were granted government-secured market niches, have accumulated losses and suffer from unhealthy balance sheets (as the theory of government-secured market niches outlined above, would suggest!). Like anywhere else where market discipline is lacking, Malaysian state-owned businesses suffered from administrative, that is, non-entrepreneurial management styles, waste of scarce capital (under-utilization of capacities), insufficient innovation, lacking cost control and inappropriate technologies. No Industrial Master Plan can change this, only genuine privatization and exposure to competition East Asian style. Industrial Master Plans are in the tradition of constructivist social engineering by central authorities, who invariably have insufficient knowledge and hence cannot cope with continually changing conditions. They tend to impose confusing, centrally conceived administrative rules from above, normally based on outdated information. The East Asian experience has shown that only decentralized, profit/loss driven innovations, which originate from market incentives and within competing firms, are able to mobilize genuine entrepreneurship, enhance industrial performance and ensure *sustained* growth.

— The main driving force for Malaysia to move to more regulations and socialism in the 1970s and early 1980s has of course been the wish to implement a policy of positive discrimination for the Bumiputera. Such a policy was probably necessary half a generation ago to break the cultural and other barriers to equal economic opportunity. But like all market interventions, such interventions have insiduous and complex long-run side effects that develop gradually and cumulate over time. Some new regulations may be good for someone, but most old regulations are bad for the common good! Some of the long-term consequences of detailed positive discrimination are that important segments of the labour force now work in an artificially protected, non-entrepreneurial environment (state-sponsored niches) where they have developed unrealistic expectations and attitudes, that the incentives for all to acquire marketable industrial skills have been weakened, and that the balance in public-sector budgets and external accounts have been endangered by inefficiencies and losses in the socialized industries. The Malaysian experience seems to support the general rule that the overall costs of intervention tend to grow, whereas the proximate benefits do not. Of course, the time lags in moving from a competitive to a rent-seeking socio-economic order are very long; but, once set in train, these trends are extremely difficult to reverse because political regulation acquires a dynamics all of its own. The only way to disrupt this dynamism is to shift more allocational decision back into markets, which are "racially blind", and to de-politicize industry (Rabushka 1974; Sowell 1975, 1983, 1988).

The lessons for Malaysia seem fairly obvious. Indeed, some of the lessons I would draw have already begun to be implemented since the mid-1980s. *If* Malaysia wants to emulate accelerated industrial evolution at a sustained pace, similar to that observed in North-East Asia, it would have to go further in implementing a few, admittedly difficult, practical lessons:

(a) Economics and business should be given priority over politics and politics and business have to be clearly separated. Positive discrimination to achieve would have to be replaced by *assistance with equality of starting opportunities*, but responsibility of each and everyone for his or her income. This means that distribution policies might de-emphasize equality of *outcomes* and strengthen help with equal *starting opportunities*.[17] The longer the time during which discriminatory redistribution policies are pursued, the bigger their cumulative "dead weight "on the spontaneous forces of genuine entrepreneurship and growth.

(b) The protected, inward-looking parts of the economy would have to be opened up. *All industries* would have to be exposed to *international competition in foreign and domestic markets*. The requirements for official approvals for a great many economic activities and projects would have to be abolished, where such approvals serve no rational social purpose. At this juncture in Malaysia's economic history, it might be useful to undertake an independent, comprehensive review and cost-benefit analysis of all regulations of manufacturing, keeping in mind that a "political market" for regulations may easily be in conflict with the objective of accelerated growth and industrial evolution. It might also be kept in mind that — in a complex world of constantly changing circumstances — discriminatory "picking-the-winners" strategies are probably not feasible and might easily create tensions that could overburden Malaysia's social fabric.

(c) The New Economic Policy has led to the socialization of much economic activity and has weakened the competitive economic order, after the public and quasi-public sectors were made the "stakeholder" of Bumiputera interests. The *state* might therefore continue to *devolve its direct interests in industrial production by privatization*. For sustained industrial success, it will be important that newly privatized firms compete without public patronage. Little is to be gained from converting public into private monopolies, and no amount of surveillance can suppress the abuses of private monopolies. The proceeds from the sales of publicly owned assets would allow the public sector to repay some of its costly debts.

It is apparent by the late 1980s, that Malaysia has already turned in the right direction, moving some way from a mechanistic, interventionist policy approach to placing more trust in the market. Much will, however, depend on whether that direction continues to be pursued with consistency and vigour, and whether the deregulatory momentum is maintained to keep industry in the state of "creative unease" which is so good for the wealth of nations. It has also to be kept in mind that many other countries are also moving towards more liberalization. What was an acceptable level of interventionism in 1975 is seen to be comparatively regulatory in 1990. The spontaneous growth responses of the economy in the late 1980s should indicate to policy makers that the rewards for trusting the market

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[17]This might be done by promoting education vouchers for the less privileged or by replacing direct interventions through racial quotas and the like with the introduction of a negative income tax. See Kasper1983b.

and entrepreneurs are prompt and considerable. The removal of some of the obstacles and impediments to genuine entrepreneurship has already demonstrated that Malaysians can compete successfully in the first international league of new manufacturing industry!

It is of course easy for an outspoken foreign visitor to preach, but policy reform in this area is extremely difficult. World-wide experience shows that patronage and interventions create their own rent-seeking interest groups, so that the state finds it hard to pursue the common interest of fast industrial evolution and genuine competition.

It seems appropriate to conclude with a quotation from Nobel Prize winner, Jim Buchanan (1988: 4):

> "Modern rent seekers are under no delusion about the "social good". They do not abide by the precepts of honesty, fairness, respect for the rule of law, etc. that are necessary for our civilization to survive.
> Are we to accept their behaviour as a temporary aberration which cannot be changed by conscious effort, or are we to use the combined forces of scientific analysis and moral argument to defeat them?"

Appendix: Interpretations of East Asian Industrial Policies[18]

Post-war Japan

The undisputed economic success of Japan, especially since the Second World War, and the rather flexible adjustment of Japanese industry to the various shocks of the 1970s and 1980s, are seen by many observers as the result of far-sighted, cooperative industrial policy under the guidance of the MITI.[19] Japan's post-war economic system retained some traits of the corporatist economic order of the 1930s and 1940s. It was based on a tradition which stresses harmony, co-ordination, and the subordination of individual interests to the long-term common good. Yet, the facts do not permit the label of "Japan, Inc.", which suggests a government-industry monolith out to conquer the world.

The links of consultation have been fairly close between key bureaucrats from the Ministry of Finance, MITI and the Prime Minister's office on the one hand,

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[18]Although it might be tempting to scrutinize the early industrialization of Japan and China's coastal cities for lessons for Malaysia, we shall desist. It seems that changed circumstances — much freer international trade, greater trans-continental mobility of certain production factors, lower transport and communication costs, different technologies — have altered the gameplan for industrialization so much over the past hundred years that possible lessons would have to be greatly qualified.

[19]Bieda 1970; Peck and Tamura 1976; Vogel 1978; Thurow 1980. "Business Week" makes the case fairly regularly, see The Business Week Team, 1982. See also Adams and Klein 1983.

and the Keidanren federation of big business, influential company managers and even organized crime on the other.[20] But industry planning in the past 25 years has not been from the top down, but rather from the bottom up. MITI officials often seek to establish a consensus among industry participants, although it is not formally binding. Industry policy often simply extrapolates averages and confirms private expectations. "Inducements" to subscribe to the consensus have sometimes been used (credit steering, import protection, waivers of anti-trust action, subsidies and moral suasion), but now more rarely. Nowadays, MITI has directive power over industry only in exceptional cases.

What is now being done differs greatly from the immediate post-war reconstruction period after 1949. Then, MITI was created out of the remains of the war-time Ministry of Munitions which had a nationalistic tradition. Its task in the cold-war era was to transfer Western technology to Japan. During the great shortages and disequilibria of the 1950s, basic industries (steel, cement, electric power) were promoted by fairly direct intervention and, from the mid-1950s, "infant industries" with an expected growth potential, like automobiles and petrochemicals, had been given protection. But since the late 1960s, the industrial guidance by the bureaucracy has been less assertive and cohesive, although MITI frequently still tries to fight foreign competition for Japanese industries. Fairly prescriptive industry plans of the post-war era have long made way for the subtle, coordinative approach of "industry visions" prepared by the Industrial Structure Council.[21] Like in other old industrial countries with powerful lobbies, industry promotion has frequently concentrated on supporting declining industries and keeping NIC competition at bay.

Japan abandoned prescriptive industry policies because the technological gap with the West has been closed. When a country is still far below the development level of the leading industrial countries, it is relatively easy to identify potential growth industries. Japan, wanting to catch up with the leading economies in the 1950s, could imitate the economic structures of those further "up the development ladder". But as the gap closed, new "sunrise" industries are harder to pick for the bureaucracy. No longer can a committee readily identify entire industries; growth opportunities now lie at the infinitely more detailed level of individual production activities. Another problem with "picking the winners" policies is this: As long as Japan was the only country to target certain industries and overseas markets for rapid and favoured expansion, it was relatively easy to be successful. But in recent years, others (like Korea) have emulated Japan; and all industry-policy committees around the world seem to have discovered the same promising growth

[20]For an account of the Japanese system see: Abegglen 1984; Tresize and. Suzuki 1972; Johnson 1977; Vogel 1978; Allen 1980; Magaziner and Hout 1980; Hosomi and Okumura 1982; Lincoln 1984; Patrick 1986; van Wolferen 1989; Johnson, Tyson and Zysman 1989.

[21]MITI 1980. Earlier visions were published in 1963 and 1971. See also OECD 1983, p. 48.

industries at the same time. (In reality, they copy from one another because they simply do not know!). This has led to excess capacities and low profits all around (for example, in consumer electronics).

Like everywhere else, Japan's industry policies did not foresee certain problems and only responded after the problems had become clearly evident, like the petroleum price rises. Like anywhere else, industry-specific policies were often motivated by the joint economic good of the influential participants. Costs to the consumer or the nation as a whole were often underrated. However, in Japan the government probably intervened less in supporting shrinking industries than in most other OECD countries, except in agriculture.

When the interests of individual companies were at stake, the much-heralded Japanese consensus broke down frequently [as when Honda was told by MITI not to produce motor cars], or failed to produce results [as when MITI failed in a costly attempt to set up a passenger aircraft industry in the 1960s[22]]. And a considerable number of MITI designs to create priority industries have failed because industry and government could not reach a consensus [sugar refining, plywood, ferro-alloys, synthetic textile fibres]. Other schemes to assist specific industries failed because the Ministry of Finance could point to high potential costs and imposed budgetary restraints. Inter-departmental bureaucratic squabbles were and are as frequent as anywhere else.

The impression is therefore incorrect that there is an elite of insightful, disinterested leaders who identify "sunrise industries" which are encouraged by concerted action, and 'sunset industries' that are wound down by central directive. Considerable resources have been lavished to prop up activities with poor growth prospects in Japan, for example, rice farming, cotton textiles, shipping, and coal. This type of industrial policy has directly limited the export opportunities of the new industrial countries. Industry plans and credit by the Japan Development Bank have favoured industries like "steel, petroleum refining, petrochemicals, and electric power [which] had profit rates substantially below the manufacturing average during the 1960s" (Tresize and Suzuki 1972: 810). Indeed, Japanese industry policy more often than not picked the losers. By contrast, the spectacularly performing industries (cameras, some consumer electronics, motorcycles) have never been made the subject of official plans, and industrial high-flyers like Honda or Sony owe little to MITI guidance. The great names in industrial and export success — like Toyota, Honda, Canon, Ricoh, Sony, Yamaha, TDK or YKK — are not part of big trading houses, like Sumitomo or Mitsubishi, which are reputed to have close links with the bureaucracy.

These companies frequently managed to get hold of (and improve on) promising new products and processes and then went for mass production at low per-unit of output profits. Like Ford with the Model T, they banked on realizing

[22]*Financial Times*, "Economic Survey of Japan", 6 July 1981.

downward-sloping supply curves thanks to scale economies. These scale economies were both of a static kind (distributing fixed costs of development, etc., over a large output run) and of a dynamic kind (learning by doing and innovating fast, thanks to frequent model changes). This policy of "riding downward-sloping supply curves" was made possible by an orientation towards big world markets and a concentration on technology-intensive products. The educational infrastructure and the level of development in post-war Japan enabled Japanese companies to pursue this strategy. But industrial targeting and MITI policies had, more often than not, no direct impact on this strategy of Japanese companies.

In response to the "oil shocks" of the Kondratieff slow-down of the 1970s and 1980s, the Japanese industrial apparatus concentrated on structural adjustment from energy-intensive, heavy industries to more knowledge-intensive activities. In this, it was more successful than most other OECD countries, which in turn contributed to high and rising current account surpluses that entailed an appreciation of the Yen and massive foreign investment by Japanese savers (Balassa and Norland 1988; Park 1989).

The Japanese industrial success has been created by individual firms with exceptional enterprise and innovative drive, not by people on MITI committees. But industry-specific interventions have forged intransparent power alliances between the bureaucracy, politicians and preferred industries that are at the root of the many corruption scandals surrounding the finances of political parties. No administration, at least since the mid-1970s, seems to have left office totally untainted. Only the future can tell what that will do to the long-run stability and cohesion of Japan's exceptionally homogeneous society. But no one has suggested that corruption and power politics will not hurt Japan's long-term growth. It is doubtful whether less homogeneous nations could stand similar sustained tensions for long.

If one "looks East" with a scrutinizing eye, one has to conclude that "Japan's policy has not been notably farsighted ...specific policies have often been a compromise, with major errors in forecasting" (Abegglen 1984:113). We can lay to rest the impression — created by many visiting academics, businessmen, diplomats and journalists — that leadership by the Great and the Good has managed to pick winners and hasten the rational decline of shrinking activities in post-war Japan. Factors other than industry policy explain Japan's industrial success: Producers have enjoyed a remarkable degree of political and social stability and have, on the whole, been able to plan and produce within a stable policy framework, in which economic objectives had priority. There were few redistributive and welfare-state policies that might have conflicted with the high-growth objective (as was the case with Malaysia's NEP). The Japanese government's involvement in the economy was smaller than in Europe. Total public-sector employment has been about 12 per cent of the total labour force in the 1960s/70s which was much less than in Western Europe (or in Malaysia).

The growth in aggregate production can be attributed to the standard proximate cause of growth: advances in knowledge, more capital per worker, movement of labour from agriculture and self-employment, and other factors like better education and reduced trade barriers (Denison and Chung 1976). But advances in knowledge and scale economies, which centrally guided rationalization is supposed to promote to an exceptional extent, have not made an unusual contribution to Japanese growth. On close, careful scrutiny, one has to conclude that Japan got the fundamentals of growth and industrialization right and that there were no industry-policy panaceas.[23] We do not have to go much beyond what we have always known about the sources of industrial growth anywhere to explain Japan's excellent industrial performance.

The Republic of Korea

In strategy and implementation, Korea modelled itself most closely on pre-war Japan. With a high degree of state intervention and central planning of privately owned industries, the Koreans concentrated on fostering big conglomerates. These are organized along almost military lines. Korea's policy towards international trade and flows of production factors owes much to the tradition of the "Hermit Kingdom". It is possible that Korea, after its unfortunate experience as a Japanese colony, could simply not opt for more open policies towards foreign firms and imports; this might have been too reminiscent of colonialism.[24]

The country emerged chastised and impoverished from Japanese occupation and the Korean war. In line with the prevailing "development mechanics" fashion of the early 1950s, it implemented a protectionist import-substitution policy and artificially stimulated investment, whilst remaining heavily dependent on American aid. Foreign capital assistance amounted to no less than 14 per cent of gross national product after the Korean war (Suh 1986). Government and industry demanded heavy sacrifices from the population, who had emerged from great existential dangers and were prepared to postpone income claims to secure their national existence. By the late 1950s/early 1960s, Korea had introduced prescriptive five-year plans, stringent import controls, multiple exchange rates — and had rampant inflation, little domestic saving, and serious external deficits.

The violent overthrow of (military) President Syng Man Rhee in 1960 laid the basis for the rise of a new generation of American-trained technocrats (many of them economists) who induced the new (military) President Park Chung Hee to embrace a strategy of export-led industrialization. This outward re-orientation

[23]G. Eads and R. Nelson, Chapter 7, in Patrick 1986: 262-64.

[24]Key references on the Korean experience are Hong and Krueger 1975; Lee 1981; Lim 1981; Hong and Krause 1981; Woronoff 1982; Balassa 1982; Riedel 1984; Kim and Roemer 1985; Korean Development Institute 1985, 1986; Mutoh 1986; Scitovsky 1986; Kwack 1987; de Franco 1987; Dornbusch and Park 1987; OECD 1988.

relied again heavily on market interventions: choice of priority sectors (textiles, consumer electronics), targeting of sales to the lower end of the US market, generous depreciation for investment, tax exemption for exporters, cuts of customs duties on capital equipment, subsidized electricity, freight, and bank loans. Park also established many executive ministries with direct functions in public enterprises. If ever there was a concerted "picking-the-winners" policy, Korea implemented it in the early 1960s. All these policies had the common purpose of favouring profitability in preferred, well-connected conglomerates (*chaebol*), whose profit opportunities were nurtured to make them the main agents of change. The necessary technology was acquired mainly by license (predominantly from Japan and the US), and only sparingly through joint ventures and foreign direct investment.

The aim of the coordinated Korean policies was to imitate the successful Japanese strategy of "riding downward-sloping supply curves": getting into innovative industries at the start of their life-cycle and realizing static and dynamic scale economies. Whereas the market pre-conditions and level of development in Japan enabled existing big companies to succeed, Koreans had to form such big companies afresh and quickly create the technical and educational infrastructure. They did so by government coordination and initiative, and could do so because they were further down the development ladder, so that future growth industries were still relatively easy to spot. But they targeted export markets, also by collective action and with government involvement. Korean exporters are exempt from sales tax, pay half the rate of company tax on export earnings, enjoy special depreciation and receive subsidized loans. This bears within it the danger of all collusion and the likelihood of counter-action by foreign countries. Only Korea's special political circumstances have kept retaliation by the US and the Europeans at bay.

The policy has led to cronyism within a closely knit, Mercantilist military-industrial-bureaucratic complex, as well as to forced savings and the repression of democracy. Strict, military discipline (including direct interventions by President Park in operational industry matters), a fierce nationalist commitment and — most importantly — exposure to competition in export markets kept a rein on abuses and corruption, at least in the 1960s. The sacrifices imposed on the population were possible thanks to the trauma of the 1940s and 1950s, the continued military threat from the North, the racial-cultural homogeneity of the Korean nation and the fact that public opinion, the rule of law, and the principle of popular sovereignty are much less accepted than in those Asian countries that have a British tradition.

Shortly before the oil crisis was about to hit, the industry policy of the Ministry of Trade and Industry (MTI) shifted priority towards heavy (hence energy-intensive) production: steel and non-ferrous metals, chemicals, machinery, shipbuilding, and heavy construction. Since the late 1970s, this list has been expanded to include passenger cars. Such targeting was relatively easy, because Korea is still far behind the leading-edge countries and because the United States was long tolerant of Korean practices for political reasons. More recently, however, these policies, which often violate GATT rules, have led to political tensions and trade conflicts.

In the 1970s, Korea went through an adjustment crisis because of the artificial concentration of its industries. To overcome the drop in export earnings and to maintain development programmes, Korea borrowed heavily overseas. Concerted efforts during the early 1980s raised productivity fast enough to ensure that capital productivity exceeded the interest cost and private income growth was constricted. Korea could therefore pay back much of that foreign debt. Different from Malaysia, Korea had of course not been able to mortgage its natural resources during the heavy-debt episode and therefore felt constrained to repay faster.

The interventionist, big-industry policies of the past are coming to a head in the late 1980s. The government is trying to shift towards favouring small enterprise, but it is not so easy to withdraw patronage from long-favoured industries. When, in 1989, the big *chaebol*, Daewoo, ran into financial difficulties, the government was not game to let market forces run their course, but promptly bailed the company out with US$600 million government credit. At the same time, big industry gave in to massive wage demands which will make Korea less competitive in future.[25]

By now, the Korean economy is heavily dominated by large, diversified conglomerates, and a (highly educated) bureaucracy which works closely with them. A powerful military-bureaucratic-industrial complex is the machine that propels Korean export industries. The "machine" has made for high and secure profits, but the need to compete overseas (though not so much in the protected domestic markets) has continued to exert discipline in controlling input prices and stimulating productivity. But there have been frequent corruption scandals. And political tensions with a new generation of workers and students, who no longer want to make sacrifices and who want more democratic say and a free press, are now making the Korean experiment unstable. Labour unrest has triggered a profit compression, and a recession by 1990 is likely.

So far, industry policy has been able to focus on supporting "sunrise industries" because industrialization is a relatively new experience in Korea. But as wage costs rise, labour-intensive "sunset industries" will have to shrink (creative destruction). This economic requirement for further growth will severely test the interventionist political-economy set-up of Korea. The record of protectionist/defensive policies in Korea regarding food production induce one to be pessimistic about the "sunset side" of structural adjustment policies.

The new government under (military) President Rho Tae Woo has tried to de-

[25]*Newsweek*, 3 July, p. 57 (Australian edn.).

emphasize big firms, by specifically intervening in favour of smaller firms and new, flexible technologies. The big question for the 1990s is whether the interests of the deeply entrenched, powerful and privileged "industrial club" or rational insight and general legal rules will dominate policy. The artificial privileges of big industry will have to be curbed to facilitate structural adjustment and higher wages. But the yielding to Daewoo's demands does not augur well. Meanwhile, some of the few foreign investors, who are sensitive indicators of the relative climate for entrepreneurship, are closing down their Korean operations (Ciba-Geigy of Switzerland, Fairchild Semiconductor of the United States).[26] The outcome cannot be predicted.

To sum up, the single-minded Korean industry strategy of the past thirty years has generated:

- reasonably secure profits in privileged conglomerates and effective cost controls despite the privileges;
- the build-up of an industry- and technology-oriented workforce and skills base;
- an industrial infrastructure that has, so far, been able to adjust whilst expanding;
- a determined bureaucracy which has been reasonably disciplined by a fervent commitment to national advancement; and
- a considerable technological capacity;

but also:

- an unstable social and political system with great internal tensions;
- power concentration in a small, affluent class of industry leaders and bureaucrats;
- limited flexibility in over-capitalized heavy industry, dependent on high external demand;
- limited channels of technology transfers from overseas; and
- isolation of most Korean workers and managers from direct world-market influences.[27]

The Korean experiment shows that the mobilization of resources for industrialization and the continuing adjustment of industry structures to changing circumstances by single-minded officially coordinated entrepreneurship can work. Yet, the Korean success seems to depend on conditions which do not exist in Malaysia. The tensions generated by rapid industrialization and market interventions have so far been controlled within the rather monolithic, militarily governed Korean society which recalls hard times and accepts sacrifices for national advancement. But these tensions would, in my view, have exceeded the limits of tolerance in more open and multi-racial Malaysia.

[26] *Far Eastern Economic Review*, 18 May 1989, p. 9.

[27] Till recently, ordinary Korean citizens were, for example, not permitted to travel abroad for pleasure, despite mounting foreign-exchange surpluses.

Taiwan

Taiwan's recent economic history — like Korea's — probably owes much to a traumatic, unifying, but ultimately mobilizing shock: in this case, the expulsion of the Guomindang by the Communists in 1949. Different from Korea, the population is not homogeneous; 90 per cent are indigenous Taiwanese who lived through Japanese occupation, when they experienced the early beginnings of industrialization; and 10 per cent are Mainlanders, who originally concentrated on government, as well as the military and civil service. Originally the Guomindang elite brought with them an interventionist Mandarin-Fascist economic culture and state-owned industries.[28]

Like Korea and unlike Malaysia, Taiwan started from dire poverty after the war and has a very poor natural resources base. In the early 1950s, Taiwan was a typical, hopeless underdeveloped country: The economy was heavily regulated. Inflation was high, real interest rates negative and savings below the international average at the prevailing income level. Since 90 per cent of exports consisted of agricultural products with poor growth prospects (rice and sugar), imports were elaborately restricted. Because of chronic foreign-exchange shortages, over-valued multiple exchange rates were used to promote import-substitution. Unemployment was high. The country depended heavily on aid. The prospect for the terms of trade was poor.

Between 1954 and 1959, the government (which was not beholden to an electorate or powerful industry lobbies) drew on the expertise of two eminent academic economists, T.C. Liu and S.C. Tsiang, who advised a two-pronged reform:

- to liberalize the factor market for capital and permit positive real interest rates [the factor market for labour was not regulated, and there was also a land reform which mobilized capital, land and rural entrepreneurship]; and
- to liberalize product markets, which meant above all, reducing tariffs and quotas and the establishment of a uniform, equilibrium exchange rate.

These reforms had dramatic effects on industry: In the wake of positive real interest rates, the savings rate gradually rose above the normal international level and rationed industrial investment (inducing high labour-intensity). The rate of capital formation and the capital-labour ratio rose. This induced rising labour productivity and rising real wages, as well as job creation (measured unemployment went from over 12 per cent to about 3 per cent between 1960 and 1965). Industry's share in output rose from below to far above what is normal internationally; and industrialists discovered, thanks to equilibrium prices for inputs

[28]Key references on Taiwan's industrial experience are: Power 1971; Galenson 1979; Fei, Ranis and Kuo 1979, 1981; Li and Yu 1982; Kuo 1983; Council for Economic Planning and Development, Executive Yuan 1986; Liang and Liang 1986; Woronoff 1982; Dumont 1986; Tsiang 1988; OECD 1988; Grabowski 1988; Liang and C.I.H. Liang 1988.

and outputs, numerous products in which Taiwanese producers were internationally competitive.

Taiwan is the classic example of a country that rejected the rampant "export pessimism". When it did not like its terms of trade, it created better terms for itself by pioneering new exports. In contrast to Malaysia, which had good natural resource endowment and therefore could develop "Ricardo export goods" (like tin, rubber, palm oil, and more recently oil and gas), Taiwan gave up its traditional colonial exports of rice and sugar and concentrated exclusively on "Heckscher-Ohlin goods", exporting the fruit of cheap and increasingly skilful labour.

Correct prices and market forces worked spectacularly well, because the reforms were accompanied by other far-sighted, Schumpeterian supply-side policies (that made the supply of production factors elastic):

- Taiwan relied more on foreign capital than Korea and attracted more of it through cooperative joint ventures. This had the advantage that foreign capital came bundled together with technical know-how, knowledge of input and output markets, and entrepreneurship. Because foreign capitalists had some control over the use of their capital and because certain transaction costs were eliminated, direct foreign investment was often cheaper than loans.
- An initially high share of state ownership in industry (50 per cent in the early 1950s) was scaled down (to less than 15 per cent now). Instead of direct state entrepreneurship, the government concentrated on the "classical tasks" (defence, law and order, education, infrastructure) and created a climate favourable to small and medium-sized enterprises.
- Education and training were reformed and oriented towards science and technology. Wage structures in industry were adapted to reward skills. And, like in Korea, the education and industrialization processes were wide open to women, particularly in labour-intensive industries (Gannicott 1986).
- Research and development and the attraction of promising technologies from abroad were promoted systematically by fiscal and financial means. And the openness to foreign capital goods and foreign firms brought much embodied technology into the country. In recent years, government has actively promoted "science and technology parks" and attracted Chinese scientists and engineers from the U.S.
- The basic legal system and regulations were simplified and the (autocratic) government was stable and ensured economic freedoms. The government sector was kept small, despite the perceived need for a large defence force.

These general, non-discriminatory policies were of greatest importance. Policy moved in the direction of more reliance on market forces. But selective policies were also employed to stimulate profitability in light industries (food products, textiles, consumer electronics). Later, heavy industries (steel, petrochemicals, machine tools) were encouraged by financial and fiscal preferment. Export finance was subsidized and special export-processing zones were established. Industrialization was facilitated by the creation of industrial estates in which entire land packages and infrastructures were provided. This was sometimes coupled with special privileges, as for example in free-trade zones. The policy framework were certainly not *laissez faire*. Rather, it can be characterized as a comprehensive policy package aimed at the supply side along Schumpeterian lines to facilitate profitability, entrepreneurship and growth. Otherwise, industrial evolution was guided by market forces.

The tendency for preferred industry groups to enter rent-seeking arrangements with the bureaucracy and the politicians was contained by the fact that the government was small and autocratic. It normally kept its distance from commerce (along the lines of the traditional Confucian model). The government was strong, because it concentrated on few priority tasks (including defence) and left allocation largely to markets. What also helped matters was that most industry was small or medium-scale. Competition was lively and controlled excessive profits. There was no clique of rich industrialists who could have challenged the government's supremacy in policy making. International competition and neo-Confucian discipline confined the scope for rent-seeking games.

Rapid growth of certain exports, that were sometimes targeted not only by Taiwan, but also at the same time by South Korea and other NICs, led at times to official counter-attacks on Taiwan exporters: "Voluntary" limits on Taiwanese processed agricultural products and the Multifibre Agreement are instances where industry-specific interventions by the NICs have triggered product-specific trade interventions by industrial countries.

However, when protectionist moves in OECD countries limited export-market growth for specific products, Taiwanese entrepreneurs quickly found other market niches. The agility of the many small and medium-sized firms in marshalling resources for new exports and the prompt entrepreneurial responses to the need for restructuring in the late 1970s and 1980s led to external surpluses and an appreciation of the Taiwanese currency, as well as a continuing liberalization of imports. Far from harming the average Taiwanese citizen, this constellation enabled Taiwan to enjoy cheaper costs of imported inputs and facilitated structural changes towards the comparative advantages of the year 2000 and beyond (Liang and Liang 1986; Watanabe 1988).

In the late 1970s and early 1980s, rapid industrial development suffered from some reversals in world (mainly US) demand, as well as internal bouts of inflation. It ran into bottle-necks on the supply-side, namely with the infrastructure and shortages of industrial land. It was also felt that the industrial base needed broadening. Selective industry policies were adopted to promote capital-goods production and basic industries, including in socialized government enterprises. But these turned out not to be very profitable. In recent years, many of the latter (aluminium, shipbuilding) have shown losses and have been de-emphasized. Rationalization was promoted. Different from many other LDCs where state industries are sacrosanct for political reasons, loss-making public-sector enter-prises were made to react as they should in a market economy. Socialized ownership did not amount to the suspension of market forces, as in many other nations.

Taiwan's export successes, direct foreign pressures, and the rapid accumulation of foreign exchange have forced the country in the 1980s to liberalize imports further. This has helped to control inflation. And Taiwan's industries — flexible and highly responsive due to their small scale and market orientation — appear to rise readily to new competitive challenges. Constant world-market exposure has educated Taiwan's industrial culture in the art of innovation and change, and the small-scale structure has helped industry to diversify and exploit market niches, even if small. Mechanisms for acquiring skills and adopting new technologies are by now well developed and industry structures are evolving organically to include more skill- and capital-intensive activities.

Taiwan has thus built up an efficient, growth-prone industrial sector with great evolutionary capability. This was done mainly with the help of general encouragement for enterprise and some specific industry policies that respected the principle of minimal state intervention, recognized the institutional conditions for economic evolution and did not raise protection.

By the late 1980s, Taiwanese industry was fairly sophisticated and able to shift further up the ladder of productivity and technical complexity. A very important role in continuing high industrial performance has been the gradual improvement of product quality and the move to higher-value models. This could not have been achieved by central directive or moral suasion, but only by an exposure to market forces and the need to remain competitive. Technical improvement has been driven by feed-back from export demand, in line with the general theoretical insight that most technical progress in industry is market-driven (Demsetz 1969; Rosenberg 1982). Many of the more labour-intensive activities are now being relocated to lower-cost locations, including the Peoples Republic of China (PRC) which supplies directly or indirectly a growing flow of labour-intensive inputs to Taiwan's industry, and countries with an enterprise-oriented, open economic order like Thailand. It appears that this relocation not only transfers industrial plants, but also a great deal of the Taiwanese industrial culture which has evolved over the last generation.

Taiwan's industrial evolution occurred on the basis of a national consensus that economic development requires high priority. There were no forced income redistribution policies. But the highly competitive industrial system, coupled with good education and training, which gave everyone good starting opportunities in the competitive game, have resulted in a high degree of income equality. There is no Westminster-style democracy, but — very importantly — the basic human and economic rights of citizens and legal security for entrepreneurs were ensured.

Now, with generation change, more democratic government and a freer press are evolving, and with much less commotion than in Korea.

Some obvious lessons from the Taiwan experience for Malaysia are:

- Resource-poor countries (like Scotland, Switzerland, Hong Kong or Taiwan) feel a much greater urgency to industrialize on the basis of knowledge, skills and market-oriented agility. Maybe, rubber, palm oil, tin and the oil and gas bonanza were not an unmitigated blessing. They kept the real exchange rate high and hampered a Taiwan-style industry strategy.[29]
- Taiwan shows that a high priority for industrialization and growth, and abstaining from conflicting policies of positive discrimination, produces impressive results. Taiwan overtook Malaysia with regard to living standards during Malaysia's oil bonanza and big-spending programmes of the late 1970s. In the process, even the poorest in Taiwan grew richer, since interventionism and rent-seeking were limited. General education and training, as well as small enterprise and market competition, are evidently better able to create conditions for greater income equality and the eradication of poverty than interventionist positive discrimination. Moreover, such redistribution policies tend to weaken the forces of economic growth.
- It is possible to promote certain promising industrial activities by artificially enhancing profit opportunities, but one has to retain or increase openness to world markets and impose strict bureaucratic and political discipline to keep the natural drift into rent-seeking under control.
- What matters most for the development of a competitive order is not the absolute level of intervention, but the direction of change. If market interventions are uniformly and gradually reduced and the political leadership sets clear signals for gradual liberalization as in Taiwan (and Korea), enterprise perceives the need for controlling costs and improving the product.
- Government policies towards industry need not be *laissez faire*. Policy can do much to develop the critical production factors by concentrating on a stable economic and legal order, good education, high savings, a growing infrastructure and creating general technical capabilities, but leaving the complex allocation decisions of industrial production to markets and entrepreneurs.

In many respects, Taiwan has gradually moved towards Malaysia's "Old Economic Policy" which was simple, steady, market-oriented and therefore easily manageable, and which was, on the whole, very successful (Kasper, 1975b). Like in pre-NEP Malaysia, political man and the bureaucrat are less important and prominent in present-day Taiwan than the entrepreneur and producer.

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[29]For reasons of better racial integration through direct daily contact in economic life and to accelerate Malaysia's economic growth, I advocated such a strategy in the early 1970s (Kasper 1975a). See also Kasper 1988.

Hong Kong and Singapore

In many respects, the lessons of the city-state economies of Hong Kong and Singapore are variations on the above theme.[30] They validate the lessons of Taiwan and Korea.[31] Both developed more in a modernized "treaty-port" tradition of industrialization. Both city states pursued systematic policies to ensure an elastic, responsive supply of production factors — labour was available, but much was done to train industrial skills, to encourage and attract entrepreneurship and technical know-how, and to ensure high rates of capital formation on the basis of "abnormally" high domestic savings and foreign investment. Both were open economies, but Hong Kong more than any other of the "four dragons".

Both city states began their accelerated development with reliance on export oriented industrialization. But like the economies of Venice, Amsterdam, London or New York before them, they became central trading cities and after some time, providers of financial and other services. Hong Kong benefited in the 1980s greatly from the location near China, where sophisticated Hong Kong-made services were in high demand. It is an open question whether the stepping-back of China from an outright market reform course in 1989 will mean a durable set-back to this part of the Hong Kong economy and whether that would not lead again to more reliance on manufacturing.

The differences in policy approach were that Singapore's policies were more Statist/interventionist (more akin to the Taiwan model) than in *laissez-faire* Hong Kong, where the colonial government concentrated on a basic list of government tasks which Adam Smith would have approved, such as law and order, defence, basic education, essential infrastructure, and a minimum of welfare services. The government of Hong Kong can be described as one of "businessmen for businessmen", given the intricate relations between the (largely autonomous) Hong Kong government and the major business houses. In addition, there was some public assistance with the formation of industrial skills, for example, by the setting up of excellent clothing industry training centres, and with land development.

Maybe, Hong Kong citizens were lucky that there was no national government which set national objectives and industrial targets, and left them to set and pursue their own priorities. As a result, most industrial production and job creation was

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[30]In many ways, it is of course easier to generate fast industrial growth in a city — indeed, the Kuala Lumpur-Klang region would stand out as an "industrialization miracle" if "national statistics" were prepared for it and if the rest of the country did not absorb resources and influence the exchange rate (the resource exports keep the Ringgit higher, so that the industrial regions of Malaysia can export less than if they were a separate country).

[31]Some of the key sources on Singapore are: Lim and Lloyd 1986; Ministry of Trade and Industry, Singapore 1986; Lim and Pang 1986; Krause 1987; Rodan 1988; Lim 1988. Some key sources on the Hong Kong industry are: Smith 1966; Hopkins 1971; Rabushka 1973; Riedel 1974; Riedel 1972; as well as sources already cited for other countries.

in small- and medium-sized industrial firms and service companies, carried forward by a lively, energetic and resourceful entrepreneurial culture in which many Chinese businessmen (including refugee industrialists from the PRC) live in fruitful symbiosis with Western businessmen. The real test of the Hong Kong industrial system is beginning to take shape now. Will it prove to be superior in the international rivalry of economic systems when the colony is taken over by the PRC? However, after the 1989 crack-down in China, the PRC withdrew at least temporarily from an open, peaceful "competition of economic and social systems".

By contrast, Singapore engaged in more planning and guidance from above, with systematic schemes to promote forced private savings and to steer the types of industry that a small, informed elite thought good for the growth of the Singapore economy. This has made Singapore's industrialization more orderly, has led to larger-scale industries and has increased reliance on foreign entrepreneurship (multinationals).

In Singapore (as in many developing countries), independence led to the erection of a tariff wall in the late 1950s. However, when the city state was expelled from Malaysia in 1965, the reason for import substitution lapsed and Singapore industry was "shocked" into free trade. The "infant industries" were exposed to "teenage competition" (Bautista 1983), in retrospect a lucky event!

Singapore has promoted its industrialization heavily by attracting foreign companies with capital, technology, skills, and market access (Parry 1988). It has succeeded because it created the relevant locational factors: stable government, simple, consistent rules and regulations, a disciplined civil service, attractive tax structures, an industry and technology-oriented education system, openness to international trade and payments, free capital markets and an improving transport and communications infrastructure (which in itself is becoming a major world-class growth industry). Singapore subsidizes exports by tax exemptions, tax holidays and double tax-deduction for trade fair participation and the creation of foreign sales offices. With a little prompting, multinational companies have been transferring skills and know-how to young Singaporeans, largely because this is advantageous for these firms.

Coordination and guidance from above has had the advantage of a more orderly outcome, but the occasional disadvantage of having led "coordinated mistakes", like the unusual episode when the Singapore government tried to push increases in labour productivity by encouraging higher wages ahead of the gradual, organic processes of skill learning and technical progress. They learnt very quickly that one cannot push up labour productivity by higher wages (this is bound to produce unemployment), and very quickly corrected the blunder by implementing co-ordinated cost-cutting exercises (Cheah 1986, 1988). This was possible because the Singapore state elite is not beholden to industrialists and conducts its business in a sovereign, arms-length fashion. One episode where policy makers demonstrated this was the abandoning of plans to subsidize car assembly in the early 1980s.

In reality, Singapore policy guidance has often looked over its shoulder, and simply formulated and implemented what market developments indicated anyway. It does little harm, but neither is it very useful. This sort of pseudo-guidance (an elite bureaucracy formulating plans that simply codify the market forces from below) is — as we have seen — typical of much industry policy in Japan.

The different approaches to industrial development of the two city states have, however, made little difference to the growth record in living standards and industry. Both had closely comparable growth rates and had their crises of instability. But both overcame instabilities and quickly reverted to the growth path with impressive responsiveness and resilience. Both Hong Kong and Singapore are "economic miracles". No economic planner would have discovered comparative advantages there for rapid industrialization at the end of the second world war. Yet, they are now monuments to the maxim that most relevant comparative advantages for industry can be created by man, if development is given priority. In this, Singapore has taken a more activist role than Hong Kong, but it is not clear, at least to this observer, whether that is making all that much difference.

One has to conclude that the specifics of policies towards industry do not matter much (other than providing jobs for a modern Mandarinate of bureaucrats and economic advisers). What matters primarily is the creation of the right climate for entrepreneurship (a stable policy framework, confidence, a basic set of reliable rules and laws, elastic supply of production factors).

Both city state economies reinforce the insight that openness to world markets and reliance on market forces is good for industrial prosperity, and that a stable, simple economic-political order is essential to reduce transaction costs and attract creative enterprise.

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THE MANUFACTURING SECTOR: MALAYSIAN EXPERIENCE AND OUTLOOK

Shiew Wan Shing*

From import-substitution in the 1950s, Malaysian manufacturing, then contributing to 8 per cent of GDP, expanded by 10 per cent through the 1960s until the 1970s when, growing by 11 per cent, the sector's focus shifted to export-oriented labour-intensive industries. By the 1980s, the electronic and electrical, textiles, rubber, wood-based and heavy industries had emerged as key sectors. For the first time, in 1987 manufacturing contributed more to GDP than did agriculture, when its share of GDP rose to 22.5 per cent. Government policies have strongly influenced its development.

Notwithstanding the impressive performance, some concerns must be addressed. Uncertainty over the post-1990 economic policy, a narrow base, low value-added, rising costs and negligible R&D need to be resolved. In addition, against a global backdrop characterized by stagnating growth, rising protectionism, saturation in raw material consumption and growing competition, Malaysia's strategy should include supportive and consistent government policies that maximize growth and investment opportunities, development of entrepreneurship and competitive labour, flexible specialization and horizontal integration, among other measures.

1. Introduction

The global environment of the past four decades has been characterized by relative peace and stability: US support for liberalization of global trade and investment flows, support for ready access to a rapidly expanding US marketplace, and consequently healthy growth in global Gross Domestic Product (GDP) and world trade in manufactured goods and services.

The winners under this post-war economic order have been those economies which have most willingly embraced export-oriented development strategies, and have accepted direct foreign investment (especially from the US and Japan) as a

*This paper incorporates data and insights from SRI International, Southeast Asia and South Pacific Regional Offices as well as other published sources. In addition, able assistance was received from Tan Keok Yin of the FMM and Mark Chen, my colleague. While I have received inputs from the above sources, only I am responsible for the contents of this paper. My grateful thanks to all.

means to gain access to capital, markets, new products, process technologies, and management skills.

The paradigms of the successful, export-oriented manufacturing and/or services based development strategies are the four Asian Newly Industrialized Countries (NICs), which have achieved phenomenal real economic growth over the past three decades and integrated with the global division of labour.

With the onset of a new decade and eventually a new century, fundamental changes in the structure of global economic and strategic relationships can be expected. These changes are expected to lead to:

- long term, non-cyclical decline in terms of trade of primary products;
- continuation of US economic difficulties in terms of the twin deficits (federal and current accounts) with low savings being increasingly recognized as a further problem;
- slower growth in international trade and greater potential for trade conflicts;
- greater potential for inter-regional conflicts as self-interest blocs proliferate; and
- growing political conflicts in Asia as the majority of Asian nations have achieved independence only in the past forty years, causing traditional and modern societies, with their democratic principles, to operate side by side.

All these external environmental changes are paving the way for greater global competition as corporations strive to maintain high growth in revenues, market share, and profitability. Therefore, those developing economies, which do not take advantage of their available resources today to build a globally competitive manufacturing sector, may eventually face problems of servicing external debt obligations and of foreign investors migrating to labour-saving technologies and larger markets.

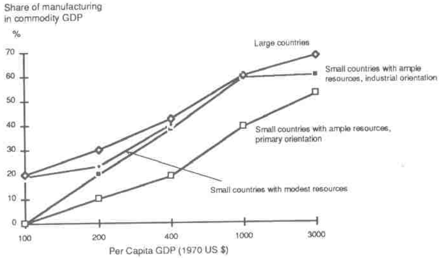
It is within this context that the Malaysian economy and its manufacturing sector should be viewed. Although Malaysia's balance of payments has been improving since 1987, with exports showing double digit growth, and the share of manufacturing in GDP rising, the country is still greatly dependent on global primary product prices and on its weak currency. Unfortunately, both these factors are not sustainable in the long run as the demand for primary products is cyclical and a weak currency, if left unattended, will eventually lead to greater inflation.

Malaysia, therefore, has to identify new areas of competitive advantage in terms of mutually supporting investments in diversified, high value-added product lines. This move towards greater value-added manufacturing will eventually allow the country to benefit from the explosive growth in trade within the Asia-Pacific region and with the US, and the development of new global technologies, organizational skills, and international connections.

2. Why Manufacturing?

The aspiration on the part of economies such as Malaysia to raise output and income causes them to move from being agriculture-based to developing the manufacturing sector. Initially the products manufactured are low in value-added and labour intensive, but over time this sector becomes more automated and produces higher value-added products. If the increase in the share of manufacturing can be maintained, this should lead eventually to a substantial and sustained rise in per capita GDP (Figure 1).

Figure 1
Estimated Per Capita GDP and the Share of Manufacturing



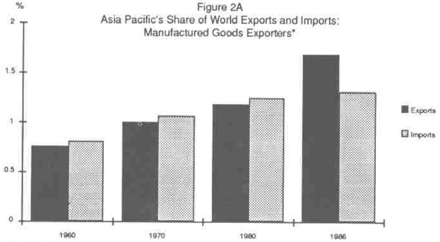
Source: World Development Report 1987, World Bank.

Statistics suggest that countries specializing in manufactured goods will enjoy appreciably faster development than those with predominantly service and/or primary commodity economies. Since 1980, the growth rate of Japanese and European productivity in manufacturing has exceeded that in all other sectors by 5.4 per cent and 2.9 per cent, respectively. In the US, over the same period, manufacturing output per working hour grew nearly 3.5 per cent each year, while non-manufacturing productivity increased 0.3 per cent annually.

In our part of the world, the NICs along with China and Japan, were the star performers, scoring spectacular economic advancement primarily through the expansion of their exports in manufactured goods. Between 1983 and 1986, when commodity prices in general waned and the terms of trade of primary commodity exporters worsened, the trade sectors of Japan and the NICs, however, continued to prosper. Jointly, they captured 46 per cent of the US$122 billion growth in US manufactured imports during these four years, contributing in no small way to their continued economic growth over this period.

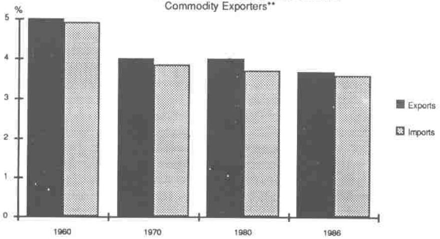
The more industrialized members of the Asia-Pacific (Japan, the NICs and China) have increasingly captured larger slices of total world trade since 1960, while the more primary commodity dependent economies (Indonesia, Philippines, Thailand, Malaysia, and even Australia and New Zealand) have not been able to increase their share of world trade (Figures 2A, 2B).

Figure 2A
Asia Pacific's Share of World Exports and Imports: Manufactured Goods Exporters*



* China, Hong Kong, Japan, Singapore, South Korea, Taiwan
Source: World Bank, 1988.

Figure 2B
Asia Pacific's Share of World Exports and Imports: Commodity Exporters**



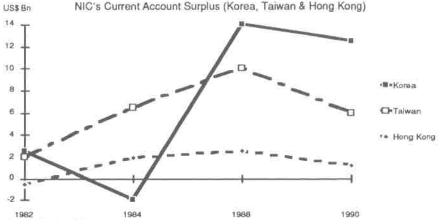
** Australia, Indonesia, Malaysia, New Zealand, Philippines, Thailand
Source: World Bank, 1988.

The increasing share of global trade for the NICs was eventually translated into improvement in GDP and per capita GDP growth (Figure 3). The development by the NICs of their manufacturing export sectors (as opposed to commodity trade) also led to large current account surpluses and positive trade balances, whereas many primary product-oriented economies, including Malaysia, accumulated large external debts (Figures 4A, 4B).

Figure 3
Developing Countries: Real Per Capita GDP Growth
(1971 – 1990)

Source: International Monetary Fund, World Economic Outlook, 1989.

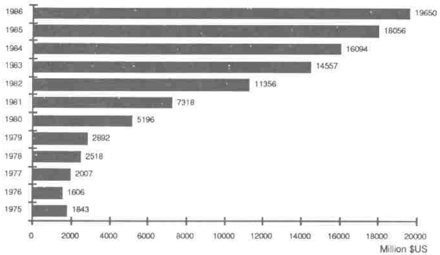
Figure 4A
NIC's Current Account Surplus (Korea, Taiwan & Hong Kong)



*Goods & Services Balance

Source: Business International Forecasting Service, 1989.

Figure 4B
Malaysia: Total Long-Term External Debt



Source: World Bank, 1988.

Quite apart from that, economies that have managed to nurture competitive manufacturing sectors have enjoyed a steadier pace of growth that is less vulnerable to cyclical ups and downs (Figures 3, 5).

2.1 Consequences Of An Underdeveloped Manufacturing Sector

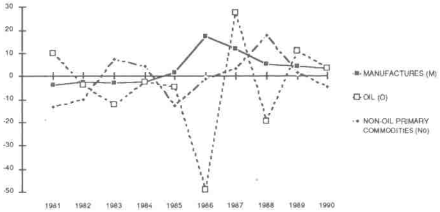
If a country such as Malaysia, an emerging NIC, ignores the development of its manufacturing sector, the consequence will likely be a fall in real output. In today's competitive environment, even the maintenance of real per capita income requires positive changes within the manufacturing sector. Eventually, the lack of a competitive manufacturing sector will also lead to:

- deterioration of technical skills and infrastructure;
- decline in demand for labour, both skilled and unskilled; and
- lower demand for products developed through the intensive use of the existing resource base.

Additionally, an underdeveloped manufacturing sector will foster an inward looking economy, a slower growth rate, and the inability to leverage off the rapidly growing intra Asia-Pacific trade, which is based on a "horizontal" division of labour.

Industrialization is, therefore, potentially the driving force changing the traditional structure of the less developed economies, and the advocation of

Figure 5
Annual Growth of World Trade Prices (US$) for Major Commodity Groups
(1981 - 1990)



Source: International Monetary Fund, 1989.

manufacturing-based development is particularly compelling for primary product-dependent economies facing cyclical export demand and a rapidly growing labour force.

Finally, one further objective of industrialization is to promote a greater sense of confidence, security and self reliance among developing nations that have suffered in the past from excessive dependence on others. Such self reliance, however, does not mean autarky. One of the merits of industrialization is the fact that while it makes possible the satisfaction of requirements in developing nations to a great degree, it also creates through the very complexity of the processes involved a web of interrelationships, which over a period of time bring the countries closer together and make them more dependent on each other. This type of balanced interdependence promoted by industrialization is an important factor in building up the economic foundations for more stable and cooperative relationships among nations.

3. The Malaysian Experience

3.1 Before 1957

From its days as a loose-knit collection of semi-feudal states, Malaysia's economy was a highly dependent one, initially on the British, and subsequently on the prices of primary commodities in world markets. During this period of dependence, British economic dominance of Malaysia's primary goods export sector brought about rapid structural changes in the economy. These included substantial foreign ownership and control of productive resources, especially natural resources (tin) and a plantation sector (rubber) focused on supplying world markets. Together they made the economy highly sensitive to fluctuations in world demand and supply.

Therefore, in the years prior to national independence, the major industries — tin and rubber — and the supporting trade and commercial sectors were largely influenced by external forces, and the economy was transformed from one composed of self-sufficient village communities to one with a high dependence on global markets. Actual manufacturing was minimal. For instance, in 1955 manufacturing contributed only about 8% of the nation's GDP.

3.2 1957 - 1970

Manufacturing began to figure increasingly in post-Independence Malaysia. Initially, Malaysia experimented with low key import-substitution policies. Exchange controls were not imposed, quantitative restrictions were rarely adopted and tariffs remained modest. (An increase in tariffs could have led to a reduction in necessary imports.) The primary target of import substitution industries was obvious — the domestic market. Nonetheless, in the first flush of manufacturing success, impressive growth was recorded in the food, beverages and tobacco, printing and publishing, construction materials, and chemical and plastic industries. Overall, the manufacturing sector grew by about 10 per cent per annum in the 1960s.

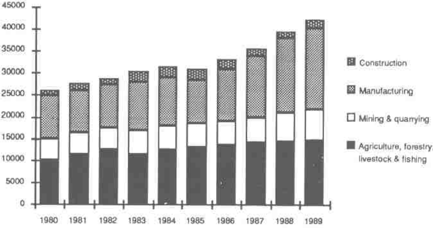
However, it soon became evident that the Malaysian market was near saturation and that import substitution could no longer ensure significant growth of manufacturing output and employment opportunities. Also, seeking export markets for these goods as a means of further growth was not a realistic proposition as these were generally not price- nor quality-competitive internationally.

In the 1970s, the manufacturing sector shifted its direction of growth from import-substitution to focus primarily on resource-based processing and labour-intensive industries. The market orientation also began to move from domestic concentration to export markets. The leading growth industries during this decade were electrical and electronic products, textiles and footwear and processed agricultural products. This strategy of diversification in both products and markets, although limited, yielded an even more remarkable annual growth of 11.4 per cent for the manufacturing sector.

Notwithstanding such achievements in the manufacturing sector, Malaysia continued to depend critically on commodity production and prices. To feed the twin appetites of the growing manufacturing sector and the more affluent populace, Malaysia continued to trade its commodities for both capital and consumer goods on increasingly unfavourable terms of trade.

But what are we to make of Malaysia's booming growth in the 1970s? It appears that much of that growth emanated from price increases rather than volume. Export volume grew in the range of only 2 per cent between 1976 and 1980.

Figure 6
Malaysia: GDP by Industry Origin
(1978 constant price M$ million)



Source: Malaysia, Economic Report 1988-1989.

3.3 1980s

By the 1980s, Malaysia had become an important producer of electronic devices, room air-conditioners, textiles and rubber products. Indeed, in 1986, exports of manufactured products had surpassed petroleum to become the single largest foreign exchange earner. In the following year, manufacturing contribution to real GDP, for the first time, surpassed that of agriculture. By year-end 1989, the value of manufactured to agriculture products is expected to be in the ratio of 5:4 (Figure 6).

The future thrust of Malaysia's industrialization strategy, as outlined in the 1986 Industrial Master Plan (IMP), is aimed at further diversification of the manufacturing base, thereby setting the foundation for a more rapid and balanced growth.

In retrospect, many factors have influenced the direction and character of the Malaysian manufacturing sector. Two in particular are worthy of note: the lop-sided incentive structure in favour of Free Trade Zone (FTZ) companies, and government policies used to regulate the manufacturing industry through the Industrial Coordination Act (ICA). However, since 1985, there have been efforts to ease government regulations on manufacturing (as evinced by the amendments to the ICA) and to have a more balanced incentive scheme for industry through the promulgation of the Promotion of Investment Act (1986) and the incentive package for small and medium-sized industries. Such efforts to liberalize government policies have been of much benefit, particularly in raising the level of investment. The government should continue to review its policies so as to respond quickly and effectively to the needs of the private sector.

In summary, the transition of the manufacturing sector from agricultural modernization and simple import substitution industries to electronics and heavy industries has now set the stage for the next phase of industrialization.

4. Outlook

After the slump in 1985/86, the manufacturing sector has grown strongly to emerge as the leading sector of the economy. The statistics are impressive:

- The value of manufacturing output in 1987, for the first time, exceeded the combined output of agriculture, forestry and fishing.
- Manufacturing output in 1988 increased a further 15 per cent, reinforcing its lead over agriculture.
- Manufactured exports in 1988 grew at 32 per cent per annum.
- Manufactured exports represent half of total exports.
- Manufacturing goods make up 25 per cent of GDP and are still growing.
- The manufacturing sector employed 1.01 million people in 1989, up 10 per cent over 1988.

4.1 Issues And Concerns

Be that as it may, there are issues and problems that need to be addressed if the trend established over the last two years is to be maintained, and if the manufacturing sector is to succeed in its vital role as the engine of growth. These include:

4.1.1 Uncertainty over Post-1990 Economic Policy

From a purely investment perspective, the uncertainty over the post-1990 economic policy has a negative impact on current levels of investment. The extent of the impact is debatable but what is clear is that, even with the recent substantial rise in investment (both local and foreign), the level is still well below that which is generally accepted as being required if Malaysia is to achieve the kind of growth targets embodied in the IMP. In this context an early conclusion and enunciation of the post-1990 policy will go a long way to removing uncertainties which all investors, both local and foreign, abhor. Also, in a broader context as well, it is hoped that there will be clarity in policies as well as consistency between policies and their implementation.

4.1.2 Role of the Non-Financial Public Enterprises

The 1970s and early 1980s saw a proliferation of Non-Financial Public Enterprises (NFPEs). Armed with special privileges and concessions, these operations have tended to crowd out private sector enterprise and have introduced monopolistic practices into the system. Notwithstanding the exercise to privatize NFPEs, their activities continue to expand. It is the hope of the private sector, however, that the activities of NFPEs (and that of the State Economic Development Corporations as well) will be restricted to being facilitators, providing public amenities, services and utilities.

4.1.3 Narrow Manufacturing Base

Malaysian manufacturing is dominated by two large sectors — electrical and electronics, and textiles. Together they constituted 60% of total manufactured exports in 1988. Further, Malaysia's export markets for these goods are also narrowly based, with the US accounting for about 50% of total electronic component exports and about 43% of textiles and related product exports.

4.1.4 Weak Industrial Linkages

This concern is particularly obvious in the FTZs. While there has been spectacular development of FTZs, and enhanced employment opportunities along with it, linkages to the rest of the economy have remained weak. Development of the FTZs has created only an insignificant demand for local intermediate products, resulting in little technology transfer, adaptation or infusion.

4.1.5 Low value-added

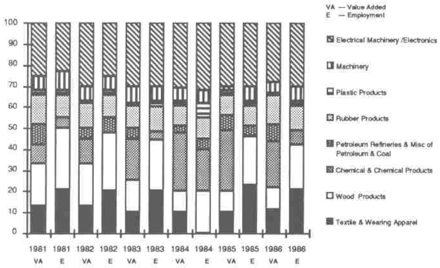
One of the primary problems plaguing Malaysia's manufacturing sector is its concentration on low value-added products including electronic components, textiles, and chemicals. Although the value-added has been highest in these industries after 1981, and they have seen the largest number of applications for the establishment of manufacturing projects, the annual percentage increase of value-added in these sectors has continued to be insufficient for the creation of internationally competitive sectors (Figures 7A, 7B).

Therefore, the low value-added, low level of automation, and high proportion of employment found in protected industry sectors will, in the long run, increase the risk of these sectors becoming dependent on "permanent" protection. Eventually, the lack of product innovation and technical change in these protected sectors will lead to Malaysia's inability to compete in global markets.

4.1.6 Reliance on the Weak Currency Factor

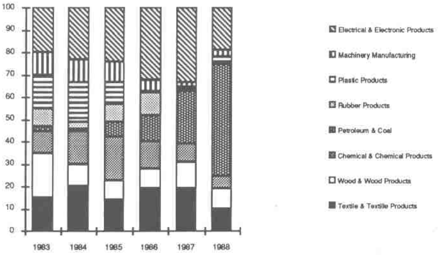
Although improved quality in Malaysian manufactured products has been increasingly cited as a contributor to buoyant export performance, more often stressed is the other large factor contributing to expanding manufacture exports — the relatively weaker ringgit against the currencies of our main trading partners. While Malaysian manufacturers should capitalize on this perhaps transient advantage to secure a foothold in the export market, they should not consider it a permanent competitive advantage. Soon the forces of international trade will no longer permit the ringgit to remain depressed in the face of healthy exports. The ringgit will adjust upwards, consistent with the flow of trade.

Figure 7A
Malaysia: Value-Added (VA) and Employment (E) in the Manufacturing Sector 1981 - 1986



Source: Department of Statistics.

Figure 7B
Malaysia: Percentage of Applications Received for Establishment of Manufacturing Projects by Industry (1983 - 1988)



Source: Department of Statistics.

4.1.7 Rising Costs

In a recent Federation of Malaysian Manufacturers survey, 83 per cent of respondents reported that costs of manufacturing have increased significantly, with labour, raw materials and manufacturing overheads as the important factors. This trend, if unaccompanied by a quantum leap in increased productivity, will seriously erode the competitiveness of Malaysian manufacturing.

4.1.8 Negligible Research and Development

There is no strong supportive structure for research and development (R&D) activities, particularly in the private/manufacturing sector. Of the total funds expended on R&D, some 93 per cent is undertaken by the public sector; of which three-fourths are agriculture based. By comparison, the public sector in the UK accounts for only 10 per cent of total R&D expenditure, while 96 per cent of the US economy's R&D is undertaken by the manufacturing sector. The relative absence of private sector R&D in Malaysia stems mainly from resource constraints, availability of alternative technology sources, lack of incentives to off-set R&D expense, and inadequate scales of economy.

4.2 Conclusion: A Competitive Strategy for Malaysia

The global economy has undergone dramatic structural shifts since the early 1970s. In this new context, the forces which are expected to shape the global economy in which Malaysia must compete include:

4.2.1 A Slow-Down in World Economic Growth

The post-war era of rapid economic growth driven by reconstruction of war damaged economies and an unprecedented growth in global trade and capital movements seems to have ended in the mid-1970s (Figure 8).

4.2.2 Saturation in Material Consumption

The impact of new technologies on both the supply and demand of traditional materials has decoupled demand for traditional materials from global GDP (Figure 9).

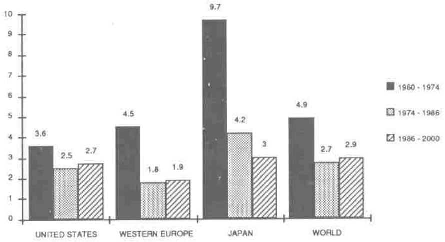
4.2.3 Reduced Economic Growth in the LDCs

Strong growth of the 1960s and 1970s was fuelled by high prices for export commodities and by heavy foreign borrowings. These conditions are unlikely to be repeated (Figure 10).

4.2.4 Increasing Barriers to Trade

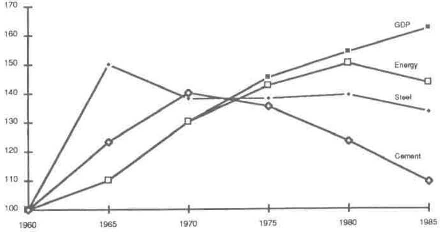
The dramatic growth in world exports achieved during the 1960s and 1970s has now slowed. Future export growth will correlate more closely with global GNP (Figure 11).

Figure 8
Real GDP Growth:
Developed Countries (per cent per year)



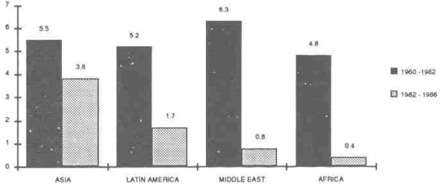
Source: SRI International.

Figure 9
Per Capita World Materials Consumption and GDP
(Index: 1960 = 100)



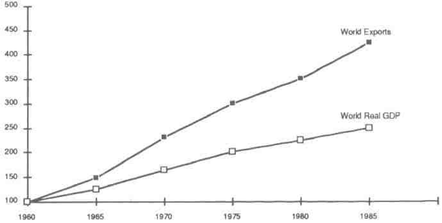
Source: SRI International.

Figure 10
Real GDP Growth:
Developing Countries (per cent per year)



Source: SRI International.

Figure 11
Comparative Growth of World GDP and Export
(Index: 1960 = 100)



Source: SRI International.

4.2.5 Driving Forces in the Global Economy

The current driving forces include growing global and industrial competition and competitors; total quality control in production; accelerated technical change; flexible production (vs. mass production); and focus on value-added investment in inputs (technology, human resources, capital, entrepreneurship).

Against this background Malaysia needs an industrial action plan to create a globally competitive manufacturing sector based on the following factors:

4.2.6 Identification of Comparative Advantage Sectors

These diversified value-added sectors can include traditional manufacturing goods as well as specialized industrial chemicals, advanced pharmaceuticals, computer-aided publishing, and medical/scientific instruments. The basic aim here, however, has to be the transition from labour intensive sectors (shoes, garments) through capital intensive sectors (steel, autos), to knowledge intensive ones. However, in order to sustain traditional sectors as the transitions occur, attempts have to be made to upgrade manufacturing technology in labour intensive sectors.

4.2.7 Internationalization Through Free Trade

Trade is essential for development because it provides:

- material means (capital goods, machinery, etc.);
- a means for the dissemination of technical knowledge and ideas;
- a vehicle for the international movement of capital;
- the growth of healthy sectoral competition.

Thus, the ideal trade policy for a developing country is a free trade flow with only marginal, insubstantial corrections and deviations. These marginal interferences, coupled with the removal of trade restrictions (tariff barriers), if properly selected, speed up development and raise manufacturing production.

4.2.8 Globalization of Product Lines

There should be enhancement of the horizontal integration process of products through more efficient procurement of parts. This can be done along Japanese lines (for example, Sony) of four global segments: Japan, Europe, North America, and Asia, each with its own regional headquarters which plans strategy according to the local environment and global corporate blueprints. To increase the efficiency of the global segments, individual bodies can be established to coordinate the parent company's regional manufacturing operations, extra-regional exports, and internal precision component supplies to plants throughout the world. Subsequently, financial management, product design, and data communication divisions can be established within the local manufacturing environment.

4.2.9 Access to Technology

Access to technological developments can enhance economies of scale and allow lower break-even points, make inter-relationships between products and sectors possible, create opportunities for "Just-in-Time" management, and influence relative cost positions and/or product differentiation. However, in order to achieve this position of lower costs and enhanced differentiation, there must be the development of a competitive edge in automation through:

- Systemic innovation (including physical transformation of materials, manipulation, control, and transfer of information);

- Flexible and advanced machining and processing of more sophisticated products;
- The development of competitive systems integration capabilities among local capital goods producers;
- The adoption of flexible perspectives, that is, a willingness to switch to different forms of organization with corresponding technological changes; and
- Perspectives on total quality control.

4.2.11 Flexible Specializations

Restructuring through the growth and enhancement of skills is expected to produce heterogeneous products (in contrast to mass production which involves the utilization of special purpose machineries to manufacture standardized goods with an unskilled, hierarchically organized labour force). Initially this can be done by adopting mass production strategies for the global market and flexible ones for the domestic market. However, other types of flexibility, found to be more efficient in the restructuring process, can be utilized. The processes here involve flexible mass production in which the competitive advantages which accrue are related to product differentiation (vs. product specialization) and cost savings due to lower inventories, fewer defects and rework costs, and less excess capacity/inventory build-up.

4.2.12 Development of a Globally Competitive, Multi-Skilled Labour Force

The process of division of labour and deskilling of production has to give way to a multi-task, multi-skilled labour force with two way flows of information and greater line-worker responsibility, total quality control, and emphasis on greater group orientation. In the end, this system will allow the creation of comparative advantage based on the richness of skills in the labour force rather than low level wages.

4.2.13 Physical Infrastructure

In order to capture the benefits of advancing technology, modern highly integrated infrastructure, improved air, land, sea, and data transportation are necessary. The development of such infrastructure requires long-term planning and long-term dedicated capital investment.

4.2.14 Development of Entrepreneurship

The investment climate should be one where entrepreneurship (coupled with management and marketing skills) and innovation are actively encouraged and seen as necessary for better start-up and transition of existing firms into new products and production processes.

4.2.15 Capital and Savings

There should be greater availability of financial capital for all types of businesses, ranging from venture capital for new companies to financing the modernization of older industries (the end-users of new industrial technology).

Greater efficiency in the use of capital leads to higher plant capacity utilization. Also, if consumer demand is to play a role here, then a greater share of income needs to be retained as discretionary cash-in-hand rather than as forced savings.

4.2.16 Investment Incentives

Competitive taxes, tax holidays, and economically sensitive environmental regulations are needed to better Malaysia's competitive position with the existing and emerging NICs.

4.2.17 Changing Role of the Government

The successful implementation of any industrial action plan relies critically on the supportive role of the government and the soundness and consistency of its economic development policies. An economic policy which maximizes growth and investment opportunities will provide the necessary base for attainment of socio-economic goals, wealth redistribution and restructuring. The private sector recognizes and subscribes to the national aspiration of a more equitable society in the country. Indeed, it is the private sector's firm conviction that Malaysia must have a development policy which promotes an efficient economic system and management to enable the country to sustain long-term socio-economic stability, and national unity.

Just as the governments of the highly successful economies of Japan and Korea have played a fundamental role in developing a competitive manufacturing sector, likewise the Malaysian policies implemented should include the following elements:

- Streamlined and efficient government with problem solving capability.
- Protection of "infant industries" through a documented strategic industrial policy with a well-defined plan for a gradual reduction over time in the level of protection.
- Creation of "visions" of the future in collaboration with the private sector.
- Identification of leading-edge technologies and promotion of relevant R&D.
- Subsidization of the acquisition of new technologies.
- Control over technology transfer policies.
- Organization and funding of pre-competitive research.
- Identification of new areas of required skills.
- Restructuring of the existing education system to make it more responsive to industry needs.

If, however, Malaysia does not create an economically acceptable investment climate for its manufacturing sector and does not help the movement of its industrial sectors from emergence to expansion, and eventually to maturity, then the economy will be forced to "muddle through" an economic scenario which includes:

- An economy based largely on raw materials in a global context of long-term decline in commodity demand and prices.
- A workforce with narrow skills not adaptable to new job requirements.
- Industries using old technologies becoming less competitive in global markets.
- Insufficient investment capital to stimulate economic growth.
- Poor management skills and inadequate marketing.
- Inefficient government with poor problem solving skills..
- Poor relations between public and private sectors.
- Large-scale public and private industries highly vulnerable to macro-economic forces.
- Wider income disparity.

Commentary

N. Sadasivan

I must confess to feeling confused after listening to both speakers. On the one hand, Professor Kasper argues eloquently that free market forces should decide what is good for a particular country and that government involvement at all levels should be minimized. On the other hand, Mr Shiew Wan Shing, appearing to reflect the views of the Federation of Malaysian Manufacturers, seems to take a different stand that the government has an important role to play in fostering the type of industrial development that we want during the next decade, such as in formulating specific industrial policies and in identifying levels of technology.

Professor Kasper has identified some of the common features of East Asian growth. The East Asian governments, he argues, opted for small government and, on the whole, desisted from massive international borrowing by the state for consumptive purposes and from positive discrimination in favour of certain groups.

The example of Korea, however, represents a considerable departure from the common East Asian experience in a number of aspects. In the first place, there is a high degree of state intervention and central planning of privately owned industries. The Korean industries, historically, were not exposed to competition and were instead granted subsidies and indefinite periods of protection. Large conglomerates were fostered by the government. They appeared to be specially favoured and there was a concentration of power in a small, affluent class of industry leaders and bureaucrats. It is only now, some thirty years after Korea embarked on industrial development, that the Korean economy is slowly moving away from concentrated government patronage towards exposure to competitive forces. In view of this I doubt whether the Korean experience is as relevant to Malaysia as perhaps the experiences of Taiwan and Singapore. Perhaps Professor Kasper could elaborate on the relevance of the Korean experience to Malaysia.

Professor Kasper has also argued that, during the 1970s when the rest of the East Asian countries were engaged in deregulation measures, Malaysia was introducing more and more detailed regulations for industry and was greatly increasing the socialized ownership of industry. The Industrial Coordination Act of 1975 (ICA) and the proliferation of federal and state government-owned companies engaged in a wide variety of economic activities would seem to support this statement.

While this was the situation in Malaysia for many years, I think it is unfortunate that Professor Kasper ignored the significant changes in policies that have taken place during the last few years. For a start, the ICA has been amended so that, for example, the exemption limits for licensing have been raised from 0.25 million ringgit to 2.5 million ringgit, and from 25 to 75 employees. This effectively eliminates the need for at least 60 per cent of new manufacturing enterprises to obtain licenses or any other form of approval from the government. In addition, export-oriented companies do not require government approval for any expansion or diversification undertaken by them.

I think Professor Kasper has also chosen to ignore the fact that the government is moving towards more privatization and less state ownership of industries. It is true that in the past that government ventured into many areas in direct competition with the private sector. However, it has been recognized that apart from the financial burden of operating such ventures, industries cannot develop in a healthy manner under such circumstances. This has in recent years led to the privatization of many ventures while a number of ailing concerns have been wound up for good.

Turning to the more specific recommendations proposed for Malaysia, I think that the need to expose all our industries to international market forces would seem to be in line with current efforts undertaken by government to reduce the level of protection granted to manufacturing industries with a view to making them more competitive. I am not sure whether the FMM fully endorses this particular action by government; perhaps we could hear more of this from Mr Shiew. The government has also decided to disregard installed production capacities in the issuing of new manufacturing licenses. This indicates that competition could be very much be the order of the day.

As far as the growth versus income redistribution policy is concerned, I think it should be borne in mind that compared to the East Asian countries and other countries in the region, Malaysia is somewhat unique in that it is a multi-ethnic society where, in the past, ethnicity has been identified with specific occupations, and there has been wide disparity in incomes amongst the ethnic groups. This has led to social disorder and instability in the past. Under such circumstances, growth by itself, without concerted efforts at income redistribution, could very well lead to economic imbalance, and in turn to social disorder and political instability.

Unlike other countries in the region, and in particular the East Asian countries, Malaysia cannot therefore pursue growth without some effort at income redistribution. As Professor Kasper himself has noted, inherent in our growth policy is a conscious effort by the government to achieve greater income equality and the eradication of poverty.

I think we would generally recognize that even in a purely homogeneous society such as Korea, the disparity in income distribution can lead to social disorder, hindering economic growth. It is therefore important and necessary to ensure that economic growth does not create vast disparity in income among the nationals of a country.

Given that growth without efforts at redistribution could create unrest in a multi-ethnic society like Malaysia, it would seem that we cannot pursue the type of growth policies characterized by the East Asian experience. Perhaps Professor Kasper may wish to suggest some alternative(s).

Personally, I would agree that certain aspects of our income redistribution efforts need to be re-examined so that individual efforts and initiatives are rewarded and that local entrepreneurship is encouraged and mobilized to bring about industrial growth in the country.

We are in the midst of formulating a new development plan to replace the New Economic Policy (NEP) and judging by the current mood, I strongly believe that our development plans after 1990 would be more pragmatic and equitable. I think it is also clear that we have chosen our own growth and development mode, on the basis of our own political, social and economic order. The growth experience of Japan and other East Asian countries are certainly worth learning from, but I think we must be careful in how we emulate these experiences. A complete adoption of their growth model does not guarantee success since there are other equally important variables such as political philosophy and structure of the population that influence the success or failure of any policy.

I think what is needed is for Malaysia to achieve a skilful balance between growth and redistribution to suit its own (changing) economic environment. The bottom line is that the improvement in the standard and quality of life for all Malaysians should be a major objective of any growth model we adopt. What we need therefore are simple pragmatic flexible strategies for the achievement of economic growth and equitable distribution of income.

Turning to Mr Shiew's paper, I think that most people in government would agree with the validity of some of these concerns, in particular, the concern about uncertainty over the post-1990 economic policy. I agree that the latter would have a negative impact on investment. While the actual details of any post-1990 policy would only be known next year, it is clear that one of the main elements of any new policy would be to continue the maintenance of a conducive investment climate to facilitate industrial development. I think it is also very clear that government is becoming increasingly aware of the occasional inconsistency between policies and their implementation and these issues would be addressed in detail in the post-1990 policy.

The concern expressed by Mr Shiew on the role of the non-financial public enterprises is generally shared by most of us and, judging by current efforts of privatization, these agencies would have certainly a less important role to play in the 1990s.

The FMM in its survey of some hundred companies expressed concern over the rising costs in manufacturing, particularly in labour and in materials. I think this is a very valid concern. Professor Kasper himself has made the statement that we have not developed our human resources according to the needs of industry. We obviously have not increased our productivity level proportionately with wage increases and we did not have an integrated plan to prepare us to meet the challenges of export-led growth. Issues of manpower development, research and development, and productivity elements were also not addressed. Perhaps, within this context, the experiences of Japan and Korea in successfully exploiting these factors would be of use to us.

Turning to the subject of weak industrial linkages, it seems to me that the fault lies not so much in government policies which led to the establishment of free-trade zones, but in the inability of the Malaysian private sector to produce, at competitive prices and acceptable quality, intermediate products required by export companies in the free-trade zones. Given the unusually high volume of imported components by companies in the free-trade zones, it is a disappointment to most people that the private sector in the country has not been able to meet this demand through local manufacture.

Mr Shiew has also suggested that what is now needed is the formulation of a competitive strategy for Malaysia. Perhaps he may want to elaborate on some of the elements involved in formulating this strategy. In particular, I would think his suggestions on the globalization of product lines and flexible specialization would be welcomed.

Finally, Mr Shiew has assigned to government a far greater role in future industrial development than what Professor Kasper thinks is necessary. In fact, judging by Professor Kasper's emphasis on the minimal role of government bureaucracy in Japan, Korea and elsewhere, some of Mr Shiew's statements regarding the role of government should almost sound sacrilegious to Professor Kasper. I think it would be interesting to hear Professor Kasper's comments on the role of government, generally in stimulating and accelerating industrial development in Malaysia for the next two decades or so.

Commentary

Fong Chan Onn

The papers by Mr Shiew on "Malaysian Experience in the Manufacturing Sector" and Professor Kasper on "Accelerated Industrial Evolution in East Asia: Lessons for Malaysia" should be read together, ideally with the Shiew paper forming the context for the more theoretical Kasper paper.

In his paper, Mr Shiew provided the rationale for industrialization in Malaysia, documenting Malaysia's industrial experience and expanding on a set of government policies for propelling Malaysian manufacturing. The fact that one needs to articulate why manufacturing is important for Malaysian economic development indicates the uniqueness of Malaysia's economic structure. Its rich resource endowments have enabled it to consider options other than manufacturing, while many of the natural resource poor countries such as Japan and the Newly Industrialized Countries (NICs) did not have any other option but to industrialize since the early 1950s. Therein lies the dilemma facing a resource rich country such as Malaysia and other countries such as Australia and New Zealand. It is really too late in the day for us to still have to convince ourselves that we need manufacturing. The government has been convinced since 1971 that manufacturing is the basis for advancing the Malaysian economic structure. In fact, the current argument is not about manufacturing. In Japan and the NICs, the whole philosophy is based on an economic structure that is beyond industrialization, preparing for the on-set of the information revolution which has just begun in the US, and to some extent also in Japan. This shows how fast we have to move to keep pace with development.

In Mr Shiew's view, Malaysia's economy is highly dependent, therefore manufacturing ought to be best left to itself with the government being the provider of incentives and infrastructure. He has also identified a number of weaknesses and uncertainties facing the manufacturing sector and suggests that in the coming decades, the government should be concerned with the identification of the 'winning' industries, and the promotion of these targeted industries through incentives and by allowing these sectors to be globally linked with the world economy. Although Mr Shiew has highlighted some of the weaknesses facing Malaysian manufacturing, such as the uncertainty over the post 1990 scenario and the role of the non-financial public enterprises (NFPEs), he has not really provided answers as to how one could address these weaknesses. What does he think the government's post-1990 strategy should be — continued deregulation, more regulation or total liberalization? What does he think should be done with the losing NFPEs? Some of the questions which Mr Shiew posed are to some extent answered by Professor Kasper. Professor Kasper's lengthy and extremely rich paper can be divided into three main parts; namely, the theoretical framework for considering industrial development including entrepreneurship, industrial organization structure and industrial policy.

On the basis of this framework, in the second part, he attempts to lay out the general pattern of East Asian experience and from this experience in the third part, he seeks to derive the major lessons for Malaysia in its quest for continued improvements in manufacturing. In this forum, it might not be necessary for me to discuss in detail the theoretical framework. Needless to say, each of the three major topics identified in his theoretical framework — entrepreneurship, industrial organization and industrial policy — could form the basis for graduate courses in economics. I would like to comment on his observation regarding the general pattern of East Asian experience. Notwithstanding Professor Kasper's assertion that a survey of the literature shows that there has indeed been a common East Asian industry experience, the general consensus among economists is that a great deal has been written about East Asia, yet there is no clear consensus on how to characterize the experience, much less how to explain it and hence draw lessons for other countries. Indeed, the twenty-two features that Professor Kasper identified as general patterns of East Asian experience — such as accelerating manufacturing accompanied by agriculture reforms and the status of women — are not common to all East Asian countries.

Given the diversity in the economic structures of Japan and the NICs, it is not surprising that one cannot find many common features among these countries. If one was to search for common features, I believe a better framework would be to delineate two major categories of exogenous (or external) factors and endogenous (or internal) factors. With respect to exogenous factors, the common features are the absence or lack of natural resources and high population density, leaving these countries without any alternative but to adopt export-oriented manufacturing. Failure in this would have meant failure in economic development as a whole. Further, there was no problem of dislocation since the primary sector in these countries was the lagging sector when these countries entered their stage of economic take-off. Assisting this process of growth was the availability of foreign resources such as foreign aid, foreign investment and foreign markets for these countries to pursue an export-oriented strategy. The period of the 1950s and 1960s, as indicated by Professor Kasper, was a period of rapid economic growth in the aftermath of the Second World War and the subsequent baby boom. Further, during this period, the US had the special responsibility of ensuring the success of Japan, Taiwan, Korea and, to a limited extent, Hong Kong.

In terms of human resources too, all these countries had the necessary preconditions for industrial take-off. In the case of Japan, Korea and Taiwan, it was the remnants of the armament industries that propelled manufacturing; in the case of Hong Kong, the inflow of Shanghai capital and entrepreneurs after the overthrow of the Kuomintang regime; and in the case of Singapore, the highly skilled labour force after the withdrawal of the British from its Naval Base.

In the case of endogenous or controllable factors, the common feature one can generally identify is the experience that the less the government involvement the better for industrial advancement. Hong Kong and Taiwan's experience supports this position and certainly Korea's experience of initial government involvement and later deregularization and liberalization reinforces this. However, these countries are also characterized by a deliberate attempt to apply industrial policy, and in particular industrial targeting and industriai incentives, for propelling manufacturing. For example, the heavy industries sector had shifted focus in Korea in the 1960s to electronics and by the late 1970s to automobiles, and in Taiwan in the early 1980s to the production of personal computers.

Although there is controversy over the extent of government involvement that is needed for advancing manufacturing, there is no denying that the essential roles for government are to maintain macro-economic stability, provide infrastructural support and incentives, and identify industries that should be promoted. Beyond that, East Asian experience does not indicate clearly what more the government should do and can do to facilitate industrial development.

Some of these features are also highlighted in Professor Kasper's paper, and based on these he suggests that the relevant lesson for Malaysia is the need to deregulate and in fact liberalize the manufacturing sector so that market forces can react appropriately to identify the most efficient and productive sector. Entrepreneurship should be urgently encouraged but Professor Kasper has not highlighted the set of policies needed for entrepreneurship development. As far as the role of the state is concerned, he is quite clear — there should be minimal state intervention in the economy. All unprofitable state enterprises should be privatized or closed down and the negative aspect of the New Economic Policy, that is the overdependence of the Bumiputera on the government, should be rectified. The arguments lead him to suggest that in the post-1990 era, the policy of discrimination in terms of specification of outcomes should be replaced by one of equality of opportunity and open competition. Further, all protected sectors of the economy have to be opened up to enable them to perform efficiently.

By and large, I applaud Professor Kasper's insightful observations and bold recommendations. However, I feel he has not touched on the unique characteristics of the Malaysian economy which separate it from other Far East countries. The applicability of the Far East experience must be tempered by these characteristics.

Firstly, Malaysia is rich in natural resources, hence the extent to which one can and should pursue manufacturing should be evaluated. The fact that Mr Shiew needs to argue why Malaysia needs manufacturing indicates the uniqueness of

Malaysia's economic structure. While other countries do not have other options, our problem is to identify the extent which we should channel resources to manufacturing. Secondly, unlike the East Asian countries, Malaysia is a multi-ethnic, multi-religious country where economic differences among races can have repercussions beyond economic dimensions. This is accentuated by the large rural hinterland where the Bumiputera live. It is because of these unique features that we must assess the applicability of East Asian experience.

Firstly, it is important that in terms of Malaysia's economic development, there should be continued focus on the eradication of poverty. Only a continuous, rigourous poverty eradication strategy would alleviate the feeling of neglect and deprivation among the poor in a relatively rich country. Depending on the trickling down effect of economic development for poverty eradication will be too slow a process, not justified by a country with such rich resource endowment. More importantly, eradication of poverty wherever it occurs — be it in the traditional rural areas, estates, or new villages — cuts across ethnic and religious borders. It is a strategy which all Malaysians can support, regardless of ethnic group, religion or class.

Secondly, although one has to believe in free market forces for the efficient working of the economy, one must recognize the fact that the Bumiputera are still behind in terms of their involvement in manufacturing activities. This is particularly true with respect to individual entrepreneurship. In this, I agree partly with Professor Kasper's assertion that the best way to rectify this inequality is through the offering of equal opportunities to all, that is, equally good education facilities in both rural and urban areas, through more concerted and programmed exposure to the business environment among the Bumiputera, as well as by ensuring equal access to the inflow of information and technology. Besides this, I feel a set of positive assistance programmes ought to be accorded to the Bumiputera to accelerate their participation in manufacturing, in particular in small and medium industries. This could be through the offer of incentives such as a significant reduction in corporate income tax rates over a specified period for non-Bumiputera enterprises to take in Bumiputera equity and workers, and double tax deduction for employment of Bumiputera and skilled workers.

The incentive mechanism is workable because it is based on voluntary participation and not coercion. The firms which cannot identify suitable Bumiputera partners could commence or expand their operation, but they would not enjoy the benefits of the incentives. The mechanism is also effective, because it implies higher rates of return for firms who open up their business to Bumiputera. Further, and more importantly, these incentives do not necessarily imply loss of revenue to the government. Under the Fifth Malaysian Plan, the government has targeted about M$1 billion per annum for restructuring programmes, including the setting up of often non-profitable manufacturing units by public enterprises. Money saved from curtailment of these programmes could counter-balance the reduction in revenue from tax incentives. For example, we know that currently corporate income tax revenue amounts to about \$2.5 - \$3.0 billion per year. If the corporate income tax is reduced from 35 per cent to 20 per cent for five years for companies complying with Bumiputera targets, and this is fulfilled by half of all corporations, this would result in a tax reduction of about \$600 million per annum. This annual foregone tax rebate for five years, however, has the inspiring effect of half of all corporations complying with Bumiputera targets voluntarily. The spin-off effects in terms of the creation of Bumiputera entrepreneurs is indeed tremendous.

I believe, in the post-1990 era, this principle of voluntary compliance in helping Bumiputera participation and involvement in the manufacturing sector based on such incentives would be appropriate and effective and, more importantly, would not distort the principle of free market operation, in which only the fittest survive and in which there are no barriers to entry and exit.

In terms of government involvement, I concur with Prof. Kasper's view that there should be minimal direct involvement in the economy. However, I still assert, in contrast to Prof Kasper's view, that there is a need for the government to identify "strategic" and "winning" industries which the nation should promote, consistent with its endowment. Prof. Kasper asserts that "Heckscher-Ohlin" goods are better than "Ricardo goods". This is precisely the point. Why should it be that resource-poor countries such as Taiwan and Korea can be the world's major exporters of "Heckscher-Ohlin" goods such as rubber gloves and fabricated furniture, while a resource-rich country such as Malaysia should have to be content with "Ricardo" goods such as raw rubber and timber logs? The challenge here for the Malaysian government is to formulate the necessary strategy that would encourage a competitive manufacturing industry based on domestically available raw materials. What are the necessary infrastructure, manpower and R&D facilities that are needed to encourage this industrial upgrading based on comparative advantage? The answers are provided by the objectives of the Industrial Master Plan. While the Industrial Master Plan should not be regarded as the end to Malaysian industrialization efforts, it does lay down the steps that the nation needs to take. Without it, we could still prosper, but by a trial-and-error approach. With it, perhaps we could increase our probability of success in seeking a better life for all through industrialization.

DESIGNING AND IMPLEMENTING VAT: CROSS-COUNTRY EXPERIENCES

Alan A. Tait

The paper reviews the experience of forty countries using a value-added tax (VAT). Another five countries are considering adopting the VAT and the most recent example (Japan) is examined briefly. Time-tables and priority organization charts show that VAT should not be introduced in a hurry. Rate structures, exemptions, effects on prices and investment, administration and the use of computers are each examined briefly. The need for VAT control visits is emphasized. While the VAT itself may have a regressive impact on household expenditures, its impact should considered in the context of the total tax and government expenditure structure which can be designed to offset VAT regressivity.

1. Introduction

I want to organize my remarks on the value-added tax (VAT), broadly, as an update of some of the chapters of my book (Tait 1988); this should give me a chance to draw attention to significant changes and to emphasize points that may be of particular interest to Malaysia as it contemplates tax changes in the next decade. There are a huge number of issues but I have selected five to update and I end with some concluding remarks.

2. Why a Value-Added Tax?

The VAT continues to grow in popularity. Table 1 shows 49 countries either with a VAT or seriously considering the tax. That is five more countries than last year (the additional countries are Cyprus, Malaysia, Trinidad and Tobago, Venezuela, and Yugoslavia). This list leaves out major countries such as China, Nigeria, the United States, and the USSR, which have indicated an interest in the tax but which, as yet, have no government commitment to try to introduce it. So the VAT is a fashionable tax and that, undoubtedly, is one reason for introducing it.

Table 1
Countries Adopting VAT and Percentage Rates Throughout the World

	Date VAT Introduced or Proposed	VAT Rates[1]	
		At introduction	On July 1, 1989
Argentina	Jan. 1975	16	15
Austria	Jan. 1973	8, 16	10, 20, 32
Belgium	Jan. 1971	6, 14, 18	1, 6, 17, 19, 25, 33
Bolivia	Oct. 1973	5, 10, 15	10
Brazil[2]	Jan. 1967	15	9, 11
Brazil[3]	Jan. 1967	15	17
Canada[4]	Jan. 1991	9	
Chile	Mar. 1975	8, 20	16
Colombia	Jan. 1975	4, 6, 10	4, 6, 10, 15, 20, 35
Costa Rica	Jan. 1975	10	8
Cyprus	Jan. 1991[4]		
Côte d'Ivoire	Jan. 1960	8	11.11, 25, 35.13
Denmark	July 1967	10	22
Dominican Rep.	Jan. 1983	6	6
Ecuador	July 1970	4, 10	6
France	Jan. 1968	6.4, 13.6, 20, 25	2.1, 4, 5.5, 18.6, 28
Germany, Fed. Rep. of	Jan. 1968	5, 10	7, 14
Greece	Jan. 1987	6, 18, 36	3, 6, 18, 36
Guatemala	Aug. 1983	7	7
Haiti	Nov. 1982	7	10
Honduras	Jan. 1976	3	5, 6
Hungary	Jan. 1988	15, 25	15, 25
Iceland	Jan. 1990	22	
Indonesia	Apr. 1985	10	10
Ireland	Nov. 1972	5.26, 16.37, 30.26	2.2, 10, 25
Israel	July 1976	8	6.5, 15
Italy	Jan. 1973	6, 12, 18	4, 9, 19, 38
Japan	Apr. 1989	3, 6	3, 6
Korea	July 1977	10	2, 3.5, 10
Luxembourg	Jan. 1970	2, 4, 8	3, 6, 12
Madagascar	Jan. 1969	6, 12	15
Malaysia	1990[4]		
Mexico	Jan. 1980	10	6, 15, 20[2,3]
Morocco	Apr. 1986	7, 12, 14, 19, 30	7, 12, 14, 19, 30
Netherlands	Jan. 1969	4, 12	6, 18.5

contd.

Table 1 (continued)
Countries Adopting VAT and Percentage VAT Rates Throughout the World

	Date VAT Introduced or Proposed	*VAT Rates*[1]	
		At introduction	*On July 1, 1989*
New Zealand	May 1986	**10**	**12.5**
Nicaragua	Jan. 1975	**6**	**10**, 25
Niger	Jan. 1986	8, **12**, 18	15, **25**, 35
Norway	Jan. 1970	**20**	11.11, **20**
Panama	Mar. 1977	**5**	**5**
Peru	July 1976	3, **20**, 40	**18**
Philippines	Jan. 1988	**10**	**10**
Poland[4]			
Portugal	Jan. 1986	8, **16**, 30	8, **17**, 30
Senegal	Mar. 1961-80[5]	...	7, **20**, 34, 50
South Africa[4]	Apr. 1990		
Spain	Jan. 1986	6, **12**, 33	6, **12**, 33
Sweden[6]	Jan. 1969	2.04, 6.38, **11.1**	3.95, 12.87, **23.46**
Taiwan Province of China	Apr. 1986	**5**	**5**, 15, 25
Thailand[4]	Oct. 1990		
Trinidad and Tobago	Jan. 1990		
Tunisia	July 1988	6, **17**, 29	6, **17**, 29
Turkey	Jan. 1985	**10**	1, 5, **10**, 15
United Kingdom	Apr. 1973	**10**	**15**
Uruguay	Jan. 1968	5, **14**	12, **21**
Venezuela	July 1990[4]		

Notes: [1]Rates shown in bold type are the so-called standard rates applied to goods and services not covered by other especially high or low rates. Most countries use a zero rate for a few goods, and Ireland, Portugal, and the United Kingdom use it extensively to ensure that substantial amounts of goods and services are free of VAT.

[2]On interstate transactions depending on region.

[3]On intrastate transactions.

[4]Proposed or under discussion.

[5]Senegal's VAT evolved from a limited manufacturers turnover tax with credits, and no precise date of introduction is given; it has only recently been extended to include services at rates of 7, 12.5, 17, and 50 per cent.

[6]Effective rates.

Source: Various reports.

There are more solid reasons than fashion for adopting VAT. It has replaced unsatisfactory sales taxes (manufacturers, wholesale, and cascade taxes); it meets the needs of countries forming a customs union; and it has proved to be a buoyant source of revenue typically yielding more than initial estimates, as for example for Korea, Indonesia, New Zealand, Portugal, and Tunisia. Providing it is kept as a general tax on all goods and services it creates few economic distortions. It is based on an economic concept (value added) that is easier to define, in practice, than income, profits, expenditure, or wealth. The resistance to further taxation of corporate or personal income has made the VAT a most attractive alternative method of raising revenue. The rapid recent expansion of computers, especially desktop machines, has revolutionized the possibilities of putting efficient VAT control into smaller economies.

These advantages continue to persuade countries to introduce VAT. The most interesting and important addition to countries using a VAT has been Japan (April 1, 1989). Despite enormous opposition in Japan the VAT was introduced as a source of additional revenue, a diversification of the tax base, and a potential source of increased efficiency. However, the most interesting aspect of the Japanese VAT, from the point of view of countries contemplating a VAT, is its structure.

Basically, a consumption-type VAT can be levied on an invoice or accounts basis. Up to 1989 all countries had continued to use the European Community's (EC) invoice method VAT, although some (Canada and South Africa) had seriously debated using an accounts base. The Japanese VAT is the first VAT to be based on traders accounts instead of using the invoiced sales and purchases for each transaction. The Japanese VAT is computed using the annual business accounts (corporations use their company's financial year and unincorporated businesses must use the calendar year); a business can elect to make interim quarterly payments and this should be especially useful if the trader is likely to be a net claimant on the government (e.g., an exporter). All businesses not using quarterly returns are obliged to file an interim six-month return and with it pay half the tax reported on the previous final return or, if preferred, the actual VAT liability for six months (Schenke 1989). This interim return must be filed within two months of the six-month liability date.

A number of interesting questions are raised by this departure from the traditional VAT. First, why did all those other countries use the invoice credit method or, to put it another way, what has Japan risked by using this unusual method?

At least five possible problems with the accounts method can be mentioned. Only a single tax rate can be used (otherwise multiproduct firms would have to identify and match each differently taxed output with inputs at appropriate rates). Of course, some may see the obligation to use only a single rate as an advantage; it reduces both administrative and compliance costs and stops lobbying for multiple favourable r [illegible] econd, accounts are usually only closed once a year and, therefore, tax pa [illegible] ther than annual are provisional and are likely to be at longer intervals [illegible] ual VAT (e.g., six-monthly intervals instead of two monthly). This c [illegible] nportant in countries where inflation is eroding the real purchasing po [illegible] government's tax collection. Third, by not using the purchase and sa [illegible] voices incorporating VAT liability a crucial audit instrument is sacrificed; this invoice trail is an important element of the conventional VAT. This leads to another point — a useful part of the usual VAT is the potential cross-check it creates to validate corporate profits from the VAT data. Although this advantage can be exaggerated it is certainly sacrificed when both VAT and profits tax liabilities are derived from the same set of accounts. A final point is that up to now GATT has recognized the VAT as the only sales tax that can be rebated on exports without countervening GATT regulations. A VAT levied on company accounts comes much closer to corporate income taxation. After all, the VAT liability could equally well be calculated by adding wages and salaries, profits, and interest payments. If such a VAT levied on a direct additive base would not be recognized as rebatable by GATT, could not similar questions be raised about the accounts based credit method?

Against these possible disadvantages must be set the easier and cheaper administrative and compliance costs of the accounts based VAT. The authorities can use the existing corporate income tax accounts, suitably adjusted for capital expensing, and the income tax staff will perform the VAT audit at the same time as the company tax audit. Traders need only communicate with the authorities twice a year.

Does this innovation by a major trading nation suggest that other countries thinking of adopting VAT should follow the Japanese example? Should countries already using the invoice method check the Japanese experiment closely to see whether the advantages are sufficient to persuade them to change?

3. Why Not a VAT?

3.1 Is the Introduction of a VAT Inflationary?

A frequent fear expressed by politicians and the general public is that the introduction of a VAT will be inflationary. The recent experience of Japan mentioned above might seem, at first glance, to support this. In the five months October 1988 to February 1989 the Japanese consumer price index fell from 102.6 (1985=100) to 101.4. In the month preceding the start of VAT (March) it rose to 101.9. In the first month of the new tax, the index rose a full 1.8 points to 103.7, and a further 0.6 points in May to 104.3. We could say, therefore, that in the three months covering the anticipation and introduction of the 3 per cent VAT the consumer price index rose by 2.9 points (2.85 per cent).

However, although it may be too early to be sure, this evidence is actually mirroring the experience of other countries that have introduced VAT. Typically, prices rise in the first quarter of the period when VAT is introduced but by less than the actual VAT percentage. Thereafter, the rate of price increase resumes its previous rate of change. What the VAT does is to shift the price line in a once-and-for-all manner. It does not contribute to an increase in the inflation rate.

Evidence from 35 countries tends to confirm this view (Tait 1988, Ch. 10). Indeed, common sense suggests that price increases actually remove inflationary pressures. Real incomes fall and consumption falls. Unless both employers and the monetary authorities acquiesce in granting offsetting wage awards and financing transactions at the higher general price level, inflation cannot occur. It is not the VAT, in this case, that is the cause of inflation but decisions in other elements of the economy to frustrate the price effects of VAT that create inflation.

3.2 Is the VAT Regressive?

The VAT is a broad-based general sales tax levied on all goods and services, including essentials, and as such must be regressive. It is designed to be neutral, efficient, and to raise a substantial revenue. In the same way the personal income tax is designed to be non-neutral and progressive. The question is not whether the VAT is regressive or not but whether the whole government tax and expenditure structure affects households in the way desired. An efficiently administered income tax and appropriately targeted transfers may offset the regressivity of sales taxes (including the highly regressive taxes on alcohol and tobacco). The revenue from VAT can be used to provide goods and services to benefit the poor (e.g., rural roads, health clinics, schools, rural water supplies).

The introduction of the VAT in Japan exemplifies this dilemma. "There seems little question that the tax changes have made Japan's system more regressive. The Finance Ministry's figures show that as a family's income grows, so does its gain from the tax changes. The hardest hit were young unmarried people and young couples without children who are actually paying higher taxes than they were before" (Weisman 1989). But it was not the VAT that created the regressivity by itself; the 3 per cent sales tax was accompanied by sizable corporate and personal income tax reductions and reduced tax rates on utilities, cars, and other items. In other words, instead of the VAT's regressiveness being offset by, say, income tax increases on higher incomes and tax increases on goods and services that form a substantial part of higher income consumption (electricity, telecommunications, cars, and petroleum) the opposite occurred. It is also interesting that suggestions to replace the sales tax include "tax increases on wealth, luxury commodities, private property, and stock transfers" (Weisman 1989).

Moreover, a most important question is whether the VAT is more or less regressive than the alternative source of revenue. After all, if the VAT is not used some other tax must be instead; increased excises could well be even more regressive. Indeed, increases in personal income taxes that were badly administered so that they exempted the rich traders and the informal sector but taxed those under pay-as-you-earn could well be extremely unfair.

VAT is regressive but evidence shows that zero rating for housing and food can make it proportional or progressive (Tait 1988, pp. 214-218). Further exemptions, zero rating and use of multiple rates, to try to introduce progressivity all greatly complicate the structure and cost of administering the VAT and do so at the expense of the main virtues of VAT — simplicity, efficiency, and neutrality. There are different and more efficient ways to help the poor than to complicate the VAT.

4. VAT Rates

Table 1 shows the VAT rates at introduction and as levied in July 1989. It is significant that most of the newer VAT systems have used a single rate (Japan's second rate of 6 per cent is used only for cars and is supposed to be phased out by March 31, 1992). The ten arguments in favour of a single rate (Tait 1988, pp. 42-44) remain convincing. The European Community's recent suggestion for a standard rate of at least 15 per cent and a lower rate between 0-9 per cent is predicated more on gaining political acceptance than on any economic theory, or weighing of administrative or compliance costs. It is also argued that equity can be achieved using other means (progressive income taxes and transfers). This may be less true in developing countries that lack the comprehensive progressive income taxes and transfer systems to carry out redistributive measures. In this case, by default, sales taxation becomes a redistributive instrument and it may help make the tax system more progressive. However, in developed countries, recent research indicates that even quite dramatic changes in VAT rates and coverage seem to have quite small effects on measures of inequality (Baccouche and Laisney 1988).

As administrative costs are more or less invariant of the rate chosen, low rates of VAT imply high costs as a proportion of revenue. The extraordinarily low rate of 3 per cent used in Japan is clearly an aberration by international standards; the more usual EC rates are 10 to 20 per cent. The 3 per cent rate is probably only acceptable because the VAT administrative costs are, presumably, largely subsumed in the existing income tax administration and because the high threshold (see below) greatly reduces the number of registered tax-payers.

5. Exemptions and Zero Rating

There are a number of issues here relevant to Malaysia but I will mention only three — food, capital goods, and financial services.

5.1 Food

Although many EC countries tax food under the VAT, most other countries exempt food, especially cheaper foods likely to be important in low-income household budgets. Evidence indicates that zero rating such foods is an effective way of making the VAT proportional or even mildly progressive. However, such exemptions or zero rating cause problems of definition. Many countries wish to exempt "essential foods" (e.g., Portugal, see Correia 1988) but whatever definition is adopted to isolate foods that are "essential" is bound to be controversial and the definition will be contested.

Some countries have tried to simplify their approach by exempting "unprocessed foods". In fact, remarkably few foods are wholly unprocessed. Even rice is usually polished; wheat is turned into flour; and meat is butchered and frequently semi-processed. The producers of canned, dried, packaged, and frozen foods will lobby that they are essential (and more hygienic and, hence, to be encouraged). Authorities try to establish lists of exempt products but demarcation between, for instance, bread, buns, pastries, biscuits, and confectionery creates opportunities for endless debate, confusion, and deliberate misclassification and evasion.[1]

Some countries (e.g., Morocco) have tried to exempt foods that are important inputs into the food industry, e.g., sugar, salt, and flour. As manufacturers of the products already pay VAT on their inputs the actual final rate of VAT is more or less unknown and, in the particular case of Morocco, very odd as sugar was already liable to a separate excise and was subsidized.

Of course, even if farmers are outside the VAT they will still have paid tax on their inputs of seeds, fertilizers, insecticides, etc., and this is likely, as in Latin America, to lead the demand for a further erosion of the VAT base by zero rating those industries. If essential food is to be exempted then the way to make the best of a bad job is to create a limited list of products. Although no recommendation is perfect, probably one of the best is to exempt only unprocessed food and to define that in as restrictive a way as possible.

5.2 Capital goods

In what might be called the "pure" VAT, all capital purchases should be allowed as a credit at once and if a net repayment is established the tax should be refunded at once. This ensures the tax is on consumption and should encourage investment. For some countries that gain a substantial amount of revenue from taxing capital goods, this is too draconian a change. Spain, for instance, requires that the VAT paid on movable fixed assets (e.g., plant and equipment) is written off over four years and on immovables over nine years.

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[1]As an example of the complexity involved in a simple definition consider, for example, bread. "Bread means food for human consumption manufactured by baking dough composed exclusively of a mixture of cereal flour and any one or more of the following ingredients in quantities not exceeding the limitation, if any, specified for each ingredient: (a) yeast, or other leavening or aerating agent, salt, malt, extract, milk, water, gluten; (b) fat, sugar and bread improver not exceeding for each ingredient 2 per cent of the weight of the flour included in the dough; and (c) dried fruit, subject to its not exceeding 10 per cent of the flour in the dough."

In Hungary the authorities felt they could not make an immediate transition to the full expensing of capital and opted to allow only a 20 per cent credit in the initial year, increased each year thereafter until by 1992 all the VAT on capital goods is reimbursed (Kupa 1989). In Argentina credits from the purchase of fixed assets must be spread over three years and can only be claimed once a year (and not deducted from the monthly payments). However, credits on fixed assets can be adjusted for inflation.

Brazil has a complex position on the treatment of capital which ends up distorting investment decisions. The ICM is the state VAT and allows no deduction for tax paid on capital goods. The IPI federal VAT, although allowing credit for capital goods, keeps large categories exempt from the VAT (agricultural inputs, transport, and other services), including many specific industrial exemptions granted over a number of years. Such exemptions create an uncertain tax content and are further skewed by separate taxes on the exempted activities (e.g., transport).

Basically, a great advantage of the VAT is that it does not discriminate against investment and it is a mistake to erode this desirable aspect of the tax. Therefore, if at all possible, the VAT should be used to ensure that capital expenditure is free of tax.

5.3 Financial Services

A Minister of Finance once put the issue clearly, "I feel uneasy proposing a VAT on all goods and services, including food, but exempting banks and insurance companies. Why should the poor pay VAT on food and the rich not pay VAT on their use of financial institutions?" A good question. Yet, we know that all European VATs exempt financial services. They do so, first, because it is extremely difficult to identify on conventional invoice credit lines, the value added on each service provided by financial institutions. Second, the VAT actually payable on financial services would only be on the "retail" sale to households. All use of financial services by businesses (which is the greater part) would be deductible as a credit. Therefore, extending the VAT to include financial services does not, actually, greatly increase the tax base. It improves equity but does not necessarily yield large amounts of extra revenue. This is particularly so when it is appreciated that even when financial institutions are exempt from VAT they continue to pay tax on all their inputs (buildings, computers, office equipment, stationery) and this tax is not creditable. If these institutions were pulled fully into the system they would be able to claim these credits and as they did so the net yield from the VAT on that sector's final sales would fall. Also there are political implications of increasing the cost of borrowing to the private sector that may need delicate handling. Finally, both capital and financial services are internationally extremely mobile. Significant taxation, even of retailed financial services, can persuade residents to move their transactions off-shore and this creates more problems for monitoring and policing.

The Israeli authorities experimented with a VAT on financial institutions. Ingeniously, they sidestepped the problem of computing value added by levying the tax on the additive principle. A proportional tax at the VAT rate was levied on wages and profits; this was administered through the income tax system (the normal Israeli VAT is administered by Customs and Excise). Demands that other traders should be allowed to credit the implicit VAT in their purchases of financial services (interest payments, insurance premiums, etc.) led the authorities to "abolish" the VAT on financial services and recreate it, phoenix-like, immediately, as a separate income tax on wages and profits; that is, identical but not a VAT and hence not creditable.

The Canadian White Paper on their proposed VAT (called the MSST — the multistage sales tax) proposed applying the tax to the domestic financial margins. For a bank or other lender the taxable sale is represented by interest income against which a deduction for interest expense should be allowed. For insurers a further twist is needed as premiums and interest income are taxable sales against which policy-holder benefits should be allowed (Thompson 1988; Vanasse 1989). There has been substantial debate on these proposals (e.g., Hoffman, Poddar, and Whalley 1987) but the 1989 budget statement introducing the VAT (now called the Goods and Services Tax (GST)) stated "Given the magnitude of the remaining difficulties and the plain fact that no country in the world has successfully applied sales tax to financial intermediation services, the Government does not intend to apply tax under the GST to these services."

In the EC insurance premiums are often subject to a separate tax, e.g., Germany, 5 per cent; Greece, 3, 8 or 18 per cent depending on the type of insurance; Italy, 1-5 per cent; and in France from 2.4-30.0 per cent.

The realistic attitude would seem to suggest following the EC model exempting financial services from VAT but, if desired, applying a separate tax on premiums or, possibly based on wages and profits, of the financial sector.

6. Administration

The costs of administering a VAT (about 1 per cent of the yield) depend crucially on the number of staff that must be employed and the staff to be employed, in turn, depend on: (1) the exemption limits (see below); (2) exempted goods and services (see above); (3) the treatment of agriculture; (4) the treatment of affiliated companies and group trading; (5) collection of other agencies; (6) staff transferred from taxes replaced; (7) frequency of returns; (8) the complexity of tax rates (see above); (9) the standard of administration; and (10) the existing computer systems.

The broad experience is that the VAT increases the number of registered traders above that anticipated. In New Zealand the government estimated there would be 180,000 registered traders (of which 60,000 would be farmers). The actual figure was 290,000 (Due 1988). In Spain some 400,000 extra tax-payers were discovered between the introduction of VAT in 1986 and 1988.

6.1 Exemption Limits

Probably the most crucial question for simplifying the administration of the VAT (apart from the number of rates) is the choice of threshold for liability to the tax. The differences in practice are huge. In Denmark complete exemption is granted only to those with turnover below US$1,500 (approximately) whereas Japan has adopted a figure of US$210,000 (Table 2).[2] Moreover, as Japan really only applies the VAT proper to traders with a turnover above US$3.5 million (those below use a simplified scheme based on turnover), only the largest traders are fully part of the tax. An advantage of a higher threshold is that it automatically cuts out many difficult-to-tax groups, e.g., farmers. Those farmers who are large enough to be above the (generous) threshold will also be running the farm more as a business with books of account, etc. Of course, many large farms are like urban businesses (chicken, fish, shellfish, turkey, market garden).

Tables 3 and 4 give some ideas of the scale of such economies as the number of registered traders is reduced; moving from no threshold to one of $50,000 cuts the number of registered traders to a quarter of the previous number. If the threshold is lifted to over $1 million the number of traders drops to a fortieth of the total. The Japanese threshold of $3.5 million suggests that relatively few traders will have to pay the VAT calculated on the full accounts basis. This, in turn, implies large economies in staffing.

Table 4 indicates the sharp fall in staff needed as the threshold is lifted. Note the much larger number of staff needed for an invoice based VAT and how, as the exemption threshold rises, the staff needed for either the accounts based or invoice based VAT start to equal each other. This is because the number of field audits for an invoice/credit method VAT is much higher than one where the audit for VAT takes place at the same time as the income tax; but as the number of traders to be visited drops sharply as the exemption limit increases the staff needed for audit starts to be similar under both accounts and invoice VATs.

A high threshold does create some problems. Small businesses, the value added of which is untaxed, are given an advantage. Traders are, therefore, tempted to misrepresent sales to remain below the threshold. Indeed, there is an incentive to split businesses to keep each below the threshold when the single entity would have been taxable. Against these arguments it is also found that small traders will volunteer for the VAT if they are supplying larger VAT registered traders who want the VAT shown on their purchase invoice so that they can claim the credit.

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[2]Note Table 2 should be read as an update of Table 6-2 in (Tait 1988).

Table 2
Treatment of Small Firms Under VAT

Country	*Complete Exemption*	*Simplified Schemes*	*Forfait*
Europe			
Hungary	(a) Ft 1 million (retailer) (US$15,900) (b) Ft 250,000 (other) (US$3,975)		
Portugal	(a) Esc 7.5 million (retailers) (US$27,300) (b) Esc 800,000 (entrepreneurs) (US$4,850) (c) Esc 500,000 (professionals) (US$3,030)	Small retailers pay quarterly 25 per cent of tax on purchases	
Spain	Pta 50 million (US$393,700)	Quotas fixed according to numbers employed, e.g., sq. meters of premises, number of vehicles, chairs, rooms, etc., regardless of initial turnover	Used extensively
EC	ECU 150,000-300,000 (suggested) (US$144,000-287,000)		
Western Hemisphere			
Argentina		Monthly lump-sum taxes paid according to sales (for non-manufacturing firms only	

contd.

Table 2 (continued)
Treatment of Small Firms Under VAT

Country	*Complete Exemption*	*Simplified Schemes*	*Forfait*
Mexico		(a) Income must not exceed 32 times the minimum wage; (b) No more than three employees; (c) Business space no more than 50 sq. meters	Applied on a presumptive basis if (a) to (b) are met
Trinidad and Tobago	TT$75,000 (US$17,650)		
Africa			
Niger		Turnover below: CFAF 30 million (goods) (US$88,950) CFAF 10 million (services) (US$29,650)	
Asia/Pacific			
Japan	¥ 30 million (US$210,000)	¥ 30-60 million (US$210,000-220,000) ¥ 500 million (US$3,500,000) or less (rate is 0.6 per cent of sales except for whoesalers where it is 0.3 per cent). Also if interim tax liability is under ¥ 300,000 tax payment can be delayed until year end.	
Philippines	P 200,000 (US$9,250)		

Source: Various country documents.

Table 3
Accounts Based VAT: Estimates of Changes in Taxpayer Numbers and Returns Processed as Exemption Limit Changes

Gross Receipts Over US$ (Exemption Limit)	Number of Taxpayers (Thousands)	Quarterly		Monthly	
		Returns (Millions)	Processing Costs ($ Millions)	Returns (Millions)	Processing Costs ($ Millions)
0	20,000	80	53.0	240 (153)*	160
50,000	5,000	20	13.0	60	40
1,000,000	500	2	1.3	6	4

Note: * Figures in parenthesis are approximate equivalents for a US invoice VAT.
Source: Various estimates.

Table 4
Accounts and Invoice VAT: Estimates of Number of Staff Needed According to Frequency of Returns and Exemption Limits

Gross Receipts Over US$ (Exemption Limit)	Accounts VAT						Total Staff for European Invoice VAT
	Processing/Accounting Quarterly	Processing/Accounting Monthly	Audit	Collection	Legal	Total	
0	3,200	4,000 (7,500)*	6,500 (7,000)	3,000 (3,000)	1,600 (1,000)	16,000 (21,000)	80,000
50,000	700	1,000	2,000	800	600	5,000	20,000
1,000,000	75	100	1,200	100	325	2,300	2,000

Note: * Figures in parenthesis are approximate equivalents for a US invoice VAT.
Source: Various estimates.

There may be a case for distinguishing between service traders (smaller and, hence, lower thresholds) from others, but many businesses are both service and other traders and introducing such a distinction is yet another administrative burden.

Overall, it is sensible to adopt a higher rather than a lower tax threshold. The administrative resources needed to monitor numerous small tax-payers can be put to much more effective use concentrating on larger traders. Also resistance to a new VAT is likely to be lower if many small businesses are omitted (e.g., Korea).

6.2 Frequency of Returns

Tables 3 and 4 show examples of the reduction in numbers of returns to be processed and the number of staff needed if returns are quarterly or monthly. Clearly, quarterly returns yield substantial administrative benefits. Though there is some loss of revenue flow using quarterly returns the flow of work is spread as traders can be allocated to make returns in different months. On the whole, bi-monthly or quarterly returns are preferred.

6.3 Timetables for Introduction of VAT[3]

As the staff of the Fiscal Affairs Department of the IMF has worked on the introduction of some twenty VATs throughout the world we have developed timetables to identify the main decisions to be made in the introduction of the VAT. Of course, all countries differ in their administrative and legislative processes. They also differ in their adoption of special provisions for VAT. Nevertheless, the common characteristics are many and it may be interesting to examine a "typical" timetable. Chart 1 is an outline of a timetable to introduce VAT on January 1, 1991. Even making a tabulation such as this forces the authorities to concentrate thinking logically about things to be done.

A timetable is only one facet of thinking about the introduction of VAT. Chart 2 shows the linkages between the various stages in the development project. It states what activities must be wholly or largely complete before later stages can be commenced and also what stages cannot be started before the current one is completed.

In using the timetables, the following points should be noted: (1) timetables are not a substitute for detailed work plans which should be prepared by the VAT implementation unit management for each principal task; (2) only major tasks have been shown on the charts; (3) the times indicated are subject to review and amendment as the development proceeds; (4) there is a logical flow to the sequence in which the primary tasks can be completed, i.e., first — decide policy; then — develop legislation; then — design systems and procedures; then — prepare manuals; then — prepare training material; then — train staff; then — educate tax-payers; then — collect the tax.

However, this does not mean that each phase must be completed before the next can be started. There are overlaps between adjacent tasks so that, for example, system design, manual preparation, and the production of training aids and material are all being worked on together. While this flexibility permits a large task to be handled within a relatively short time, it does mean that careful management of resources and outputs is needed.

Once the VAT is introduced numerous administrative issues are raised (see,

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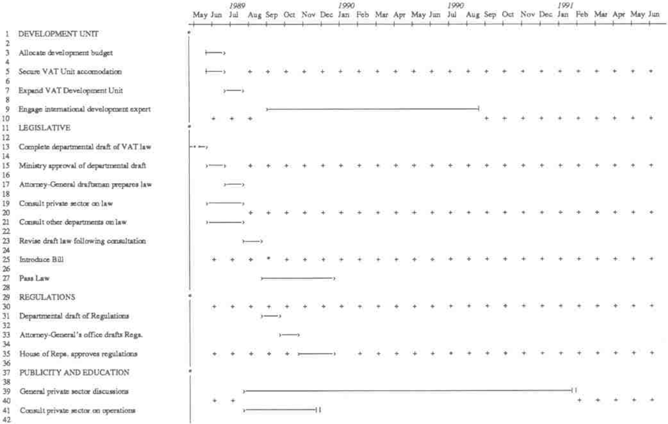
[3]My colleague, Mr. Holland, is an expert in this field and has been a major contributor to the development of these timetables.

Chart 1
Timetable to Introduce VAT on January 1, 1991



contd.

Chart 1 (continued)
Timetable to Introduce VAT on January 1, 1991

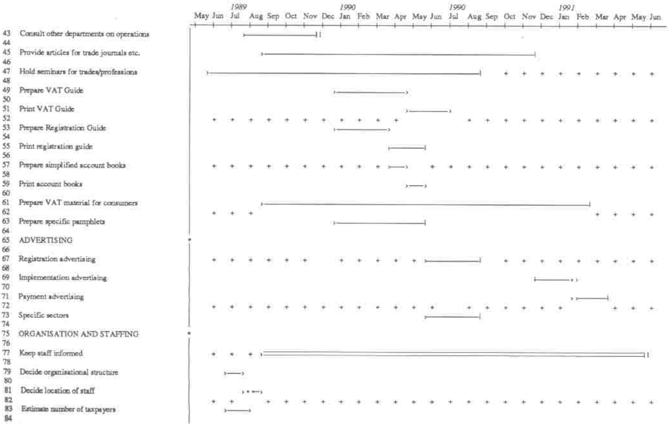


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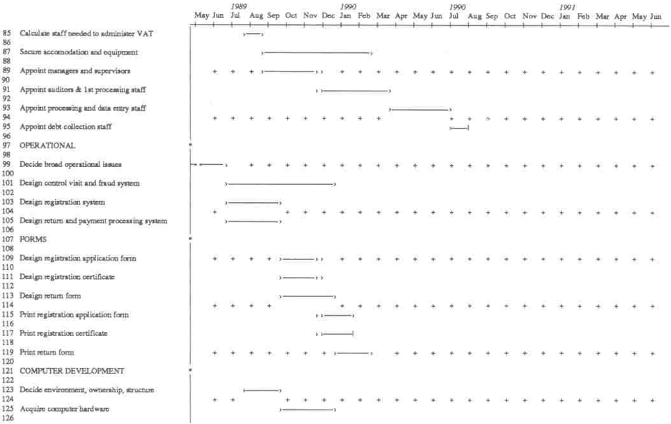
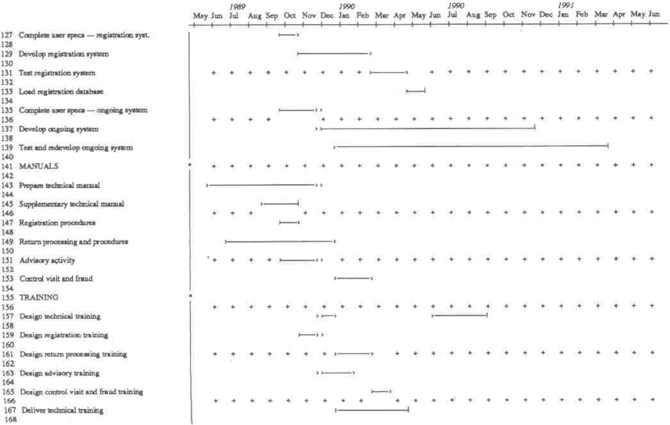
Chart 1 (continued)
Timetable to Introduce VAT on January 1, 1991



contd.

Chart 1 (continued)
Timetable to Introduce VAT on January 1, 1991



contd.

Chart 1 (concluded)
Timetable to Introduce VAT on January 1, 1991

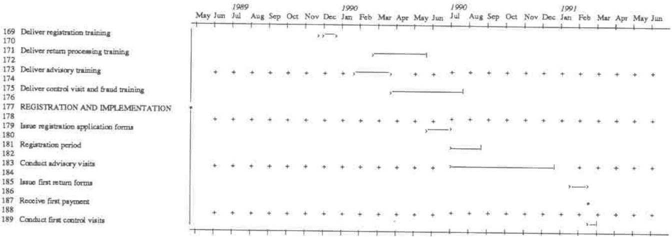


Chart 2

Priorities in Development of VAT

	TASK			PREDECESSOR		SUCCESSOR	
	No.	*Description*	*Duration in Months*	*No.*	*Description*	*No.*	*Description*
DEVELOPMENT UNIT							
	3	Allocate development budget	1.00			7	Expand VAT development unit
	5	Secure VAT unit accomodation	1.00			7	Expand VAT development unit
	7	Expand VAT development unit	1.00	5	Secure VAT unit accomodation	39	General private sector discussions
				3	Allocate development budget	123	Decide computer environment ownership structure
	9	Engage International development expert	12.00	25	Introduce Bill		
LEGISLATIVE							
	13	Complete departmental draft of VAT Law	1.00			15	Ministry approval of departmental draft
						19	Consult private sector on Law
						21	Consult other department on Law
						47	Hold seminars for trades/professions
						143	Prepare technical manual
	15	Ministry approval of departmental draft	1.00	13	Complete departmental draft of VAT Law	17	Attorney-General draftsman prepares Law
	17	Attorney-General draftsman prepares Law	1.00	15	Ministry approval of departmental draft	25	Introduce Bill
	19	Consult private sector on Law	2.00	13	Complete departmental draft of VAT Law	23	Revise draft Law following consultation
						41	Consult private sector on operations
						43	Consult other departments on operation

contd.

Chart 2 (continued)
Priorities in Development of VAT

	TASK			PREDECESSOR		SUCCESSOR	
	No.	*Description*	*Duration in Months*	*No.*	*Description*	*No.*	*Description*
	21	Consult other departments on Law	2.00	13	Complete departmental draft of VAT Law	23	Revise draft Law following consultation
	23	Revise draft Law following consultation	1.00	19 21	Consult private sector on Law Consult other departments on Law	25 145	Introduce Bill Prepare supplementary technical manual
	25	Introduce Bill	1.00	17 23	Attorney-General draftsman prepares Law Revise draft Law following consultation	9 27	Engage International Development expert Pass Law
	27	Pass Law	3.00	25	Introduce Bill	31 45 61 77 49 53 67 73	Departmental Draft of Regulations Provide articles for trade journals etc. Prepare VAT material for consumers Keep staff informed Prepare VAT Guide Prepare Registration Guide Registration advertising Advertising for specific sectors
REGULATIONS							
	31	Departmental draft of Regulations	1.00	25	Introduce Bill	33	Attorney-General's office drafts Regulations
	33	Attorney-General's office drafts Regulations	1.00	31	Departmental draft of Regulations	35	House of Representatives approves Regulations
	35	House of Representatives approves Regulations	2.00	33	Attorney-General's office drafts Regulations	49 53 63 73	Prepare VAT Guide Prepare Registration Guide Prepare specific pamphlets Advertising for specific sectors

contd.

Chart 2 (continued)
Priorities in Development of VAT

TASK			PREDECESSOR		SUCCESSOR	
No.	*Description*	*Duration in Months*	*No.*	*Description*	*No.*	*Description*
PUBLICITY AND EDUCATION						
39	General private sector discussion	18.00	7	Expand VAT development unit		
41	Consult private sector on operations	4.00	19	Consult private sector on Law		
43	Consult other departments on operations	4.00	19	Consult private sector on Law		
45	Provide articles for trade journals	15.00	25	Introduce Bill		
47	Hold seminars for trades/professions	15.00	13	Complete departmental draft of VAT Law		
49	Prepare VAT Guide	4.00	27	Pass Law	51	Print VAT Guide
			35	House of Representatives appproves Regulations		
51	Print VAT Guide	2.00	49	Prepare VAT Guide	183	Conduct advisory visits
53	Prepare Registration Guide	3.00	27	Pass Law	55	Print Registration Guide
			35	House of Representatives approves Regulations	57	Prepare simplified account books
					67	Registration advertising
55	Print Registration Guide	2.00	53	Prepare Registration Guide		
57	Prepare simplified account books	1.00	53	Prepare Registration Guide	59	Print account books
59	Print account books	1.00	57	Prepare simplified account books	183	Conduct advisory visits
61	Prepare VAT material for consumers	18.00	25	Introduce Bill		
63	Prepare specific pamphlets	5.00	27	Pass Law		
			35	House of Representatives approves Regulations		

contd.

Chart 2 (continued)
Priorities in Development of VAT

	TASK			PREDECESSOR		SUCCESSOR	
	No.	*Description*	*Duration in Months*	*No.*	*Description*	*No.*	*Description*
ADVERTISING							
	67	Registration advertising	3.00	53	Prepare Registration Guide		
	69	Implementation advertising	2.00			71	Payment advertising
	71	Payment advertising	2.00	69	Implementation advertising		
	73	Specific sectors	3.00	27	Pass Law		
				35	House of Representatives approves Regulations		
ORGANIZATION AND STAFFING							
	77	Keep staff informed	21.00	25	Introduce Bill		
	79	Decide organizational structure	1.00	99	Decide broad operational issues		
	81	Decide location of staff	1.00	79	Decide organizational structure	87	Secure accomodation and equipment
	83	Estimate number of taxpayers	1.00	99	Decide broad operational issues	85	Calculate staff needed to administer VAT
	85	Calculate staff needed to administer VAT	1.00	83	Estimate number of taxpayers	87	Secure accomodation and equipment
	87	Secure accomodation and equipment	6.00	85	Calculate staff needed to administer VAT	89	Appoint managers and supervisors
				81	Decide location of staff		
	89	Appoint managers and supervisors	3.00	85	Calculate staff needed to administer VAT	91	Appoint Auditors and 1st processing staff
	91	Appoint Auditors and 1st processing staff	4.00	89	Appoint managers and supervisors	93	Appoint processing and data entry staff
	93	Appoint processing and data entry staff	3.00	91	Appoint Auditors and 1st processing staff	95	Appoint debt collection staff
				87	Secure accommodation and equipment		
	95	Appoint debt collection staff	1.00	93	Appoint processing and data entry staff		

contd.

Chart 2 (continued)
Priorities in Development of VAT

	TASK			PREDECESSOR		SUCCESSOR	
	No.	Description	Duration in Months	No.	Description	No.	Description
OPERATIONAL							
	99	Decide broad operational issues	2.00			79	Decide organizational structure
						83	Estimate number of taxpayers
						101	Design control visit and fraud system
						103	Design registration system
						105	Design return and payment processing system
						149	Return processing and procedures
	101	Design control visit and fraud systems	6.00	99	Decide broad operational issues	153	Control visit and fraud (manuals)
	103	Design registration system	3.00	99	Decide broad operational issues	109	Design registration application form
						111	Design registration certificate
						147	Registration procedure (manuals)
	105	Design return and payment processing system	3.00	99	Decide broad operational issues	113	Design return form
						151	Advisory activity (manuals)
FORMS							
	109	Design registration application form	2.00	103	Design registration system	115	Print registration application form
	111	Design registration certificate	2.00	103	Design registration system	117	Print registration certificate
	113	Design return form	3.00	105	Design return and payment processing system	119	Print return form
	115	Print registration application form	2.00	109	Design registration application form	179	Issue registration application form
	117	Print registration application form	2.00	111	Design registration certificate		
	119	Print return form	2.00	113	Design return form	185	Issue first return forms

contd.

Chart 2 (continued)
Priorities in Development of VAT

TASK			PREDECESSOR		SUCCESSOR	
No.	Description	Duration in Months	No.	Description	No.	Description
COMPUTER DEVELOPMENT						
123	Decide computer environment ownership, structure	2.00	7	Expand VAT Development unit	125 127 135	Acquire computer hardware Complete user specs registration system Complete user specs ongoing system
125	Acquire computer hardware	3.00	123	Decide computer environment, ownership, structure	131 139	Test registration system Test and redevelop ongoing system
127	Complete user specs — registration system	1.00	123	Decide computer environment, ownership, structure	129	Develop registration system
129	Develop registration system	4.00	127	Complete user specs — registration system	131	Test registration system
131	Test registration system	2.00	129 125	Develop registration system Acquire computer hardware	133	Load registration database
133	Load registration database	1.00	131	Test registration system		
135	Complete user specs — ongoing system	2.00	123	Decide computer environment, ownership, structure	137	Develop ongoing system
137	Develop ongoing system	12.00	135	Complete user specs — ongoing system		
139	Test and redevelop ongoing system	15.00	135 125	Complete user specs — ongoing system Acquire computer hardware		
MANUALS						
143	Prepare technical manual	6.00	13	Complete departmental draft of VAT Law	157	Design technical training
145	Supplementary technical manual	2.00	23	Revise draft Law following consultation		
147	Registration procedures	1.00	103	Design registration system	159	Design registration training
149	Return processing and procedures	6.00	99	Decide broad operational issues	161	Design return processing training

contd.

Chart 2 (concluded)
Priorities in Development of VAT

	TASK			PREDECESSOR		SUCCESSOR	
	No.	Description	Duration in Months	No.	Description	No.	Description
	151	Advisory activity	2.00	105	Design return and payment processing system	163	Design advisory training
	153	Control visit and fraud	2.00	101	Design control visit and fraud system	165	Design control visit and fraud training
TRAINING							
	157	Design technical training	1.00	143	Prepare technical manual	167	Deliver technical training
	159	Design registration training	1.00	147	Registration procedures (manuals)	169	Deliver registration training
	161	Design return processing training	2.00	149	Return processing and procedures (manual)	171	Deliver return processing training
	163	Design advisory training	2.00	151	Advisory activity (manuals)	173	Deliver advisory training
	165	Design control visit and fraud training	1.00	153	Control visit and fraud (manuals)	175	Deliver control visit and fraud training
	167	Deliver technical training	4.00	157	Design technical training		
	169	Deliver registration training	1.00	159	Design registration training		
	171	Deliver return processing training	3.00	161	Design return processing training		
	173	Deliver advisory training	2.00	163	Design advisory training	179	Issue registration application forms
	175	Deliver control visit and fraud training	4.00	165	Design control visit and fraud training		
REGISTRATION AND IMPLEMENTATION							
	179	Issue registration application forms	1.00	115	Print registration application forms	181	Registration period
				173	Deliver advisory training	183	Conduct advisory visits
				169	Deliver registration training		
	181	Registration period	2.00	179	Issue registration application forms		
	183	Conduct advisory visits	6.00	179	Issue registration application forms		
				59	Print account books		
				51	Print VAT Guide		
	185	Issue first return forms	1.00	119	Print return form	187	Receive first payment
	187	Receive first payment		185	Issue first return forms	189	Conduct first control visits
	189	Conduct first control visits		187	Receive first payment		

Tait 1988, Chaps. 13, 14, 15, and 16). I wish to mention only two, i.e., audit visits and computers.

6.4 Audit/Control Visits

I have come to the conclusion that it is a mistake to speak of VAT "audits." VAT is usually administered by the same authorities that run the income taxes and to refer to "audit" suggests to these officials that the same standards of audit should apply to VAT as are used in income taxation. Nothing could be farther from the truth. The VAT audit is a more simple affair than the corporate income tax audit. It does not require the detailed examination of the treatment of capital or the detailed checking of banking records. Nor does it need sophisticated accounting skills. An office VAT auditor can be expected to complete an average of 10 to 20 cases a month (Tait 1988, pp. 206-207) and a field VAT auditor at least an average of 4 to 6 cases a month (indeed in developing countries where traders are typically smaller this figure could rise to 10 to 15 a month).

Moreover, using the word "audit" suggests a similar knowledge to that needed for income tax audits. This is wrong. VAT control visits (i.e., "audits") need not be conducted by highly qualified officials, since only a basic knowledge of accounting is required. Officials should normally be employed only on VAT control visits not on both VAT and income tax. (This, of course, is not true if an accounts — Japanese style — VAT is adopted.) Such control visits should, on average, be conducted about once every four to five years.

Another aspect of VAT control visits that should be emphasized is the importance of creating a sensible, straightforward, audit or control manual. The importance of this cannot be overstated. Inspection of some of the European VAT manuals might frighten anyone from undertaking a VAT; however, it is quite possible to draft a clear and simple manual to start with and which can be added to as experience is gained. The important point is that staff should be accustomed to order and sequence in their work. Supervisors should know what to expect, in detail, from their staff. This may all seem obvious but it is surprising in how many countries a request to see the official tax manuals is met with panic or incomprehension.

Manuals should cover what is needed on the first visit, the basic checks, more elaborate checks, checks for retailers and service traders, and appropriate simple procedures.[4] Supervisors should accompany officers or visit sometimes arriving

[4]As an example, one manual under the heading "Evasion" lists the following: "General failure to notify, exploitation of registration limits, suppression of supplies, suppression of purchases, misdescription, undervaluation, credits, part-exchange, self-supplies, input tax deduction, self-billing, imports and goods from bond, exports, partial exemption, exploitation of tax points, manipulation of tax periods, arithmetical errors, false returns, contrived insolvencies, long-term fraud, missing traders, retailers, group registrations, computer fraud." Separately detailed notes are given on some 50 types of traders to inform the inspector on the characteristics of the trade, the accountancy used, special forms of evasion, and special points to be covered on visits.

unannounced and sometimes carrying out a duplicate audit a week or two after an officer's visit. All in all, control visits (or, most important, the threat of control visits) are the heart of the VAT and need to be successfully planned, executed, and monitored according to well-documented procedures.

6.5 Computers

There is one point (in addition to Tait 1988, Ch. 15) I would wish to emphasize. The expansion of capacity and speed of desktop computers has meant a huge expansion in the applicability of computers to VAT. Computing can be decentralized to regions and districts. No elaborate airconditioned and humidity-controlled environments are needed. Local supervisors can be given more responsibility and information can be sent on disks by courier. This decentralization gives more power to smaller centres but also gives central management a crucial measure of the effectiveness of their local supervisors.

Typically, such desktop computers can be bought off-the-shelf as can most of their programs. Their costs are remarkably low and they can be plugged in quickly. Altogether the flexibility and relative cheapness of such EDP systems is a most attractive development of the last few years.

7 Final Comments

What are some of the messages for Malaysia from this rapid survey of the current state of the VAT?

First, there is no doubt about the continuing popularity of VAT. In the last year five more countries have expressed an interest to introduce a VAT. The Japanese experiment in using an accounts based VAT is unique. This method is administratively more simple and cheaper to operate. However, it means only one rate can be used, there is a lag in collection, the audit trail is weakened, the cross-check between VAT and profits taxation is eliminated, and there is a potential confusion between sales tax and income tax liabilities. The introduction of VAT is not necessarily inflationary. Regressivity may be moderated It is a relatively straightforward tax to apply and with which to comply.[5]

Second, it is clear that VAT is not a tax to be introduced in a hurry. As the timetables and priority organization charts show, a careful logical sequence should be followed. If this is not done the authorities are left to try to catch up with registration (Indonesia) and audit (Philippines) as the tax starts running. This creates unreasonable demands on the administration and, in the worst case, can jeopardize revenue. The rewards of careful preparation and comprehensive public relations (Korea and New Zealand) are a smooth transition from the old taxes to the VAT and a revenue yield that exceeds forecasts. Not only is revenue greater

[5]For example, approximately only one VAT accountant or lawyer is needed in private tax and law offices in Europe for every 25 income tax specialists.

but frequently far more businesses are "discovered" through the VAT than through income taxation (New Zealand and Spain).

Third, newer VATs (and some older VATs) are adopting fewer rates and fewer exemptions. The costs in administration and compliance mount sharply as rates multiply. Equity can be more accurately achieved through other forms of taxation on income and wealth and through transfer expenditures. Exemptions should be few, clearly expressed, and comprehensive. Thresholds for liability to VAT should not be expressed by traders or groups (e.g., retailers or wholesalers) but simply by turnover. The turnover specified should be sufficiently high (e.g., say, US$50,000) to cut out the smaller manufacturers, farmers, retailers, and wholesalers. It is better to err on the high side for the exemption limit so that at least, initially, staff can concentrate on securing revenue from larger concerns; over time inflation may push smaller traders into the VAT unless the threshold is raised.

Unprocessed food, as a very limited list of products, can be exempted. Capital goods should be allowed fully as a credit. Financial services should be exempt from VAT but might be taxed by a separate schedule.

VAT audits should not be confused with audits for income taxes. They are better thought of as "control visits", carried out by non-accountants, taking a relatively short time. There should be a fairly high probability for a business to be audited (especially in evasion-prone trades, e.g., builders, hotels, and restaurants). It is important to design and follow a carefully prepared VAT manual. The emergence of cheap desktop computers has greatly expanded the options of giving substantial VAT administrative independence to region and district level offices.

All in all, the VAT continues to prove itself one of the better and more durable tax initiatives of the last 30 years. The range of countries that now use the VAT shows it to be a tax for all times and climes.

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Commentary

Ali Abul Hassan bin Sulaiman

I congratulate Dr. Alan Tait on a very comprehensive paper. Dr. Tait has divided his paper into four parts.

Why VAT?

The first part deals with the arguments for a value added tax (VAT). The major points he brings out are:-

- It is widely used, in 49 countries around the world.
- It has high revenue-yielding potential.
- If properly planned, it can lead to fewer economic distortions.
- It can replace existing sales tax.

Each country has its own objective(s) for introducing the VAT. In the Malaysian case, if ever VAT is introduced, it would be because of its high revenue-yielding potential. Cross country experiences show that revenue yield has been significant, as high as 30 to 40 per cent of total revenue or about 10 per cent of GDP in some countries.

Malaysia presently imposes a sales tax at the manufacturers level and on imports. In view of the high number of exemptions as well as the limited scope of the tax, the revenue collected from sales tax in 1988 was about $1.4 billion or 6% of total revenue. Instead of introducing VAT, one alternative would be to extend the sales tax to the retail level, with a cut-off point for exemptions. However, the extension may lead to reduction in revenue because of revenue leakages arising from the system of sales tax which depends on the ring system for its operations. The existence of a credit mechanism in VAT ensures that leakages are minimized. Under the VAT system, if exemptions are given, some revenue would still be forthcoming in the form of VAT paid on inputs. The high revenue allows us to reduce direct taxes.

In the first part of his talk, Dr. Tait also raised a new point, that is the choice between an invoice-based VAT and an account-based VAT. Dr. Tait's arguments seem to indicate that he does not seem to favour an account-based VAT. He noted that although an account-based VAT is easier to administer and compliance cost is less, there are several defects in the system. Perhaps Dr. Tait may wish to give his personal view on the choice between these two systems.

Vat Rates

In the second part, Dr. Tait deals with the rates of VAT. I agree with him that we should go for a single rate. At present, we have three rates for the sales tax, 5 per cent, 10 per cent and 15 per cent (four, if we include the zero rate, applicable to say, exports). Most goods are subjected to the 10 per cent rate; the other rates have been imposed to gain general acceptance of raising revenue by extending the sales tax to cover a wider range of goods. Similarly, in the case of VAT, while a single rate is ideal, socio-political reasons may force the adoption of more than one rate.

Exemptions and Zero Rating

The third part of his paper deals with a controversial area: exemptions and zero rating. In designing and implementing a VAT, this is one area where we feel that most discussion should take place.

As I observed earlier, a reason for the low revenue from sales tax is the high number of exemptions that have been granted to various types of goods. At present, basic building materials, medical equipment and health products, educational and reading materials, tourist items and petroleum products are all exempted from sales tax. Inclusion of these goods in the VAT is necessary to ensure increased revenue. However, this could then make the VAT less acceptable than the existing sales tax.

I agree that we should grant some form of exemption to unprocessed products in the agricultural sector and to capital goods, such as plant and machinery. Exclusion or exemption of agriculture from VAT has its attractions, but where agricultural produce becomes an input for the manufacturing of some other goods, then the issue of double taxation arises and the question is whether it would not be better to zero-rate this sector instead of allowing users of agricultural produce a presumptive fiscal credit on the value of their purchases of agricultural produce. However, the alternative of allowing zero rating is also not attractive as it would not only increase the administrative burden and cost of compliance, but would also open the doors wide open to abuse and loss in revenue.

While Dr. Tait's paper makes a strong case for excluding the financial services sector, he is somewhat silent on the imposition of the VAT on other services such as professional services, electricity and other activities such as water supply. An additional area is that of the construction sector, particularly that for housing. Dr. Tait may wish to comment on whether such activity should be part of VAT, or should be excluded in view of the structure of the housing industry and on equity grounds.

Administration of VAT

The fourth part of the paper deals with the administrative aspects of VAT. The most crucial aspect touched upon is exemption limits, that is the choice of threshold for liability to tax. The general feeling expressed is that it is sensible to adopt a higher rather than a lower tax threshold because the administrative resources needed will be less and there will be less resistance from small businessmen. It was also pointed that in Japan the value added tax only applies to traders with a turnover of US$3.5 million and above, and that a simplified scheme based on turnover is used for enterprises below a turnover of US$3.5 million. What is a reasonable cut-off point for VAT? Is it advisable to have a high cut-off point and continue with a sales tax for those below the cut-off point in order to ensure that there is no substantial revenue loss?

Concluding Remarks

Finally, there are a number of issues that Dr. Tait has rightfully excluded since his paper deals with designing and implementing VAT. These issues are important for countries which are planning to implement VAT. In this regard, I refer to the criticisms that are levelled against VAT: (i) it is regressive since it imposes a greater burden on the lower income group and; (ii) it increases the cost of goods and therefore leads to inflation, which in turn affects the poor. From a political angle, the implementation of the VAT can be a problem, especially when the Government, while reducing corporate and other direct taxes, and providing incentives to industries, passes the burden of financing development to the consumers through a broad based consumption tax such as VAT. In order to make the VAT acceptable, how should concerns such as these be taken into account in designing the VAT? For example, New Zealand has introduced a supplement programme to compensate low income families. Such a programme would be difficult to implement in a developing country, as it would require substantial resources.

PRIVATIZATION: PERFORMANCE, PROBLEMS AND PROSPECTS

Mohd. Sheriff b. Mohd. Kassim

Having privatized twenty-two projects within five years of policy implementation, Malaysia's achievement in respect of her privatization policy can be considered creditable by international standards. Methods used have been varied, including divestment of ownership, leasing, management, contract, contracting out, licensing and "build-operate-transfer".

Measured against the objectives it was designed to achieve, the policy has been a success. Several indicators testify to the increase in efficiency and growth it has brought about, the administrative and financial burden it has relieved the Government of, the reduction in the size of the public sector it has resulted in and the New Economic Policy objectives it has helped to achieve.

Nevertheless, the implementation of the programme has not been problem-free. Among the problems faced are resistance, particularly from government employees, legal impediments, inadequate implementation machinery, and inadequate supply of capable managers.

To provide the Government with a clear direction in steering the programme, a Privatization Masterplan study was embarked upon. The study identified six central requirements for an expanded and accelerated programme. Firstly, privatization must be a part of a wider process of economic reform. Secondly, its strategies must be tailored to national objectives. Thirdly, the implementation machinery needs to be improved. Fourthly, staff sensitivities must be carefully handled. Fifthly, changes in the laws are needed and lastly, support for the programme needs to be enhanced.

The study has proposed an Action Plan based on an analysis of a sample of 434 Government-owned-entities (GOEs) in terms of their feasibility and desirability for privatization. (The GOEs have been classified by industry and timing of privatization.) The Masterplan seeks to strengthen the programme further in the future.

1. Introduction

The privatization policy in this country is now about six years old. The first part of the paper shows that by international comparison, the country's achievement in the implementation of this policy is quite creditable. However, much remains to be done to strengthen the programme. The paper first elaborates on the achievements in implementation of the policy and analyses its impacts. The problems and obstacles encountered are discussed next. Finally, the paper highlights some of the issues that are addressed in the forthcoming Privatization Masterplan. It is not the intention of this paper to discuss the philosophy of the privatization policy; it is presumed to be well-understood and accepted by now.

2. Review of Achievements

In reviewing the achievements thus far, the Malaysian privatization programme shows up well against the experience of other countries within this region. Since the adoption of the privatization policy announced by the Government in 1983, twenty-two projects have been, or will be, privatized (Table 1). Nevertheless, the Government had undertaken privatization activities even prior to 1983, by way of divestment of companies. About forty government companies had been divested to Permodalan Nasional Berhad (PNB) and thereafter to the Amanah Saham Nasional (ASN) Unit Trust holders, and another forty-one such companies were sold to individuals and companies. However, for the purpose of this review, attention is focused on the twenty-two projects privatized since 1983.

2.1 Methods of Privatization

Although the number of projects privatized is not large, the methods used are quite varied. In fact, for two projects a combination of methods have been used (Table 1). Privatization may involve existing projects, that is, those that have already been developed by the Government, or new projects which would normally have been implemented by the public sector. Of the twenty-two projects, nine are new projects while the balance are existing projects. Six of the existing projects were privatized through divestiture of ownership by way of offer for sale to the public or by way of private placement, two through leasing, four through management contract, and one through corporatization. Of the new projects, four were privatized following the Build-Own-Transfer (BOT) concept while the remaining two were privatized via licensing or contracting out to the private sector.

2.2 Review of Performance by Objectives

The success of any policy should be judged against the objectives it is designed to achieve. Privatization, like any other policy, is merely a means to an end and not an end in itself. As is widely known, the privatization policy hopes to achieve five objectives, that is,

- raise efficiency and productivity;
- accelerate growth;
- relieve Government's financial and administrative burden;
- reduce the size of the public sector; and
- achieve the objectives of the New Economic Policy (NEP).

Table 1
Privatization Projects of the Malaysian Government

Existing Projects	*Method*
Sports Toto Berhad	Sale of shares (private placement)
Malaysian Airline System Berhad	Sale of shares (public listing)
Malaysian International Shipping Corporation Berhad	Sale of shares (public listing)
Tradewinds (M) Berhad	Sale of shares (public listing)
Cement Manufacturing Sarawak Berhad	Sale of shares (public listing)
Maintenance of RMAF Aircraft	Leasing
Container terminal operations, Port Klang (KCT)	Sale of shares (private placement) and leasing
Taman Negara Facilities	Leasing (privatized but failed)
Sungai Semenyih Water Supply	Management Contract
Marketing Advertising Time of Radio Malaysia	Management Contract
Maintenance of Water Boreholes in Labuan	Management Contract
Marketing Division of RISDA	Management Contract
Jabatan Telekom	Corporatization
North Klang Straits Bypass	Build-Own-Transfer
Jalan Kuching-Kepong Highway Interchange	Build-Own-Transfer
Water Supply to Labuan	Build-Own-Transfer
KL Roads and Interchanges	Build-Own-Transfer
North-South Expressway	Build-Own-Transfer
Labuan Beaufort Interconnection	Build-Own-Transfer
Commercial TV Station (TV3)	Licensing
DBKL Waste Disposal	Contracting-out
Ipoh Water Supply	Build-Own-Transfer and Management Contract

2.2.1 *Raising Efficiency and Productivity*

Given the brief history and experience, it is difficult to make generalizations regarding the impact of the policy on efficiency. However, there are clear indications in many cases that privatization has led to increased efficiency. Several examples are cited below.

- The licensing of TV3 has introduced competition into the television industry hitherto monopolized by the public sector, thereby setting new standards to the benefit of the viewing public.
- Prior to the privatization of the container terminal, the average turn-around time per vessel was 11.7 hours. Two years after privatization, the turn-around time had been reduced to 8.9 hours per vessel. Aggressive marketing by the company (KCT Berhad) partly accounted for the increase in throughput from 244,120 TEUs (1113 ships) in 1985 to 273,335 TEUs (1257 ships) in 1987.
- Since its corporatization, Syarikat Telekom Malaysia Berhad (STMB) has instituted several improvements. For example, the introduction of the detailed billing system has reduced errors and complaints, the marketing of new services has increased its earnings, counter services have improved and there is faster response to applications for telephone installation and to breakdowns.
- The Labuan Water Supply Project was completed ahead of schedule and within budget. The solution proposed by the private sector was much less costly than that initially put forward by the public sector authorities.

2.2.2 *Accelerating Growth*

Privatization has led to economic growth in at least three ways. Firstly, the efficiency gains that ensue following privatization have led to growth in the sense that more output is produced using a lesser amount of resources.

Secondly, resources that are released as a result of efficiency gains are being actively used for corporate expansion. For example, STMB has introduced several new services, marketed aggressively and has upgraded services that were scarcely known prior to privatization. These include the Malaysian Packet Switched Public Data Network (MAYPAC), a second Automatic Telephone Using Radio (ATUR) network, INTELSAT Business Service, telebanking, International Direct Dialling Service, Datel Service, private leased lines and others.

Thirdly, growth has been generated in a more direct manner through the various Build-Own-Transfer (BOT) projects and licensed activities. These have encouraged private entrepreneurship in sectors previously the domain of the Government and have permitted an enhanced rate of infrastructural project implementation at a time when the public sector is cutting back its development expenditure.

2.2.3 Relieving Financial Burden On Government

The Government's financial burden has been relieved in two ways. Firstly, the one-off proceeds from sale of Government interests in companies have to an extent helped to reduce Government borrowing to finance Government expenditures. However, the realization of proceeds from privatization is only incidental and does not represent a primary objective of the Government. To date, the sale of Government-owned shares has generated some $755 million in terms of proceeds. Apart from these one-off proceeds, recurrent revenue from privatization comes in the form of lease payments as in the case of KCT, and more generally, in the form of corporate tax. In addition, the exposure of the Government in privatized projects is also rapidly declining with loan refinancing activities undertaken by STMB and the Malaysian International Shipping Corporation (MISC), particularly.

However, the main financial relief comes from the savings on BOT projects. The savings represent the amount the Government would have had to expend if the projects had not been privatized. The total estimated cost of BOT projects to date is about $4.9 billion.

2.2.4 Relieving Government's Administrative Burden

Privatization has succeeded in reducing the administrative burden of the Government, particularly in terms of personnel and financial administration. The relief has been very marked with the privatization of big projects and organizations like the Jabatan Telekom which had some 29,000 employees and average annual recurrent and development expenditures of $831 million and $1,371 million, respectively, prior to corporatization. Its privatization as STMB has greatly reduced the administrative responsibility of the Public Services Commission and the Public Services Department in terms of hiring and firing, promotion and training of personnel, and the like. It has also greatly reduced the administrative responsibilities of the Treasury, the Ministry of Energy, Telecommunications and Post and the Economic Planning Unit (EPU) in terms of budget, contract and financial administration as well as detailed monitoring and supervision of project implementation. However, privatization of Government functions or entities, particularly monopolies, does not mean that the administrative responsibility of the Government will be removed altogether, since private monopolies need to be regulated so as to protect consumers' interest. Nevertheless, the extent of administration required for regulatory activities is much less compared to the degree of administration required in running the monopoly itself.

The privatization of new projects has also avoided the increase in administrative responsibilities. These projects involve a capital expenditure of $4.9 billion and personnel numbering about 1,650 in total.

2.2.5 Reducing The Size Of The Public Sector

Privatization has quite appreciably reduced the size of the public sector. In terms of personnel, privatization has managed to reduce the public sector workforce (that is, in government departments and statutory bodies) by about 30,000. As mentioned above, privatization has also allowed the Government to avoid a substantial amount of capital expenditure arising from the BOT projects. In addition, a substantial amount of capital expenditure has been avoided by privatizing existing organizations such as the Jabatan Telekom which is continuously developing to meet the growing demands of the public to be abreast with technological advancements that are continuously taking place.

2.2.6 *Achieving the Objectives of the NEP*

Poverty is mainly a rural phenomenon. At best, privatization can only help alleviate it indirectly. However, by privatizing commercially viable new projects via the BOT concept, the Government has been able to re-channel its funds from these projects towards areas where poverty relief measures are needed more urgently.

In respect of the restructuring target of the NEP, the privatization programme has helped to increase Bumiputera participation in the corporate sector. Most of the privatization projects had at least 30 per cent Bumiputera participation, and Bumiputera promoters have played an important role in the development of new projects.

3. Problems

As often occurs with new programmes, the privatization programme has faced a number of problems in implementation. These are discussed below.

3.1 Resistance

The privatization of existing projects, more often than not, has seen resistance from several quarters, particularly the employees and the management, and to some extent the consumers. The profit motive of the private sector presents a threat to the worker. There is always a fear that this motive may encourage the management of the privatized project to undertake cost-cutting measures, the worst form being retrenchment of the workforce. It cannot be denied that there is a higher degree of job security in the public sector as compared to the private sector. Retrenchment by the Government through the abolition of posts due to redundancy, though feasible, is quite unheard of. In addition, disciplinary action undertaken against errant employees is time-consuming and cumbersome.

Recognizing this threat and also that many government agencies are overstaffed, the Government imposed two conditions to protect the interests of workers upon privatization: no employee of privatized entities should be retrenched on account of redundancy, and all employees of would-be privatized entities must be offered terms of service no less favourable than those they are currently enjoying. Any redundancy has to be dealt with through natural attrition and expansion of activities. Employee support was also obtained through share-ownership opportunities. In all privatizations through public offer, 5 per cent of the offered shares were reserved for employees. Not only does the employee share-ownership scheme help to garner employee support of the policy, but it also works to imbue a sense of belonging and dedication in workers, thereby promoting productivity enhancement.

The level of cooperation from controlling government ministries and departments in the initial stages of policy implementation depends on their level of understanding of the policy. Public relation efforts were undertaken to increase their awareness of the policy and to enlist their cooperation in its implementation. In this connection, a measurable degree of success has been achieved.

The anxiety of consumers in respect of privatization, particularly where privatization of monopolies is concerned, is focused on the likelihood of increased tariffs and lowering of service quality as a consequence of the heavy stress of the private sector on profit maximization. However, as long as these impacts are not felt, the average consumer will be quite indifferent about the policy. It is difficult to gauge general consumer response towards the policy at this juncture as consumers are not much affected as yet by privatization efforts, except in the areas of telecommunication services and transportation. However, there seems to be an increasing awareness on the part of consumers that nothing comes freely, that is, "one pays for what one gets and one gets what one pays for".

3.2 Capital Markets

In implementing the privatization policy, due cognizance must be given to the absorptive capacity of the capital (both debt and equity) market, particularly the domestic one. Privatization will not succeed if the absorptive capacity is inadequate.

The Malaysian equity market is relatively well developed by regional standards, but nevertheless suffers from inadequate liquidity, limited sectoral coverage and limited participation by institutions. Thus far, all privatizations through public flotation have succeeded. The average annual flow of funds into the equity market in recent years has been around $1 billion. But there are grounds to believe that growth has been held back by inadequate supply of quality issues. In fact, all of the issues have been oversubscribed between 1.2 to 87.8 times.

Privatization has helped broaden and deepen the Malaysian stock market. It has increased market capitalization and introduced new sectors into the market, thus offering the investing public a varied choice of stocks. Much more can be absorbed if good market conditions hold and attractive issues are available. Nevertheless, in planning privatization exercises through public flotation, care must be taken to ensure that privatization issues do not crowd out private sector issues and private sector investment in real capital formation.

As for debt capital, privatization involves refinancing of government debt as well as the creation of new debt. In this connection, the domestic banking system is well developed to meet the demands of privatization. However, the securitized debt market has to be developed further to provide the private sector alternative sources of debt capital.

3.3 Legal

Many of the laws in this country were drafted without privatization in mind. Hence, many of them have provided unintended obstacles to the privatization programme. These laws relate mainly to the functions of and activities carried out by the government, land, civil service provisions and taxation.

Most of the legal obstacles with respect to land matters, especially transfer of ownership, have been removed through amendments made in 1987 to Articles 83, 85, and 86 of the Constitution. The legal constraints in respect of civil service provisions, especially for pensions, have also been surmounted by amendments made in 1980 to the Pensions Act and the Statutory and Local Authorities Pensions Act.

Transfer of government functions or activities, particularly of departments and statutory bodies, have faced legal constraints. These functions most often are bound by laws such that the transfer thereof to the private sector requires amendments to the relevant Acts. Amendments to the law are, by the very process, time-consuming.

3.4 Management

One of the prerequisites for the success of the privatization programme is an adequate supply of efficient managers. This is one basic resource with which this country is not richly endowed. As the Prime Minister noted at a conference on privatization in July 1988,

> "Management is not one of Malaysia's strong points. In the first instance, we do not have enough managers.... If privatization is going to remedy the ills of nationalization, then we must have good managers".

The dearth of good business managers may be attributed to the growth of the public sector during the last decade and the early part of this decade. The public sector with its multiplicity of objectives, its much protected environment, and bureaucratic traditions has not produced many managers with business skills and risk taking habits.

Privatization involves a change in working culture and environment to which both existing management and worker groups need to adapt themselves. This process takes time to produce results. Hence, privatization is not expected to produce dramatic changes overnight.

3.5 Machinery

For any programme to be implemented successfully, an efficient machinery needs to be in place. The existing machinery for implementing the programme suffers from a number of shortcomings. These are

a) a lack of integration, as several units are involved, namely the Economic Planning Unit, Industrial Coordination Unit, the Treasury, other Ministries;
b) inadequate personnel both in terms of number and expertise;
c) insufficient priority given to the exercise by several participants in the machinery; and
d) overly centralized concentration of decision-making authority at the top level of the machinery.

These shortcomings inevitably lead to slow and uncoordinated implementation.

4. The Privatization Masterplan

Recognizing the problems that have been faced in implementing the policy, and the need for clear direction in steering the programme, the Government decided to embark on a Privatization Masterplan study in 1988. This study is nearing completion. The Masterplan will address all of the problems mentioned above and several others, and will recommend various lines of action in order to strengthen the programme.

The Privatization Masterplan study has identified six central requirements for an expanded, accelerated and effective programme. The first two relate to the overall policy framework. The other four relate to actual implementation of the programme. These are discussed in the following paragraphs.

4.1 Privatization Must Be a Part of a Wider Process of Economic Reform

Firstly, the argument for privatization is premised on the belief that *entrepreneurs reacting to market signals will make better decisions than public servants responding to administrative directives.* To allow this change to be realized, privatization must be accompanied by the granting to privatized entities of *commercial freedom to respond to market signals and opportunities.* Hence, existing regulation of private sector activity will need to be reviewed. These, among others, include regulation of pricing of inputs to production, regulation of terms of employment and regulation of investment decisions.

Residual involvement of the Government in privatized activities needs to be minimized. Where possible complete divestment should be aimed at. Where this is not possible, *the residual Government holdings should not be used in a way that conflicts with the commercial objectives of the company.*

Secondly, changes in management style are required to adapt to a fully commercial environment. Within the business, management structures should be reorganized to reflect new priorities. Relations between the Government and privatized entities should be at arms length even though the former may have participation in the latter. The new service conditions should provide performance incentives. While in the short term, the managers needed for privatized concerns can be drawn from the existing pool of entrepreneurial talent within the public and private sectors, in the long term a sharper focus on training and development of middle level managers will be needed, despite the fact that the new opportunities created by privatization should directly encourage more rapid development of managerial talent. In complex privatizations, the process of change will be protracted and is highly dependent on the top management. The ability of top management to spearhead privatization must be given due recognition but any changes to the top leadership that are to be effected must be handled sensitively.

Thirdly, supplementary policies are needed to ensure that market behaviour fulfils national objectives. This means Government influences private sector behaviour indirectly and in a predictable manner. These policies may relate to the system of taxation or subsidy, or provision of indirect assistance through infrastructure, training or research. In general, these policies will influence private sector activity rather than direct it.

Improvement in efficiency can be effectively achieved in the presence of competitive pressures. Hence, privatization ought to be accompanied by regulatory reform. Reform is needed in two areas, *the lowering of barriers to competition; and in non-competitive areas such as monopolies, the introduction of regulation to stimulate beneficial pressures exerted by competition.*

Where monopolies remain, effective regulation is essential to protect consumers' interests. The general guiding principles for a regulatory framework are (i) that discretionary powers to intervene in the commercial decisions of the privatized entity should be avoided to minimize uncertainty and preserve the scope for commercial initiative, and (ii) that powers to regulate price increases and quality of service should be closely defined. Although the mechanics for each monopoly will differ, considerations have been given to the location of regulatory powers outside the government ministry concerned to reduce the risk of general discretionary intervention. More specifically, the Masterplan study has considered the establishment of a single *Federal Regulatory Commission* regulating many industries rather than having a separate body for each industry; its merits being that it will be a stronger commission, experience from one industry can be applied to another and there will be economies of scale in staffing and other costs.

Recognizing that many government entities have significantly higher staffing levels than those justifiable on commercial grounds and given the condition that privatization should not result in increased unemployment, several short term solutions have been considered, including the encouragement of new activities by privatized companies, retraining, more flexible work practices, and voluntary retirement schemes. However, long-term *employment policies* will need to be developed in order to ensure that better use is made of the country's manpower resources, irrespective of whether the enterprises are privatized or not.

Fourthly, *privatization will require a substantial increase in the supply of capital available to the private sector*. Although the size of potential demand for equities is estimated to be large, it is highly dependent on the overall funds available to potential investors as well as overall market confidence. A package of policy measures to underpin this demand has been considered. It includes, among others, promoting wider share ownership, encouraging the issue of partly paid shares, promoting unit trusts, relaxing restrictions on employee participation in equities, reviewing present investment guide-lines of institutions and selective permission to foreign investors to participate in large initial issues.

4.2 Privatization Strategies Must Be Tailored to National Objectives

Firstly, recognizing the need for consistent principles governing the choice of privatization candidates and the strategies to be followed, an action plan has been recommended to help channel efforts to priority areas in a more organized manner, so that the programme as a whole acquires momentum and credibility. Priority is based on the feasibility and desirability of privatization. A relatively large number of government functions and entities has been reviewed and each has been classified into various categories, each of which in turn requires a different set of actions to be taken for privatization. The actions needed for each candidate will dictate the timing for its eventual privatization. Even with the setting out of an action plan by the Government, there should still be scope for the private sector to initiate privatization so as not to stifle entrepreneurship. In this connection, guide-lines governing response to each proposal must be made clearer.

Secondly, privatization may involve the transfer to the private sector three elements of an entity, the authority to manage, present assets and existing employees. However, it is not always possible or desirable to transfer the ownership of assets at the same time as the other two elements. Hence, a process of phased privatization may be called for. As a general rule, however, to achieve the best results and the objectives of privatization, a total transfer that includes all the elements to the private sector is preferred.

4.3 New Integrated Machinery is Needed to Prepare and Take Decisions Quickly

The present machinery has been found to be inadequate to handle an expanded programme. Administrative reform has been proposed along the theme of centralised planning but decentralized implementation. In addition, to assist implementation, a *Privatization Fund* has been proposed in the Masterplan Study. While privatization is self-financing, the revenue raised is currently not directly available to finance expenditures required or desirable for further privatization. The creation of the Fund is expected to solve this problem. Some of the uses that have been identified are financing of specialised expertise drawn from the private sector, financing of restructuring measures which are essential for successful privatization, and financing staff retraining and staff relocation.

4.4 Staff Sensitivities Must Be Carefully Handled

The cooperation of employees of to-be privatized government entities is vital to successful privatization. To ensure this, greater efforts must be made to involve employees at an earlier stage in privatization. The terms and conditions for the transfer to the private sector need to be clarified, and a generous share ownership scheme should be used to obtain employee support.

4.5 Changes in the Law Are Needed

To avoid the need for amendments required to individual acts, the enactment of an umbrella *Privatization Act* has been proposed in the Masterplan Study to codify legal procedures common to all privatizations. The Act, however, is not expected to address specific obstacles which must be resolved by the privatization plan for the entity. Amendments to the tax laws have also been suggested to reflect the principle that privatized entities should be taxed on the same basis as other private entities. Enabling provisions regarding the award of tax incentives and concessions have also been suggested in cases where privatization of a function is judged to be desirable but found to be not feasible in the absence of such incentives.

4.6 Support for the Programme Must Be Enhanced

The current image of privatization is at best neutral. The benefits of privatization must be made known within and outside Government to enhance support for the programme. Public relations exercises targeted at specific groups, such as employees, civil servants, the financial community and the consumers, need to be developed.

4.7 Action Plan

Apart from laying down the various outstanding issues relating to privatization as discussed above, the Privatization Masterplan has also come up with a tentative Action Plan. The formulation of this Action Plan is based on an analysis of a large sample of 434 government-owned-enterprises (GOEs) both in terms of feasibility and desirability. A privatization programme based on the result of this analysis is proposed as in Table 2.

The privatization programme envisaged in the Masterplan cuts across all levels of Government, that is, the Federal, State, and Local Government functions as well as the Non-Financial Public Enterprises (NFPEs). Likewise, the programme also cuts across the various economic sectors with concentrations in three major sectors, manufacturing, agriculture and transportation. In terms of the time frame

Table 2
Summary Indicators of Masterplan Programme

	100 Agri-culture	*200 Forestry & Logging*	*300 Mining & Quarrying*	*400 Construc-tion*	*500 Manufac-turing*	*600 Transport-ation*	*700 Utilities*	*800 Finance*	*900 Marketing & Distri-bution*	*1000 Hotel & Recrea-tion*	*1100 Medical*	*1200 Real Estate*	*1300 Other Services*	*1400 Investment Holding*	*1500 Govt. Adminis-tration*	*Total*
GOEs Involved (Number)																
Classification 1	12		4		11	9	4	3	2	6		5	8		5	69
Classification 2	14	3	2	2	23	10	9	6	8	9		2	15		4	107
Classification 3	5	1	3	1	4	2	1	2	1		12		38			70
	31	4	9	3	38	21	14	11	11	15	12	7	61	0	9	246
Employees Involved (Number)																
Classification 1	5681		382		5415	15640	35551	3453	263	164		134	6689		2006	75378
Classification 2	10369	2031	249	267	6592	14615	34137	4845	1477	2022		87	3121		708	80520
Classification 3	314	152	804	765	909	502	585	182	1431		21041		15529			42214
	16364	2183	1435	1032	12916	30757	70273	8480	3171	2186	21041	221	25339	0	2714	198112
Emoluments Involved ($'000)																
Classification 1	25043		2265		35114	164221	224453	48873	3091	1115		1564	53262		20473	579474
Classification 2	65596	19867	1952	2980	85102	126299	338771	57818	18587	11305		540	24148		7473	760518
Classification 3	2445	1458	14698	8410	16740	4467	2020	2925	2855		196843		160338			413199
	93084	21325	18915	11390	136956	294987	565244	109616	24533	12500	196843	2104	237748	0	27946	1753191
Value Involved ($'000)																
Classification 1	420158		13385		327063	871234	1000000	512179	40534	80497		260290	0		0	3533341
Classification 2	949041	335115	0	18731	514771	970462	6002895	547792	93100	89724		11921	42936		0	9576489
Classification 3	2790	0	206675	1236113	1307612	0	0	209665	264300				0			3227155
	1371989	335115	220060	1254044	2149446	1841696	7002895	1269635	397934	170222	0	280212	42936	0	0	16336981

for implementation, 69 projects are identified to fall in Category 1 which is defined as privatizable in the short term (within 2 years), 107 in Category 2 which is considered as privatizable in the medium term (2-5 years) and the remaining 70 projects in Category 3 which represents projects privatizable in the long term (over 5 years).

Obviously, the Masterplan is not meant to be a rigid document. Some additions and deletions of projects from the proposed privatization programme are only to be expected as situations may alter the desirability as well as the feasibility of a privatization candidate. The Masterplan is meant to provide an indicative Action Plan for the Government and to provide a set of procedures for solving problems raised by privatization. It presents a map for the privatization programme and not a single path. The Masterplan should be treated as a dynamic and practical document and should be adapted and updated as experience is gained.

5. Conclusion

As observed in the introductory remarks, although this country has achieved some success in implementing the privatization policy, much needs to be done to strengthen the programme. It is hoped that the Masterplan will help in this direction and make the programme more efficient.

Commentary

Malek Merican

Introduction

Since I have been asked to be a commentator on Dato' Sheriff's paper, and Arab-Malaysian Merchant Bank is one of the Consultants to the Privatization Masterplan (PMP), I should say at the outset that views expressed here are my personal views, and not necessarily those of the Bank, or of the Consultants.

Dato' Sheriff, as the Secretary General to the Economic Planning Unit, is the Chairman of the Inter-Departmental Committee on Privatization and is directly responsible for the privatization programme. Hence, he has been able to give us an authoritative and very useful review of performance, problems and prospects relating to privatization.

The progress to date is creditable by international comparisons and very advanced by regional comparisons. As of June 1989, twenty-two projects had been privatized, apart from some forty trust companies that had been divested to the Permodalan Nasional Berhad and another forty-one companies that had been sold to Bumiputera individuals and companies. In examining the list of twenty-two projects that is provided in Table 1 in Dato' Sheriff's paper, one is impressed that the list includes the public listing of six companies with a current market value of \$8.3 billion (accounting for 6.4 per cent of the total Kuala Lumpur Stock Exchange (KLSE) market capitalization as of June 1989). The list also includes the privatization of the North South Expressway and six other Build-Own-Transfer (BOT) projects which is said would have cost the Government \$4.9 billion if these projects had not been privatized. The list includes the corporatization of the Jabatan Telekom, a major step towards its eventual privatization and public listing. However one assesses the list of twenty-two projects that have been privatized, whether in terms of capital value, projected capital expenditure or employment, we have to recognize that the privatization programme is proceeding apace. After five years of effort, the Malaysian privatization programme compares favourably with those of many other countries.

Although the PMP has not been made public, we are fortunate that Dato' Sheriff has given us a preview of some parts of the plan. I will focus only on certain features of the PMP that he has revealed to us.

The Action Plan

At the core of PMP is a tentative Action Plan. This Action Plan, he has revealed, is based on an analysis of 434 Government Owned Enterprises (GOEs), which have been analyzed in terms of the desirability and feasibility of privatizing these "candidates". His Table 2 lists 246 candidates for privatization. In terms of the time-frame for implementation, 69 projects/candidates are grouped in Classification 1 which is defined as privatizable in the short term (i.e., within 2 years); 107 under Classification 2 which is considered as privatizable in the medium term (i.e., between 2 and 5 years); and the remaining 70 projects under Classification 3 which represent projects considered privatizable in the long term (i.e., over 5 years). These 246 project candidates employ 198,112 employees with annual emoluments of $1,753 million. The projects are also somehow valued at $16,336 million.

"Utilities" account for 14 projects, 70,273 employees with emoluments of $565 million per annum and are somehow valued at $7 billion. The table whets one's curiosity. Do the big numbers for "Utilities" include the privatization of the Jabatan Telekom which is grouped under Classification 2 rather than Classification 1? One can ponder about the extent of this privatization programme. For example, twelve projects under "Medical" with 21,041 employees is grouped under Classification 3, that is, privatizable only after 5 years. For some reason, these projects have zero value.

Alternatively, one may speculate about where the big flagships are in this Privatization convoy. Jabatan Telekom and Lembaga Letrik Negara must be among the biggest and presumably in Classification 2. Then there is the Jabatan Pos which may be in Classification 1. Where is the Malayan Railways classified with its value of supposedly not more than $1?

We will have to wait for the PMP to be published or more tables to be provided to answer many questions. But there is no doubt that the PMP covers a lot of projects employing a lot of people and has a large aggregate value. The summary indicators of the PMP Programme in Table 2 indicates that the plan being considered is large and extensive.

A Single Federal Regulatory Commission

At most conferences where privatization is discussed, it has always been emphasized that effective regulation must be arranged to protect consumer interests against monopolies, especially when they have been privatized. The key regulatory objective is to control potential abuse by privatized companies with substantial natural or protected monopoly positions in the market. Regulations should also aim at protecting or promoting competition or competitive forces in an industry.

Dato' Sheriff has indicated that the PMP study has considered the establishment of a single Federal Regulatory Commission to regulate several industries rather than a separate regulatory body for each industry, as is the usual practice in Britain and elsewhere. This novel proposal for a single regulatory commission will no doubt provoke considerable debate.

In its most ambitious form, the proposal is to establish a single regulatory agency with overall responsibility for regulation of privatized monopolies, including telecommunications, power, transport, ports and water. It is argued that the single commission will be stronger, experience from one industry can be applied to another, and there will be economies of scale in staffing and other costs.

On the whole, I am on the side of a single stronger regulatory commission, even though I can see problems if the Federal agency is to oversee, for example, state water authorities and there will be the inevitable initial rivalry of those who may aspire to head commissions for each industry.

A Privatization Fund

The other novel feature of the PMP that Dato' Sheriff revealed to us is the proposal to establish a Privatization Fund. While privatization is self-financing, the revenue subsequently raised from sale of shares or assets is currently not directly available to finance expenditures required for further or other privatizations. It has been suggested that the fund may be used for studies, to finance specialised expertise drawn from the private sector, finance restructuring measures which are essential for successful privatization, and for financing staff re-training and staff relocation. It is an interesting idea and will no doubt facilitate the operations of the Privatization Task Force, and should give a high return on the funds appropriated. On the other hand, it may not be enthusiastically welcomed by the Treasury, which may continue to require a clear case being made for every fund appropriation.

Privatization Act

Among the new ideas mentioned by Dato' Sheriff is the enactment of an umbrella Privatization Act. This is to avoid the need for amendments to individual acts. An umbrella Privatization Act is proposed in the PMP to codify legal procedures common to all privatizations. For example, the Privatization Act could provide for the principle that privatized entities, especially BOT project companies, should be taxed on the same basis as other private entities. Another example is to provide in the Privatization Act powers to enable privatized companies to implement leveraged management or employee buy-outs.

I am sure there will be considerable debate on whether such a Privatization Act will be required at all. Arguments will be made for the relevant laws — income tax, etc. — to be individually amended rather than to have a Privatization Act which will override the specific current laws.

Capital Market Issues

The PMP study had also given considerable attention to possible capital market constraints in implementing a large privatization programme. From Dato' Sheriff's paper, one would gather that capital market limits are not serious constraints. The paper mentioned the desirability of "promotion of wider share ownership, encouraging the issue of partly paid shares, promotion of unit trusts, relaxing restrictions on employee participation in equities [all very commendable and reasonably clear], reviewing present investment guide-lines of institutions [one is tempted to ask which institution?] and selective permission to foreign investors to participate in large initial issues". This last point would refer necessarily to issues to list Jabatan Telekom and Lembaga Letrik Negara, since the listing of MAS and MISC have been successfully undertaken.

Generally it is not surprising that capital market considerations are not a major constraint on the envisaged implementation of the PMP, as our domestic market is already well established unlike in other third world countries.

Concluding Reflections

After a creditable start, there is some query why the Malaysian privatization programme had not gathered more momentum. While we hear about Jabatan Telekom planning to privatize soon through a public listing of its shares, there has been a relatively long silence about the privatization of the Lembaga Letrik Negara and also of the Jabatan Pos. Intermittent announcements relating to divestments by state development corporations (SEDCs) of their subsidiaries have often left the public wondering about how the privatization had been effected, who and how the buyers were chosen, and what are the impacts of these transactions.

The PMP and its Action Plan will be providing us with a clearer view of the privatization programme, its scope and extent, and some indication of the timing of the various privatization candidates. The summary indicators of the PMP Programme provided by Dato' Sheriff (at Table 2) indicate that the programme is large and extensive, even if we focus only on the sixty-nine projects grouped under Classification 1 and the one hundred and seven projects grouped under Classification 2, that is, the projects privatizable within the next five years.

With such a programme, it is desirable to substantially strengthen the privatization machinery. With the creation of a stronger and more integrated privatization machinery, the proposal for a Privatization Fund to speed up financing for studies, and implementation of various exercises should also be seriously considered. A Privatization Act to codify legal procedures common to privatization exercises has also been proposed.

To implement this extensive programme will require substantial sustained political will. The case for, and benefit of, privatization will continue to be argued with each project decision. General support for the programme from employees, civil servants, the financial community and the consumers will depend on how the programme is developed and implemented; and how rationally the asset sales are arranged.

Finalising the PMP study will provide an opportunity for the Government to reaffirm its commitment to implement a more explicit Privatization Action plan.

In the process the public will have more opportunities to discuss aspects of the PMP, which will presumably be made public.

In commenting on Dato' Sheriff's paper, I have no basic problem with the approach adopted and the preview given on the PMP. I am however conscious that among the audience there will be those who would wish for more clarification on certain issues.

There will be those who wish to argue about the extent of the privatization programme. They may wish to argue that water supply and hospitals, among other projects, should not be privatized. Dato' Sheriff has taken the position that the philosophy of the privatization policy is presumed to be well understood and accepted. This type of question may continue to be debated especially when the final decision on the privatization of specific projects is being made.

I am also conscious that a number of people, including Bumiputera individuals, continue to query the basis on which government owned enterprises are sold to particular individuals or private sector companies. There is no problem when shares are offered to the public at time of listing on the Kuala Lumpur Stock Exchange. At the core of the questions is the uneasy belief that some divestments might have been made to political favourites. This type of questioning has to be faced by all governments undertaking privatization programmes. It may be useful if each privatization award is accompanied by a clear statement of the basis on which the award was made.

To conclude, one may emphasise that privatization must be part of a wider process of economic reform. The Malaysian programme to privatize a large segment of the government sector should help to make the Malaysian economy more efficient and competitive. Consequently, I hope that Dato' Sheriff will be able to make available the final version of the PMP and help to steer its successful implementation.

STRUCTURAL ADJUSTMENT AND LABOUR FLEXIBILITY IN MALAYSIAN MANUFACTURING: SOME POST-NEP DILEMMAS

Guy Standing

This paper uses the data of the 1988 Manufacturing Labour Flexibility Survey to examine labour flexibility in Malaysian manufacturing. The analyses show how firms had responded to the shocks of the mid-1980s and suggests how firms could be expected to influence labour market developments in the post-NEP era.

1. Introduction

Malaysia may be one of those countries which experienced successful industrialization without there ever being a period in which manufacturing accounted for anything like a majority of total employment. Policy makers and social scientists in the 1990s may also look back on the growth of labour flexibility in the manufacturing labour market of the late 1980s as not just a response to the international economic crisis of the early and mid-1980s but as a critical phase in the emergence of a modern society and economic structure.

This is not to suggest that the phase is desirable in itself, or even necessary. It does, however, pose a considerable dilemma for those who will have to shape labour market policy in the era following the end of the New Economic Policy (NEP) in 1990. As will be suggested in this paper — albeit tentatively and partially — a more flexible labour market will place a far greater onus on labour policy to provide protection against abuse and insecurity and to provide an environment in which the interests of equity and efficiency are jointly served.

This paper is based in part on the analysis of data from a survey carried out in 1988 of over 2,600 manufacturing establishments across Peninsular Malaysia. The context of the study was particularly intriguing, for the 1988 Manufacturing Labour Flexibility Survey (MLFS) came at the mid-point between the end of the crisis that hit the economy in the early 1980s and the beginning of the post-NEP era. In a sense, the survey was designed to tell a story about what has happened between 1985 and 1990. The story may be deficient in details and unclear in some respects, but it has been hoped that it would establish a national bench-mark for economists and policy makers inside and outside Malaysia to examine subsequent labour market changes in an era of structural adjustment and accelerated industrialization. As a detailed analysis is being presented to the Economic Planning Unit (EPU), this paper will only provide some hints of the principal findings.

Any study of the manufacturing labour market in Malaysia has to be placed very firmly in the historical context of the objectives and evolution of the NEP and the underlying development goals of successive Governments since Independence in 1957. It is worth reminding ourselves of the main macro-policy changes.

Malaysian industrial policy has passed through four distinctive phases. The first was one of import substitution, which lasted from Independence in 1957 until 1968; the second was what might be called selective export-led industrialization, from 1968 until the early 1980s; the third was a phase of crisis and retrenchment, from 1983 until 1986; and the fourth could be described as liberalized export-led industrialization, which began in late 1986.

From 1958 until 1968 the most symbolic policy instrument for manufacturing investment and employment was the *Pioneer Industries Ordinance* which provided fiscal incentives to production rather than tariff protection; this was supplemented by the Tariff Advisory Board, set up to promote "infant industries" through the granting of selective protection. It was a decade in which capital-intensive industries flourished, partly because tax exemptions were linked to capital expenditure. Total manufacturing employment grew, but only slowly.

In 1968 there was a marked shift to export-led industrialization with the introduction of the Investment Incentives Act, drafted in the face of chronically high unemployment and growing racial tensions. The latter were associated with the labour market stagnation and growing inequalities that had accompanied the pattern of economic development. The Investment Incentives Act boosted export-oriented industrialization by providing tax relief for export-oriented firms, investment tax credits, accelerated depreciation allowances, export incentives, tariff protection for new manufacturing establishments and exemption from import duty and surtax. These were complemented by the establishment in July 1971 of the Labour Utilization Relief, which granted tax relief to companies based on the number of workers employed, and by the abolition of the 2 per cent pay-roll tax so as to encourage labour-intensive industries. But this second phase of export-led industrialization was also marked by the strong direct involvement of government, in that industrial growth was made dependent on the restructuring objectives of the NEP. Public enterprises spread, as did public investment in private industrial enterprises, while government regulations played an important role in shaping the emerging pattern of employment.

From then until the early 1980s the growth of manufacturing output, exports and employment was spectacular, far faster than the equivalent for the whole economy. Between 1970 and 1980 the value of manufacturing exports almost quadrupled in real terms, and as a share of total exports, rose from under 11 per cent to 27 per cent. The manufacturing employment growth rate was double that of the whole economy, while its share of total employment rose from 9.0 per cent in 1970 to 15.7 per cent in 1980. Most of that growth came in export-oriented sectors and most of that in the Free Trade Zones. Most spectacular of all was the expansion of the electrical components and electronics sector, mainly through electronic component assembly.[1] Overall, manufacturing employment more than quadrupled between 1968 and 1980, the annual growth peaking in 1981 at nearly 57,000.[2] By the early 1980s it was not just the estate and construction industries that were complaining of labour shortage; by then there was a tight labour market in many parts of the country.

In 1983 the international recession and the collapse of commodity prices began to bite. For a while total manufacturing employment stabilized, with falls in key export sectors such as textiles and rubber products. Then in 1985-86 a severe recession — the worst since Independence — shook manufacturing, obliging managements to focus on their labour policy and resulting in widespread retrenchments in wood products, electrical goods, electronics, textiles and many other industries. To a certain extent it was the responses to this upheaval — which in later times may be seen as a hiccough in the country's industrialization — that formed the context of the MLFS.

One can identify 1986 as the beginning of a fourth distinctive phase, that of liberalized export-led industrialization. Its key features have been a relaxation of the NEP in the interest of boosting industrial investment, exports and employment, with the intention of attracting more foreign investment, coupled with a reversal of the long-standing policy of promoting industrialization through investment in publicly-owned enterprises.[3] In particular, there has been a drive to create "Malaysia Inc." via privatization. There has been the much-discussed Industrial Master Plan 1986-95, which *inter alia* identified twelve industrial sectors for special expansionary treatment in the early 1990s. More immediately, the 30 per cent foreign equity restriction on foreign investment was dropped; since 1986 foreign investors have been able to hold up to 100 per cent of the equity as long as the company exported at least 80 per cent of its production, and could hold up to 51 per cent if more than 51 per cent of its production was exported or if the output consisted of high-technology products. New investment applications received from October 1986 until 1990 were allowed to have any level of foreign equity

[1] One is tempted to call this phase assembly-led industrialization, so prominent was this aspect of the process.

[2] Department of Statistics, *Industrial Surveys*, various years, Kuala Lumpur: Department of Statistics, Government of Malaysia.

[3] In an earlier survey done for the EPU in 1982, we showed how upward socio-economic mobility in the labour market — a critical aspect of the NEP — had been achieved predominantly through public-sector employment.

as long as the company agreed to export more than 50 per cent of its product or if it employed more than 350 Malaysians.

This fourth phase has involved a macro-economic policy shift within the NEP, away from restructuring and towards boosting economic growth, primarily through its focus on market liberalization. This is not to suggest that policy makers abandoned the one or had formerly given the other no attention, merely that there has been a perceptible reorientation. It seems, for example, that there has been a shift from income redistribution, via the expansion of public non-financial enterprises, the public sector and tax-financed subsidies to Bumiputera interests, to capital redistribution via privatization and a more concerted policy of subsidizing export-oriented enterprises. Probably, a policy of market liberalization means that micro-level policies will have to bear more responsibility for social restructuring, not just in the conventional Malaysian sense but in terms of protecting all vulnerable groups in the labour market.

Although unemployment rose to over 10 per cent in 1987 and 1988, by then industrial expansion was once again impressive. The ideas of supply-side structural adjustments were being promoted in an international atmosphere favouring labour and capital market "deregulation", including the wholesale privatization of economic and social activities. Industrial policy has shifted towards a more market-oriented, outward-oriented strategy that favours multinational capital and more management control of their establishments. By 1988, with privatization in full swing, the industrial structure seemed set for a period of profound change.

That reorientation made it important to take stock of how manufacturing firms had responded to the shocks of the mid-1980s and to obtain an impression of how the further influx of foreign and export-oriented firms could be expected to tilt subsequent labour market developments.

Our core hypotheses can be stated quite clearly. In the second half of the 1980s a more sharply defined industrial dualism has been emerging: large establishments have been growing and strengthening their position relative to small ones, while within establishments of almost all sizes and in all industries a labour flexibilization process has been gaining strength, involving a shift away from employment security and a shift of employment risk from companies to workers.

If these trends were supported by the data, then policy makers might be advised to address both questions with some urgency in the post-NEP era, particularly as the most disadvantaged groups tend to be crowded into more precarious forms of employment. It would be in nobody's interest for industrial fragmentation to undermine the considerable social achievements of the past two decades. Yet it will be argued that certain long-term trends in the labour market that were expected to accompany industrialization, including the "formalization" of employment, have been checked if not reversed. This partly reflects adoption of trends from highly industrialized economies and partly arises because manufacturing enterprises in Malaysia have realized the advantages of alternative employment relations.

2. Supply-Side versus Social Adjustment Labour Market Policies[4]

At this point it might be useful to step out of the Malaysian scene to consider the swirl of international debate surrounding the two vogue notions of "structural adjustment" and "labour market flexibility", the latter being seen by many as a necessity for the former, which in turn is seen as necessary for successful industrialization and development.

For a long period — probably throughout the time when most of us in this conference were learning our economics and developing our box of tools — the dominant mode of economic thinking about the medium and long-term was what might be called "social adjustment". In essence, its underlying model is Keynesian, with a social-democratic ethos and a belief that markets could and should be circumvented or moderated by institutional and other regulatory devices in the interest of both equity and long-run economic growth.

For well-known reasons this model was thrown onto the defensive by the economic upheavals of the 1970s and 1980s and the pressure for rapid and extensive adjustments to internationally-transmitted economic shocks and instability. The pursuit of outward-oriented development became a global panacea, with earnest economists everywhere diligently searching for "rigidities" — particularly associated with trade unions and labour regulations — that were alleged to be raising production costs and undermining the international competitiveness of country x or y. There reemerged an overwhelming faith in markets untrammelled by regulations, collective organizations or other institutional interventions. This supply-side critique has been pervasively influential during the past decade, becoming the conventional wisdom of the era. In Malaysia, as elsewhere, it can be predicted that the next few years will witness a critical debate between this supply-side model of structural adjustment and a reemerging social adjustment model that is more concerned with distributional issues.

One can juxtapose, necessarily rather crudely in the interest of brevity, the two perspectives as they relate to labour market policy and the pursuit of labour flexibility. In doing so, we may be able to highlight some of the critical dilemmas facing economists and planners considering the next phase of Malaysia's economic development. As for the notion of labour flexibility, it has been used as a euphemism for many changes but ultimately refers to the responsiveness of the labour market, the ease and cost with which labour mobility of various types can be achieved, and the ease with which the workforce can be adjusted to achieve rapid productivity growth. For unions and workers, flexibility has suggested insecurity; for employers, it has suggested efficiency and adaptability. In a sense, both sides are correct.

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[4]This section could be skipped by those interested only in the specifics of the Malaysian industrial labour market.

In recent years the pressure for adjustment to external shocks and the belief in outward-oriented development have led to a sustained "supply-side" critique of many labour market policies that had been perceived as desirable attributes of socio-economic development. One is therefore obliged to consider this critique, and the appeal of alternatives that they wish to put in their place, dwelling rather more on those that might have resonances in Malaysian debates.

2.1 Price versus Social Distortions

The essence of a social adjustment strategy is "growth with social protection." Among its elements are the following labour-related aspects. First, to ameliorate poverty of the most basic kind, there are usually food subsidies and price support systems to encourage the production of domestically-consumed food. Critics say this is a "market distortion." Second, there is usually some minimum wage protection machinery, designed ostensibly to reduce exploitation and alleviate poverty. Critics say that this amounts to a market distortion, raising wages above the market clearing, equilibrium level, deterring employment by favouring capital-labour substitution and increasing "inequalities between the formal and informal sectors." Third, there are institutional forms of labour security protection — safety-and-health standards, employment security regulations — preventing arbitrary dismissal, for example, limits on working time, overtime, etc. These are also intended to protect workers from exploitation and, by ameliorating working conditions, enhance productivity. Critics say these amount to market distortions, since they represent non-wage labour costs and rigidities that impede labour mobility and thus the efficient allocation of resources.

Fourth, the social adjustment school believes in promoting freedom of association and that participatory collective organizations, notably trade unions, should be given an active role, to encourage dynamic efficiency, to strengthen democratic tendencies, to ensure more equitable income distribution and to restrict discrimination. Again, critics see such organizations as market distortions in that they limit the ability of firms to react to market forces and limit the realization of high profits that could boost investment. Fifth, the social adjustment school sees public expenditure as complementing private expenditure, as potentially productive and as a means of mobilizing and retaining resources for national development. Critics say this too is a market distortion, arguing that it results in "financial crowding out" of private investment and growth, while being unproductive, unresponsive to market forces and an inappropriate standard setter for wages and conditions of employment.

By contrast, the labour-related policies that characterize the supply-side strategy focus on price mechanisms and overcoming price distortions. The approach to structural adjustment combines a "stabilization" policy and a development policy, for which a set of micro-economic reforms are perceived as necessary for macro-economic success. Stabilization essentially means a deflationary monetary policy to hold down domestic demand — so limiting imports — and combat inflation. That means temporarily lowering consumption and employment. This is complemented by an "outward looking" development strategy, involving "trade liberalization", nominal and real exchange rate devaluation and a shift in relative prices between tradeable and non-tradeable goods and services. Governments should cut subsidies to basic consumption goods, thereby raising the relative return to investment in tradeable goods and services. The social adjustment school might say that this results in "social distortion" and that subsidies on non-tradeables promote productivity of the current and future workforce while lowering the efficiency wage in the sectors. The evidence is far from conclusive that cutting such subsidies is unequivocally beneficial for development.

2.2 Minimum Wages and Relative Wages

The supply-side strategy puts overwhelming emphasis on "competitiveness", which *inter alia* means reducing labour costs and making them more flexible. Statutory minimum wages are opposed on the grounds that they price goods out of the market that would be produced by low-paid, low-productivity workers, thus causing unemployment. Critics of that view refer to the multiple functions of minimum wages. They note that very low wages encourage low productivity, and favour unscrupulous employers over those more concerned for long-term stability and community development. Perhaps most importantly, although minimum wages may be above the average or marginal income of those outside modern, export-oriented industrial enterprises, or above the "aspiration wage" of unemployed job-seekers, it cannot be presumed that they exceed the optimum "efficiency wage", the wage at which the average worker works with optimal effort. Finally, critics of a policy of wage reduction claim that lowering unit labour costs can be achieved either by lowering wages with constant productivity (or with a lower decline in the latter) or by raising productivity with constant wages (or with a rise in the latter, if they rise less than productivity).

Those advocating a supply-side approach also press for relative wage changes, or adjustment in the "equilibrium" structure of wages. Supposedly, wages of skilled workers in consumer-goods industries have to decline, to encourage them to shift to export industries, while wages in the latter should stabilize, or rise if inter-sectoral labour mobility is slow or limited. They also contend that reducing wage differentials by minimum wage regulations or other mechanisms reduces the return to education and training to the point that the incentive to invest in them is insufficient. This is further reason, in their view, to avoid minimum wage machinery.

This too is not clear-cut. At the micro-level, real wages may fall below the efficiency wage level, resulting in poor or stagnant productivity. At the macro-level, it is too easy to assert that high unemployment (in whatever form) is "classical", due to excessive real wages. Yet it may be more "Keynesian" in nature, even in low-income countries and even where there is high inflation. In that case, the critics would say, if real wages rose, not only would there be efficiency gains in tradeable industries, but demand for wage goods produced outside the export-oriented sectors would grow. Structural adjustment could be aided because the demand for such goods would stimulate small-scale, informal businesses. If so, higher real wages would not "crowd out" investment in tradeable sectors, but could create a virtuous process of accumulation in low-income sectors.

As for securing labour mobility into the tradeable sectors, the supply-side school, recognizing that relative wages are "sticky", argue that as most governments have little control over private-sector wages, they should concentrate on reducing public sector wages. They should also restrict wage indexation, while wage subsidies designed to limit unemployment resulting from structural changes are opposed on the grounds that they would slow the shift of resources into export industries, from those supposedly with low to those with high social marginal product.

However, do wages in non-tradeable sectors have to fall? The social adjustment side would argue that labour market policies, notably those associated with (re-)training and mobility, could avoid the need for wider wage differentials. Some argue that by *reducing* wage differentials, labour mobility from low to high productivity sectors would be accelerated, rather than slowed, if only because that would raise the relative and absolute return to high-productivity sector investment, while high costs in low-productivity industries would squeeze firms out of business. They also argue that it is too facile to claim that by narrowing wage differentials, minimum wages deter skill acquisition by reducing the return to education. There are many non-wage benefits of education, and as in any case schooling is a job screening device; it is the enhanced access to job opportunities that maintains high individual economic returns to education and training. In sum, low wages plus wider differentials are not a panacea for labour market adjustment.

2.3 Public versus Private Sector Employment

As for reducing public sector wages, this may or may not make sense. In many countries, just as it has been too easily presumed that the public sector is "bloated" and that it is socially unproductive, it has become almost an article of faith that public sector wages and fringe benefits are excessive. It may be that wages should be reduced; or it may be that they should be maintained while public employment is cut to raise efficiency; or it may be that wages and employment should be cut relative to expenditure on other inputs involved in social service provision. All these responses are possible. But the necessary analysis rarely precedes the action taken.

Similarly, one should be wary about justifying wage cuts by referring to higher productivity in the private sector. That might be valid. But if high profits in some private sectors were the result of wages and working conditions that were so poor that workers could only be productive for a while before having to leave or before reaching the point where employers sought their replacement, then a policy of cutting public sector wages could compound an overall problem of stagnant labour productivity. Again, one cannot presume that if relative prices are in imbalance then the higher one should be lowered.

Another aspect of public sector wage and employment policy is that while salaries, benefits and employment security of a core of public sector employees may be advantageous in many countries, there are many whose wages are low in comparison with many private sector workers and whose security of employment is minimal. In the face of public expenditure cuts those workers are the first to suffer. Yet they are often the least skilled and thus the least able to transfer from non-tradeable to tradeable sectors. In short, the role of the public sector in labour market adjustment is a major unresolved issue.

2.4 Unemployment Policies for Structural Adjustment

The structural adjustment model expects a period of resource reallocation — through trade liberalization, market deregulation, etc. — to lead to a transitional period of high unemployment. Advocates and critics alike agree this should be minimized. But supply-side economists would leave that largely to market forces, and would explain prolonged high unemployment as due to "market failure" or even "voluntary unemployment", whereas social adjustment proponents call for institutional mechanisms to secure labour reallocation, and thus would attribute high unemployment to inadequate labour market policies.

Conceptually there are four modes of labour (market) adjustment: (i) external (mid-career) labour market; (ii) inter-generational; (iii) internal labour market; (iv) redeployment.

The first can be painful, since it means existing workers being retrenched in some sectors and competing for jobs in others, during which overall and relative wages are expected to adjust in response to labour market disequilibria. With the second, most of the existing workforce does not engage in mid-career job changes, but labour force entrants, mainly youth, are channelled into tradeable rather than non-tradeable sectors; in a period of structural adjustment, this mode can result in high youth unemployment, and possibly accelerated "early retirement". With the third mode, workers change jobs within enterprises, corresponding to product or technological changes or job restructuring. There is certainly scope for more resort to this form of adjustment, a point that we will take up later with regard to Malaysian developments. Finally, the redeployment mode relies more on the State or some institutional mechanism to direct labour mobility, perhaps on a subsidized basis or with retraining.

The more inter-sectoral and other labour mobility can be achieved by the third and fourth modes of adjustment, the less likely it is that structural change will result in high unemployment. As that would also mean less reliance on relative wage rate changes, and the more policy makers can rely on modes (iii) and (iv), the less the need to widen wage differentials.

In discussing adjustment and employment, Streeten (1988 p. 27) recently concluded,

> "There is one good aspect in conducting adjustment policies in the current environment of unemployment. It is easier to move unemployed workers into the right industries than to shift workers from one job to another. Redeployment and restructuring out of unemployment should be the programme for both developing and advanced countries".

No doubt that was drawing small comfort from adverse realities. But it is far from self-evidently true. Workers are rarely made more productive by the experience of unemployment, especially if that is prolonged, while unemployed, impoverished workers are scarcely able to indulge in optimal labour market mobility in response to job restructuring. There is little evidence that high unemployment is either necessary for structural change or preferable to other forms of labour market adjustment, and a number of countries have shown that structural change can be achieved without any period of high unemployment.

2.5 Labour Regulations and Labour Market Fragmentation

Both the supply-side and social adjustment perspectives give a pivotal role to labour market "dualism". According to the former, excessive regulations and minimum wages are shown by the growth of the "informal sector" and the non-growth of the "formal", tradeable sector. They advocate dismantling regulations so that more of the "informal" can become "formal" and so that employment can rise. The social adjustment school retorts that the long-term objective should be the extension of social protection to those currently uncovered and surviving in petty units of production or in other peripheral activities, whether productive or merely survival-oriented. In particular, the social adjustment model would give high priority to anti-discrimination and protective regulations designed to reduce the marginalization of socially vulnerable groups, notably women, children, migrants and ethnic minorities.

To be fair, the debate about the role and impact of labour regulations is unresolved. What we do know is that there has been an enormous growth in so-called informal economic activities all over the world. Part of that has been due to the international recession, and so on, whereby the unemployed have taken up petty production and the like, or whereby those whose regular earnings have fallen have supplemented them with secondary activities. Partly it reflects a growth of sub-contracting by large enterprises, to reduce costs, or as an aspect of privatization or in response to the increased uncertainty and risk in times of recession and structural adjustment. And partly it reflects resort to more informal, unprotected types of work, to by-pass regulations or reduce costs.

Considering such developments, statements about the supposedly adverse effects of labour market regulations on employment levels should be treated with reservation. This is important to stress, for a key theme of the supply-side perspective is that "fewer labour market regulations... would promote labour market flexibility and higher employment" in developing countries, and that "rules on job security... distort the labour market in ways that reduce employment and overall living standards" (IBRD 1987, p. 9; 32). Yet labour regulations may have more impact on the types of employment rather than on the level and have positive effects on living standards by setting guide-lines, which may not be met everywhere, but which help to reduce the prevalence of poor working conditions, exploitation and oppression. Once again, these are empirical matters on which it is too easy to reach conclusions in the absence of real data.

The key theme is worker security, of which there are various forms. Unfortunately, some economists lump them together, thus blurring analysis and policy debates. One should distinguish between: (i) labour market security; (ii) employment security; (iii) job security; (iv) work security; and (iv) income security. Labour market security is high when job changing involves only moderate personal costs and reasonable prospects of subsequent benefits, and is typically inversely related to the level of unemployment. Employment security is high when workers cannot be dismissed without either costs to employers or the satisfaction of pre-specified conditions. Job security is high when workers have rights to particular niches within enterprises, and where unions or other institutions safeguard craft barriers or skills. Work security is high when working conditions are safe and so on. Finally, income security is high when workers have their wages or earnings protected from income fluctuations, either through indexation, collective bargaining or other forms of institutional protection.

All five forms of security have potential costs and potential benefits for enterprises. Because there has been overwhelming stress on their alleged costs in recent international debates, it may be appropriate to stress the potential benefits, bearing in mind that ultimately these too are empirical matters.

Take, for example, job security. Many firms have introduced job security arrangements precisely because they were perceived as conducive to productivity growth; this was the essence of Taylorist management, since narrowly-defined job classifications were seen as enabling employers to have control over output, work input and labour costs. Accordingly, one should not presume that the erosion of job security is always desirable even on efficiency grounds. Moreover, job security surely encourages the development of technical skill within jobs, because workers can expect a return to training and informal learning. Against that, if job demarcation results in workers resisting technological change and redeployment, then regulations or union agreements protecting job security could hinder structural adjustment and thus impair economic growth.

However, it is employment security that most critics have in mind when castigating "regulations", claiming that workers in secure employment have less incentive to be productive, are immobile in the face of a need for structural adjustment, or have to be compensated so much that the potential benefits of resource reallocation are lost. It is also argued that employment protection discourages firms from hiring and encourages them to opt for more capital intensive techniques. Unfortunately, there is little evidence to support or refute such arguments. Moreover, employment security regulations also have potential benefits, as follows:

a) They can improve workers' commitment to the enterprise and thus raise work motivation and productivity;
b) They may reduce the "transaction costs" of employment by reducing labour turnover, especially important where productivity rises with on-the-job learning;
c) They may encourage worker acceptance of productivity-raising rationalization and other modernization measures;
d) They may improve job and work flexibility, that is, improve the willingness of workers to accept occupational and work environment changes;
e) They may induce greater acceptance of work disciplinary measures;
f) They may improve "dynamic efficiency", by obliging management to become more efficient and competitive by means other than by laying off workers;
g) They may induce workers to accept lower wage rises in return for the employment security;
h) They may reduce the probability of frictional unemployment by enabling workers to have adequate notice of impending job loss to seek out alternative employment.

In sum, the benefits of employment security may well offset the costs. But one should not stop there, for what is needed are forms of employment security that promote flexibility and productivity. That is the challenge that comes to the fore in the context of structural adjustment rather than stable development. Advocates of social adjustment would argue that only if workers could share in the decisions and in the benefits of investment could this issue be resolved.

2.6 Wage Flexibility

As for income security, the supply-side view is that wages should be allowed to fluctuate and that, if they were tied more to economic performance and profits, not only would employment be stabilized cyclically, but it would do so at higher levels than with fixed wages. Critics of this view would argue that as long as workers do not at least share in decisions over investment or productive strategy, it would be unjust for them to have to bear the risk. Moreover, if payment systems were made more flexible — as is happening in some countries where adjustment strategies are being implemented — then earnings differentials will grow between those in high-tech sectors and those outside them. This has been a feature of such systems. For some economists, that is perfectly acceptable, but from a social equity point of view it may be undesirable, leading to active discontent among those unable to share in the benefits. Furthermore, flexible payment systems may result in extremely low and uncertain earnings for low-productivity workers and may slow structural change rather than accelerate it, to the extent that capital could be tied up in inefficient, low-productivity production.

Again, there are pros and cons about more flexible payment systems. The challenge is to move towards systems that promote adjustment, productivity and flexibility while maintaining rather than disrupting progress towards social equity.

2.7 Education and Training for Adjustment

Both the social adjustment and supply-side models favour increased education and training to promote flexibility and adjustment. But there is a difference of emphasis. The supply-siders stress that schooling and training should be geared to the needs of export-oriented industries, and take an economic rate of return approach to investment in education and training. By contrast, the social adjustment adherents see education as more of a social end in itself, as well as a means of promoting development.

There is no space here for an extended discussion, but given the emphasis on education and training, a few words of caution are in order. It is conventional to argue that the economic rate of return to investment in schooling is higher than in "physical capital". This is comforting. However, the utilization of educated or trained workers may be very sub-optimal, since access to many jobs may require an excessive level of schooling, simply because schooling attainment is a convenient low-cost "screening" device in recruitment. Far more attention should be given to the effective deployment of educated workers. The sub-employment of educated and technically-proficient workers in large corporations, as well as in the public sector, is a phenomenon found in many countries.

We should be wary too about the potential abuse of the system for short-term efficiency purposes. It is no coincidence that the word schooling means both taming and liberating. If used to produce docile, disciplined workers (as many stress as a primary objective), then it may actually hinder the workforce's mobility and relearning potential in future eras of adjustment. This is a reason for having reservations about policies based on short-term economic rates of return.

Similar problems arise in assessing the extent to which governments should invest in training, making it hard to accept that "some developing country Governments have tended to expand higher-level vocational training too fast." The difficulty has been in identifying appropriate criteria for reaching such conclusions.

A training policy can facilitate structural adjustment by raising productivity of workers in existing jobs, by raising overall productivity of the labour force, and by facilitating labour mobility as job structures change with technological and productive restructuring. Also, the policy can be oriented either towards vocational (or craft) training or job training. The former puts emphasis on developing all-round capabilities, whether through prolonged apprenticeship or institutional courses. The latter means workers being trained solely for jobs they are required to perform in the immediate future. That is cheaper and has involved schemes that impart "modules of employable skill"; as such, it may make fewer demands on trainee and trainer alike, requiring less formal schooling and work commitment. However, it probably also leaves the worker less adaptable and less equipped to shift jobs or work status in times of industrial restructuring. In effect, a low-cost option with a higher short-term return may yield a lower longer-term social return.

Similarly, the training policy should not be divorced from job structures. If those are highly stratified, such that there is a limited internal labour market, the required amount of more costly off-the -job training will rise. To reduce the need for public investment in training schemes, policy makers could explore ways of promoting internal labour adjustment, through on-the-job learning, incentive structures, anti-discrimination regulations, etc.

Too often, a perceived shortage of skilled labour is presumed to mean that the appropriate policy is more schooling or training. It is conceivable that a more appropriate and cost-effective approach would be a policy to alter job structures rather than the attributes of people required to fill them. It is technologically deterministic to focus exclusively on training.

Finally, there is the form of training. Many economists favour government labour market training schemes as a way of easing labour force adjustments. Undoubtedly, such schemes have a role to play. But they do have drawbacks. If Governments subsidize the training of the unemployed, firms may simply substitute those trainees for others already trained or partially trained, implying a "substitution effect". Or the subsidy may result in workers being trained who would have been trained anyway, resulting in a "deadweight effect". Or the trainees may be hired to do jobs for which their training is not really required, because the cost of the training is underpriced. Or, as a result of altering the effective "price" of technically-skilled workers, enterprises may alter job structures to increase the relative demand for workers with those skills, thereby contributing to a persistent "shortage" of such workers. In sum, because labour market training schemes are very rarely evaluated, they tend to be overvalued as a means of promoting labour market adjustment.

An alternative policy to facilitate labour mobility and adjustment is "in-plant" training. If, as is common, this involves the use of subsidies, the same problems arise, perhaps in more acute form since employers receive the subsidy directly, even though the public cost of this form of training may be lower because part of it may be borne by employers.[5] Here too, the challenge is to minimize substitution and deadweight effects.

[5]It is probably not uncommon for the "subsidy" to exceed the cost of training.

These notes of caution should not be construed as dismissive of a training policy *per se*. They do suggest that, in encouraging firms to train more extensively, other policies are worth more active consideration, such as anti-poaching regulations — preventing other enterprises attracting newly-trained workers without bearing the costs of training — and statutory obligations on firms to train a stipulated percentage of their workforce, perhaps distributed across the range of skills normally required. Such proposals would have to be carefully considered, so as to minimize costs and to maximize efficiency and dynamic flexibility. But they may be critical for successful labour force adjustment.

3. Labour Flexibility in Malaysian Manufacturing

The preceding may seem to have been a protracted theoretical discussion of little relevance to current developments in the Malaysian economy. It is hoped that is not the case, though by international standards the Malaysian labour market has been fairly deregulated in that there has been no minimum wage, no effective system of employment security, and so on. However, we turn now to a few aspects of the labour market that seem likely to emerge as more critical issues in the post-NEP era. The discussion will skirt the paramount issue of the NEP, if only because it is implicit in every labour market policy question and because others are much better equipped to deal with it. As the following highlights a few points from the 1988 MLFS, the focus is on manufacturing, which should not be taken to imply that this is seen as the only important sector. Indeed, the transition to a high-technology service-oriented economy will be a major challenge for Malaysia in the 1990s.

3.1 *Labour Absorption in Manufacturing: Recent Trends and Prospects*

3.1.1 *Overall Changes 1985-1990*

The manufacturing sector has long been regarded as a primary source of employment expansion in the country, especially considering the long-term labour displacement in agriculture and mining and the desired shift of the rural workforce into modern, urban-based industries. However, in the 1980s economists became less sanguine about the ability of manufacturing to provide large numbers of new jobs. Despite the unprecedented surge of manufacturing in recent months, a big question is whether the employment elasticity has shrunk to the point where reasonable output expansion could be achieved with little impact on employment. The cause could be technological or the result of a shift towards more capital-intensive industries and types of establishment or because companies are more inclined to pursue a labour-shedding and labour-avoiding policy in the wake of the recent recession.

Employment expansion in manufacturing slowed sharply in the mid-1980s when, as the MLFS shows, there were far more widespread labour surplus conditions than were implied by the level of retrenchments, conditions which persisted after 1985. Yet, according to retrospective data from the survey, between mid-1985 and mid-1988 a majority of manufacturing establishments in the country expanded employment. Export-oriented industries such as textiles and electronics, and to a lesser extent chemicals and wood products, recovered most robustly. But in such large employment-generating sectors such as food, beverages and tobacco, non-metallic mineral products, basic metals and fabricated metals, and machinery and equipment only a minority of establishments expanded in the three years covered by the data (Table 1). Foreign establishments were far more likely to have expanded than their Malaysian counterparts (Table 2).

Table 1
Change in Manufacturing Employment 1985-1988, by Industry

	Fell (%)		*No Change*	*Rose (%)*		
	25.1+	*0.1-25*		*0.1-10*	*10-25*	*25.1+*
Food, etc.	7.8	28.0	21.7	13.0	11.9	17.6
Textiles, etc.	10.5	21.0	8.8	9.7	15.5	34.4
Wood, etc.	8.7	22.6	12.6	13.7	12.6	29.9
Paper, etc.	6.7	27.9	8.5	9.1	12.1	35.8
Chemical	7.8	26.5	8.7	13.0	12.4	31.8
Non-metals	21.1	28.5	18.8	9.7	7.9	13.9
Basic metals	14.5	28.9	10.5	14.5	10.5	21.0
Fabricated metals	18.7	20.1	12.2	6.6	11.6	30.7
Electronics	17.2	19.0	3.4	8.6	13.8	37.9
Other Manufacturing	11.8	15.6	21.6	7.8	15.7	27.4

Table 2
Change in Employment, 1985-1988, by Ownership

	Fell (%)			*No Change*	*Rose (%)*		
	25.1+	*10.1-25*	*0.1-10*		*0.1-10*	*10.1-25*	*25.1+*
Foreign	9.1	14.9	11.7	6.4	13.9	10.7	33.3
Chinese	10.7	12.2	8.5	17.2	9.5	13.6	28.3
Others	14.6	15.6	15.7	10.0	12.1	10.3	21.6

The MLFS also revealed that only a minority of establishments expected to expand employment in the next two years.[6] No doubt this partly reflected a lack of employment planning at the firm level, which is surely worth encouraging in the interest of promoting an orderly, efficient labour market and of helping planners formulate labour market policies. However, although the number of firms that expected to expand employment was much greater than the number that expected to cut it, the largest group by far consisted of those that expected no change. A further substantial minority were uncertain. The net expected expansion corresponded to the bullish sentiments in mid-1988. Even so, only in the electronics industry did a majority expect to increase employment. If one excludes those without employees at the time and counts those under receivership or closing as expecting employment to fall, then over 7 per cent of all establishments were ready to admit that they expected employment to decline, whereas about a third expected it to grow. These figures have to be seen in the context of what was a booming economy when a strong expansionary sentiment could have been expected.

Table 3
Expected/Planned Employment Change in Next Two Years by Industry, 1988
(including closing establishments and
those under receivership as expected "falls")

	Expected Change			
	Rise	*Fall*	*No Change*	*Don't Know*
Food, etc.	18.7	8.2	68.5	4.5
Textiles, etc.	47.3	7.0	41.9	3.7
Wood, etc.	30.5	6.9	57.7	4.9
Paper, etc.	39.9	8.3	49.4	2.4
Chemical, etc.	41.4	7.0	47.5	4.1
Non-metals	25.6	8.3	60.7	5.4
Basic metals	26.6	5.1	64.6	3.8
Fabricated metals	37.1	5.5	50.9	6.5
Electronics	51.7	13.8	34.5	—
Other manufacturing	43.1	7.8	45.1	3.9

Note: "Closing" includes those already closed, those not having any workers at the time of the survey and those planning to close or under receivership.

[6]See Appendix II for a brief methodological note on employment planning.

Establishments in export-oriented industries were most likely to be expecting to expand their employment. Even so, one can only be struck by the widespread caution, or pessimism, shown among firms manufacturing non-metallic mineral products, wood products and basic metal products.

One potential tool for employment planning policy is identification of what management perceive to be the main factors affecting their employment change. Normally, one would expect that the main factor would be the level of demand for their final product. But that cannot be presumed in any specific period. Accordingly, respondents were asked to identify the principal and second most important factors influencing their employment, and were asked separately about the past two years, the present (that is, mid-1988) and the expected factors in the next two years.

Over the previous two years, from mid-1986 to mid-1988, the major factor besides overall demand was business uncertainty, which was scarcely surprising in the wake of the recession. This factor was particularly prominent in industries dealing with basic metals, non-metallic mineral products and wood products. It shows just how important the creation of an economic environment of stability and steady growth is to employment creation.

The second most cited factor was new technology, notably in electronics, followed by plant capacity, implying that a fairly large number of establishments could not expand employment without first expanding their productive investment.

Table 4
Main Factor Besides Demand affecting Employment, 1986-88, by Industry

	Industry								
	Food	*Text.*	*Wood*	*Paper*	*Chem.*	*Non-Metal.*	*Basic-Metal.*	*Fabr.-Metal.*	*Electr.*
Factors									
None	54.3	43.0	46.4	50.9	50.6	47.6	43.0	48.4	24.1
Work Reorg.	4.0	4.5	3.0	3.5	6.5	5.9	5.1	4.7	1.7
New Tech.	5.9	8.3	2.7	6.4	7.0	3.6	1.3	3.7	27.6
New Products	1.8	3.3	3.8	2.9	5.5	2.4	6.3	5.5	8.6
Short.Qual.Lab	1.3	2.9	1.9	2.9	0.7	0.6	2.5	1.2	—
Comp.Restruct.	1.2	1.2	1.1	1.2	2.4	0.6	—	2.2	6.9
Rising Wages	1.7	2.9	2.5	2.9	1.7	2.4	—	1.8	3.4
Export Quota	0.3	4.5	1.1	1.2	0.2	—	—	0.6	1.7
Des.Stab.Lab.	3.7	3.3	3.8	4.1	5.1	3.0	5.1	3.5	3.4
Plant Capacity	5.9	5.8	9.6	5.8	6.7	4.8	5.1	5.5	5.2
Rising NWLC	0.7	0.8	0.3	0.6	0.2	1.2	1.3	0.4	—
Uncertainty	11.1	8.7	16.9	9.4	7.2	20.8	24.0	12.5	8.6
Labour Laws	—	—	0.3	—	—	0.6	—	—	—
Others	8.1	10.7	6.6	8.2	6.0	6.5	6.3	10.0	8.6

This raises questions about the extent to which financial and other encouragement is given to expansion of existing enterprises rather than new ones — a crucial policy issue for the 1990s.

A key point about Table 4 is the rarity with which labour-related factors were cited as having influenced employment, although some did report as their main or second most important consideration the desire for a *stable* workforce, presumably because either cutting or expanding the workforce could affect morale, productivity, training and supervision costs.

Wage costs were scarcely mentioned in any industry or size category of establishment, and nor were non-wage labour costs. As for the much-discussed labour shortage factor, a mere 1.5 per cent of all establishments mentioned a shortage of qualified labour as having had an adverse effect. Finally, at a time when some commentators were calling for reform of labour regulations to promote industrial employment, it is instructive that on the ground, as it were, employers did not see labour laws as having had any substantial effect. This is strong evidence from a large survey and should be recalled in the event of further calls for "deregulation".

As for what firms expected to be the major influences on employment in the next two years, much the same pattern emerged, with labour-related factors being remarkable for their insignificance, even as a secondary factor. Abstracting from the demand influence, Table 5 shows that new technology and business uncertainty were expected to be the main factors, followed by plant capacity and

Table 5
Main Factor besides Demand Expected to
Affect Employment in Next Two Years, by Industry
(Per cent)

	Food	*Text.*	*Wood*	*Paper*	*Chem.*	*Non-met.*	*Basic met.*	*Fab. met.*	*Elect.*
Factors									
None	42.3	35.1	29.5	40.9	36.9	39.3	35.4	40.0	27.6
Work Reorg.	2.0	1.6	6.0	8.2	4.6	5.4	2.5	3.9	1.7
New Tech.	11.6	8.7	6.6	11.1	10.6	8.3	7.6	6.5	19.0
New Products	6.7	4.1	6.0	5.3	11.6	1.8	7.6	8.8	24.1
Short.Qual.Lab.	0.7	2.9	1.6	1.7	0.7	—	2.5	0.8	—
Comp.Restruct.	1.7	2.1	1.9	1.2	1.2	3.0	1.3	2.2	3.4
Rising Wages	1.2	2.5	2.5	1.7	1.7	0.6	1.3	2.2	1.7
Export Quota	0.2	6.6	4.4	0.6	1.4	—	—	2.3	1.7
Des.Stab.Lab.	2.3	2.5	3.8	1.2	2.2	3.6	3.8	2.7	—
Plant Capacity	7.6	7.8	9.0	7.6	11.3	7.7	6.3	7.1	5.2
Rising NWLC	0.2	0.8	—	—	1.0	0.6	—	0.2	—
Uncertainty	16.3	14.9	18.8	10.5	11.1	22.6	29.1	17.1	6.9
Labour Laws	—	0.4	—	—	—	1.2	—	—	—
Other	6.5	9.5	8.2	9.4	5.5	4.8	2.5	5.7	8.6

new products. Neither labour costs nor labour shortage nor labour laws were perceived as very significant at all. In sum, as employers saw it, it is market stability and technology that most influence plans and changes in employment.

3.1.2 Industrial Relocation and Employment Mobility: A New Geographical Divide?

Labour mobility and enterprise mobility may have a growing impact on restructuring in the 1990s. For years Penang and the Klang Valley have been the industrial hubs of the Malaysian economy, drawing capital and labour from the rest of the country and from abroad. In the late 1980s that began to change fairly dramatically, although it has probably been insufficiently absorbed into policy debates.

There has been a drift of manufacturing establishments and employment "southwards", which other secondary evidence suggests has been a more general trend. Thus, as Table 6 shows, manufacturing establishments were far more likely to have expanded employment in southern States than elsewhere, except in Penang. Thus in Johore and Malacca nearly a third of all establishments had expanded their employment by more than 25 per cent between 1985 and 1988, and a further one in four had expanded by up to 25 per cent. By contrast, only a minority of establishments had expanded at all in Trengganu, Kelantan, Perak,

Table 6
Change in Employment 1985-1988, by State

	Fell		*No Change*	*Rose*	
	25.1+	*0.1-25*		*0.1-25*	*25.1+*
State					
Johore	10.5	22.2	11.0	23.4	32.8
Kedah	8.1	21.6	15.3	27.9	27.0
Kelantan	15.0	15.0	28.3	23.3	18.3
Malacca	11.8	15.3	16.5	25.9	30.6
N.Sembilan	5.7	25.3	17.2	27.6	24.1
Pahang	6.7	31.7	11.5	29.8	20.2
Penang	8.8	24.2	15.4	20.5	31.1
Perak	9.7	26.4	17.0	24.1	22.7
Selangor	14.0	28.2	8.0	22.8	27.0
Trengganu	14.5	34.5	20.0	18.2	12.7
Kuala Lumpur	15.4	21.1	15.2	21.4	26.9

Selangor and Kuala Lumpur, and hardly any in Perlis. Other States had modest expansion in net terms, though one should note the stronger growth in Kedah, as well as Penang, as moderating the "southern" trend. There are various reasons for a southern drift, among which of course is the proximity of Singapore, with its tight labour market, rising labour costs and the desire of Singapore-based companies to set up factories close to where there is a more ample and lower-cost labour supply (Salem 1988).

It is expected that Johore and Malacca will become the next industrial growth centres in the Malaysian economy, and these data lend support to that belief. Already Johore Bahru is closely linked to Singapore and the State Government has made "economic twinning" with Singapore one of the four components of its Development Strategy. But the drift southwards seems set to continue. Establishments in Malacca, Johore and Negri Sembilan were the most inclined to expect employment expansion. Conversely, the limited growth in the least-industrialized States should be a worry for those concerned with formulating post-NEP policies.

Table 7
Expected/Planned Employment Change in Next Two Years, by State

	Expected Change			
	Rise	*Fall*	*No Change*	*Don't Know*
State				
Johore	44.5	5.5	45.4	4.6
Kedah	42.7	6.8	47.0	3.4
Kelantan	21.3	3.3	73.8	1.6
Malacca	47.7	1.2	50.0	1.2
N.Sembilan	44.2	4.6	45.3	5.8
Pahang	26.5	2.9	68.6	2.0
Penang	40.2	2.6	53.6	3.7
Perak	27.7	3.7	63.4	5.2
Perlis	(40.0)	—	(40.0)	(20.0)
Selangor	32.0	7.4	55.0	5.3
Trengganu	12.7	1.8	78.2	7.3
Kuala Lumpur	23.9	5.4	64.3	6.4

Note: Figures in parentheses indicate that there were too few observations to justify confidence in the data.

3.1.3 The Intensification of Establishment Dualism?

Another crucial feature of recent changes in employment is that while there was an overall stability in the size distribution of establishments, with a large majority remaining approximately the same size in 1988 as in 1985, only a very small proportion of establishments with less than five employees expanded. Employment growth was concentrated in establishments that were already large in 1985. As Table 8 shows, a majority of very large firms with over 500 workers in 1985 had grown over the following three years, whereas only a minority of those with 1-4, 5-20 and 21-50 workers had grown. It appears that small firms were not a good source of new jobs in the late 1980s, which should be borne in mind in formulating policies for the post-NEP era. Moreover, on balance only large firms with more than 250 workers expected to expand in the next two years; most other size groups tended to expect no change, although on average the smallest firms actually expected to shrink still further (Table 9). That surely is a signal of immense significance. It scarcely suggests that small is very beautiful, and probably partly reflects a realistic expectation among small-scale concerns that they may go out of business.

As many believe that small-scale enterprises have a great potential for generating employment, this point should be stressed. As research has shown elsewhere, the vast majority of small concerns begin and stay small and do not operate on the basis of expected expansion into corporate giants. They seek a niche of security. What this means is that those who push for deregulation and hefty subsidies, etc., for small-scale "informal" firms, on the grounds that they could

Table 8
Percentage Change in Employment 1985-1988 by
Size of Establishment in 1985

Change in Employment		*Employment Size in 1985*						
		1-4	*5-20*	*21-50*	*51-100*	*101-250*	*251-500*	*501+*
Fell:	Over 25%	3.6	10.0	12.1	10.5	12.6	15.6	17.0
	10.1 - 25	—	12.6	13.5	10.5	16.2	20.8	18.9
	0.1 - 10	—	4.0	10.2	13.3	16.8	7.8	7.5
No Change		57.1	30.1	14.1	6.8	5.6	—	1.9
Rose:	0.1 - 10	—	3.8	10.1	16.4	13.3	7.8	18.9
	10.1 - 25	3.6	11.0	10.2	14.11	3.8	16.9	7.5
	25.1 - 50	10.7	9.8	12.7	13.1	10.1	13.0	15.1
	Over 50	25.0	18.6	16.9	15.4	11.6	18.2	13.2

Table 9
Expected/Planned Employment Change in Next Two Years by Establishment Size (including closing concerns etc. as "falls")

	Expected Change			
	Rise	*Fall*	*No Change*	*Don't Know*
Employment				
1 - 4	2.9	17.1	71.4	8.6
5 - 20	20.0	5.5	68.0	6.5
21 - 50	30.2	6.2	59.5	4.0
51 - 100	34.3	7.8	53.2	4.7
101 - 250	38.6	7.7	50.1	3.7
251 - 500	50.8	8.6	35.8	4.8
501 - 1000	54.6	10.5	33.7	1.2
1001+	56.2	10.9	29.7	3.1

increase labour absorption, are effectively proposing an increase in the *number* of such concerns, not in their average size. The implications of that are not usually well articulated; one is inclined to believe that there is a distinct chance (to put it no stronger than that) that this strategy would merely force down average incomes and the "survival probability" of any small-scale establishment, at least of those not tightly linked to one or more larger-scale companies. That in turn would inhibit risk-taking investment, in-plant training, and so on.

Some economists have claimed that small firms in Malaysia are relatively efficient because they are "subject to a higher degree of competition as a result of unrestricted entry into the industry. The only reason why they have not been able to hold their own is that the fiscal incentives are heavily biased against them" (IBRD, 1990). There would be widespread agreement that fiscal policy has favoured large, export-oriented companies, but there is little reason to suppose that an even more competitive environment, in which mere survival for small firms would have to be a very high priority objective, would be conducive to productive efficiency. In sum, manufacturing employment growth is likely to come from large firms rather more than from existing small-scale establishments.

The feeling that undue emphasis has been laid on the creation of new establishments is given added weight by the fact that most very small-scale firms could give no identifiable factor for not changing employment, further supporting the view that most small establishments do not actively contemplate expansion or, therefore, the constraints to it. They react, not plan — and they ought to be helped to do the latter. Scarcely any factor other than demand and business uncertainty were cited as influencing employment changes in small-scale establishments, whereas technological change and new products were the main factors in large firms. This pattern also applied to their future expectations. In an economic climate of more intense competition, such patterns suggest that small firms would be less inclined to expand employment than in more stable periods and be less able to take advantage of employment-enhancing technological change.

In the late 1980s export-oriented firms expanded their employment, whereas import-substituting firms did not. As small firms scarcely export, whereas over half of all manufacturing establishments with over 500 workers export over three-quarters of all their output, this has been a major cause of the strengthening of large establishments and the weakening of small-scale units. Indeed, the close relationship between size, export orientation and employment expansion is an increasingly strong feature of the Malaysian economy.

There is little evidence that small-scale manufacturing firms could be the major source of labour absorption in the next few years. They are also relatively unlikely to be generators of new technology. Almost certainly, workers and others connected with such firms will also be subject to more income insecurity, as well as lower incomes. Such uncomfortable realities will need to be taken into account.

3.1.4 Sales and Employment Changes

Ignoring the (probably unsustainable) recent surge in manufacturing output, there is reason to be cautious about labour absorption. Nearly two-thirds of all firms increased the value of their sales in 1986-88. Yet only a little over half of those reported that they had increased employment as a result; for most of the remainder, it had made no difference (Table 10).

Table 10
Change in Value of Sales in Past Two Years and the Perceived Impact on Employment, 1988

	Value of Sales	
	Risen	*Fallen*
Employment Effect		
Increased	52.2	2.9
Decreased	3.7	41.0
No Change	43.6	54.6
Don't Know	0.4	1.5

Table 11
Percentage of Establishments whose Increased Sales had "Increased Employment", by Establishment Size

Employment Size	*Per cent*
1 - 20	25.3
21 - 50	42.1
51 - 100	54.5
101 - 250	54.6
251 - 500	73.5
501+	78.7

Table 12
Percentage of Establishments whose Reduced Sales had "Decreased Employment", by Establishment Size

Employment Size	*Per cent*
1 - 20	41.0
21 - 50	35.8
51 - 100	41.3
101 - 250	53.1
251 - 500	29.6
501+	36.4

This corresponds to the view that employers were reluctant to hire labour in the late 1980s, even when business was picking up, because of the lasting effect of the crisis of the mid-1980s. This leads one to ask whether manufacturing can be expected to be a major source of new jobs in the next few years. Will increased demand for the product be met by only limited labour absorption as firms either limit their output to "plant capacity", introduce labour-saving technological change or turn to "outsourcing"? These may become major questions for the post-NEP era and for industrial policy. And, although one should treat such qualitative data with due caution, Table 11 suggests that it was the larger firms that were relatively likely to expand employment in response to sales increases. So, a disturbing point for those who believe small-scale firms are the potential source of labour absorption is that the likelihood of increased sales leading to increased employment was positively related to the size of the establishment. The measure is crude, in that the scale of the rise in sales would have varied considerably. Nevertheless the sample was large and the relationship quite strong. Moreover, of those whose sales had fallen the larger the firm the less likely it was to have cut employment as a result.

3.2.4 The Growth of External Labour Flexibility

Industrial enterprises across the world have been responding to economic instability and international competition by making the level and structure of employment more flexible. In that regard Malaysian enterprises have been no exception.

In recent years, as noted in Section II, there has been a fierce debate over the links between employment security and the level and growth of employment. Many economists argue that employment protection regulations and non-wage labour costs hinder employment growth. An alternative hypothesis that guided this study is that faced with uncertainty and the need for labour flexibility, enterprises in Malaysia and elsewhere respond by trying to *by-pass* (not evade) such regulations as well as social security contributions and other institutional "rigidities" such as collective agreements. Firms find ways of containing wage and non-wage labour costs, while regulations and "rigidities" act not so much on the level as on the nature of employment.

What seems to have happened is this. Nearly one in five manufacturing establishments suffered from surplus labour in the mid-1980s, and to increase their employment flexibility many reduced the fixed core of their workforces. Many retrenched only to rehire the same workers, often on lower wage rates and usually with less employment security. Very small-scale firms tended to replace wage workers with family, unpaid workers, or relied on them more exclusively. More importantly, very many firms resorted more to temporary or casual labour. In every manufacturing industry the number of firms resorting more to such workers relative to regular full-time workers increased, while firms that expanded total employment were the most likely to have expanded the proportion that were in temporary or casual work.

In principle, there is no such category as temporary worker in Malaysian labour law. Its prevalence reflects labour market reality and difficulty of enforcing the Labour Laws in circumstances where the major reason cited by respondents for hiring temporary and casual labour was either fluctuating demand or market uncertainty, followed by the ability to pay lower wages. The authorities would be concerned by widespread casualization, and if it is accepted that casual workers need employment protection by enforcement of the Labour Laws, then it is important to know where in the country and in what types of establishment casual forms of employment have been spreading. This is particularly important given the limited number of labour law officers employed by the Ministry of Human Resources — some 200 in the whole country.

All this begs a number of questions. In what respects is temporary, casual employment precarious for the workers concerned, putting them in need of legislative and administrative protection? A lack of employment security is one major characteristic, but there one finds wide variation. Some temporary workers have the most precarious contractual relationship, that is, a casual work status involving an oral understanding that can be modified from day to day or week to week. Others have a written contract for some short-term period, such as three months or a month. In mid-1988 temporary workers in small-scale establishments tended to be in the most precarious, casual relationships (Tables 13 and 14), giving further cause for reflection about labour in small firms.

One feels that the Ministry of Human Resources should be enabled to ensure

Table 13
Main Form of Temporary Work Arrangement by Employment Size of Establishment, 1988

	Employment Size, 1988						
	1-4	*5-20*	*21-50*	*51-100*	*101-250*	*251-500*	*501+*
Short-term, specific							
— written contract	—	10.5	23.5	40.2	66.4	81.0	72.1
— oral contract	(66.7)	52.6	55.1	29.5	20.3	10.3	13.1
Continuing, casual	(11.1)	33.7	19.4	23.2	12.6	8.6	11.5
Other	(22.2)	3.2	2.0	3.6	0.7	—	3.3

Table 14
Whether or Not Temporary Workers Given New Contracts, by Employment Size, 1988

	New, Temporary Contract	*Regular Contract*	*No New Contract*
Employment Size			
1 - 4	(22.2)	—	(77.8)
5 - 20	30.9	9.6	59.6
21 - 50	38.1	13.4	48.5
51 - 100	47.7	17.8	34.6
101 - 250	47.9	18.7	33.3
251 - 500	46.6	25.9	27.6
501 - 1000	32.1	28.6	39.3
1001+	27.3	39.4	33.3

that temporary workers be given the minimal protection of written contracts of employment. Labour Inspectors could perhaps concentrate more on small-scale establishments, because it is there that temporary workers are most vulnerable to the absence of a protective contract. That conclusion follows unless, perhaps, those who favour labour market deregulation could show realistically that such protection would harm the employment prospects of the workers involved. That seems unlikely.

Casual workers also have little prospect of moving from temporary to regular or quasi-permanent status, particularly in smaller establishments. They are in effect used as a buffer or labour reserve, bearing the risks of cyclical fluctuations in demand. Is temporary employment a major form of labour stratification emerging in Malaysian industry, just as it is elsewhere? It was scarcely surprising that those employed as temporary worker were not compensated by higher wage rates, the reverse being the case, again most of all in small-scale firms. And they had much less access to fringe benefits than regular workers. In short, the lot of a temporary worker is not an enviable one. Moreover, not only had casualization grown but overall firms expected to increase the share in total employment of temporary workers.

Contracting out employment has also been spreading, notably in larger companies and in Japanese companies most of all. But the trend has been fairly widespread. Again, this is symptomatic of a downloading of employment risk. However, in terms of employment flexibility the outstanding development has been a growth, or regrowth, of *contract labour*. In Malaysia this was a traditional feature of the wood products industry, but it grew between 1985 and 1988 in practically all industries. Firms also expected it to continue to grow relative to regular employment, particularly in the wood products, textiles and non-metallic mineral products industries.

In some respects contract workers are in a less precarious position than casual or temporary workers, and were less likely to be among the low paid. Often they have skills in demand. What they lack is employment security, and also one suspects that a long-term cost of reliance on contract labour is that such workers have skills that do not evolve with technological change, if only because there may be a lack of pressure to innovate when production work is fragmented into contract labour. This need not be the case, but is an hypothesis that deserves to be pursued, especially given the spread of managerial models of decentralization. Short-term expediency may have long-term costs in terms of lost dynamic efficiency, involving an atrophy of manual skills at a time when the need for higher-level skills is growing.

In sum, although there has been only a modest spread of part-time working, there has been a fairly substantial shift from regular, full-time wage and salaried employment to various forms of non-regular work, particularly at the lower end of the labour market. This trend was widely expected to persist into the early

1990s, at least. It may have been started as a short-run response to the recession of the mid-1980s. That it was expected to continue suggests that it is a longer-term trend that will need to be addressed by policy makers in the post-NEP era. What sort of protection do such non-regular workers receive? For temporary and casual labour, the primary need is for income protection and contractual security, or at least knowledge of where they stand. For contract labour, the primary need is access to training and some mechanisms for reducing income fluctuations.

There is another type of employment flexibility that also needs to be monitored in the next few years. Many workers are put on probationary status for some months, during which they have no employment security and can be laid off at any time. Employers have good reasons for using this device. But there has been a tendency for the probation period to grow and for more workers to be in that insecure status. The most likely reasons are that such workers can be easily laid off and be paid lower wages and benefits. If probationary employment were abused it could erode the already vulnerable position of those who only have a foothold on the labour market ladder. Tighter regulation of the probationary worker status seems desirable, so that it corresponds more closely to reasonable criteria, such as the time required to learn the skills required for the job.

As for the role of labour regulations on these trends, it is worth reiterating that they did not appear to have a negative effect on the level of employment. When asked whether the provisions of the Employment Act on termination of employment had affected their employment policy in any way, nearly 94 per cent of manufacturing firms said that it had not had any effect; only a little over 2 per cent said that it had affected the level of employment, and 1.6 per cent said that it had encouraged them to resort more to contract labour rather than direct labour. One must be wary about drawing too much from such figures, because the Act may have conditioned behaviour and was only one of various factors having an influence. Nevertheless, the responses do not indicate pressure or the need for reform on employment grounds. With the growing employment flexibility, there does not seem to be any need. It is not labour regulations that dictate employment levels but market influences such as cyclical fluctuations in demand, structures of production, technological options and the need for a flexible labour force. There is no evidence that labour regulations have affected those issues, so that one can conclude that there is no prima facie case for weakening existing regulations. Conversely, one might also be inclined to conclude that strengthening them or their implementation would have little effect on employment *per se* but may have a beneficial effect in encouraging good employment practices. In general, in the 1990s for both welfare and dynamic efficiency reasons, policy makers may be concerned to see that labour flexibility is achieved in a context of growing labour market and employment security, not the reverse.

3.3.5 Internal Labour Flexibility

We have been looking also at how firms have been adjusting "internal labour market" practices, including many aspects of recruitment, training, retraining, mobility and retrenchment that may preoccupy policy makers in the next few years. Here there is only time to highlight one or two trends, which are elaborated elsewhere.

Preliminary analysis indicates that both labour turnover and internal labour mobility are low in manufacturing. The latter may be related to the growth of something like skill polarization of employment, corresponding to what has been happening in some industrialized economies. This has implications for labour market and training policy. Technological and other changes have been increasing the demand for technicians and diminishing that for skilled manual workers. And large-scale establishments, which have been growing relative to smaller firms, have higher ratios of technical and semi-skilled workers to other categories than were found in small-scale firms. These combined shifts imply a reduced scope for internal labour markets, whereby workers who enter on lower rungs could expect to climb occupationally, through on-the-job experience or training. If so, off-the-job training and qualifications will become more important for labour mobility and for overall labour efficiency. That will probably mean that Government will have to assume a greater role in the provision or organization of technical training. And if there is a further growth in demand for technicians, the fact that only larger and more profitable companies could afford to pay for training courses will surely mean that the Government will have to strengthen "anti-poaching" measures. Otherwise many firms will find that the prospective return to training such workers will be insufficient to justify the cost. Already small firms do little training and have faced difficulties in retaining those they have trained.

Section II discussed the four modes of labour adjustment. The data show that the least developed in Malaysia is the third and fourth, which happen to be the least painful for the workforce. On-the-job *retraining*, both to replace obsolescent skills and to augment those workers have absorbed, must play a greater role in the post-NEP era. And the Ministry of Human Resources will surely have to develop a more complex and multi-layered employment exchange service, to reduce frictional unemployment and help make the labour reallocation process more efficient.

3.4 The Feminization of Labour

In many parts of the world, the growth of external and internal labour flexibility has led to a rapid growth in female employment (see, for example, Standing 1989). Of course, that was a feature of the second and third phases of Malaysia's industrialization, involving an influx of young girls to carry out semi-skilled jobs in the main export industries. Some fears have been expressed about a reversal of that trend, through automation and declines in "direct labour". Yet in the late

1980s female employment grew across the board. A large number of establishments in the 1988 MLFS had increased their female employment shares and reported that they expected to increase it further in the next two years. Moreover, the nature of the demand has been changing, since proportionately fewer women workers seem to be hired on the expectation that they would work for two or three years and then withdraw in their early twenties to have families. The Malaysian economy in the 1990s will have passed the stage when it could rely on low-paid, young female labour. Women have been gaining shares of skilled, technical and administrative employment.

The authorities may have to consider refining family policy to correspond to such changes in the labour market. More women should be enabled, if they choose, to remain in the labour force to pursue an uninterrupted "career", which means that Government and employers may have to give more attention to the provision of child-care facilities. Labour policy may have to shift from the point of labour market entry, since it is apparent that women have been gaining access to a broad range of jobs, towards measures to facilitate subsequent labour mobility. Other studies have found that women workers, unlike men, have had no discernible income return to labour market experience. In future, the discouragement of discrimination against women in the internal labour market of enterprises will be more important than at the enterprise entry point. This will have a triple purpose. It could reduce sex-related inequality in the labour market. It could reduce inter-household inequality — since almost certainly it is women from lower-income households who most suffer from discriminatory barriers, and it is they who provide a substantial share of their family income. And it could reduce ethnic inequality — since Malay women in particular will need to be assisted in obtaining upward occupational and income mobility. This issue will be made all the more critical if privatization and cutbacks of the public sector continue, since the public sector has been a major source of upward labour mobility for Malay women under the NEP.

3.5 Wage Flexibility and Inequality

Income inequality has diminished in Malaysia according to official statistics. If so, whatever the causes, then the emergence of more flexible labour markets suggests that several specific forms of wage inequality may grow. Probably a growing proportion of the labour force in manufacturing are not having access to fringe benefits because of their work status; these nowadays have considerable financial value for many workers, and their exclusion from measures of earnings results in an understatement of earnings inequality, because it tends to be the lower-paid who do not have the access to such benefits. There is also an international trend whereby management and "white-collar" workers are receiving larger shares of their incomes in the form of bonuses, shares and perks that lower-paid blue-collar workers do without. There is some evidence that this divergence has been growing in Malaysia too.

As for pay flexibility, efforts to promote "profit sharing pay" systems are in their early days in Malaysia, although of course traditional forms have characterized many small, family business. We found that only about 3 per cent of manufacturing establishments were operating a profit-related pay system, but various observers believe that this practice will spread as a means of imparting wage flexibility. If so, it can be predicted that it will contribute to income inequality, between those in large, profitable, export-oriented enterprises and those outside them, and between privileged insiders in such enterprises and others. Finally, if there is a skill polarization of sorts in progress, that in itself could widen earnings inequality, enabling a small core of technicians and upper-level management to strengthen their position at the expense of middle-level supervision labour (which, quite clearly, has been shrinking) and skilled manual workers. This will pose policy makers with various dilemmas connected with tax policy and redistribution, in particular. It will also pose a challenge for trade unions, since bargaining only for "insiders" may become increasingly difficult, especially if employers can effectively play off one group against another, if only by the threat of turning to more flexible worker categories. This is going to be a major dilemma for trade unions everywhere, and nowhere more so than in Malaysia where unions are facing a painful phase of adjustment.

4. Some Concluding Points: The Danger of Beggar-my-Neighbour "Competitiveness"

The Malaysian economy has rebounded from the traumas of the mid-1980s, and industry surely faces the post-NEP era with justifiable confidence. The NEP has been a success by many yardsticks. But what we have called the fourth phase of the country's industrialization strategy raises new challenges for policy makers.

One issue that must be reconsidered is the headlong pursuit of "competitiveness" based on measures and pressures to lower labour costs, symbolized by amendments to the labour laws, hostility towards industrial trade unions, and so on. It is understandable that cost cutting should be a response to a recession, but already labour costs are only a small proportion of total production costs, while such a strategy is inherently unstable and inequitable. The call to pare labour costs usually means lowering the wages and benefits of low-wage production workers relative to those earning their income from profits or those in salaried employment whose incomes are tied to levels prevailing in other typically higher-income countries. That aside, the concern to cut labour costs in this way to match those of other economies is likely to be more than matched elsewhere, whether it be in Thailand or Indonesia tomorrow or some other countries shortly afterwards. "Beggar-my-neighbour" wage cutting is simply not a realistic or desirable option. The emergence of a more flexible labour market may make wage and other labour cost cutting more feasible in the short run, but as labour costs are probably only about 15 per cent of total production costs, there is not much to be gained by that route anyway.

It is the alternative strategy that deserves to be pursued more vigorously and single-mindedly, that of providing a regulatory framework coupling worker security with labour flexibility in which the overall utilization, development and replenishment of skills can be ensured. A basic issue for Malaysia in the post-NEP era will be the awkward transition from an economy geared to exports based on low-cost, semi-skilled labour to one based on dynamic efficiency and technical skills. This in a sense is what lies behind many of the current traumas in the South Korean labour market. And this is what is meant by a Human Resource Development Strategy. As part of that strategy one could envisage a set of policies to promote the model of human-resource-oriented enterprises (HRE), firms that pursue active labour policies to upgrade their workforces through work design, training, retraining and negotiated flexibility.

Seeing the future labour policy framework in this way may not seem very novel. But being quite clear about it does alter one's sense of priorities and concerns. It implies a more systematic recognition that workers are more than factors of production. It will mean that very long workweeks of 60 hours or suchlike will be regarded as alien to dynamic efficiency, to be curtailed or discouraged as incompatible with the refinement of real technical skills. It will mean giving contractual security in which workers are encouraged to feel the dignity of work, which should not be seen as the right of a minority but which will be essential for effective labour utilization in an era when "flexible specialization" of various kinds will be a key to long-term development success. It will mean creating a framework in which organizations genuinely representing the interests of workers will be integrated into the production process, where employers and government can recognize that this could be a vital source of pressure on industrial enterprises to achieve dynamic efficiency in the work process.

Such conclusions may seem to relate to some distant future. However, Malaysia's successful development owes a great deal to a correspondence between its industrial strategy and the character of its labour supply. The post-NEP era will see an evolution of that industrial strategy, to higher-technology, higher value-added production and more complex production and work processes. To be truly successful, the labour supply and the labour policies that shape it will have to evolve accordingly.

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Appendix 1

The 1988 Malaysian Manufacturing Labour Flexibility Survey

This paper is based on a national establishment-level survey of manufacturing conducted in mid-1988, the methodological details of which are given elsewhere. It is nevertheless appropriate to include a few methodological comments. Before doing so, it is nice to acknowledge the kindness and encouragement given by officials in the Human Resources Section of the EPU, in the Department of Statistics (DOS) — whose team of enumerators and supervisory staff entered the exercise with a professionalism and enthusiasm that should be more widely appreciated — and friends in the Ministry of Human Resources. None of them should be blamed for errors, but they know my gratitude. It was some of them who persuaded me to do this work and to return to Malaysia five years after having conducted two large surveys in the early 1980s, in the Federal Territory and PJ and in Kelantan. Therefore, I would like to take the opportunity to thank those who have helped and encouraged me during this survey, and to say that I will do so more formally when the full manuscript is finalized.

Briefly, it was decided at the end of 1987 to launch an establishment-level survey of labour market mechanisms. Initially we intended to select a few industries in three major urban-industrial areas, but it was then decided to make it a national, representative survey of the manufacturing sector as a whole, with a few minor omissions that had previously caused difficulty for the Department of Statistics' sampling frame. Clearly a national survey was preferable, although of course the increased scale and scope created a great deal of additional work. It was only feasible because we were able to mobilize a national team of experienced enumerators drawn from the Department of Statistics' staff. Ideally, it would have been better still to have included the construction and service sectors, but this was ruled out on practical grounds.

In the early months of 1988 the questionnaire design was finalized through a necessarily protracted process, which included numerous meetings, a seminar in the Bureau of Statistics in the ILO and a "pre-pilot", in which we visited about 50 companies in Kuala Lumpur and Selangor, in each case using the draft questionnaires to structure interviews with senior personnel officers or senior management or the owner of the business. In March-April 1988 we organized two pilot surveys in and around the Free Trade Zone in Penang and Butterworth. In July there was a two-stage training process, the first week of which was devoted to the training of the supervisors and heads of local DOS offices, the second to training at the local level in all States of Peninsular Malaysia. The fieldwork was launched in the second half of July and lasted until the end of August. Data were checked at the local level and then validated in KL over the next few months. The real analysis of the data was started in early 1989 and is now close to completion.

The contents of the survey could be described in various ways, none of which would be ideal. But very approximately, the principal topics covered were as follows:

Employment structure 1985-1988
Expected employment changes 1988-1990
Wages, earnings, benefits, etc
External labour flexibility — work statuses, etc
Recruitment practices
Training and retraining
Internal labour flexibility — mobility, job structures, etc
Labour turnover
Working practices
Technological change influencing employment
Labour regulations
Labour surplus, retrenchment, etc
Labour shortages and responses

Not all of those topics were covered in the same detail — or with the same degree of adequacy or success — but a considerable amount of information was gathered. The data were collected by means of a two-part questionnaire and a two-stage process. First, accompanied by a letter of introduction explaining the broad objectives of the survey. Section One of the questionnaire was delivered to the management of the establishment, with instructions that it should be completed and signed by a senior representative of management dealing with employment and personnel matters. Section One covered basic statistical data on employment, vacancies, working practices, earnings, payment system, working time, capital, sales, ownership, exports, etc. Then, a week or so later the enumerator visited the establishment for a pre-arranged interview with the owner, manager or personnel officer. The interview itself was preceded by a check that Section One had been completed and correctly understood. The enumerator then proceeded with an oral interview based on Section Two of the questionnaire, which contained a mix of factual and attitudinal questions, most of which had sets of precoded responses.

One should stress these basic methodological issues, however dull they may be to the economist reader, because too many surveys are reported with unstated methodology. They can often be very slap-happy, undeserving of the seriousness with which the results and analysis are subsequently treated. Postal questionnaire surveys of the sort of issues covered by the MLFS are worth practically nothing unless one can guarantee a very high and representative response rate and that the respondent is senior enough and in an appropriate position to give valid, honest answers to questions that he or she has understood. I am not for a moment claiming that we overcame all such problems in this survey, far from it. But the pre-pilots, the pilots, the detailed training, the type of fieldwork and the validation procedures gave us a reasonable chance of obtaining reasonable data. It had been expected that we would attain a response rate of 50 per cent or less, given the sensitive nature of the issues, the type of respondents, the length of the questionnaires and the wide geographical coverage. It was a tribute to the team that we achieved a response rate of over 80 per cent; in only one State did we fail to secure a reasonable response rate, where fortunately there are very few manufacturing establishments. By any standards, with such a large sample and survey, the response rate was satisfactory.

In sum, the MLFS was both ambitious and fairly comprehensive albeit only intended to be *impressionistic* on certain issues. It seems to have provided data of good quality for such a large establishment-level survey. When the analysis is completed, we hope that the information generated will provide a sound basis for policy debates and a sound basis for follow-up work that will further the analysis of the Malaysian labour market, and be a useful guide for policy formulation in the post-NEP era.

Appendix 2

Expectations of Employment Changes: A Methodological Note

Many methods have been devised for forecasting employment, but relatively few attempts have been made to ascertain company employment plans at the micro-level. As in all such exercises, three difficulties arise. First, unforseen circumstances inevitably cause plans to be changed; second, many firms operate on very short-term planning horizons, essentially reacting to market and personal events; and third, the limited reliability of necessarily subjective employment planning data will depend on the reference period set in the questions addressed to management.

Given those caveats, establishments were asked whether they expected or planned to increase or decrease employment or maintain the existing level during the next two years. Clearly, this is a short time horizon, but it was felt that extending it to, say, five years would have resulted in excessively unrealistic and "soft" information. In any case, probably reflecting the lack of employment planning at the firm level as much as anything else, about half the sample reported that they expected or planned no change in their level of employment in the next two years.[7]

[7]As a methodological and policy-relevant aside, while asking employers about their plans and expectations on employment is a useful means of helping planners and macro-economic policy, one should not ask such questions through a postal questionnaire in which answers are obtained from junior employees. It is also recommended that in future separate questions should refer to *plans* and to *expectations*, with a specific question asking whether or not the company has formal plans for expanding or cutting employment. A potentially important aspect of such a process would be the encouragement given to firms to plan employment, which could only help to develop an orderly, efficient and more equitable labour market, which would be in everybody's interest.

Commentary

Lee Kiong Hock

Although there has been a noticeable shift in policy from redistribution towards boosting economic growth, the latter is not being pursued to the complete exclusion of the former. Guy Standing's paper is therefore most timely for it points to a need to strike a balance between labour flexibility on the one hand, and social equity on the other.

The paper goes into a somewhat lengthy, though informative and readable, discussion of the debate between the two principal schools of thought: the supply-side model of adjustment associated with the arguments for labour flexibility, and the social adjustment model associated with the arguments for social equity. The real meat of the paper comes after a lengthy discussion on some empirical findings drawn from a mid-1988 survey of some 2,600 Malaysian manufacturing establishments.

One of the most important findings, which Standing argues should be recalled in the event of any call for deregulation in the labour market, is that labour issues are seldom cited as having influenced employment within the establishments. The factors which turn out to be important are demand, business uncertainty, new technology and plant capacity.

At this point, it should be remembered that the survey was conducted in the middle of 1988 — not very long after the nation's worst economic recession in more than a generation. 1985 was in fact the worst year. It was also a period when retrenchments reached a peak. The turn-around in the economy began no more than a year and a half before the survey was conducted. Even then, the turn-around was somewhat uncertain, at least until the latter part of 1988.

It is therefore not surprising to find that, aside from demand factors, business uncertainty was cited as the next most important factor influencing employment levels within the establishments. In a period of business uncertainty it would not be too surprising to find that labour factors do not feature prominently among the factors affecting employment. In a different setting labour issues could turn out to be very important; for instance during a recession as establishments seek to reduce costs in order to remain in business. Further, the fact that labour issues do not feature prominently now does not imply that the situation will remain unchanged if an attempt is made to introduce further labour regulations.

The principal challenge posed by Standing is the need to strike a balance between the need for labour flexibility and the need for social equity. No one would possibly deny that this challenge should be met. Unfortunately, Standing does not discuss how this balance can be achieved, or what form it should take. It would have been of greater practical relevance to policy makers if Standing could have suggested some indicators which could be used to show when tolerable levels of deregulation or labour flexibility have been exceeded. To go a step further, in terms of practical relevance, Standing could have also suggested the type of institutional mechanism that is necessary to achieve this balance between labour flexibility and social equity.

When it comes to employment creation, Standing seems to favour large-scale establishments by arguing that small-scale establishments have not been a good source of new jobs. Clearly, the question is not whether individual small-scale establishments are a good source of new jobs but rather whether small-scale establishments taken as a whole are a good source of new jobs. As Standing himself notes, when reference is made to employment creation among small-scale establishments such reference must not be confined to existing establishments but should be extended to new small-scale establishments.

A look at the available data, for instance Table 8 in Standing's paper, shows that the actual proportion of small-scale establishments that increased their labour force is not "very small", as Standing implies. Almost forty percent increased their employment size over the 1985-1988 period. On the other hand, the observed growth in employment among the large-scale establishments, over the same period, can be attributed in part to the rehiring of workers retrenched in 1985. Retrenchments in 1985, the base year, might have been excessive as the establishments, as Standing notes, sought to rehire the same workers but on less favourable terms.

Standing is clearly not arguing against labour flexibility but rather for the need to protect certain categories of workers such as casual, temporary and contract workers. It would have been useful to know the actual proportion of workers who are in fact engaged in such forms of employment across industries and occupations, and also how these proportions have changed over time. If the proportions are small, even though they may be increasing particularly during a recessionary period, one wonders if it is worth the additional costs needed to monitor this problem or to enforce additional labour regulations designed specifically for such categories of workers. As Standing notes, there is a very limited number of labour law officers — no more than 200 in the entire country. Additional labour regulations might require substantially more labour law officers for adequate enforcement.

Notwithstanding these comments, which could serve to improve the paper's usefulness particularly for those who shape labour policies, Standing's paper should be read by all concerned with labour policies in Malaysia. His call for a balance between labour flexibility on the one hand and social equity on the other is most opportune; lest in the pursuit of greater international competitiveness we should neglect the needs of those least able to protect themselves.

REFORMING THE WAGE AND SALARY SYSTEM

M. Zain Majid

This short paper argues for reorientation of the current system of wage and salary payments which generally feature long and often open-ended scales, pre-determined and automatic increments, and increases being awarded on the basis of seniority rather than employee's productivity or the firm's profitability. The suggestion is for a more flexible system to accommodate changing economic situations and to take into account the enterprise's profitability and the employee's productivity. This revision still allows for negotiations between representatives of employers and employees. The proposal would also necessitate sharing of information between both sides, more trust between employers and employees and a non-confrontational approach to industrial relations.

1. Introduction

The word "reform" may conjure up something radical or even revolutionary. For the reform suggested here, in the light of present economic circumstances, the word "realignment" or "readjustment" may be equally appropriate.

2. Two Important Labour Market Phenomena

Within the Malaysian context, two labour market phenomena should be noted. First is the unemployment rate, which now stands at around eight per cent of the labour force. The growth in the labour force has not been matched by an increase in employment opportunities. There is a two-fold problem of providing jobs for those without work, and providing employment stability for those in employment.

The second phenomenon is this. There are indications that wage and salary costs as a proportion of total costs in many firms are increasing year by year. For example, a confidential study of a number of manufacturing industries over a ten-year period found that wages and salaries per employee in these establishments grew by an annual average rate of 10.6 per cent. The consumer price index for the same period rose by only 4.9 per cent per annum. There are also signs that labour costs per employee are rising much faster than labour productivity.

According to the Industrial Master Plan, if Malaysia is to join the ranks of the NICs, wage increases should be held at three per cent per annum for ten years. At the same time, labour productivity should increase by ten per cent per annum. It is crucial for wage and salary increases to lag behind increases in productivity, especially when the country is trying to expand its economic base and to generate increased exports.

3. Effects of Present Wage Structure

Wage structures in the organized, that is the unionized, private sector in Malaysia are usually determined through the process of collective bargaining. The typical salary scale begins with a minimum starting salary, continues with annual increments in pre-determined steps, and ends with a maximum. Sometimes the maximum is not provided for so that the scale is open-ended. In such cases, unions often demand that the employee should continue to enjoy salary increments throughout his/her service. This could well result, say, in a hotel doorman drawing a basic salary comparable to that of a manager. Besides the usual annual increments, there is also a salary adjustment whenever a collective agreement is concluded. Usually, the rate of this salary adjustment is two-thirds of the percentage increase of the consumer price index in the previous three years. If we take into account both the usual annual increment, and the salary adjustment given every three years following renewal of the collective agreement, the increase in salary over a period of, say, six years, could be as much as seventy five per cent based upon two salary adjustments of about five per cent on each occasion plus the usual annual increments.

As an illustration, consider the following:-

basic monthly salary as at 1/1/83	\$315
annual increment in 1983	\$30
basic monthly salary as at 1/1/84	\$345
annual increment in 1984	\$30
basic monthly salary as at 1/1/85	\$375
salary adjustment in 1985 under new collective agreement	\$20
annual increment in 1985	\$32
basic monthly salary as at 1/1/86	\$427
annual increment in 1986	\$32
basic monthly salary as at 1/1/87	\$459
annual increment in 1987	\$32
basic monthly salary as at 1/1/88	\$491
salary adjustment in 1988 under new collective agreement	\$25
annual increment in 1988	\$34
basic monthly salary as at 1/1/89	\$550
percentage increase in basic pay over six year period	75%

The above is a typical example of how the present system works. Since 1983, the scale has been revised twice (in 1985 and 1988). As a result, the employee has had two salary adjustments aside from the annual increments. The seventy five per cent increase in basic pay over the six year period is not related to the employee's productivity or the company's performance. The increase has become permanently built into the employee's salary and this is not adjustable downwards even when there is a downturn in the economy.

Perceptions of what is a minimum wage, a fair wage or a living wage vary. The employer may be interested in a wage rate which is stable and predictable. The worker may be interested in his take-home pay, net of any deduction. There is no one system or method of payment universally suitable for all workers or all employers. In any system of payment for work or services, there should be agreement on certain major criteria, for example, the needs of the worker, and the job to be done. There must also be agreement that the system of payment should not be too complicated and should allow for some adjustment to changing economic conditions.

4. Addressing Deficiencies of the Present Wage System

There are several deficiencies of the present wage and salary system. For example, the salary scales are often too long or open-ended and the quantum of the annual increments is predetermined and given automatically. Wage increases are awarded on the basis of seniority of service rather than the performance of the company or the employee. Further, bonus payments are sometimes contractual and once given are not normally adjustable. These deficiencies have to be addressed. In particular, the wage system must be more flexible and responsive to changing economic situations.

It is necessary to develop a wage system that is flexible enough to accommodate changing situations such as a severe recession or erosion of the country's competitiveness. In such situations, the level of remuneration should be capable of some downward adjustment. On the other hand, when an employer's fortunes are good especially if achieved through increased productivity, extra benefits should be made available to workers. In other words, the wage system should contribute to the company's competitiveness, and at the same time it should reflect the value of the job. The system should take into account the company's profitability and the employee's performance. Wage increments should lag behind productivity growth instead of outpacing it. It is, of course, natural to expect that the wage system should also provide income stability to the worker and should foster the growth of a responsible workforce, dedicated to raising productivity levels and reducing cost.

In trying to devise a new wage and salary system, the following objectives should be kept in mind. The system should:

a) contribute to the social and economic growth of Malaysia;

b) provide for stable and fair relations between employers and employees;
c) provide a reasonable incentive to new investors so as to create more employment.

In designing a new wage system for Malaysia one should have regard to certain considerations such as:

a) the need for a much shorter salary range;
b) the need for some flexibility in the structure;
c) the need for a moderate automatic annual increase in the basic wage, the basis for the system being that annual wage adjustments should be performance and productivity related; and
d) the need for wage rates to reflect the worth of the job.

5. Towards A More Flexible Wage System

Last year the Malaysian Employers Federation (MEF) sought the assistance of the International Labour Organization to make a study of our wage systems and make recommendations for reform. The study recommended that, initially through Government intervention, a national maximum or ceiling for wage increases should be set. This ceiling, and the period for which it should be applicable, would be determined through consultation with employers and unions, and other relevant interests. Any collective bargaining undertaken during this initial stage of the reform process must limit the aggregate cost of wage increases to an amount not greater than the established ceiling.

In the second stage of the reform process, the study recommended that wage increases should be related to performance. One way of achieving this is through dividing the salary scale into four quartiles. All employees in the first quartile will be entitled to receive their full annual increment on the due date. Employees in the second quartile would receive seventy-five per cent of their annual increment automatically on the due date, while the remaining twenty-five per cent would constitute the maximum of the variable component to be given, based on the performance of the company or the employee or a combination of both. Employees in the third and fourth quartiles will have a variable component of fifty per cent and seventy five per cent, respectively. The effect of this is that as an employee progresses towards the maximum of the scale, a greater percentage of his annual increment will be tied to productivity and profitability while a smaller percentage becomes automatic entitlement.

The above is one model of the flexible wage system. Another one that is often talked about is the profit-sharing model. It may consist of a basic wage; a small percentage (usually 2-3 per cent) as service increment; a bonus of no more than a month's basic wage to serve as a supplement; and a variable performance bonus based on profit to be determined through collective negotiation. Another variant is the productivity model. Here the variable element is a productivity payment, the general rule being that wage increase should always lag behind productivity increase.

Trade union circles sometimes have the misconception that the purpose of instituting reform or change in the wage and salary system is to reduce worker income. Nothing can be further from the truth. No one disputes that the worker should be given a fair basic wage adequate for a decent standard of living. Such basic wage must, however, reflect the value of the job in the market place. Thus, any reform towards a more flexible wage system must start with the notion of a fair basic wage. Other components of the system may include elements as outlined above. The principal feature of the formula is the use of a variable component, that is a flexible portion, the amount payable being determined by profitability and/or productivity.

Whether one uses the profit-sharing model, the productivity model or any other, it is necessary that relevant data are readily available. Even if these are available, there must be agreement between the negotiating parties on which figures to use. This is important as profit can be reckoned in several ways, and productivity measures are often subject to dispute. With regard to employee performance, it is essential that there exists a workable system of job evaluation and staff appraisal.

The implementation of a flexible wage system is best left to representatives of employers and employees. Progress towards reform is likely to be very slow if the Government plays no part in initiating the process. The Government should act as a catalyst and initiate the necessary action towards reform. It is hoped that some positive steps will be taken in this connection. In the meanwhile, the MEF has appointed a special sub-committee to study the matter in greater depth to see how flexibility may be implemented, beginning at the level of the individual corporation.

6. Concluding Remarks

Successful change from the present system requires a non-confrontational approach to industrial relations. There must be more trust between employers and employees. It follows that there must be more regular formal and informal meetings between both parties. Discussions should be held in a frank manner, and there should be greater sharing of market and other corporate information.

Commentary

Martin Khor

Wage Policy in a Complex Setting

The first point to make is that an appropriate wage policy is a complex issue in an economy as differentiated as Malaysia's. We cannot have a single wage policy because there are different sectors and different types of production units. In particular:

- The wage economy is only part of the total economy; there is a large non-wage sector of especially farmers and self employed.
- We have the "modern sector" that is exposed to international markets — part of the manufacturing sector, banking and big trading companies. This is the sector where labour is better organized, there are collective agreements with annual increments up to a maximum. But this is only a tenth of the manufacturing workforce, and much less than a tenth of employees in all sectors.
- And there are sectors where there is no annual increment, such as in estates, where workers are still daily rated and daily rates are negotiated once in three or five years, and in construction, where some workers are employed on a contract basis.
- Even within the modern sector, such as in manufacturing, there is a difference between big and small firms. In small firms (industrial, retail, transport, professional services) there is no annual increment or scale but then neither is there a maximum.
- Finally, there is also the government sector which basically follows the big modern sector, except that wage adjustments are usually made once in five years (not three years) but sometimes stretch to eight or nine years.

Therefore when we talk of wage policy or reforms, we should differentiate where it would apply. We cannot have one policy for all sectors as this would lead to problems.

Wages, Productivity and Inflation

Mr Zain Majid says wage rates are rising faster than productivity; also that salary costs are rising as a proportion of total costs in most firms. He says wages per year grew at 10.6 per cent per employee in manufacturing over ten years whilst the Consumer Price Index rose by only 4.9 per cent per annum.

All these statements are very hard to believe. Firstly wages as a percentage of value-added has been dropping from 35 per cent or so in the 1960s to only 20 to 25 per cent now. It is hard to believe that wages per employee per year rose 11 per cent in manufacturing. To begin with, it is not true that every worker or even most workers in manufacturing have an annual increment. The Ministry of Labour's latest Occupational Wage Survey in Manufacturing found that in 1987 the number of workers who received increments was 61 per cent in electronics, 51 per cent in textiles, 57 per cent in fabricated metal products; but also was only 18 per cent in palm oil, 26 per cent in dairy products, 26 per cent in plywood, 32 per cent in furniture, 20 per cent in clay products and 34 per cent in motor vehicles. Those who did not receive increments perhaps did not have a wage scale or had reached their maximum.

Even if it is true that wages grew 10 per cent and the CPI 5 per cent, what is wrong with that? This would imply a real wage rise of 5 per cent. If the Gross National Product (GNP) in real terms was growing at 7.5 per cent and population or workforce by 2.5 per cent, then physical productivity is rising about 5 per cent per worker. If we want to retain the wage share in value added, the wage rate should then rise 5 per cent in real terms. If inflation is 5 per cent then the money wage rate should rise roughly 10 per cent. There is nothing shocking in this.

What is surprising is that the reverse seems to have happened. Wages have not kept pace with productivity increases in many areas of the economy. There are at least two ways to measure productivity:

a) Usually wage increases are compared with physical productivity. It is assumed that wages should rise at the same rate as output per worker, so that wage share remains the same and so that there would not be a wage-push inflation. Measured against physical productivity, wages have not kept pace in many areas. For example, in the rubber estate sector, average output per tapper rose from 2,247 kg in 1960 to 5,083 kg in 1980 — by 120 per cent. Yet the wage rate rose by less than 100 per cent (from \$3.40 to \$6.70) and in real terms it actually fell from \$3.40 to \$3.14 in 1960 prices.
b) Even then it is not fair to compare wage changes with changes in real output if we want to consider the issue from the viewpoint of social equity. This is because in an economy as open as Malaysia's, prices often rise irrespective of wage changes. For instance, when world prices go up, so do Malaysian exports earnings; or when the ringgit depreciates, there is greater revenue in ringgit terms for products sold abroad.

Hence we should look at productivity as the revenue-earning capacity per worker, in other words the monetary value-added per worker in current terms. If we assume the wage share should be constant then wage rates must rise at the same rate as value-added per worker. This has not been happening as a trend. Further it can be argued that the wage share of value added is too low — about 20-25 per cent in Malaysia compared to 65-70 per cent in Europe — and that therefore there is still room for wages to rise further.

Wages and Employment

However I agree that one limiting factor to wage increase is unemployment. This is mentioned in Zain's paper. There could be a relation between unemployment and wage levels. Should we protect the high wages of existing workers and risk lower growth and higher unemployment; or should we check wage increases so that there are more jobs? This is a serious dilemma. However there is no guarantee that lower wages would lead to more jobs. Unemployment can also be tackled by allowing people to use idle land for agriculture, etc.

Wages and Productivity

Zain's paper seems to be very biased towards productivity rise without a corresponding rise in wages. This implies a profit maximization policy. On the second page of his paper he quotes the Industrial Master Plan as saying that wage increases should be held at three per cent per annum for ten years whilst labour productivity should rise by ten per cent per annum. This means that wages would lag by 7 per cent per annum over ten years, at the end of which the share of profits would have risen stupendously. His statement that labour cost per employee is rising very much faster than labour productivity is not backed up by data; remember that whilst some staff get annual increments, others are frozen at the maximum and even if that maximum rises every three years it is unlikely to match the rise in productivity especially if that is measured in current prices.

Wages and Profits

The bias towards employers is shown again in the support for the International Labour Organization's (ILO) recommendation that the government should set a national maximum or ceiling for wage increases. This of course is going to be very difficult to do. Should we limit the wage increase in companies that are making super profits in particular years? What maximum should we take: the average increase rate, the rate among firms doing well or among those doing badly? And labour may justifiably ask: why set a ceiling on wages but not on profits? Should it not be much fairer to tax away excess profits so that the wage share in the economy is maintained? Employers will answer that taxing away high profits would dampen investor incentive. That's true. But setting a ceiling on wage increase would also dampen the morale of labour in the good performing companies. However it would be a good idea for the government to take the initiative to set wage guide-lines as to how much wage increases should be in particular year; and employers can pay even beyond that if they want to. This is like the National Wage Council (NWC) mechanism in Singapore.

Wage Reforms

The most important part of the paper concerns the suggestions for wage reform. Here the paper contrasts between a rigid system of constant regular wage increases up to a maximum versus a "flexi-wage" system in which increments are at least partly dependent on the company's ability to pay, profitability and individual performance of the worker. This is a very complex issue and it is clear that the experience of the 1985-86 recession was an impetus towards thinking of flexibility of wages. There are pros and cons to both systems.

In the system of constant wage increase: the advantage is that the worker knows he is getting an increase and by how much, so this reduces uncertainty and is good for stable relations. The employer also knows, so he can plan better. The disadvantage is that there is a possible disincentive to work hard since the increment is "automatic". On the other hand it can be argued that the stability that comes with knowing one's increment also fosters better morale and thus productivity. The great disadvantage to employers is that in a bad year or period it is very difficult to reduce wages which are inflexible downwards. So the problem arises in a recession. For the worker the disadvantage is that there is a maximum point beyond which increment stops.

In the system of flexi-wage, a part of wage increment is tied to the firm's profitability or to the individual worker's performance or to both. The advantage to the firm is that in a recessionary period there is greater room for manoeuvre to limit wage increments. Another advantage is that the good workers are given better reward and so are better motivated. The great disadvantage is that flexi-wage increases the degree of uncertainty and also increases the element of subjectivity in evaluating different staff performances. However "objective" an evaluation system is, there are controversies over who deserves how much. There could well be less stability in labour relations.

In the flexi-wage system, a lot depends on trust on the part of labour on the fairness of employers. The system is more open to controversy in areas like how do you measure productivity, profitability, ability to pay, judgement on individual performance, etc.

The Malaysian Trade Union Congress (MTUC) has already announced its misgivings on flexi-wage. The *New Straits Times* of 7.8.89 reported that the MTUC president, Zainal Rampak, said that the flexi-wage concept was unacceptable as workers would be deprived of yearly increments and employers would be free to discriminate in determining the wage — according to job performance or other questionable factors such as looks and personality. He called instead for minimum wages as a policy.

An alternative to a flexi-wage system could be to introduce flexible-reward components into the existing system. For instance, workers who do well could get more than the normal increment and workers who perform unsatisfactorily could get less — but only a small minority on either side should deviate from the norm. Another method is to give an additional bonus (perhaps mid-year) to better staff. The company's ability to pay could also be stated as a condition for increment; this could allow deviations from the normal increment in bad years;

but with a balancing clause that after the recovery the lost amounts could be at least partly made up for. In any case any modifications to the system should be done with care; employers have to prove they have the workers' interests at heart.

An Off-Setting Incremental System

One final point. It seems to me that a large part of the wage issue has to do with the fact that there are two categories of workers in the modern sector: those still having annual increments and those already on the maximum level. The demand for wage adjustment comes especially from those who have reached their maximum. Should they not be protected from inflation even after reaching maximum? That is why there is an adjustment. But should those already getting annual increment also at that point enjoy an adjustment? Ideally, inflation and productivity should be covered in the normal increments. An idea worth considering is to have adjustments only for those already at the maximum point, once in three years or so. Take a scale of $300 to $600 with $25 increment a year. After 12 years the worker reaches maximum but has the maximum increased every three years or so. When this happens, existing staff still on annual increment will have increments for more years since the maximum is extended to, say $700. In Singapore's NWC system, this concept is sometimes used. Those already getting a normal increment need not get a full part of an adjustment. They call it "off-setting". For example, in a particular year the NWC recommends a 10 per cent wage increase. It may say 10 per cent with off-setting. If someone is already getting 6 per cent normal increment, then he gets 6 per cent plus only 4 per cent NWC increment to make it 10 per cent, whereas someone on maximum will get the full 10 per cent NWC increase. Without off-setting, the first person would get 6 per cent plus 10 per cent equals 16 per cent increase, which could be too high. But if he gets 10 per cent, it does not mean he loses the 6 per cent extra altogether: it will be added on to the maximum level pay so that he gets it later. In other words there is a longer period of wage increments, better spaced out, which makes it more orderly.

MALAYSIAN SAVING IN THE 1990S: PROBLEMS AND PROSPECTS

Homi Kharas

This paper reviews aggregate savings performance and the sectoral composition of savings in Malaysia. It concludes that high savings in Malaysia results primarily from rapid economic growth and from macro-economic policies to promote competitiveness — largely via exchange depreciation. Institutional arrangements for generating contractual savings via provident fund contributions, however, do not raise the level of saving but do alter its composition.

The household sector is the dominant source of saving surpluses in Malaysia. These funds are mostly mobilized through provident funds, insurance companies and other special saving schemes (ASN, LUTH, NSB), which for prudential reasons prefer the safety of investing in public sector assets. These funds have helped to finance public investment in the past, but now provide an excess over more moderate current levels of public investment. Compared with other countries, very little household savings is mobilized through the domestic banking system. There is, therefore, a problem in channelling household savings to finance private investment.

1. Introduction

Malaysia has saved an average 33.6 per cent of GNP over the last two years, a level among the highest in the world. For many economists, this would be perceived as an indicator of superior economic performance and of buoyant future growth prospects. After all, Lewis (1954) called raising savings rates the "central problem of economic development". Domestic savings were identified as the key to raising investment and investment was taken as a *sine qua non* of growth. Since then, empirical evidence linking domestic savings and domestic investment,[1] and the external debt problems of LDCs seeking to break this link with foreign borrowing, has given fresh emphasis to the policy prescription to raise domestic savings.

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[1]See, for example, Feldstein and Horioka 1989.

More recently, however, the idea that high aggregate saving levels drive growth has been questioned. Kaldor and others argued that income distribution would adjust to equate ex-post savings and investment, so that efforts to raise savings would be futile without a rise in investment demand.[2] In this model, investment drives growth which drives saving. The causality in the savings/growth relationship has been analyzed econometrically; for example, Ortmeyer (1980) concludes that income drives saving rather than vice-versa. This seems to fit the East Asian experience well, and has been interpreted as evidence in favour of the permanent income hypothesis.[3] The implication is that high savings are symptomatic of good performance rather than a cause. Thus, government policies which artificially boost savings may not by themselves result in higher growth. Deaton (1989) also finds, based on cross-country evidence, only a weak relationship between savings and growth rates, which varies in strength depending on choice of countries in the sample.

The inconclusive and often contradictory empirical results are partly the result of faulty data. One problem that arises in time-series analysis of national savings is that aggregate data are normally used, with a reliance on national income accounts data so as to be consistent across countries (for example, Giovannini 1985). The usefulness of such equations, however, is limited because the choice of a common functional form across countries inevitably imposes a specification error by failing to take into account important institutional and policy differences that influence savings. For example, few studies account separately for the important role played by contractual savings in Malaysia through the Employees Provident Fund (EPF) and other such agencies. Aggregation also does not permit a detailed analysis of behavioural differences between households, corporations and the government. Only under extreme conditions (so-called Ricardian equivalence), can it be assumed that changes in the distribution of income between the public and private sectors are unimportant. Such changes have been widespread in Malaysia as the foreign and public sectors in particular have seen large shifts in relative incomes during the course of the New Economic Policy (NEP).

This paper reviews the determinants of savings and their intermediation in Malaysia with the objective of analyzing whether intervention in the savings process has a role in supporting Malaysia's long-term growth goals. A set of specific questions is addressed. First, are current high savings levels cyclical or do they reflect long-run savings propensities? Second, will rapid growth itself bring forth an adequate level of domestic savings? Third, what is the role of contractual savings schemes? Fourth, how do changes in income distribution that

[2]Recall Kaletsky's famous aphorism that "capitalists get when they spend while workers get what they spend."

[3]See Yusuf and Peters (1984) for Korea; Liang (1983) for Taiwan; Sato (1987) for Japan, and Lahiri (1989) for an overview.

may follow from the choice of a specific development strategy affect the level and composition of national savings? Fifth, what role does the process of financial intermediation have on the allocation and efficiency of investment?

The approach taken in this paper is to use the national income and other macro-economic accounts to disaggregate between the public, corporate, household and foreign sectors. This disaggregation is the minimum that is required to assess the underlying behavioural determinants of saving; it also permits the study of distributional issues and of the intermediation of net savings between sectors.[4] Thus, the analysis can be used to address questions about the roles played by financial, fiscal and institutional policies.

One drawback to disaggregation is that the required data are not readily available for Malaysia. The first section of this paper describes a methodology for deriving a crude sectoral breakdown of savings using macro-economic data. These data are then used to estimate savings functions. The paper concludes with some comments on financial intermediation in Malaysia as compared to other countries in the region.

2. Measuring the Components of Savings

Data on national savings in developing countries are notoriously unreliable. Typically, they are measured as a residual between gross national product (GNP) and consumption, and therefore include any statistical discrepancies that may arise between computation of the national accounts by industrial origin and by aggregate demand. Yet even these data are insufficient for assessing savings performance. The major savers in an economy — households, corporations and the public sector — respond in different ways to economic change. And often the most important issues with regard to savings do not concern the aggregate national savings level but the composition and intermediation of savings. As the Malaysian authorities do not collect or report on the major components of savings, these details have to be estimated by indirect means. The methodology adopted here uses data from a variety of different sources and derives household savings as a residual element in total savings. Thus, the computed figures can be construed as only rough approximations, suitable for the detection of broad trends.

Total savings available to the economy are, by definition, equal to total investment. Investment data can be obtained from the national income accounts. Savings can be decomposed into public, private and foreign components. Public savings are available from the budget and consist of the current surplus of the government and the operating surplus of the non-financial public enterprises (NFPEs). Again, a word of caution is in order. Budget data are presented on a cash-flow basis whereas the national accounts are on an accrual basis. Furthermore, budgetary definitions of current and capital expenditure do not coincide

[4]Nam (1989) uses a similar disaggregation for Korea and the Philippines.

exactly with national accounts data. A comparison of the consolidated government plus NFPE development expenditure with public investment in the national accounts (adjusted to include Petronas) shows the latter to be about 80-90 per cent of the former. That is to say, some items in development expenditure do not show up as investment in a national accounts sense. Where these are capital transfers or purchases of land, no adjustment to public savings is required. In other cases, however, items classified as development expenditure may be included as public consumption. Because of the differences in concept between budget and national accounts categories, the public savings estimates are only approximations.

Foreign savings available to the economy are given as the current account of the balance of payments. This figure includes net lending to Malaysians, direct and portfolio investment, and importantly, the profits of foreign controlled companies operating within Malaysia. Even in the case where these profits are reinvested domestically, they are treated as a factor service outflow and capital inflow by standard accounting conventions.

The difference between national savings and its public and foreign components is the estimate of private domestic savings. This, in turn, can be decomposed into two: corporate savings and household savings, with the latter including savings by small, unincorporated family-owned businesses. Again, lack of readily-published data means back-door methods must be used. Specifically, survey data on corporate profits and depreciation are used to establish corporate savings, and household savings then derived as the residual.

The Department of Statistics conducts an annual Financial Survey of limited companies which has extensive data on corporate balance sheets and income statements. Although not strictly comparable over time,[5] the surveys permit a picture of corporate savings to be drawn. Corporate gross savings are defined to equal post-tax retained earnings plus depreciation of private domestic corporations. This implies that four major adjustments must be made to the survey data which report gross profits and depreciation of the whole corporate sector. First, direct corporate income taxes must be deducted from the gross profit data reported in the survey. This is available from the budget. Second, dividends paid to domestic residents need to be subtracted, as these form part of household income and household savings. Total dividend payments for companies on the Kuala Lumpur Stock Exchange (KLSE) are available. Bank Negara Malaysia (BNM) has also published data from the recent survey of private investment in Malaysia on dividend pay-outs for 1986 and 1987.[6] A portion of these is dividends paid by

[5]The survey covered all companies prior to 1973, those with annual revenue greater than $1 million for 1973-78 and those with annual revenue greater than $5 million from 1979 onwards. In the most recent period, coverage is probably over 90% of all companies.

[6]Bank Negara Malaysia, Annual Report 1988, pp. 14-18. The relationship between dividend pay-outs and net profits estimated from the survey data, coupled with information on dividends paid out by listed companies, was used to estimate a historical series for dividend payments.

public corporations (largely Petronas) to the government (identified in the budget). A further portion is paid to foreigners (assumed equal to the share of profits of foreign-controlled companies in total profits, except where noted by BNM). The difference is taken as dividend payments to domestic residents. The third adjustment is to remove the profits of public enterprises (which are already included within the public savings category) from the total profit data reported in the financial survey. Hence, the NFPE operational surplus is subtracted. Finally, profits of foreign companies (net of taxes) which, as explained above appear as one element of foreign savings, are subtracted. The adjusted figure is taken as the estimate of corporate savings.

Household savings follow immediately as the residual between private and corporate savings. As the residual of a residual, many accumulated errors are likely to be concentrated in household savings. While some of these may be random,[7] others may impart a systematic bias to the figures. In fact, one can identify three sources of negative bias to the household savings figures. First, public savings are probably overstated because of the misclassification of some public spending as investment rather than consumption. Thus, both private and household savings would be underestimated. Second, data on dividend payments to domestic residents are estimated on the basis of dividends paid by listed companies. To the extent that total dividends are likely to be higher, corporate savings would be lower and household savings higher. Third, some of the surplus of the NFPEs does not accrue to the government but to households via their unit trust and other shareholdings and hence should not be classified as public savings. For example, since 1981, a substantial portion of the profits of companies such as Pernas has been channelled to households via dividend distributions under the Amanah Saham Nasional scheme.

The imputed savings by category are shown in Figure 1. Several trends are clear from the data. Overall, national savings have been consistently high, averaging 27.9 per cent of GNP since 1970. Savings follow a typical pattern of rising steeply during boom years, such as 1973 and 1984, while declining during recessionary years such as 1975 and 1985/86. Overall, however, national savings have been quite stable relative to the components of savings. This is to be expected when corporate, household and public savings are either independent or negatively correlated.[8] Certainly the national level of savings, especially if augmented by modest foreign capital inflows, is sufficient to sustain investment levels consistent with 6-7 per cent gross domestic product growth.

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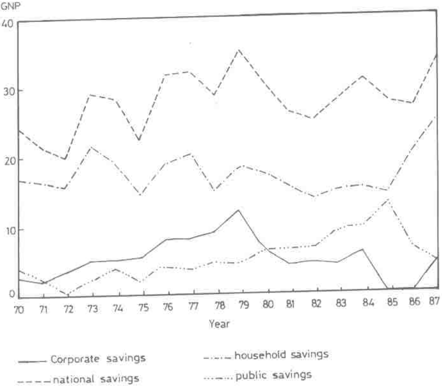
[7]Presumably inaccuracies in measured income or consumption are as likely to be positive as negative.

[8]Sometimes referred to as Denison's law — that changes in one sector will be offset by changes in another sector. Considerable empirical work in developed countries confirms this effect (see Danziger, Hareman and Plotnick 1981 for a summary).

Figure 1

Components of Saving in Malaysia, 1970–87



The data on domestic corporate savings shows a rising trend through 1979, followed by a sharp decline in the 1980s until a pick-up in 1987. The growth of domestic corporate savings in the 1970s reflects both the expanding size of the sector, as foreign interests were scaled back following the NEP,[9] and strong profitability ensured by a booming domestic economy and improving external terms of trade. The turn-around in savings in the 1980s occurred simultaneously with an increase in public expenditure and in quasi-taxes, such as corporate contributions to the EPF, to finance spending. At the same time, the labour market was overheating, fuelled by a construction boom. The cash-flow squeeze on

[9] In 1970, foreign-controlled companies accounted for two-thirds of gross profits in Malaysia; by 1979 this was reduced to one-third.

corporations during the recession of 1985/86 was extreme. Since then, an improvement in external and domestic demand, a fall in real wages and a rebound in commodity prices have helped the corporate sector recoup lost ground. Nevertheless, the corporate sector has contributed to national savings only in a relatively minor way. Compared to corporate savings in Korea and Japan of around 10 per cent of GNP, the Malaysian corporate sector average savings of just over 5 per cent appears meagre.

Public savings on the other hand have played a more important role in the generation of high national savings in Malaysia as compared with other countries, particularly in the early 1980s when petroleum and gas production and profits reached substantial levels. However, the sharp fall-off in public savings since energy prices collapsed in 1986 is a testament to the dependence of the public sector on the energy sector. The fact that this did not result in a fall in national savings is attributable to the offsetting (but perhaps coincidental rather than causal) rise in private savings.

Perhaps the most striking feature of Figure 1 is the high level of household saving. On average, households have generated almost two-thirds of national savings, or 17 per cent of GNP, a level that is comparable to Japan in the early 1970s and, more recently, Taiwan. The data also show an acceleration in the savings rate through 1987, to levels not seen since the early 1970s. In four of the five years between 1983 and 1987, private consumption growth has lagged behind national income growth. This has been a period of generally tightening fiscal policy, with the major exception of 1987. Hence, private disposable income has shrunk relative to GNP, making the rise in private savings even more remarkable.

2.1 Estimating savings

A complex set of factors motivates households to save. Savings are undertaken to finance lumpy expenditures at some future time (particularly housing and education). They are also used to alter a potentially volatile income stream, associated with life-cycle changes or wage and employment uncertainties, into a smoother consumption stream. Parents may wish to leave a bequest to their children, or may retain assets in their old age because of uncertainty as to how long they might live.

Testing various saving hypotheses has been a busy area of economic activity (see Virmani 1986 for a recent review and Yusuf and Peters 1984 for an application to Korea) and there is no single estimating equation which permits a nested test of the various theories. Thus, choice of a specification inevitably involves some *ad hoc* procedures. We postulate below that private consumption is based on private disposable income, the real effective exchange rate[10] and the real rate of interest on deposits.

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[10]Alexander (1952) was one of the first to emphasize the effects of distribution on expenditure.

There does not exist any primary data on private disposable income in Malaysia. Some analysts have used GNP as a proxy and the results using this are reported below. Use of GNP, however, is satisfactory only when the ratio between GNP and private disposable income is constant. This is unlikely to be the case in Malaysia where there have been income tax changes and an expanding size of the public sector over time. Revenues from primary commodities (including oil, timber, oil palm and rubber) have been important sources of public income and have been quite volatile as commodity prices vary. As an alternative, a series on private disposable income has been constructed by noting the identity between private disposable income and consumption plus savings. Using the series on private savings computed above, private disposable income can be calculated.[11]

As contractual savings schemes play an important role in Malaysia, it is interesting to test whether the overall level of private savings is affected by these schemes or not. If households view contractual savings as forming part of the savings they would anyway undertake to finance retirement age expenditure, they would simply decrease other forms of non-contractual savings in response to an increase in contractual savings. In certain circumstances, if for example the benefits from the scheme were felt to be greater or more stable than other available savings instruments, the existence of contractual savings may even decrease overall savings.[12] The behavioural responses may be easily tested. In the model below, private disposable income is decomposed into a non-discretionary component, given by the change in the accumulated value of contributors' balance in the Employee Provident Fund, and a remainder out of which discretionary spending is possible. Although no consumption out of EPF balances is technically feasible, households can modify their behaviour as if it were possible to access these funds directly, either by borrowing against the future income stream or by altering consumption out of discretionary income. Econometrically, if the propensity to consume out of the two sources of income is identical, than contractual savings have no bearing on aggregate savings levels.

The real effective exchange rate captures changes in relative prices in Malaysia and hence in the distribution of income. There are several channels through which this may work. According to Maizels (1968), the propensity to save in the export sector is higher than in the rest of the economy. A depreciation in the real effective exchange rate, which raises incomes in the export and other traded goods sectors, would be expected to decrease consumption. Alternatively,

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[11]This can create an econometric problem as measurement errors in consumption will also appear as errors in income. This can be overcome with the use of a two-stage least squares procedure.

[12]For example, Feldstein (1974) finds this to be the case for the United States; but Shome and Saito (1978) find no evidence to support this for Malaysia. Danziger *et. al.* (1981) summarize the issues and findings.

it can be argued that the real effective exchange rate is a proxy for real wages.[13] A depreciation effectively lowers real wages and, if workers have a higher propensity to consume than recipients of profits, aggregate consumption is expected to decline.

The relationship between the real wage and the real effective exchange rate can be most simply seen in the context of an economy producing two goods, a tradeable and a non-tradeable, with Ricardian technology. This allows the prices of both goods to be dependent only on technologies; demand can be ignored. Normalizing the nominal exchange rate to unity, and using standard nomenclature we can write:

$$P_T = a_{LT}W = P_T^* \qquad (1)$$

$$P_N = a_{LN}W \qquad (2)$$

$$e = P_T/P_N \qquad (3)$$

$$w = W/P_T^{\,a}\,P_N^{\,1-a} \qquad (4)$$

where W and w are the nominal and real wage, P_T and P_N the prices of traded and non-traded goods and e is the real exchange rate. In this model, both e and w depend only on the production technology of the two sectors. Some re-arrangement gives:

$$\hat{e} = \hat{a}_{LT} - \hat{a}_{LN} \qquad (5)$$

$$\hat{w} = a(\hat{a}_{LN} - \hat{a}_{LT}) - \hat{a}_{LN} = -a\hat{e} - \hat{a}_{LN} \qquad (6)$$

where $\hat{}$ denotes the percentage change in a variable. It is now clear that technological improvement in the traded goods sector ($\hat{a}_{LT} < 0$) will generate a real appreciation and higher real wages. Hence, insofar as changes in the real wage are driven largely by developments in the traded goods sector, the real exchange rate and real wages will be inversely related to each other.

This simple story does not, of course, capture the complexities of actual macroeconomic developments. In any economy, there will be a degree of policy flexibility to alter the real exchange rate in the short-run. The impact of an exchange rate movement induced by such policy is likely to differ from a terms-of-trade or productivity-induced change in the exchange rate as the latter have important income effects not present in policy-induced changes. In the regressions below, however, income effects are separately captured. The real exchange rate variable therefore reflects only distributional changes.

The interest rate variable can also be expected to have a variety of effects. From the perspective of a household, there are well known "income" and

[13]From an empirical standpoint, the real exchange rate is easier to measure than the real wage. The latter must be built up from a variety of different sectoral and occupational wage indices, adjusted to include benefits, overtime and the like, and be consistently defined over time.

"substitution" effects on savings which, while theoretically ambiguous, are in general assumed to be positive. But high real interest rates in an economy are also indicative of a high return to capital and a larger share of corporate income in total private income. If the corporate sector is considered to be independent of the household sector (although in the final analysis it is households who own corporations) then the shift in income distribution associated with higher interest rates can alter aggregate private consumption.

The regression results are presented in Table 1. The sample time series are from 1971 to 1988. The real effective exchange rate is a trade-weighted average of Malaysia's bilateral real exchange rates with six major trading partners, where the real exchange rate is the nominal exchange rate deflated by relative price movements in each country's wholesale price index. The real deposit rate is defined as the three-month commercial bank fixed deposit rate less the percentage increase in the price index.[14] The income variable is considered in its level form (using both GNP and private discretionary income (PDY)) and in the form of a transformed variable to proxy permanent income (PPY). Following Bhalla (1980) the transformation uses a weighted average of past income levels: $PPY_t = 0.37*PDY_t + 0.33*PDY_{t-1} + 0.3*PDY_{t-2}$ where the weights correspond to a 10 per cent discount rate, as derived by Bhalla. All nominal variables are deflated by the Consumer Price Index and are expressed in logarithmic form (except for the real interest rate). Estimation was done using two-stage least squares to avoid measurement error in consumption and income. Instruments used for income are the logs of real exports, real investment and real money supply (M2). The regressions are also carried out in first differences to ensure stationarity of the error.

Several insights can be gained from Table 1. The dangers of using GNP rather than a measure of private income are clearly illustrated by comparing regressions (1) and (2). The overall fit and the Durbin Watson coefficient improve in regression (2). Importantly, the coefficient on the real interest rate also becomes significant when the second specification is used. This illustrates the advantages of disaggregation and careful specification. The finding of a positive interest elasticity of savings differs from the results quoted in Giovannini (1985) for Malaysia and most other developing countries; but his results use GNP and aggregate savings rather than disaggregated data.[15]

Regression (2) shows all the coefficients significant and with their expected signs. The coefficient on contractual savings is positive, indicating that discretionary savings are reduced *pari passu* with an increase in contractual savings. Given the relative magnitudes of contractual savings and permanent income,[16] the marginal propensities to consume out of each, derived from the

[14]This approximation holds for Malaysia as interest and inflation rates have been low historically.

[15]Results similar to ours are obtained by Fry (1980).

[16]In 1987, contractual savings was about 7.5% of permanent income.

Table 1
Determinants of Saving, 1971-88

Regression Dependent Variable	*(1) Private Consumption*	*(2) Private Consumption*	*(3) Change in Private Consumption*	*(4) Household Savings*	*(5) Average Savings Rate*	*(6) Private Consumption*
Sample Period	*1971-88*	*1971-88*	*1972-88*	*1971-87*	*1972-87*	*1971-88*
Constant	1.336 (4.08)	2.895 (5.69)	0.004 (0.31)	-3.727 (-1.37)	0.265 (9.14)	3.934 (4.24)
Income	0.862[1] (23.39)	0.711[2] (10.58)	0.776 (4.80)	0.660[3] (1.99)	3.603[4] (4.57)	0.573 (4.65)
Income growth					0.122[4] (2.73)	
Contractual savings		0.112 (2.96)	0.065 (0.88)	0.103 (0.56)	-0.359[5] (-3.61)	0.132 (3.42)
Real effective[6] exchange rate	-0.104 (-1.16)	-0.214 (-3.76)	-0.285 (-2.80)	1.119 (2.51)	0.001 (2.39)	-0.253 (-4.15)
Real deposit rate	0.004 (1.52)	-0.004 (-2.54)	-0.005 (-2.63)	-0.018 (-1.44)	-0.001 (-1.17)	-0.003 (-2.11)
Real exports						0.077 (1.31)
Household savings share					-0.130 (-4.61)	
Adjusted R^2	0.985	0.995	0.711	0.847	0.959	0.995
Durbin Watson	1.344	1.836	2.215	1.766	2.268	1.820

[1]Income variable used is real GNP.
[2]Income variable is permanent discretionary income.
[3]Income variable is real discretionary income.
[4]Income variable is real private income.
[5]Contractual savings as a fraction of household saving.
[6]An increase in the index signifies a real depreciation.
Note: Variables expressed in real terms and natural logarithms (except deposit rate), with the exception of model (5) where real variables are used.
t-statistics in parentheses.

estimated elasticities, are not significantly different from each other. If anything, the marginal propensity to consume out of EPF accumulation is higher than that out of discretionary income. Overall then, it does not seem that the EPF has increased private savings and it may be the cause of a slight decline in the savings rate.

The impact of fiscal policy can also be inferred from these results. As private incomes rise, following a tax cut for example, the private savings rate will also rise, and vice-versa. The impact on national savings depends on how the public sector reacts to changes in tax revenues. Where current revenues increase in response to higher taxes, overall savings will decline with a tax hike.[17] Similar arguments may be made with respect to public enterprise surpluses. With privatization, the private sector's savings rate may increase, but overall national saving will only rise if public consumption expenditure is restrained such that public savings do not also fall. Where the revenues from privatization are used to retire domestic public debt, there will be minimal changes in income distribution between the public and private sectors as the loss of NFPE surpluses will be offset by reduced public interest payments.

Regression (3) is the same model as (2) but estimated in first-differences. The results do not change substantially. The constant term is small and not significantly different from zero indicating that a pure time trend is not an important variable in explaining consumption or savings.

The impact of the EPF on savings is considered further in (4). Here, the dependent variable is the log of real household savings, derived as described earlier. The coefficient for contractual savings is insignificant, further supporting the proposition that households simply offset contractual savings by reducing saving out of discretionary income. The elasticity with respect to discretionary income is not significantly different from unity and is consistent with economic theory. Less conventional is the negative (insignificant) coefficient for the deposit rate. Combined with the results of (2), this suggests that interest changes do not affect household choices as to inter-temporal consumption, but do affect the distribution of income between households and corporations, with the latter saving more when interest rates and rates of return in the economy are high.

The inference that the distribution of income between households and the corporate sector is important is supported by the results of regression (5). There, the dependent variable is the average propensity to save (defined as private savings/private income). The independent variables are the level and growth of real income, the real effective exchange rate, the real deposit rate and two additional distributional variables — the share of contractual savings in household saving, and the share of household saving in private saving. The surprising result is that the latter two variables are significantly negative. As observed above, high contractual savings do not induce households to save more, but are offset by lower discretionary saving. They do, however, represent a tax on the corporate sector, which currently pays 11 per cent of wages to each employee's provident fund account, and hence reduce corporate savings. The net effect is to redistribute income from the corporate to the household sector and to reduce the average private savings rate. A negative coefficient on the share of household savings reinforces this point. When household incomes and saving are high relative to the corporate sector, the average propensity to save in the economy falls. This

[17]Known as the Please effect (Please 1967).

negative correlation between household and corporate savings imparts a degree of stability to overall private savings in Malaysia.

In order to separate out the factoral and sectoral distribution effects of the real effective exchange rate, regression (6) was estimated. This is the same as (2), but with real exports included as a separate explanatory variable. The coefficient on the export variable, however, is small in magnitude and insignificant. On the other hand, the real effective exchange rate improves its significance. The interpretation is that it is not because the export sector saves more that consumption declines in response to a depreciation but because a depreciation is symptomatic of a real wage decline.

The explanation for the recent sharp rise in private savings can be summarized on the basis of regression (2). The first and quantitatively most significant explanation lies with the cyclical behaviour of income contrasted with the more stable pattern of consumption. During the recession year of 1985, private savings dropped as consumption rose by 1.6 per cent while private income fell by 12 per cent. Permanent discretionary income, however, continued to rise by 1.4 per cent as memories of the 1982 down-turn in private income faded. As the recovery strengthened in 1987 and 1988, real private income grew to a level almost 17 per cent higher than in 1985. Permanent income, however, grew by much less (2.8 per cent) and hence consumption demand was less. The private sector was intent on rebuilding savings run down during the recession.

A second important development was the depreciation of the real exchange rate by 30 per cent between 1985 and 1988. By itself, this would have reduced consumption by about 6 per cent and, hence, would have added an equivalent amount to the savings rate. Coupled with the real depreciation, booming commodity prices and world demand for Malaysian manufactures led to strong profit growth amongst Malaysian corporations. This was reinforced by reduced income tax payments as losses from the recession were carried forward and corporate tax rates reduced. Strong corporate savings added to overall private savings. Meanwhile, lower wages and lower interest rates brought down the proportional role of contractual savings, effectively reducing the burden on corporations.

The regression results suggest that Malaysia can ill afford to be lulled by its current high savings rate. A large portion of these savings are transitory and can be expected to disappear by 1990 once the process of rebuilding assets lost in the recession is over and when expectations of high growth are revised upwards. Although rapid medium-term growth will ensure that household savings stay strong (albeit weaker than current cyclical peaks), both corporate and public savings remain weak. The principal instruments for raising savings must be handled with care. Higher "forced" savings are unlikely to be effective and may, in fact, reduce the overall savings effort. High interest rates are likely to generate more savings but only if they are symptomatic of strong corporate profitability. Artificial intervention in credit markets designed to raise interest rates would not generate more household savings. One key parameter that should be monitored is the real exchange rate. Through accommodating a real depreciation, the authorities have given the domestic corporate sector a much needed boost. Unless this is sustained, the three legs of public, corporate and household saving will remain uneven. In order to utilize savings efficiently, then, financial intermediation must play a key role in allocating surplus funds across sectors.

3. Financial Intermediation

The preceding section demonstrated the importance of fiscal, interest and exchange rate, and institutional policies in changing the level and composition of savings between the public, corporate and household sectors. The impact of these changes on investment and growth depends on the relative ease and efficiency of financial intermediation. The changing pattern of inter-sectoral flows during the 1980s is shown in Table 2. For each of the main sectors, net lending can be deduced as investment less saving. For the household sector, investment is assumed equal to the value of residential construction for the year.[18] Estimates of foreign investment (direct investment and reinvested profits of foreign companies) and of public investment (adjusted to include Petronas and other off-budget agencies) have also been made.

The figures in Table 2 show that the foreign sector in Malaysia plays a large residual role for each sector. When the public sector sharply expanded its investment and net borrowing requirements in the early 1980s, it was the foreign sector that provided the funds. Indeed, the large external borrowings of the NFPE and government sectors during this period are well-known. There is very little evidence that the domestic corporate sector was squeezed out. Conversely, when the household sector built up net lending surpluses from 1983-86 (and most likely in the next two years as well), only a limited amount of this was absorbed by the domestic corporate sector. The bulk was reflected in a growing repayment of foreign debts and accumulation of foreign assets.

There are three main channels through which household savings have leaked abroad in recent years. First, households have built up sizeable balances in pension funds, life and general insurance companies and the like. These institutions invest predominantly in safe assets, such as government securities. By tapping these domestic funds, while sharply curtailing its expenditure, government has found itself with a surplus that has been used to prepay foreign loans. Second, household deposits in the banking system have risen, driving down interest rates and providing ample liquidity. In the face of stagnant investment demand, there have been a number of financial innovations in the market. For the first time, domestic corporations have been able to issue medium-term notes directly, often using the proceeds to repay existing foreign liabilities. Third, the banks themselves have

[18] See Department of Statistics, *Yearbook of Statistics*, various issues.

Table 2
Intersectoral Flow of Funds (% of GNP)

	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*
Households								
Investment	3.2	3.2	3.6	3.2	3.1	2.9	2.4	n.a.
Savings	17.4	15.4	13.6	14.9	15.1	14.2	20.2	25.0
Net Lending	14.2	12.2	10.0	11.7	12.0	11.3	17.8	
Domestic Corporations								
Investment	10.7	7.1	7.0	9.3	10.9	7.2	8.9	
Savings	6.6	4.3	4.6	4.1	5.9	0.2	0.0	4.6
Net Lending	-4.1	-2.8	-2.4	-5.2	-5.0	-7.0	-8.9	
Public Sector								
Investment	13.7	20.7	23.0	23.6	19.5	17.2	13.7	
Savings	6.3	6.4	6.7	9.2	9.7	13.1	6.6	4.2
Net Lending	-7.4	-14.3	-16.3	-14.4	-9.8	-4.1	-7.1	
Foreign Sector								
Investment	4.0	5.2	5.5	4.5	2.4	2.4	2.1	n.a.
Savings	1.2	10.1	14.1	12.5	5.3	2.1	0.3	-8.1
Net Lending	-2.8	4.9	8.6	8.0	2.9	-0.3	-1.8	
Total								
Investment	31.6	36.3	39.1	40.6	36.0	29.7	27.1	25.7
Domestic Savings	30.4	26.2	25.0	28.1	30.7	27.6	26.8	33.8
Foreign Savings	1.2	10.1	14.1	12.5	5.3	2.1	0.3	-8.1

Notes: 1. Total may not add to 100 due to rounding error.
2. Rough approximations are made to include Petronas and other NFPE's in public investment.

built up sizeable foreign assets as interest rate differentials between Malaysia and the rest of the world widened.

3.1 Household savings

The finding that households are largely responsible for the high national savings rate in Malaysia conforms with similar findings for other East Asian countries. The distinguishing characteristic of Malaysia lies in the composition of household savings, which reflects the nature of Malaysian financial institutions. There is unfortunately no detailed flow-of-funds data which would permit the capital accumulation and capital finance accounts for households to be constructed. But by reference to banking sector statistics, an overview of households' accumulation can be achieved.

Data on the sources of funds on which households draw are comparatively easy to obtain. In addition to household saving out of income, households make use of mortgages from the banks and the Treasury and of consumer credit from finance companies and cooperatives. As is clear in Table 3, however, three-quarters of household funds are generated through their net savings. The disposition of these funds is less easily identified. On average, about 20 per cent goes into housing; a further 26 per cent goes into the Employee and other provident funds; 2.5 per cent goes towards building up cash balances to maintain liquidity for transactions; about 14 per cent goes into insurance companies and other special savings schemes such as the National Savings Bank, cooperative societies, the National Unit Trust Scheme and the Pilgrim's Management Fund; slightly under one-quarter is deposited in the banking system and the remainder (about 13 per cent) is unidentified, probably going primarily into foreign deposits, equity in cooperatives and firms and other assets. The residual item also contains all errors and omissions, such as the exclusion of capital transactions in land and other assets or stock accumulation.

Table 3
Household Capital Accumulation Account 1981-87 (Billion Ringgit)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*
Sources of Funds	11.0	11.2	12.6	15.1	14.1	15.9
Housing loans	2.0	2.4	1.9	2.2	2.7	1.7
Other consumer loans	0.4	0.6	1.0	1.6	1.1	0.8
Savings	8.6	8.1	9.7	11.2	10.3	13.4
Uses of Funds	11.0	11.2	12.6	15.1	14.1	15.9
Housing[1]	2.4	2.9	2.8	3.1	2.8	2.1
Currency[2]	0.3	0.6	0.3	-0.1	0.2	0.4
Provident Funds	2.6	2.9	2.8	3.8	4.1	4.4
Bank deposits[3]	2.5	3.4	3.3	3.1	3.4	3.1
Other[4]	1.0	1.2	1.5	2.1	2.2	3.6
Unidentified[5]	2.1	0.1	2.0	3.1	1.4	2.2

[1]Includes construction plus one-third for land.
[2]Excludes currency held by financial institutions.
[3]Deposits of other customers in commercial banks and finance companies.
[4]Includes National Savings Bank, life and 50 per cent of general insurance, Pilgrim's management, Amanah Saham Nasional, rural and urban cooperatives.
[5]Includes deposits abroad, holdings of negotiable certificates and other securities and new equity other than through Amanah Saham Nasional deposits.

Note: Capital transactions, such as net sale of land or other assets, are excluded.
Source: Bank Negara Malaysia, Annual Report, various issues; for "savings", see Figure 1; for housing, see Table 2.

The data in Table 3 indicate the diversity of financial asset accumulation by households and the importance of special schemes in mobilizing these savings. A striking feature is the limited extent of asset accumulation in the form of deposits with institutions that lend directly to industry. In Malaysia, increased deposits in the banking system by households only account for about 4.7 per cent of GNP. In other high saving countries, a more typical figure is 9.3 per cent.[19] Instead, far more Malaysian household savings pass through other channels, with an important impact on resource allocation. Bodies such as the provident funds, National Savings Bank, insurance companies and the like primarily invest in government securities and other relatively risk-free assets. In practice, it is very difficult for the private sector to access such funds without substantial deepening of the financial system. Thus, the principal channels of saving in Malaysia are oriented towards mobilizing resources that can be tapped by the public rather than by the private sector. If government is to play a significant role in direct investment, as was true in Malaysia over the past decade, these channels of intermediation are appropriate. They will, however, act as a barrier against the government's new policy initiative aimed at promoting private-sector led development. Some institutional change is required to funnel savings back towards the corporate sector.

3.2 Financing investment

The reverse side of the coin of large household savings financing public sector deficits is low corporate net borrowing and investment. Most fixed investment in Malaysia is financed through own funds, that is retained earnings or new equity — only about 20 per cent is borrowed.[20] This has resulted in a very conservative debt structure; overall the manufacturing sector had a debt/equity ratio of 1.3 in 1985, compared with 3.6 in Korea, 3.2 in Japan, 2.4 in the Philippines and 2.1 in Turkey. Hence, low corporate savings have been translated into low corporate investments.

The dimensions of the differences in inter-sectoral flows between Malaysia and other countries are shown in Table 4. The table shows that the domestic corporate sector in Korea and Japan during high growth years was investing more than double the amount invested by private Malaysians. The incremental resources required for such investment came in equal portions from higher corporate savings and greater mobilization of surpluses from other sectors. Intermediation of funds for the corporate sector from the rest of the economy averaged 12 per cent in Japan and 10.8 per cent in Korea compared with 4.5 per cent for Malaysia.

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[19]See Honohan and Atiyas (1989). Figure is an average for Cameroon, Côte d'Ivoire, Ecuador, Korea, Portugal, Thailand, Turkey and Yugoslavia.

[20]Department of Statistics, Business Expectations Survey, various issues.

Table 4
Financing Corporate Investment (% of GNP)

	Period	*Corporate Saving*	*Corporate Investment*	*Net Borrowing*
Korea[1]	1981-85	9.1	19.9	10.8
Japan[2]	1970-74	9.5	21.5	12.0
Malaysia	1981-85	3.8	8.3	4.5

[1]Figures for Korea include quasi-corporate enterprises.
[2]Non-financial corporations only.
Sources: Bank of Korea, National Accounts, 1987; for Japan, Sato (1987), Tables 16 and 17.

The figures in Table 4 show a vicious circle in the pattern of saving and intermediation; low corporate savings can only sustain low net borrowings and hence yield low investment rates. Part of the puzzle is that the corporate sector has paid out substantial dividends to households; over one-third of its cash-flow in 1987 and almost the entire amount in 1985 and 1986. By contrast, firms in Japan or Korea pay out very little in dividends. One may speculate on several reasons why this should be the case. First, it must be recognized that although dividends are high as a percentage of cash-flows, the yield is quite low (4-5 per cent on the Kuala Lumpur Stock Exchange (KLSE)) because of the very high price/earnings ratio on the KLSE. Government regulation of the stock market, such as guide-lines for new issue pricing and definitions of Trustee stocks, may have some bearing on dividend pay-outs. Second, it may be the case that investors in Malaysia are highly risk averse and operate with short time horizons, perhaps because there are limited opportunities for diversifying risk and because government plays a minimal role in underwriting risk relative to that played by Japanese or Korean authorities.

At the same time, banks do not readily lend to manufacturing corporations and require conservative debt/equity ratios because of the volatility in profitability. In countries like Korea, Taiwan and Thailand which depend primarily on manufacturing, any loss of competitiveness in the sector which might result from rapid domestic wage growth, for example, can be offset by aggressive government action to depreciate the exchange rate. In a natural-resource based economy such as Malaysia's, however, both the exchange rate and wages take their cue from commodity prices. When these rise, as they did in the early 1980s, the competitiveness of manufacturing can be significantly reduced. The cyclical pattern of earnings presents a barrier to more aggressive bank lending to manufacturing companies and results in the low gearing observed in private domestic corporations.

4. Concluding Remarks

In the coming years, Malaysia's growth strategy is likely to be increasingly focused on development of the manufacturing sector. This will require sustained investment to raise productive capacity. This paper addresses the issue of whether the domestic savings mobilization effort in Malaysia is well-equipped to support such a strategy. One finding is that raising savings is unlikely to be sufficient to raise growth. In fact, because of the existing channels of financial intermediation, high household savings are likely to result in accumulation of foreign assets (reduction of foreign debt) rather than higher investment. On the other hand, measures to increase the profitability of investment are likely to generate high savings, both from the corporate and from the household sector as growth accelerates.

The overall level of domestic savings in Malaysia has averaged 28.6 per cent of GNP from 1980-87. Of this, 7.8 per cent has come from the public sector, largely as a result of large revenues from natural resource exploitation — first petroleum, and more recently natural gas, logs and timber. With the decline of energy prices, the public savings effort has faltered. However, this has been more than offset by a dramatic rise in private sector savings. Our analysis cautions that this rise is likely to be temporary. A significant portion can be attributed to the slow response of consumption to the strong income gains of 1987 and 1988, particularly as compared with the preceding period of stagnant growth. The corporate sector in particular has used this growth to rebuild its financial strength, which had eroded in the recession. For two years, during 1985 and 1986, corporate investment was financed almost entirely by issuing new liabilities. Once asset positions have recovered, corporate savings will likely decline to long-run levels.

Households also sharply raised their savings rates in 1986 and 1987, having adjusted consumption down to expectations of lower future income during the preceding years of slow growth. These expectations are likely to be reversed once the vigorous nature of the recovery is confirmed. By 1990, memories of the recession will have faded and at this point, household savings levels are likely to decline steeply.

The government has been able to influence private savings through a variety of instruments, by altering the distributional balance between households and corporations. In the early 1980s, the household sector benefited from rising corporate contributions to the EPF, attributable to higher assessed rates and broader coverage. Wages were also rising in this period and the real exchange rate appreciated. With the economic recovery and exchange depreciation, the balance has tilted back somewhat. Net surpluses of the EPF have shrunk as a per cent of total savings, and profits have recouped their earlier losses. Nevertheless, corporate savings in Malaysia remain at low levels and further action is required to boost profitability. Recent reductions in the corporate income tax rate, the phasing out of the development tax and the ringgit depreciation will help in this regard.

As a result of institutional and other policies, Malaysia relies more heavily on household saving than most other rapidly industrializing economies. High household saving levels can be attributed to strong growth performance but not to the prevalence of "forced saving" schemes. An outstanding issue is that mechanisms for intermediating between the household demand for financial assets and the corporate sector's liability requirements have not yet emerged. Partly because of low average corporate savings, there has been little bank lending to the manufacturing sector. Furthermore, most household savings are deposited in pension funds and insurance companies which invest largely in government securities. This structure was well-suited to a development strategy oriented around high levels of public investment. But the inefficiencies associated with such a strategy have led to a reversal and public investment has fallen off. With the decline in the demand for funds by the public sector, there has been a considerable surplus of funds available to the government. These have been utilized to prepay external loans, but this can only be a temporary expedient. New outlets for the institutional funds must be sought.

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MALAYSIA: ISSUES IN CAPITAL MARKET DEVELOPMENT

Lin See Yan

This paper addresses three specific issues in development of the capital market in Malaysia. The first discusses the need for domestic enterprises to diversify the sources of funding for business expansion and investment directly from the capital market rather than from the banking sector. The paper then examines the current development and problems in the secondary government securities market. Finally the paper evaluates the need for a bold venture capital industry to be established to encourage and sustain the current industrialization momentum.

1. Introduction

As an economy develops over time, there will be a growing dependence on the financial system to play a major supportive role. Concomitant broadening and deepening of the capital market is therefore essential if real growth is to be sustained and if capital resources are to be allocated efficiently.

In recent years, a "revolution" has been taking place in the financial sectors of both the industrialized and less developed countries (LDCs). This revolution is reflected in various ways: the reduction of government controls on financial operations, the elimination of strict demarcation lines among different types of financial institutions; the creation of many new financial instruments combining the factors of efficiency, liquidity, and riskiness that previously could be enjoyed only by large and diversified portfolios; the securitization of financial operations; the emergence of financial conglomerates that combine institutions with a wide range of specializations in financial activities; and the widespread use of new technologies based on latest developments in computers and telecommunications. All these have been observed in varying degrees in the Malaysian financial system.

This paper does not attempt to address all these areas of development. Instead, it focuses on three specific issues. One, the need for domestic enterprises to diversify their sources of funding for business expansion and investment, particularly directly from the capital market as opposed to the current heavy dependence on bank borrowing; two, the current development and problems in the secondary government securities market; and three, the need for a bold venture capital industry to be established in Malaysia to help "push" the current industrialization momentum.

The paper first recounts the traditional arguments why Malaysia should seek to develop its capital market, while the next section describes the composition of financial claims and equities in the market. This is followed by a summary "backdrop" of the major markets in the country, namely, the equity and the government securities markets. The next focus is on an evaluation of the capital market, with emphasis on secondary trading activities. The fifth part then outlines the recent reforms undertaken in the government securities market and is followed in the next section by a critical assessment of the current state of the market. In this same section, some ideas are offered on how the existing system can be improved, and in what circumstances the establishment of a financial futures market is appropriate. The next part broadly discusses the nature of venture capital business and why such an industry is important for Malaysia. Finally, some brief concluding remarks are presented.

2. Capital Market Development

The key issue facing policy-makers is not whether market-oriented LDCs should have capital markets but rather the degree to which Government policy should aid their development. There appears currently to be a consensus to dispense with the view that governments need not actively develop their financial and capital markets, because financial development is best fostered in response to the demand for financial services by investors and savers in the real economy.

Although less studied by academicians, greater emphasis is now given to what is conventionally termed *the "supply-leading" phenomenon*: the creation of financial institutions and the supply of their financial assets, liabilities, and related financial services in advance of the demand for them. Based on our experience, there has been a distinct shift in the type of "supply-leading" financial development undertaken by the Bank Negara Malaysia (BNM) in the early years of the nation *vis-a-vis* those undertaken in recent times. For good part, this shift reflects the growth in maturity and sophistication of the domestic economy. It also reflects a shift from the traditional function of financial development, which aims to transfer resources from non-growth (traditional) sectors to the modern sectors, to the function of increasing the level of efficiency in financial intermediation, both in the allocational and operational sense.

The main objective of the financial system is to achieve the structure and rate of growth of various financial assets and liabilities which are consonant with, and will induce the optimal characteristics of, real capital stock. There are three major ways in which the financial system can influence the capital stock for growth purposes. First, it can encourage a more efficient allocation of a given total amount of tangible wealth (capital in a broad sense), by bringing about changes in its ownership and in its composition, through intermediation among the various types of asset-holders. Second, it can encourage a more efficient allocation of new additions — investment to capital stock from relatively less to relatively more productive uses, by intermediation between savers and entrepreneurial investors. Lastly, an efficient financial system can induce an increase in the rate of accumulation of capital by providing increased incentives to save, invest, and work.

This in turn implies that an economy without an effective capital or financial market would suffer the allocational inefficiencies involved in having no mechanism to ensure that capital is allocated where its (marginal) productivity is greatest. It would also fail to achieve an optimal intertemporal allocation of resources by equating marginal time preference with the marginal productivity of capital. Saving rates would be adversely affected because of the lower overall return to capital in the economy, as well as because of an unnecessarily large spread between the return to savers and the return to investors.

Consequently, an economy without an effective capital market would suffer considerable efficiency losses, both static and dynamic. Further, it is also natural that as a market matures, it will be capable of absorbing greater risk in the system, by transforming and by distributing risks amongst the different types of risk-taking agents in the market. In addition, the financial markets would eventually become the main arena for the implementation of monetary and stabilization policies of BNM.

3. Financial Claims and Equities

Financial development involves the evolution of financial instruments and markets, as well as financial institutions. Financial instruments or financial claims fall into one of two categories — direct and indirect. Direct financial claims are issued by non-financial units. They include mortgages, corporate bonds and government securities, issued by households, business firms, and governments respectively. Indirect claims, such as deposits and currency, are created by financial institutions. These claims are called indirect financial instruments because the depositors or lenders supply funds that are channelled indirectly to ultimate borrowers. In other words, financial institutions such as commercial banks, merchant banks and finance companies intermediate between lenders and borrowers, or between savers and investors. They sell indirect financial instruments, such as deposits, and buy direct claims, such as commercial bills, loans, and government securities.

Table 1 shows the composition of the outstanding types of financial instruments. It is notable that claims formed the bulk of financial instruments issued in 1973, 1980 and 1984. The dominance of financial claims implies that the financing needs of business enterprises, the government and the households (collectively treated here as non-financial sectors) were met through loan or debt transactions. Equities only accounted for 9.5 per cent of the total financial

Table 1
Financial Instruments in Malaysia

	Outstanding ($mil)			% Composition		
	1973	1980	1984	1973	1980	1984
I. Claims Against Financial Institutions	14,468	51,042	95,503	48.6	48.4	44.4
A) Marketable Instruments						
Currency Issued	1,870	5,105	6,555	6.3	4.8	3.0
B) Non-Marketable Instruments	12,598	45,937	88,948	42.3	43.6	41.4
Demand Deposits	2,030	5,326	8,088	6.8	5.1	3.8
Deposits from Public Sector	1,685	6,777	10,792	5.7	6.4	5.0
Deposits from Private Sector	4,625	21,623	44,690	15.5	20.5	20.8
Life Insurance & Provident Funds	4,258	12,211	25,378	14.3	11.6	11.8
II. Claims Against Non-Financial Institutions	11,530	46,444	99,055	38.7	44.1	46.1
A) Marketable Instruments	5,793	17,376	33,560	19.5	16.5	15.6
Treasury Bills	625	1,416	2,769	2.1	1.3	1.3
Government Securities	5,168	15,960	30,791	17.4	15.2	14.3
B) Non-Marketable Instruments	5,737	29,068	65,494	19.2	27.6	30.5
Loans to Public Sector	194	796	1,957	0.6	0.8	0.9
Loans to Private Sector	5,003	25,088	58,960	16.8	23.8	27.4
Commercial Bills	540	3,184	4,577	1.8	3.0	2.2
Total Claims	25,998	97,486	194,558	87.3	92.5	90.5
III. Equity Securities						
A) Marketable Corporate Issues (nominal value)	3,780	7,861	20,442	12.7	7.5	9.5
IV. Total Financial Instruments	29,778	105,347	215,000	100.0	100.0	100.0
% of GNP (current prices)	(164.8)	(205.0)	(287.4)			

Source: SEACEN 1986.

instruments issued.[1] However, Table 1 does not show the amount of claims held within the non-financial institution and the financial institution sectors. For example, if corporation A had issued $100 million in bonds to corporation B, this would not be captured because inter-corporate holdings would have been netted out for the corporate sector as a whole. However, to the extent that we know that hardly any significant amount of bonds or promissory notes were issued during the period 1960 to 1984, we can neglect this aspect altogether. In the same

[1]Claims against the financial institutions are obtained from the liabilities side of their balance sheets, while claims against non-financial institutions are obtained from the assets side of the balance sheets of financial institutions.

manner, we can confidently say that *equities are the major type of corporate securities issued in the market.*

One of the important characteristics of a country's financial structure is the extent to which domestic non-financial claims are absorbed or held by domestic financial sectors. In Malaysia, the domestic financial institutions have absorbed or held an increasing proportion of the issues of domestic non-financial institutions: from about 39 per cent in 1973 to 46 per cent in 1984 of the claims against non-financial sectors. Loans to the private sector had risen considerably from about 17 per cent of all financial instruments in 1973 to 27 per cent in 1984. In short, *Malaysian companies depend primarily on bank borrowings to finance their business operations rather than additional calls-up for capital directly from the market place or from agents with surplus funds.* This mode of financing reflects, to a large extent, the minor role played by the capital markets in corporate finance so far.

The heavy reliance on debt whether through bank borrowing or bond issuance, can have adverse effects at both the macro-economic and micro-economic levels. At the micro-economic or "firm" level, this often leads to unbalanced capital structures with high gearing ratios. High debt-equity ratios are unlikely to pose problems so long as growth can be sustained. At the macro-economic level, once growth slows down or there is a significant rise in interest rates (as experienced in 1985-86), debt servicing charges will strain the company's cashflow regardless of its financial acumen, thereby increasing its vulnerability to adverse developments beyond its control.

It is imperative that as the private sector assumes its place as the permanent engine of growth, *the role of the capital market must be significantly expanded to help finance the future development of the real economy.* The financial system must not be left behind; it must be developed to meet the new challenges. It must also be recognized that as the country grows, additional savings will be inevitably generated and this, coupled with an increasing level of sophistication of savers and investors, would mean that the capital market has to be sufficiently dynamic and responsive to meet the portfolio desires of these agents.

For the present purposes, the focus will be mainly on the capital market and its instruments, that is, I will not touch on the short end of the market (or, in conventional terms, the market for near-monies and financial assets with maturities of less than one year).

4. Brief Summary Background of the Markets

The Malaysian securities market was practically non-existent until the early 1960s. Since then, both the markets for Government securities (MGS) and equities have grown significantly, albeit in a rather isolated fashion. In terms of primary funds raised, the MGS market is by far the largest, but in terms of secondary trading activity, the equity market has flourished by comparison.

4.1 Equity Market

The buying and selling of shares in Malaysia have been recorded as early as 1870 and represent the first instance of any form of a security market in the country. The first brokers' association comprising four members was founded in 1937. The types of equities traded were limited to those of plantation and mining companies, as these enterprises formed the backbone of Malaysia's economic activity then. Concomitant with the emergence of an equity market was a rapidly developing banking system. The banking sector in the first few decades of the twentieth century was characterized by a few British banks which provided the basic services, especially in the area of trade financing.

As the economy expanded, the banking system also grew with the establishment of domestic commercial banks and other specialized financial institutions. A satisfactory payments mechanism was thus in place and this, no doubt, has been an important factor in facilitating the growth of the equity market. The existence of a well-established banking system also promoted bank borrowing as an important source of funds for the private sector.

As the pace of industrialization picked up, particularly after the 1960s and 1970s, the profile of equities in the market also changed, displaying a growing preponderance of commercial and manufacturing companies. In general, the stockmarket developed in tandem with the economy. Buoyant external demand in the post-war years provided a major impetus for corporate and business expansion and coupled with a concern to keep their gearing ratios at a prudential level, companies found it expedient to resort increasingly to financing from the equity market.

There has been a discernible increase in the total amount of net funds raised through the stock market by way of ordinary share issues, bond issues, term notes and loan stocks, particularly in the more recent years of 1983-84 and 1987-89. *By far, the market was dominated by equity share issues.* In the two years 1983 and 1984, funds raised through the market amounted to M$3.8 billion, which exceeded the entire amount raised during the preceding 22 years from 1961 to 1982. The record number of new issues in 1984 (64 issues with a total value of M$2.4 billion) reflected the growing tendency for companies to substitute equity capital for bank borrowing, which had become more costly with rising interest rates during a period of relatively tight credit. The shift towards equity capital also reflected the need to comply with the requirements of the New Economic Policy which was aimed at, among other things, meeting a target of 30 per cent ownership of the corporate sector by the Bumiputera community. However, funds raised through new issues declined sharply in the following two years, falling to $195 million in 1986 as a result of a moratorium on new share issues in 1985 and 1986. The moratorium served as a temporary measure to revive market confidence and to enable the stock market to consolidate. In tandem with the strong economic recovery and the pick-up in private investment in 1987-89 and the lifting of the moratorium, net funds raised through the private sector (consisting of shares, loan stock, bonds and promissory notes) increased substantially to M$1.8 billion in 1987, $2.9 billion in 1988 and $2.3 billion in the first half of 1989. The publicly listed companies also took advantage of the high liquidity in the economy to raise funds to finance their operations as well as to improve their debt-equity ratios by substituting equity capital for bank borrowing.

4.2 Government Securities Market

Until the mid-1950s, Government domestic debt in Malaysia was insignificant. There was little need to borrow as the Government generally kept the overall account of its budget in balance, reflecting in the main, the pro-cyclical stance of fiscal policy. The issue of Government securities was made mostly to meet the investment needs of the Employees Provident Fund (EPF), which was set up in 1951. The amount of Government securities outstanding initially was small, reaching only $120 million by the end of 1961. In the last two decades, especially in the 1980s, as a result of the rise in spending under the Government's development programmes and the resultant fiscal deficit, the amount of Government securities had increased steadily. However, *the market had remained skewed towards the primary issue segment, with little secondary trading*. In general, the market's growth was highly dependent on a captive market created by administrative and legal requirements for most financial institutions to invest in MGS.

Over the years, the maturity structure of Government securities had lengthened. Since the funds were raised for the financing of development projects in the public sector, the emphasis had been on issuing longer-term securities. On average, 15-20 year securities accounted for about 90 per cent of the new issues annually. Since the initiation of reforms in 1986, however, there has been a shift towards the shorter and medium-term tenures.

Prior to the recent reforms, the interest rates paid on Government securities had been relatively stable and changes had been infrequent. Adjustments were of a one-step nature and, generally, lagged behind market rates. The absence of movements in yields and the captive nature of the market encouraged the original subscribers of these securities to hold them until maturity. As a consequence, the secondary market for Government securities has remained relatively underdeveloped, although there is always a ready market in papers nearing their maturity dates.

In a sense, *the Malaysian capital market is more akin to the Japanese*. First, compare the US and Japanese experiences in the capital markets. Private stocks and bonds accounted for about 150 per cent of GNP in Japan, about 100 per cent in the US. But, there are fundamental differences: in Japan, stock market capitalization comprised nearly 90 per cent of the market or 130 per cent of GNP — about two times that of 74 per cent in the US; in contrast, the private bonds market is virtually non-existent in Japan. In the US, straight corporate bonds accounted for 15 per cent of the market or about 15 per cent of GNP, making up the core of the bond market. *Not unlike Malaysia, the popularity of equities in Japan is due mainly to expectation of capital gains.* Furthermore, the divergence in price-earnings ratios (PERs) between Japan and the US reflected the lack of objectivity or rational criteria in stock price discovery in Japan. Overall, US PERs have remained fairly constant at around 10; Japanese PERs did remain at about the US level in the early 1970s, picked up sharply at the start of the 1980s and surged in 1986 to reach 70 in 1987. *In Malaysia, PERs are also relatively high — within the 20-25 range.*

Second, the arbitrage relationship between stock yields and yields in other financial assets is quite weak in Japan. In general, stock yields are expected to be higher than those of short-term Government securities (these instruments being those with the highest liquidity and credit-worthiness). In the US, for example, stock yields are almost always above Treasury Bill (TBs) yields. In Japan today, yields on stocks have remained far below those on short term Government securities. In other words, the formation of Japanese stock prices appears to be rather independent of the formation of prices in other financial assets to which they should be related. *This is also the Malaysian experience.*

Third, as in Japan, *Malaysian corporations have relied more and more on equity funding in raising their external finances.* This growing dependence is bound to reduce profit per stock, thereby enhancing (intrinsically, at least) the risk of holding stocks. Accordingly, before the corporate bond market can be developed further, *it is necessary from the view point of both the borrower and the investor to ensure that stock prices are formed rationally, and to rationalize and strengthen the basic arbitrage relationship between stocks and other financial instruments.* Towards this end, both the pricing and secondary markets for corporate straight bonds should be developed from both the borrowers' and investors' view point. That is, as straight bonds are usually safer than stocks, they should produce higher yields than public bonds. Measures are being taken to ensure this. *The auction of Government bonds should serve to produce an appropriate benchmark for the longer term rate structure.*

5. Capital Market Instruments, Institutions and Secondary Trading

In order to evaluate the performance of the capital market — that is, the network of facilities by which longer term funds are raised and allocated, or through which financial assets are readjusted — it will be necessary to examine the structure and functioning of the various components of the capital market. Although it is possible to identify the components as markets for the corporates, government and mortgages, their instruments, in principle, are linked through their comparative returns and normal yield differentials. It may be noted that the "competitive cohesiveness" of the capital market can be demonstrated also by an examination

Table 2
Capital Markets: Instruments and Holders

	Outstanding ($mil)		
	1973	*1988*	*% change*
MGS	5,722.1	55,830.8	975.7
Holders:[1] (% share)			
Social security institutions	(57.2)	(60.6)	
Banks & finance companies	(14.6)	(15.8)	
Insurance companies	(2.7)	(2.1)	
Government sector	(12.2)	(1.7)	
Corporate	(0.4)	(10.2)	
Corporate Bonds[2]	—	934.0	n.a
Loan Stock	9.0	742.3	8,247.8
Mortgages	187.7	9,917.5	5,283.7
Commercial banks	(59.0)	(74.5)	
Finance companies	(32.9)	(23.7)	
Insurance	(8.1)	(1.8)	
Cagamas Bonds	—	1,300.0	n.a
Total Long Term Debt	5,918.8	68,724.6	1,161.1
Corporate Stock[3]	13,283.3	99,120.0	746.2
Holders:[1]			
Individuals	—	(19.0)	
Nominees	—	(35.4)	
Corporate	—	(32.8)	
Total Long Term Securities	19,202.1	167,844.6	874.1
% of GNP (current prices)	106.3%	206.0%	

Note: n.a not applicable
— not available
1 List of holders not exhaustive
2 Includes promissory notes
3 Equivalent to market capitalization at current prices.

of the various financial institutions involved in the several sectors of the capital market as well as by a study of the financial instruments. Table 2 gives a profile of the various intermediaries as they participate in the different segments of the capital market, and of the various instruments in terms of their ultimate owners.[2] Data of this kind affords a view of the overall development and relative size of important segments of the capital market. In effect, this market is being considered here as the market for trading in "durable" financial instruments — equities, stocks, bonds and mortgages. Mortgages have been identified separately (to be distinguished from Cagamas bonds) because they are being viewed as a tradeable capital market instrument.

5.1 Structure of the Capital Market:

Over the period 1973-1988, the capital market has expanded at a faster rate than total real output. However, the capital market mix has not shown any dramatic changes. Housing loans or mortgages remain the smallest sector of the three, although it has expanded phenomenally over the last fifteen years. Note, however, that while new issues explain the mortgage and MGS expansion, the equity expansion is explicable mainly in terms of increased price/earnings multiples. In other words, it is primarily the result of forces in the secondary and not in the new issues primary market. Further, it is only in the recent years that new capital market instruments, such as Cagamas bonds, corporate bonds and promissory notes, have entered the market.

It is worth noting that the mix of holders of MGS has not changed dramatically. MGS continued to be held predominantly by social security institutions, particularly the EPF, and the depository financial institutions. However, there is a perceptible rise in the holdings by the corporate sector from an insignificant share of 0.4 per cent in 1973 to 10.2 per cent in 1988. A large part of this was held by Petronas. The balance was mainly in the form of repose and not direct purchases. Apart from the lack of demand from the other groups, this stability in the profile of holders has not encouraged trading in the MGS market, for pension funds as investors are rarely net sellers from their portfolio, and financial institutions generally hold MGS in amounts close to their minimum requirements. The mortgage industry is rather institutionalized, with the commercial banks, finance companies and life insurance companies being the major holders. For corporate stock there is a more diverse ownership.

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[2]Table 2 is not directly comparable with Table 1 for a number of technical reasons. Although Table 2 is essentially a subset of the latter, the type of data presented relates to those instruments which are potentially tradeable in the conventional sense (for example, not demand deposits). Equity corporate stock in Table 2, in this respect, has been valued at current market prices rather than at nominal prices.

5.2 Secondary Trading:

Financial development economists tend to place rather more emphasis on the trading in new issues. It is recognized that the placing of primary securities does involve net new saving (and investment), or the transfer of funds from surplus to deficit units. However, the secondary trading market can be of equal importance and at some stage, depending on the level of maturity, it can be of greater importance. Active-going markets are indispensable to the effective marketing of new issues and trading in outstanding securities is important in its own right because of wealthholders' constant efforts to optimize their portfolios, facilitated through the ease of asset shifts.

Capital markets, in general, can be characterized by three features: its depth, its breadth and its resiliency. *A market possesses depth* when there are orders, either actual orders or orders that can be readily uncovered, both above and below the market price at which the most recent transaction occurred. *The market has breadth* when these orders are met in volume, coming from widely divergent investor groups. And, *resiliency exists* when new orders pour in promptly to take advantage of sharp and unexpected fluctuations in prices, or in short, when a price break occurs. A security traded in a market with depth and breadth obviously possesses great *liquidity*. Hence, a significant holder of MGS can readily off-load a large amount in this market very quickly with little, if any, effect on the market price. Full order books are often taken as visible evidence of depth and breadth. But actually, all that is required is that there be many potential buyers and sellers above and below the current rate — or more precisely, a large number of actual and prospective trades in close, but not perfect, agreement about what is a good deal. In sum, a market with all three of these characteristics is a market of small price changes and large quantity turnover. It is both an orderly and a busy market. Therefore, a market which lacks depth or breadth and which receives large orders sporadically will see all sorts of price quotes appearing. Such markets, without price continuity, are said to be disorderly.

These observations, however, should be qualified by the fact that even the deepest and broadest markets are occasionally subjected to large price changes and can have a disorderly appearance. The best market will respond quickly and completely to new information. Such large price changes are not inconsistent with depth and breadth, and should be distinguished from large price changes caused merely by the time sequence of orders.

Resiliency is important to the type of price continuity just discussed. Price declines promptly bring forth buy orders. Resiliency also reflect the wide diversity of the market players who evidently hold diverse views of market developments. Generally, broad, deep, resilient markets are also low-cost, high-information markets. That is, proxies for trading conditions are transaction costs in the form of flotation costs, commissions, bid-ask spreads, and the like. It is a fact that competition and economies of scale among dealers forces narrow spreads in

Table 3
Secondary Trade in MGS by Primary Dealers
($mil, Nominal Value)

Years of maturity	*(1-2)*	*(3-5)*	*(6-10)*	*(11-15)*	*(16-20)*	*All*
1989						
January	11.1	78.9	136.4	108.1	152.4	486.9
February	16.2	0.8	35.9	1.2	89.5	143.6
March	49.8	68.5	151.9	12.5	67.8	350.5
April	—	43.9	109.9	1.3	—	155.1
May	0.2	25.3	83.8	1.8	1.8	112.9
June	0.3	11.4	28.5	—	2.8	43.0
July	167.0	9.4	133.2	—	3.0	312.6
Total	244.6	238.2	679.6	124.9	317.3	1,604.6

markets with depth, breadth, and resiliency because the active trading and price continuity in such markets assures substantial and relatively safe dealer profits. And, the narrow spreads in turn reinforce depth, breadth and resiliency by encouraging transactions.

Although the Malaysian markets have yet to attain that level of maturity and sophistication where comprehensive and timely market data are collected and made readily available for analysis, it is worth mentioning that different types of indicators of market quality have been devised to measure price continuity, market depth, quotation spread and the stabilization rate.[3] Although these indicators are not readily available in Malaysia, it is evident that market quality (as defined) on the Kuala Lumpur Stock Exchange (KLSE) is at present relatively higher than in the MGS market. A glance at charts of the NST Industrial Index in the finance section of the *Business Times* will support this conclusion. It is notable that both price rises and declines are supported by substantive volume turnover. On the other hand, the number of secondary transactions in MGS, as recorded by the primary dealers in the market, is still small (see Table 3). The average turnover in value terms over the first seven months of 1989 was $229 million, about 0.4

[3]The New York Stock Exchange (NYSE) keeps track of these indicators. *Price continuity* refers to the size of the price variation, if any, from one trade to the next in the same stock. Ninety per cent of all transactions recorded in the NYSE is estimated to take place with not more than a one-eighth point variation. *Market depth* indicates the amount of buying and selling pressure a stock will withstand before its prices changes significantly. The *quotation spread* is the difference in price between the bid and offer. The *stabilization rate* is the percentage of purchases at prices below or sales at prices above the last difference price.

per cent of its total outstanding value of \$59 billion (in nominal terms). In contrast, the average amount traded in equities over the same period was \$1,192 million or 3.9 per cent of the total outstanding value of equities of \$29.1 billion in nominal terms.

Therefore, a great deal more needs to be done to improve the MGS secondary market to make it comparable in terms of activity with the equity market. Let me now turn to the reforms introduced by BNM in recent years.

6. Recent Reforms

The lack of capital market instruments and the existence of stable yields on MGS (until recently) created little desire on the part of investors to shift the composition of their portfolios, and offered little room for risk-taking activity (and profits) so that portfolio preferences remained stable. The market for MGS is basically a captive market, where the original subscribers held these securities till maturity.

In the first stage of developing the MGS market over the period 1950-1980, attention was centered on the primary issues market. Various measures were undertaken to make MGS a more attractive investment instrument, to widen its ownership, and develop a secondary market in these securities. As a result, a variety of maturities and yields were introduced. In addition, transactions in MGS were exempted from stamp duty; the securities were made tenderable as payment for estate duty at their par value; and a higher value of commission was made payable to brokers to encourage their interest in promoting greater activity in transacting these securities. Individual holders of MGS are exempt from income tax. Mandatory investment in MGS served the two purposes of diversifying the type of holders, while securing a steady source of funds to meet the Government's budgetary requirements in a non-inflationary way. More specifically, the EPF, as the largest provident fund in the country, is required to invest no less than 70 per cent of its total assets in MGS, while MGS were included as "authorized" assets of the insurance companies for the purpose of meeting their minimum Malaysian assets requirement (under the Insurance Act, 1963). Furthermore, these securities were made a "trustee" investment under the provisions of the Trustee Act, 1942. In addition, no limits were placed on the commercial banks, merchant banks and finance companies regarding the amount of MGS eligible for inclusion as secondary liquid assets in meeting their liquidity requirements, and MGS with a maturity of less than one year to run were classified as primary liquid assets. Further, discount houses were allowed to be established on the condition that all their deposits were invested in either Treasury bills or MGS with a remaining maturity of up to 3 years (subsequently, the proportion was reduced to 75 per cent and the maturity period of holdings extended to five years in January 1989).

The need to develop the MGS market to enhance efficiency in the economy quickly become apparent when the country's public sector financing deficit rose to an untenable proportion of 17.9 per cent of GNP (or M\$10.7 billion) in 1982, thus prompting a review of the Government's financial management of its resources. The squeeze on the Government's resources also brought into focus important issues relating to the overall domestic financial system, namely, those related to allocative efficiency, the ability to effectively mobilize domestic financial resources, and the capacity of the financial system to take business risk. A distortion developed in the system after the deregulation of bank interest rates in 1978. The rates of return on long-term MGS generally yielded lower rates than those for much shorter-term non-Government financial assets. This meant that long-term funds were made available to the public sector at a much cheaper price than shorter-term funds to the private sector. It should also be noted that during this period, a large amount of government spending was on commercial undertakings so that the strength of countervailing arguments using social goals and public good reasons are diminished. Nonetheless, although the regulated yields on MGS, coupled with mandatory investments by major institutions, have helped to contain the domestic debt servicing charges of the Government, there was a cost involved — namely, the distortion in the allocation of funds.

The state of the MGS market in the post-1978 deregulation period gave rise to five areas of concern:

(i) It discouraged the development of an active secondary market in MGS, thereby limiting the growth of a very important part of the overall capital market;
(ii) It limited the ability of BNM to regulate and control the money supply and credit through active open market operations;
(iii) Mandatory legal requirements squeezed and "crowded out" the supply of risk capital to corporations, by diverting funds to MGS thereby increasing the premium charged on more risky assets. Since risk-free interest rates on MGS have not declined as much as they should have in the recent environment of low interest rates in the late 1980s, the cost of funds for all other medium-term loans have been raised as well;
(iv) It *distorted the interest rate structure of the financial sector* (seen as a second-round effect), as financial institutions attempted to pass the implicit "tax" on holding MGS (as part of the statutory requirement and liquid assets) partly to borrowers through higher lending rates, and partly to depositors, through low deposit rates (thus creating a cross-subsidization effect); and
(v) It underestimated the full impact of budget deficits, thereby delaying fiscal adjustment. This is particularly so whenever the rate of interest on MGS is lower than the perceived market rate, which often was the case in Malaysia. This meant the interest charge liabilities of the Government will be correspondingly lower, so that the real cost of the deficit is not clearly identified in the Budget.

The apparent inefficient allocation of scarce funds in the system made it *imperative that the MGS yield structure should promptly be made market-related.* Not only will market determined bond yields provide investors with a more accurate assessment of portfolio choices, it will also create *an appropriate interest rate bench-mark*, particularly for long-term corporate bonds. To achieve this long-term objective of a more flexible interest rate regime, the Government would need to be prepared to accept the uncertainty of a market-determined cost of borrowing, knowing full well that interest costs will be higher since the Government's borrowing needs will have to compete with private demands for funds.

A plan to develop the MGS market was conceived on the recognition that the successful development of an active secondary market in MGS will simultaneously require:

(i) appropriate changes in the operating procedures of monetary management in order to increase the role of the market in providing liquidity for the MGS market;
(ii) continued progress in reducing the scope of captive markets in MGS by progressively modifying the statutory requirements and revising related regulations; and
(iii) modifications in the Government's debt management strategy with a view to moving towards market-related pricing in primary issues, so as to facilitate secondary trading.

The Action Plan consisted of the following steps:

	Date of implementation
1. Introduce supportive financial reforms	February 1987
2. Issue MGS with market related prices	1987
3. Introduce a principal dealership system for MGS	January 1989
4. Auction system for shorter end of MGS primary issues	January 1989
5. Auction system for MGS of all maturities	?

The phased introduction of auctions for Treasury bills/MGS will go a long way towards meeting demands for both a greater reliance on market forces in setting rates, and for a wider variety of instruments. In particular, *as the auctions based on actual market conditions take root, the longer term rate structure, with MGS functioning as the bench-mark, will improve and help rationalize the longer term private bond rates.*

The most important institutional reform was the setting up of a panel of dealers with whom BNM could conduct open market operations on *its own initiative*. The principal responsibility falling on the dealers will be that of making markets for customers, and underwriting new issues. For example, when BNM calls for competitive bids or offers involving securities, it will be incumbent on each dealer to respond. A dealer will have the freedom to bid or offer at prices of his own choosing, reflecting his own position in the market.

With effect from 1987, BNM made its first move to issue MGS with market-related coupon rates.[4] The policy of market-related rates has been maintained even in the current environment of higher interest rates when the first loan of 1989 was issued on a higher yield curve. Over the years, the yield differentials between the short and long ends of the market have been compressed from *3.6 to 2.05 percentage points.*

The principal dealership system was introduced on January 1, 1989. A total of 18 principal dealers for Government securities were appointed, consisting of four commercial banks, seven merchant banks and seven discount houses.[5] These dealers underwrite the primary issues of MGS and are obliged to provide two-way quotations in the secondary market. Only the principal dealers have access to BNM's rediscount window, while the Bank's open market operations would be conducted through these dealers only. As such, *BNM's role in the money market changed to one of maintaining liquidity in the system as a whole* and not responding to the needs of each individual institution. Individual financial institutions with excess liquidity or which are short of funds will have to square their positions in the market and not with BNM. Institutions and individuals wishing to purchase MGS from primary issues will have to apply through the principal dealers.

Securities with maturity periods of up to ten years are now issued by way of auction through the principal dealers, and, as such, BNM no longer accepts advance subscription for MGS, except from the EPF. However, the longer-dated issues are still offered on a subscription basis, *for the time being.*

7. Assessment of Experience with Recent Reforms

The first Government loan stock of 1989 was issued in accordance with the reforms of January 1989 and served as a bench-mark issue. MGS with maturities of up to ten years were auctioned through the principal dealers. Given the nascent nature of the new system, the bids received were extremely diverse, ranging from 90.00 to 100 for the 5-year 6 per cent MGS and from 83.75 to 99.99 for the 10-year 6.5 per cent MGS. Such substantial ranges of 700 and 1000 basis points

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[4]When the Action Plan was conceived in mid-1986, MGS rates were lower than perceived market rates. However, when the plan was implemented, market rates had softened significantly in the last quarter of 1986. Therefore, market related MGS meant in effect a shift downwards of its yield curve relative to its preceding levels. By the end of 1988, the coupon rates of new issues of Government securities had been reduced by a total of 1 to 2.1 percentage points.

[5]All the discount houses were transformed into primary dealers. The discount houses traditionally played the role of providing liquidity to the short end of the interbank money market. To support their new role as primary dealers, they have been allowed to hold and trade in money market instruments (MGS, Treasury bills, Cagamas bonds, bankers acceptances and negotiable certificates of deposit) of up to five years in terms of remaining maturity, compared with three years previously.

would be unheard of in a matured market. This is a clear reflection of the need for further development of the market.

Trading in general has tended to concentrate on the newer issues of MGS and the volumes have been modest. As the interest rate levels moved up in recent months, for macro-economic reasons, some existing holders of MGS incurred capital losses in their books. The capital loss in the first quarter of 1989 on the total outstanding stock of MGS of M$58 billion is estimated at M$1.4 billion. However, since current yield levels are still below the levels prevailing prior to the reforms in 1987, there is in fact a net capital book gain of M$3.7 billion. Two-thirds of this net capital gain belongs to the institutional funds (particularly the EPF) which often follow the conventional accounting of booking at cost. *Overall, bond-holders appear to be still better off despite the recent rise in yields.*

7.1 Market Thinness

Opportunities to trade can only arise if there are a large number of players in the market that hold different and contrasting views of prices and yields. The current market at the moment still does not have a well-diversified range of players, each with their specific investment objectives whether short or long term. *It is necessary to enlarge the number of players to develop the market.*

In this respect, BNM has taken steps to increase the number of financial institutions allowed to participate in the interbank market. Originally limited to commercial and merchant banks, a total of twelve finance companies (with share-holders' funds of not less than $30 million) are now allowed to participate. In addition, selected merchant banks (8) have been allowed to issue NCDs, where previously, this privilege was only extended to the commercial banks, provided that they observe a higher liquidity ratio of 12.5 per cent of total eligible liabilities, compared with 10 per cent for non-NCD issuing merchant banks.

Market thinness can also reflect a lack of choice in the available financial instruments in the market. Towards this end, BNM has been not only receptive to the variety of financial innovations initiated by the financial institutions, but has also played a leading role in developing and encouraging the creation of different types of new financial instruments. A striking example is the introduction of Cagamas bonds which are securitized mortgaged-backed bonds. Floating-rate NCDs were also allowed to be issued in the market. To complement and support the development of a secondary market, it is also essential to have a regular supply of private corporate bonds. It is only in recent years that corporate bonds and promissory notes have made their appearance in the market. To encourage private sector corporations to source funds through this means, BNM introduced a set of guide-lines (BNM 1988), with the aim of facilitating the orderly development of both the primary and secondary markets for private debt securities.

The guide-lines set out the criteria that have to be met for the issuance of private debt securities, including the making of a viable secondary market in such instruments. These guide-lines were issued with the objective of establishing a clear framework for bond financing; hopefully, this move would encourage companies to raise more funds through this channel. Any company wishing to issue bonds will now need to seek the prior approval of BNM.

With the introduction of scripless MGS trading in January 1990, it is envisaged that activities in the secondary market will increase. Computerized trading through SPEEDS (Sistem Pemindahan Elektronik (untuk) Dana dan Sekuriti) will allow a greater variety of instruments and trades to take place. Not only will this allow a more flexible management of portfolio in terms of speed, ease and size of investment, but more specifically, it will encourage the participation of more individual investors.

7.2 Regular and Anticipatable MGS Issues

Previously, Treasury Bills (TBs) were issued in an ad hoc fashion and not in regular amounts. Since 1986, there has been a regular and anticipatable supply of short-term securities of given types. Each week, 91-day, 182-day and 364-day bills at regular amounts of between $100-200 million for each series are made available for auction through the primary dealers. It should be noted that in the US, both short and longer-term bonds are issued on a regular basis, or at the very least, dealers know that they can pick up these stocks at the next primary issues, which are made within a reasonably regular period.

On the other hand, the problems of *ad hoc* and irregular issues of MGS still prevail. Efforts have been made to move away from issuing long term issues of MGS of 15 to 20 years, but the success has been limited mainly because of the need to meet the EPF's legal investment requirements for MGS.

A regular schedule of issues of MGS with standard features would help primary dealers in their trading position. If the market knows, for example, that 10-year MGS (or any distinct variety of bonds) will be auctioned off every 8 or 12 weeks (not necessarily with precision), the primary dealers will be assured of a supply of a particular stock of which they can bid for later so that they will not be wary of selling off their existing 10-year bonds.

Although there was an attempt to issue MGS on a more regular basis and with a wider range of maturities (especially of the shorter to medium term range), BNM has been successful only in 1987 when six issues, as opposed to the norm of three, were made. The difficulty lies mainly in co-ordinating and smoothing out the overall budget and cash-flow requirements of the Government over each fiscal year. Perhaps it is *now timely for BNM to raise funds for the Government from the market by way of smaller but more regular issues rather than the current method of large and lumpy issues, highly dependent on when the Government requires such funds.* But the issues should not be too small, since a certain minimum size is required to ensure liquidity for the issue. It would also be desirable for the market to be informed of the issue programme for the year in advance. In the US, the Federal Reserve Bank informs the market of its funding requirements for each fiscal year. In turn, this will help players in the market plan their financial strategies.

7.3 Inadequate Float

Although there is a sizeable amount of MGS outstanding ($55.8 billion), the actual amount available for trading is considerably smaller at $17.1 billion, after considering that 70 per cent of the EPF's holdings are statutory (which takes up approximately $24.8 billion), 60 per cent in the case of the National Savings Bank (approximately $1.2 billion), and 25 per cent for insurance companies (approximately $1.7 billion), while the liquidity requirement for the banks and finance companies takes up another $11 billion.[6] Given that institutions such as the EPF in particular tend to hold MGS well in excess of its legal requirements (exceeding 90 per cent of their investment portfolio), this available amount is effectively reduced further. *It is perhaps timely to consider discouraging these institutions from holding "excessive" amounts of MGS.* To do so effectively, viable alternatives that are suitable must be made available.

Technically, this "free" amount, which is not bounded by legal and mandatory requirements, need not be taken as the real "float size" of MGS. The float, by definition, is the amounts of MGS which are in effect actually traded in the market. In the Malaysian system, this float and the "free" amounts mentioned earlier are not the same since holders of MGS in excess of the legal requirements do not trade their excess margins. In matured markets, institutions actively seek opportunities in deriving additional income by trading on these spare margins.

Furthermore, so long as the system of advance subscription for long-term bonds exists for the EPF, BNM is obliged to issue them. The magnitude of the deposits of these institutions puts pressure on BNM to disproportionately issue long-term bonds, and at the same time deprives the "unregulated" section of the active market of a potentially large (non-captive) demand for securities. *To promote an active MGS market, it is clear that the extent of the captive market, bound by regulatory requirements, must be progressively reduced.*

To introduce greater flexibility to the banks in meeting their liquidity requirements (and indirectly reducing the need to hold excessive liquid assets which include MGS), reduce interest rate volatility caused by temporary and unexpected shortfalls in bank liquidity, and reduce the cost of bank operations, the commercial banks, merchant banks and finance companies have since 1987 been allowed to "average" their holdings of eligible liquid assets in computing their liquidity requirements (by holding, on the average, sufficient liquid assets

[6]These figures are only indicative. To the extent that financial institutions hold other types of liquid assets, the amounts will be understated, but to the extent that EPF and insurance companies hold MGS in excess of their requirements for prudential reasons, the amount will be overstated.

equivalent to the prescribed minimum holdings over the entire stretch of each liquidity period — that is, from the 1st to the 15th, and from the 16th to the end of each month — instead of observing the minimum requirement daily). The procedure for averaging involves both the primary and total liquid asset holdings and, for the purpose of compliance, a variation of up to 2 percentage points below and above the minimum requirements only would be taken into account in the computation of the liquidity requirements. Recently, the banking system has also been allowed to hold its statutory reserves on the basis of an average over the reserves period. A variation of up to 0.5 percentage points will be taken into account in the computation of the statutory reserves requirement.

7.4 Unexplored Opportunities under Present Settlement Procedures

The present settlement procedure is extremely flexible in that the day of settlement of deals is fixed mutually between the transacting parties. Almost all of the present trades are for cash or immediate settlement, although some are done on a weeklong settlement period. The advantage of having an unregulated settlement procedure is that dealers are then allowed to undertake hedging activities. For example, suppose I buy 10-year MGS for 99.5 today for settlement 7 days later. However, I also want to hedge against a possible rise in interest rate next week which could mean a capital loss for me. To protect myself, I can short sell 8-year MGS simultaneously. Since a general rise in interest rates will usually affect the prices of bonds across the board, I will be able to hedge against any losses. Although the degree of hedging will be determined by the yield differentials or the "basis" between the two types of MGS, a near perfect hedge can nonetheless be built by changing the varieties of MGS, and the amounts sold and bought continuously. Indeed, my position can be monitored and changed instantaneously with any new developments in the market conditions. For this to occur, dealers must be willing to exploit all the possible opportunities in the market. This will require a great deal of technical skills on the part of the dealers in monitoring a particular stock's volatility and the calculation of changes in its prospective yield on a continuous basis. In addition, dealers must be well-versed in the different types of arbitrage possibilities available in the market.

7.5 Futures Market

Being able to change and hedge one's position in the cash market with an extended settlement period is almost like operating on a futures market. However, capital risks may be better managed by hedging activities through the use of futures and options. This will involve taking positions in an asset that will have offsetting gains and losses. Thus, a position in MGS can be hedged by taking an opposite position in a stock option or a financial futures (interest rate) contract. For a futures market to work, the party offering the option is required to take an opposite view (or have precise expectations) of the market at a period of time in the future, whether favourable or unfavourable.

A futures contract is simply the purchase or sale of a commodity (in this case, a financial commodity) with settlement on some date in the future. It is equivalent to a forward market except that a futures contract is dealt via a recognized exchange. The advantage of a futures contract is that it is a homogeneous product in the market known to all buyers and sellers, unlike that of a forward contract where the characteristics of the product are specific to each transaction. Further, there are no credit worries because in most future exchanges, counterparts do not deal directly with each other but through the intermediary of a recognized exchange.

There are *three major reasons why people should be interested to enter into futures*. The first is because agents would like to hedge their positions. This is known as a "natural" transaction. Let me give you two institutional examples from the US bond market.

A. ABC Corp. knows it wants to borrow $100 million in three months' time. Interest rate on 10-year bonds is 10 per cent and ABC Corp. can borrow from the market at 10.5 per cent, which it finds acceptable. It can choose to borrow now at 10.5 per cent or it can short 10-year bonds for three months settlement. Suppose interest rates go up in three months' time: 10-year bond becomes 11 per cent and ABC Corp. can borrow at 11.5 per cent. Assuming that there is a constant relationship between the cost of borrowing and the bond rate (neglecting margins cost and commissions), the effective cost of borrowing for ABC Corp. will remain at 10.5 per cent, even with the rise in interest rates.

B. A Pension Fund expects interest rates to fall in three months time. It would like to invest at the current rate but does not have the funds. However, it knows from experience that there will be an inflow of $50m from contributors in three months time. Therefore, the Pension Fund can take out a long position for settlement three months later, to take advantage of what it perceives is an interest advantage position. Conversely, if it expects both large payments and interest rates to rise, it can take up a short position.

The second reason why people buy futures is because they are speculators (essentially, gamblers). They are risk-takers because they are prepared to bet on the opposite side of the "natural hedgers". This group of agents must be present for the viability of the futures market. The third reason is that they are traders (called "locals" in the US bond market) who earn commissions from executing orders for clients or by taking positions themselves. Sometimes, people do also speculate on their hedged positions!

7.6 Essential Ingredients for a Futures Market

It is essential that the underlying cash/spot market for the MGS instrument is highly liquid. Prices in the cash market determine prices of futures. This implies that even before attempting to set up a futures market, the cash market must be wide and deep which will help to create the liquidity needed. In addition, there cannot be absolute certainty about the future price of bonds or the level of interest rates. Neither can there be total agreement on how the market will behave in the future. Indeed, even a small diversity in price expectations will create opportunities for trade. It should be emphasized here that the creation of a deep cash market requires this same lack of absolute certainty and general agreement about future price trends.

Futures markets operate on low margins, so that the ease of cornering a financial product (a specific contract) is increased. It is precisely because of this that a financial future contract is made up of a basket of different varieties of bonds. However, a basket-type of futures would not make cornering more difficult if the size of the float of each component of the basket is itself small. It must also be realized that it may not always be easy to get out of a futures contract. On most exchanges, there is a daily limit on the price movements of each type of contract both ways.

Lastly, it is necessary to introduce and encourage a free borrowing market (by way of loan or repurchase agreements). This is not only necessary for the adequate functioning of a futures market but even for a cash market. For example, investor A approaches Trader B for a market in 10 years and B quotes 99-101 in \$5 million. Investor A decides to buy \$5 million at 101 for settlement tomorrow. Trader B, however, does not have any 10-year bonds but is both prepared and allowed to borrow from the EPF (of course, at a price and duration determined by both parties).

It is clear from these observations that *what happens on the cash market is paramount*. The establishment of a futures market would not help unless the cash market is already functioning adequately. This is, of course, not to deny that a futures market will enable the cash market to perform better. But there is no "chicken and egg" problem here: the cash market comes first. Indeed, the several ingredients required for the success of a futures market in good part are the same for a successful cash market.

To repeat, *a diversity in views (however small) is absolutely required in any type of market*. This diversity can be promoted by encouraging the participation of players with different portfolio requirements and objectives. As such, the participation of larger social security institutions, such as EPF and SOCSO, must be encouraged. At the same time, *portfolio management activities and different kinds of investment instruments (such as unit trusts in gilts and MGS, corporate bonds and notes) should be promoted.*

8. Venture Business and Capital

Venture capital activity is now at an unprecedented level in the industrialized countries of Europe, America and Japan. Its emergence in good part reflects the need to take bold decisions to invest in the newer technologies in order to stay ahead of the competition in an increasingly international market-place. To the extent that the Malaysian economy is also undergoing structural changes, it may be timely to pay greater attention to the gains which can be derived from having a domestic venture capital industry. However, we must be careful to be able to distinguish between the different types of venture capital businesses so as to ensure that only those which are appropriate for the Malaysian environment are promoted. To be precise, Malaysia is and has been moving away from a primary commodities based economy to one which is dependent on manufacturing. In order to make that great leap forward and to give greater momentum to the pace of industrialization, venture capital may indeed be made to play a vital role, by placing the economy in a direction which will provide the much needed dynamism. It has been proven in several countries that the establishment of a strong venture capital industry can contribute significantly towards creating a stronger equity base for industrial development, and in mobilizing private risk capital for investment in technologically innovative projects, undertaken by entrepreneurs with sound business plans and high growth and profit potential, but with limited capital resources.

Malaysia's Industrial Master Plan, 1986-1995, had identified several serious problems adversely affecting the sound development of the manufacturing sector in Malaysia. These include a low level of technology and lack of indigenous capability for technological mastery and an insufficient supply of engineer/technical level manpower that are able to absorb and improvise technology from foreign sources.

8.1 What is Venture Business and Venture Capital?

Although not clearly defined, venture business refers to knowledge-intensive and innovative small business. One of the most important problems in venture business development is fund raising. By its nature, this type of business generates large capital demands for R&D and trial production of new products. It is often the case that its R&D field is so advanced that the inspection and evaluation know-how has not been established. As a result, direct investment through a venture capital company is not always sufficient.

In board terms, we can take venture capital to mean the investment of long-term, risk equity finance where the primary reward for its providers (the venture capitalists) is an eventual high capital yield.[8] The sources of venture capital are many and varied, ranging from the entrepreneur's own savings, or those of relatives and friends, through independent or government venture capital funds and equity arms of banks (that is, specialist subsidiaries providing equity types

[8]A venture capital investment is illiquid, that is, not subject to repayment on demand as with an overdraft or following a loan repayment schedule. The investment is realized only when the company is sold or achieves a stock market listing. It is lost when, as sometimes occurs, the company goes into receivership or liquidation. Venture capital is risk finance in the extreme.

financing packages). Another particular feature is that the venture capitalist usually has a continuing involvement in the business of the "customer" after making an investment. This does not mean management interference, but a venture capitalist will seek to protect and enhance his investment by keeping close to the entrepreneur and his team in an active supporting role. This style of operation is in marked contrast to that of a banker or a development banker. It also differs radically from the approach of a stock market investor, who can buy and sell at will, and rarely even meets the management of his investment. This approach is commonly known as "hands-on" aftercare management.

Although venture capital as an idea has been around for a while, the number and extent of activities forged between the entrepreneur and those who supply capital, have not developed to any significant degree in Malaysia. Entrenched cultural and institutional factors are the main obstacles to this innovative financing technique. The prevailing conservative, inward-looking business culture and practices in our business communities is reflected in a reluctance to share management control with outsiders. *More importantly, there is no tradition of cooperation between the ideas-man and the professional manager.* That is why it is difficult to find initial seed capital financing. The problem has to do partly with the fact that our local banking system tends to do mainly collateral-based financing and in part, the avoidance by banks to take risk even at times when investible funds is plentiful, as is the case today. To the extent that the capital market is not well developed with a profitable and attractive existing mechanism for venture capital firms to cash out their investment, their growth is being discouraged.

Despite the fact that foreign venture capital firms have shown interest in Malaysia (and Thailand), there are insufficient domestic counterparts with a similar degree of interest. At the moment, there are very few venture capital joint venture companies in the country. All of them have not been too active. We also have a Technology Park, established recently in 1988 to encourage R&D on products with significant industrial and commercial value. Its success will be measured not only by the number of products which come out of the Park but by the number shown to be truly commercially viable. However, to the extent that the tenants of the Park continue to encounter difficulties in obtaining financial assistance from the banking system to fund their projects, the potential of the Park will be limited.

It is now *timely to promote the activities of both venture businesses and venture capital companies*. The Government, on its part, is committed to providing special fiscal incentives to promote their growth. These incentives were passed by Parliament in October 1989. More specifically, we will need a venture capital fund facility for the Park. At present, studies are being proposed to establish a venture capital financing facility aimed at promoting the development of commercially-oriented technology projects, particularly those involving small and medium enterprises (SMEs). Apart from reviewing the possible gaps in the existing financial system in providing funds for venture businesses, resort to the stock market as a potential source of funding for the SMEs and as exit routes (through flotation) for venture capital investors needs also to be examined.

In sum, the existence of venture capital would provide medium-term risk finance for commercially oriented risky development projects complementary to the finance traditionally provided by the existing banking system. Easy access to a variety of well-functioning and flexible venture capital finance facilities is essential to bridge the gap. Hence, the main focus would be on providing finance for risky technology-based firms which are either setting up or expanding, and whose growth begins to outstrip internal financing resources, or which may find it unsuitable or difficult to borrow sufficient funds for growth from conventional sources.

9. Conclusions

In the next few years, the domestic savings-investment gap is likely to remain small so that there will be no serious imbalances in the current account of the balance of payments. In other words, aggregate demand for and supply of capital funds will be equalized. This reflects well for the country as a whole. However, we have to look beyond the aggregates since it is almost certain that there will be compositional and structural changes in the capital funds market.

One striking feature which will manifest itself increasingly over time is the downsizing of Government expenditure. As a matter of policy, the Government is already committed to promoting private initiative as the main engine of growth. This immediately implies that there will be a much smaller public sector borrowing requirement. To a large extent, the reduction on the expenditure side reflects the Government's plans to privatize further and the continual exercise of prudence. The fact that the Government will no longer absorb large quantities of funds will result *ceteris paribus*, in the creation of a vacuum on the demand side for funds from the financial system. This will have important effects on institutions which mobilize substantial savings, particularly the EPF. The EPF is the largest single mobilizer of forced savings in the system and the bulk of its assets is held in the form of MGS. The previous and existing convenient set-up, whereby large demands for non-inflationary financing by the Government are met easily and directly by EPF's funds, is likely to be changed in a significant way. As such, there is need to find alternative avenues of investment for the EPF's funds when the Government's financing needs are materially reduced. The problem is likely to be aggravated given that the amount of investible funds that must be mobilized to fund private investment is expected to be much higher than in previous years, based on the need for sustained overall economic and employment growth.

To counteract against any adverse effects, which may arise from the shrinking of the public sector as a major source of claims on the financial resources in the economy, the capital market would need to be rapidly developed in a well-balanced and integrated manner. This means that, as far as practicable, all segments of the market must be simultaneously developed. In this paper, I have already identified five major areas which need to be developed further.

Firstly, the equity market must continue to expand to meet the needs of investors and savers. Secondly, the number of financial instruments must be increased through the development of the corporate bond market. Different hybrids of debt securities other than straight corporate bonds, such as commercial papers, convertibles and possibly warrants, must be encouraged so as to widen the choice of available financial instruments for both borrowers and investors in these debt instruments. In this way, preferences of both savers and investors will also be optimized. In this respect, the establishment of *a credit rating agency* in the near future is timely. Its presence will fill a market need to more efficiently price bond issues in accordance with their true credit standing, thereby encouraging companies to raise more fixed rate funds directly from the market (as opposed to the present heavy dependence on equity and bank borrowing) and at the same time, promote investors' demand for papers. It is expected that a credit rating agency would be set-up in Malaysia by June 1990.

Thirdly, trading in the secondary MGS cash market must be enhanced to increase liquidity and allocative efficiency in the market. Fourthly, the feasibility of establishing a *financial futures market* should also be studied. Such a feasibility study will focus on the timeliness of setting up such a market, the types of financial futures contracts that will attract interest and, if feasible, what needs to be done to bring about such a market in the country. Finally, the encouragement of a rapidly expanding *venture capital industry* (to promote medium-term funds for high-risk technology-based ventures) will complement the development of the longer end of the capital market. Such an industry will also have positive benefits on Malaysia's pace of industrialization.

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Commentary

R. Thillainathan

Introduction

We have heard two comprehensive and excellent presentations by Dr. Homi Kharas and Dato' Dr. Lin See Yan. There is little that I disagree with what they have said. This happy coincidence of views, far from making the life of the commentator easy has made it doubly difficult. Under such circumstances, I can either end up being repetitive in my comments or with little to add to what they have said. Since I have to say something, please put up with me if I am a little repetitive. In keeping with an important goal of the convention I will focus on issues rather than on methodology or findings. But this has been made possible because I have no disagreement with the authors on these areas.

Comments on Dr. Homi Kharas' Paper

Relationship between Savings & Growth

On the relationship between savings and growth the author's views are as follows:-

a) That raising savings is not sufficient to raise growth.
b) But that as growth accelerates (which is possible through the pursuit of the right policies), it should generate the required savings from the corporate and household sectors or even from foreign sources.
c) The implications for economic policies are therefore obvious. What is necessary for high growth is the creation of the right environment for entrepreneurship and effort as well as for savings and investment.

Current Savings Rate

On the current savings rate the author states:-

a) That Malaysia's current savings rate is high.
b) That a large portion of these savings is cyclical or transitory.
c) And that these savings can be expected to disappear by 1990 once the process of rebuilding assets lost in the recession is over, and when expectations of high growth are revised upwards.
d) So what do we do? The author has cautioned that the principal and soft options for raising savings, namely through "forced" savings, or "forced" increase in interest rates, or "forced" depreciation of the currency, should be avoided as

they can cause irreparable damage to the economy. I share his views fully in this regard.

Household & Corporate Savings

On household and corporate savings the author states:-

a) That in international terms the relative size of household savings *vis-a-vis* corporate savings in Malaysia is on the high side.
b) That this is so because of "forced" savings and the payroll tax that employers pay as part of such "forced" savings.
c) That "forced" savings have not led to an increase but may have in fact led to a decrease in overall personal savings.
d) And the low corporate savings and the conservatism of Malaysian bankers, as evidenced by the lower debt to equity ratio in Malaysia compared to the corresponding ratios for Far East economies, have led to lower corporate investments as a percentage of GNP, again as compared to the rates prevailing in the high-growth economies of the Far East.

Funnelling Savings to the Corporate Sector

On funnelling savings to the corporate sector, the author has this to say:-

a) That low corporate savings have led to low corporate borrowing and investment. The large household savings have been tapped in financing the equally large public sector deficits in line with the development strategies of the 1970s and early 1980s which treated the public sector as the vehicle for the restructuring of the economy and as its so-called engine of growth.
b) The author has pointed out very clearly that to-date the principal channel of savings in Malaysia is oriented towards mobilizing resources that can be tapped by the public rather than by the private sector. As the past, development strategies have been found wanting, and now that increasing reliance is being placed on the private sector as the engine of growth, the author states that institutional and policy changes are required to funnel savings back towards the corporate sector.
c) The capital market reform of the late 1980s highlighted by Dato' Dr. Lin in his paper may provide one mechanism for channelling household savings, including those mobilized by the Employees Provident Fund (EPF) and the like, to the corporate sector. This will require that institutions like the EPF participate more actively in the corporate bond market. The development of the corporate bond market is now being encouraged by Bank Negara Malaysia (BNM). A higher percentage of EPF's resources should also be invested in equities than is being presently done. But for prudent reasons, such investments must be carried out over an extended period of time and with an eye for underlying market trends.

d) As pointed out by the author, in the early 1980s, the higher EPF rates and broader EPF coverage, rising wage rates and the appreciating Ringgit, had led to the biases in the composition and the utilization of savings by altering the distributional balance between households and corporations. From the mid-1980s, the big correction in key factor and asset prices, deregulation, as well as reductions in corporate tax rates are improving corporate savings and investments. To reinforce these trends we must continue to deregulate the economy, reform the tax structure and even possibly reduce the EPF rate. These suggestions are in line with the author's own views.

Comments on Dr. Lin See Yan's Paper

Dr. Lin See Yan's paper is an excellent presentation on the Malaysian capital market. It is comprehensive, describing in clear terms the current state of the market, the major reforms that have been undertaken in the late 1980s, and the rationale for these reforms. BNM has played a key role in bringing about these reforms which may have even put us ahead of Singapore in some respects. In what follows, in view of its importance and its relationship to the issues raised by Dr. Homi Kharas, I confine my remarks to the developments in the bond market.

The Pre-Reform Bond Market

First let us look at the pre-reform market:-

a) There was an official or administered yield curve (AYC) for government bonds — these bonds were almost the only type of bonds issued and traded in the pre-reform environment.
b) BNM quoted two-way prices around the AYC.
c) BNM supported the AYC by buying or selling bonds, within limits, at redemption yields or yields to maturity (YTMs) implied by the AYC.
d) The market for bonds was largely a captive one to the extent that investors were prepared to hold bonds only up to the quantum required by statutory requirements.
e) The demand for bond holdings in excess of the statutory requirements, especially from investors who were not subject to any regulations, was minimal. It was this consideration which made it possible for BNM to support the AYC without serious difficulties.
f) The sale of new issues of Malaysian Government Securities (MGS) or government bonds was by advance subscription.
g) The market for corporate bonds was almost non-existent. This can be attributed to the high transaction costs, in the form of high stamp duty and brokerage commissions.

The Post-Reform Bond Market

What is the situation prevailing in the post-reform bond market?

a) A system of primary dealers (PDs) has been set up. The PDs are required to underwrite all primary issues but not necessarily at par value, that is, while the coupon rates are fixed, the PDs are allowed to quote their own bid prices. This is what ensured the willingness of the PDs to participate in the primary issue market even in the uncertain interest rate environment of 1989. If this basic principle of a market-determined yield curve had not been adhered to, the system of PDs would have collapsed even before it was launched. And BNM must be congratulated for upholding this principle for otherwise the reforms of the capital market it has been undertaking in recent years would have been meaningless.
b) The sale of new issues is by auction and the allocation is related directly to the bid prices received. This consideration, and the fact that PDs are allowed to make the bid either at a premium or a discount, imply that issue size and YTMs are market-determined, unlike the situation prevailing under the advance subscription system.
c) All PDs are required to quote a two-way price for bonds which, in theory, should ensure that a secondary market exist for bonds.
d) Corporate bonds can now be traded in the inter-bank market on the same terms as MGS, that is, these bonds are also exempted from stamp duty and are subject to the same brokerage fee as MGS. This means that, unlike the previous situation, the market environment has now been liberalized to a great extent.

Further Developments

What are the bond market developments in the pipeline?

a) A scripless trading system is to be introduced.
b) A rating agency is to be set up to review and establish the credit rating of each issuer and each issue on a regular basis.

And Yet Why Has The Secondary Market Been Inactive After Its Strong Performance in 1987 & 1988?

a) There is as yet not enough expertise amongst investors and fund managers.
b) The lack of a futures or options market does not enable investors and fund managers to hedge or to take a position. One can of course take a position in the cash market but the investments required are much larger. On the other hand, in a futures and options market, as trading is based on margins or premiums, the cost of investments is much lower. Therefore, the futures or options market will be more liquid then the cash market. And the existence of a futures or options market will enable investors and traders to take positions or hedge their positions in the cash market.

c) In this regard it is indeed heartening to note from Dr. Lin's paper that the authorities have a full appreciation of the role of the futures or options market. The absence of a futures or options market can in fact stunt the growth of the cash market by forcing investors to double-up as speculators, which they may or may not be willing to do. Therefore we hope that a market in financial futures will be set up in the not too distant future.

How are We Ahead of Singapore?

Singapore's Central Provident Fund (CPF) is its biggest supplier of long term funds just like the EPF here. However, the yield that the CPF receives on its investments in Singapore Government Securities (SGS) are based on a floating rate. These floating rate yields are equated to the weighted average of the savings and 12-months deposit rates of the four leading banks. As CPF funds are long-term in nature, they should not be treated like the short term funds of the banking system. A persuasive case can be made for the simultaneous development of not only a fixed rate but also a floating rate and an index-linked bond market. However, to go only for the floating rate system as is being done in Singapore for the CPF funds, is an extreme solution. In any case, if the government is to issue floating rate bonds, its yields should be related to the yield on Treasury Bills, and a premium has to be paid to the subscriber over the Treasury Bill rate to compensate for committing funds for long periods.

I have brought up the Singapore case only because certain economists have advocated a similar treatment for the EPF funds in Malaysia. If that is adopted it will be a grave mistake for the reason discussed above and the fact that, unlike Singapore, in Malaysia there is a budget deficit and the government is a net borrower on a very very big scale. Therefore, the distortions caused in the capital market will be even more pronounced.

THE MANY FACES OF REDISTRIBUTION: A SELECTIVE REVIEW OF INTERNATIONAL EXPERIENCE

Shahid Yusuf*

Over the past thirty years, several strategies have been adopted to alleviate poverty and lessen income inequality. This paper reviews the experience of several countries in this area and offers suggestions to developing countries for the nineties.

1. Introduction

Policies that reduce the incidence of poverty can also result in more income equality but this is not always the case. There are instances where incomes have risen across the board, lessening poverty, without making a noticeable impression on distribution. In many developing countries political sentiment favours greater egalitarianism for the sake of industrial peace, but this is a long-term goal. The immediate concern is with measures which will alleviate poverty. Over the past thirty years, several strategies have been deployed and much experience has accumulated. Earlier hopes have been tempered by the meagreness of gains and expectations are now pitched lower. The paper attempts to trace the recent thinking in this area[1] with particular reference to the industrialized leaders in the field; it examines the efficacy of the various mechanisms of redistribution, direct as well as indirect; and it offers a view regarding the choice of policies for the nineties by developing economics.

Redistribution can take several forms: it can involve transfers between groups in order to guarantee the less well-off a minimum living standard; it can entail life cycle income smoothing through inter-generational transfers, when younger workers support retirees through taxes and social security contributions; by

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*The view expressed here are those of the author and not of the World Bank. I am grateful to Shahid Javed Burki, Ehtisham Ahmad and Homi Kharas for their comments and to Tejaswi Raparla for assistance with statistical tests.

[1]No account is taken of the theoretical advances in this very lively field. Those interested in some of the knotty conceptual issues relating to living standards might peruse Sen (1987). A broader review of theoretical concerns relating to social security can be found in Atkinson (1987).

decreasing savings or borrowing externally, current consumption can be raised; finally consumption standards can be enhanced through an accelerated depletion of natural resources that constitute a nation's stored wealth. Each of these can raise the living standards of some or all groups within a country but by modifying incentives and the future availability of resources, they can influence the pace of economic growth, which ultimately determines whether a certain level of welfare is sustained over the long haul. Much of the debate that has swirled around redistributive tax and expenditure policies originates from the tension generated by transfers aimed at raising the consumption levels of the poor. Beyond a point, transfers can blunt the incentives of those who must surrender resources being redirected to the poor and erode the economy's growth potential. They can also breed a welfare mentality, which discourages recipients from seeking work. For nearly three decades after the Second World War, the urge to redistribute appeared to have the upper hand because it apparently left the growth impulse unimpaired. But the crises and economic turbulence that have marked the past fifteen years have brought the trade-off into sharper focus and aroused, in addition, a fair measure of political opposition to redistributive action.[2]

2. Welfare Triumphant

The immediate postwar decades were distinctive in several respects: both developed and developing countries enjoyed unusually rapid growth fuelled by remarkable gains in productivity as well as low and stable commodity prices. Among the industrial nations, the experience gained in managing production during wartime; the multiplication of controls over resources; and the perfecting of new institutions for manipulating welfare, set the stage for interventionist, Keynesian macro policies and laid the foundations for the welfare state. By taming the business cycle, cutting unemployment to the minimum and making possible a sustained increase in real incomes, post-war Keynesianism provided the necessary economic and political backdrop for welfare policies.[3] At the level of prosperity, technological change and unemployment experienced in the fifties and sixties, transfers to the aged, the unemployed and the poor seemed affordable both in terms of tax burdens as well as the dilution of incentives. While consistent management of economic performance was one factor motivating the adoption of redistributive initiatives, the tacit competition between rival capitalist and

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[2]Skidmore (1981: 2). It is noteworthy that the redistributive effect of the tax system in many developed countries has become negligible (Atkinson 1983: 84-7). In developing countries, tax systems are at best proportional.

[3]Gilpin (1987: 357), Rivlin (1975: 6). Japan lagged behind other industrial countries in the provision of pensions, child allowances and other benefits. Health care benefits for all citizens were legislated in 1958 and since the seventies Japanese welfare entitlements have approached parity with those in the West (Calder 1988: 349-50).

communist systems also exerted a pull. Socialist economies seemed in full bloom, apparently registering gains as convincing as those of the West with a far smaller dispersion of incomes[4] and providing their citizenry with comprehensive income security, education and health services.

Another force influencing postwar receptivity towards welfare programs promising greater equality was political. Active and vocal parties representing different segments of the political spectrum, increasingly muscular labour unions and sophisticated information technology, permitted a more informed and aggressive participation by poorer segments of the society.[5] To put it differently, the new politics began to erase traditional gradations of status and dominance. Once the inherited social hierarchies and the claims of the established elites were questioned, the equity of economic arrangements that sanctioned poverty and enormous variations in life chances were soon exposed to public pressure.

The industrial nations retained the concept of free choice and much of the market system, but in most countries, the fiscal and regulatory powers of the state were greatly enhanced. From an essentially minimalist position which assured equality before the law, the Western countries were pushed by economic circumstances and social aspirations, closer towards a position where the state attempted to assure each citizen the semblance of equal opportunity. The Western democracies stopped short of a redistributive stance that would have provided the equality of result,[6] partially achieved in the socialist countries, and in doing so they highlighted the limits to redistribution in a market economy.[7]

3. A Turning of the Tide

Free markets are predicated on the existence of and trade in property rights. As the recent experience of the East European countries and of the People's Republic of China shows, a dynamic market system requires well delineated and legally buttressed, private property rights. So long as private ownership or leasehold privileges are indistinct or entwined with those of the state, the capabilities of the market mechanism cannot be completely realized nor can individual energies be fully harnessed to the task of production or commerce.[8] Where the redistributive practices of a market centred, welfare state result in extensive appropriation and transfer of private property through fiscal levies, individual initiative is bound

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[4]The absence of property incomes had an equalizing effect as well.

[5]Rivlin (1975: 1).

[6]Nevertheless, from around the time of the Great Depression in the thirties, a minimum guarantee was provided (Wilbur Mills in Skidmore 1981: 5). The efforts by the Federal Government in the US to provide social security in the early thirties and the system that emerged after the Social Security Act of 1935 are discussed by Brock (1989).

[7]Coleman (1989: 49-56)

[8]See Cheung (1986) on some property rights issues in the People's Republic of China.

to suffer. Far-reaching transfers undermine the concept of free choice and equality before the law that are closely associated with a healthy market process.

By the early seventies, a combination of structural changes, rising productivity and redistributive policies had significantly narrowed the dispersion of incomes in the industrialized west. Since then, growth has been slower, business cycles have proven more recalcitrant, gains in productivity have slipped to shallower trend-lines and high rates of unemployment are no longer amenable to macro-economic medicine. In the post-Keynesian era, confidence in fine-tuning through monetary and fiscal actions is being displaced by a humbled recognition of the market frictions and institutional obstacles that dull the edge of policy tools; by the unpredictable and often overwhelming nature of supply shocks. Because macro-management cannot assure the rates of growth that underwrite the earlier redistributive initiatives, income transfers have begun to seem excessively onerous. In countries such as the UK, basic benefits and the share of resources for national insurance has fallen throughout the eighties. Economists are also coming around to the view that the state's efforts to improve on market processes through planning, rules and other controls can be counterproductive. Markets in which presence of the state is too obtrusive, are likely to be inefficient and lacking in dynamism. Individual choices and property rights can take a certain amount of manipulation by the state. Once the line is crossed, effort suffers. Programs of redistribution must be calibrated, on the one hand with market incentives; on the other hand with the fiscal mechanisms for raising and transferring resources. The slower growth in the western industrial economies in the late eighties (as compared to the sixties and early seventies), and the unwillingness on the part of the public to tolerate higher taxes may indicate, at least in part, that state intervention had exceeded the bounds of prudence and that further redistribution may no longer be compatible with efficient market functioning.

The performance of socialist economies lends additional credence to this view. State ownership allowed these countries to proceed much farther towards an egalitarian distribution of income and benefits. For a time, the ability to mobilize and allocate economic resources through planning and central control made possible commendable rates of growth, but the stripping of property rights, the emasculation of the market, and the administering of economic equality, has drained the incentive to take risks, innovate and work hard, reducing growth to a crawl. Socialist efforts to reinstate inequality provide the clearest indication that the pairing of redistribution with growth must be carefully handled to safeguard an economy's long term prospects. Although the future direction of Chinese reforms may be affected by the events of June 1989, highly egalitarian distributive policies have definitely been found wanting. The most telling remark was made by Deng Xiaoping, "Egalitarianism will not work... it is only fair that people become prosperous through their own hard work. It is good for some people and some regions to be prosperous first." Vice Premier Tian Jiyun was even more forthright, "Egalitarianism is a serious obstacle to each according to his work. Without its elimination, it will be impossible to spark the people's enthusiasm, rapidly develop the productive forces and gradually improve living standards." (Karsten 1988: 31). These statements acknowledge the need to impose restraints in the interest of growth on the state's redistributive efforts.

The late sixties and the first half of the seventies were arguably the high watermark of redistributive programs in the industrial countries. Slower growth; the weight of structural unemployment; an aging populace; the spread of underground economies that escape the fiscal net; and the desire to sharpen market incentives, have forced a reappraisal of priorities regarding welfare and redistribution. Pension obligations and the provision of health care is set to grow very rapidly as a higher percentage of the populace crosses the age of sixty five and lives through the late seventies. Full time employment in manufacturing is shrinking. The industrial economies are generating mostly part-time and casual jobs which are likely to raise the average unemployment rate. Unless the rules for compensation are altered to reflect flex-working arrangements, the cost of social insurance schemes will soar.[9]

This shift comes at an awkward time. After more than three decades, living with and on welfare is becoming a habit for segments of the poor and those marginal elements of the labour force subject to chronic unemployment.[10] They have gradually come to view the various benefits, income supplements and transfers that flow to them through the welfare bureaucracy as entitlements, something owed to them by the better off in the society. Earlier inhibitions over "being on the dole" are being displaced by an unselfconscious dependence. These changed attitudes have also raised the reservation wage of what, in some quarters, is described as the "underclass."[11] Furthermore, certain kinds of jobs are now deemed unacceptable by the unemployed subsisting on welfare. Similarly, a variety of low paid occupations have fallen from favour and become a preserve of immigrants. While the poor have become wedded to their entitlements, the social gulf separating them from white collar workers in the upper income brackets has become wider and financing transfers is increasingly problematical. In Robert Reich's words, "the top fifth may be losing the sense of connectedness with the bottom fifth, or even the bottom half, that would elicit generosity.... It is now possible for the most fortunate fifth to sell their expertise directly in the global market and thus maintain and enhance their standard of living. There is less and

[9]*The Economist* (1989a: 63).

[10]Hauser (1987: 200) found that work orientation on the part of one parent families was strong only in Sweden and West Germany. It was weakest in Israel and the UK. The US and Canada occupied an intermediate position.

[11]The term "underclass" has been popularized by Auletta (1982). On attitudes towards work among the chronically poor, see Hacker (1982: 18).

less basis for a strong sense of inter-class dependence. Neither patriotism nor altruism may be sufficient to overcome these realities. Yet without the active support of the fortunate fifth it will be difficult to muster the political will necessary to maintain, much less raise, the current levels of welfare assistance in the industrial nations." (Reich 1989: 28). The mobility of capital and labour within an integrated international market tightens the constraints on redistributive policies irrespective of the political support or economic justification they might carry.

4. Inequality: Measurement, Characteristics and Trends

Industrial nations profoundly influence the design of economic policies and institutions in the developing countries. Hence, the trends sketched above provide a perspective from which to review distributive policies in the less developed countries (LDCs).

After a strong economic start in the late fifties and sixties, many developing countries gravitated inexorably to the issue of poverty. It was politically expedient for recently established governments to strengthen their legitimacy by distributing the newly earned prosperity more widely. The commerce in ideas and in particular, widely publicized strategies pursued by the socialist economies, burnished the attractions of measures to alleviate poverty apart from engendering expectations among the vocal and literate, urban dwellers. In the early stages of development, the machinery of planning and bureaucratic control, the power latent in economic tools, also gave many relatively inexperienced regimes somewhat deceptive notions of how easy it was to manage growth and orchestrate economic activities. Distribution alongside growth seemed not just socially desirable but eminently possible.

The zeal with which many nations embraced income transfer and welfare programs might have been influenced on the intellectual plane by the findings of Simon Kuznets. His study of five countries, published in 1955, indicated that as income levels rise distribution tends initially to become more skewed, following an "inverse U" trajectory. Continuing growth of incomes first stabilizes and then reverses the pattern so that affluence goes hand in hand with greater equity.[12] This finding was reinforced by a number of later studies which enlarged the sample, combined time series results with cross-section data and refined the methodology. These investigations showed that the turn towards equality tended to occur at fairly high income levels. But they were reassuring on a number of other counts. Rising per capita incomes would reduce absolute poverty even if the overall distribution continued deteriorating; structural changes in the economy, captured by the level of income, explained a small part of the distributional changes, other variables

[12]Atkinson (1983: 23) also refers to Soltow's point that the share of income from land, which tends to be highly unequal, falls with industrial development.

were of more importance; lastly, the "inverse U" was not an immutable part of the future. Although leverage could not be exerted by way of income levels, other policy actions could ensure more benign distributional consequences than the ones charted by Kuznets.[13] The necessity for intervention seemed all the greater in view of income distribution trends if the economy was given its head.

Measuring poverty, assessing living standards and obtaining an accurate fix on the distribution of income, is beset with difficulties. Few developing countries attempt comprehensive surveys at regular intervals and as a result, our information is somewhat dated and not overly reliable. It is hard to elicit details on earnings from rich and poor alike, over even a short period of time, much less a family life cycle, which is the more appropriate indicator. The well-to-do, especially professionals and the self-employed, are often at pains to conceal their incomes for the purposes of tax-avoidance. The poor frequently do not fully report their earnings from informal/black sector activities that have begun to loom very large in many countries, developing as well as developed.[14] Remittances will also be downplayed to deflect the envy of neighbours or the demands of relatives. Payments or consumption in kind, which can be sizable in the rural areas, is liable to be underestimated. As rates of inflation differ for rural and urban inhabitants and for various income groups depending on the composition of consumption baskets, gauging real incomes or expenditures presents serious hurdles. Furthermore, urban dwellers spend on transport and rents items that do not figure prominently in the budgets of the peasantry.[15]

When rather questionable statistics are combined with less than perfect indicators of poverty and distribution, only a rough idea of magnitudes and tendencies emerges. An early computation of Gini coefficients[16] for developed and developing countries by Kuznets (1963) arrived at 0.37 and 0.44 respectively. Little change was reported in the mid 60s. But this aggregate conceals considerable dispersion. At the lower end of the scale lie the African countries with weighted Gini coefficients of 0.34, while the average for Asia was 0.43. Rural

[13]See Kuznets (1955), Kravis (1960), Cline (1975), Paukert (1973), Ahluwalia (1976 a & b), Kakwani (1988); Bigsten (1987), Field (1980), and Visaria (1979). On the relation between the Kuznets hypothesis and individual country experience, see Chang (1980) on Taiwan and Mizoguchi *et. al.* (1980) on Japan.

[14]Casual empiricism on the underground economy is rife. Precise estimates remain elusive. A range of between 15 and 40 per cent is mentioned. *The Economist* (1989b: 34) recently claimed that the Indian parallel economy was responsible for up to a third of all output. It may now be larger than the formal nonagricultural sector. On estimates for the developed countries, see Feige (1988).

[15]Visaria (1980).

[16]Although the problems with the Gini coefficient are well recognized, it is still the most frequently used measure. Many others, with varying strengths, have been devised by Sen, Thiel and Atkinson. See Fields (1980, Ch. 3) and Atkinson (1987) for an assessment.

African economies registered coefficients as low as 0.3.[17] Asian countries covered a wide spectrum. The estimate for Malaysia in 1970 was 0.51. Korea weighed in at 0.35 (1982), and Taiwan's was 0.28 (1978).[18] The People's Republic of China lay between the two. A basic needs program operated through rural communes went a long way towards assuring supplies of food and essential services to rural dwellers, while a comprehensive workers insurance system, introduced in 1951 and financed by individual enterprises, catered to the welfare of the urban labour force. An attempt at measuring Chinese inequality in 1979 obtained a Gini coefficient of 0.33, possibly an overestimate, as certain income supplements may not have been fully factored in.[19]

Poverty apparently worsened in the Latin American countries through the sixties, followed by some improvement in the seventies.[20] By the end of the seventies, the oil shock and the slow growth which came in its wake, led to increasing skewness in the economies dependent on oil imports. Except for a brief respite in the mid-eighties, the trend remains unfavourable. Flagging growth, the increase in landlessness together with the disruption caused by wars, famines and oil shocks aggravated poverty in Africa during the 70s. Industrial progress and benefits derived from the Green Revolution has benefitted a number of Asian economies. In terms of distributional equity, the East and South East Asian countries have made impressive strides especially the front-runners, South Korea and Taiwan. Higher agricultural productivity and distribution policies in India reduced the proportion of the populace living in poverty over the period 1970-86.[21] Similarly, the lowest five quantiles enlarged their income shares in the Philippines between 1971 and 1986. But in both cases the total number of poor rose: to 322 million in India (1988)[22] and to 30 million (an increase of 10 million) in the Philippines (1987) or about 40 per cent and 55 per cent of the populace respectively.[23] Both Malaysia and Thailand reduced the incidence of poverty. In Malaysia the number of poor as delineated by the official poverty line, fell from about 50 per cent of the population in 1970 to 19.3 per cent in 1987 with a concomitant decline in the Gini coefficient.[24] Higher agricultural prices and a

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[17]Haggblade, *et al.* (1988: 3).

[18]Korea's Gini coefficient was 0.34 in 1965 and peaked at 0.39 in 1976. (Gerber 1984: 2). By comparison, Taiwan's Gini coefficient was 0.32 in 1964 and it declined gradually to 0.28 (Kuo *et. al.* 1981: 92-3).

[19]Riskin (1987: 234-5), World Bank (1983).

[20]Bigsten (1987).

[21]World Bank (1989a).

[22]Calculated from the Indian National Sample Survey 38th Round. For a discussion of the definition and measurement issues, see Minhas *et al.* (1987).

[23]See World Bank (1988b). In mid 1989 the Philippine Government announced that the percentage of the populace below the poverty line had declined to under 50 per cent.

[24]Government of Malaysia (1989: 47).

surge in production, narrowed the inter-sectoral dispersion of incomes in the People's Republic of China between 1978-82 but movements in inter-sectoral terms of trade since that time, along with the faster expansion of the urban-industrial economy, may have led to rising inequality through the latter half of the eighties. Nevertheless, absolute poverty has certainly diminished from 27 per cent of the rural populace in 1979 to 11.3 per cent in 1986, driving the number living in poverty from 200 million to less than 102 million.

The years immediately following the second oil shock were especially cruel.[25] Of the 82 countries analyzed by Cornia and Stewart (1987) for the period 1980-85, only a quarter managed to sustain growth. Some 20 per cent experienced a cumulative decline in per capita GDP. Basic services, such as transport deteriorated in Africa and Latin America and many governments were forced to cut outlay on health, education and social security. Fiscal stringency forced many countries to curtail food subsidies. Ten detailed country studies revealed a deteriorating income profile in Ghana, the Philippines, Chile, Jamaica and Peru. Absolute poverty fell in Korea and the situation was unclear for Sri Lanka, Zimbabwe and Botswana.[26]

Whereas in the seventies, there may have been grounds for cautious optimism, welfare and redistributive policies were severely battered by macro-economic conditions in the first half of the eighties. In many, perhaps the majority of LDCs, modest gains in improving the income distribution or containing poverty, slipped away, and there is little evidence that the ground has been retrieved over the past four years.

Although the war on poverty will doubtless continue to be fought in the decades ahead, these first skirmishes have produced a few successes and have yielded a wealth of insights on the forces that influence distribution and the extent of poverty. The remainder of this paper assesses the contribution of these factors. They are distributed across five categories:

a) structural characteristics and changes;
b) macro-economic developments;
c) sectoral changes;
d) social and institutional factors; and
e) transfer and welfare programs.

The observations made are based largely on the experience of the developing countries but research on the industrial economies has yielded an important fund of knowledge and this is incorporated.

5. Structural Characteristics and Changes

Economies evolve structurally from an initial state as development proceeds and this affects income distribution independently of policy actions, although some

[25] Adjustment forced many countries to cut back on welfare and slowed growth.

[26] See Cornia (1987) and Cornia and Stewart (1987).

can reinforce such structural trends. Because of low productivity, landlessness or the small size of farms, poverty is generally endemic in the rural sector.[27] This is no less true of countries in the higher income brackets such as Brazil and Mexico than it is for the poorest African and Asian nations. A related characteristic is the regional nature of poverty: Mexican poor are concentrated in four regions where subsistence farming is the norm and incomes are half the national average;[28] the Northeast of Brazil is home for over 40 per cent of those living in poverty; Bihar and Eastern UP remain the poorest parts of India; seven Indonesian provinces including East and Central Java as well as parts of Sulawesi have a history of high inequality and poverty;[29] and the vast majority of the People's Republic of China's poor lie in eight of the western-most provinces. Incomes in the urban/industrial sector are usually higher but also have a greater variance, there being a wide range of employment opportunities in the manufacturing and service industries. As the urban sector expands, the nature of jobs and earnings widens economy-wide income disparities. Faster accumulation of savings leads initially to a concentration of wealth in the emerging modern sector which worsens income inequalities. This is the stage when the economy is ascending the first leg of Kuznet's inverse U.

At a higher stage of industrialization, the share of wages tends to become larger and as these are more evenly distributed, they improve the income profile. A decline in income from land or other property also contributes to equalization. Socialist countries and those where the public sector straddles much of the economy, by squeezing private property ownership, carry the process of equalization through this avenue a step farther. Rapid industry-led growth, a yet later stage of development, which results in labour scarcity, makes for even greater equality through the effect on wage earnings. But this is not the only path countries tend to follow. Many developing countries have witnessed a hypertrophy of the services sector long before the onset of industrial maturity. Several of the advanced countries have also allowed manufacturing employment to decline to a quarter or less of the total labour force.

On the average, value added in services is lower than in manufacturing, there is greater dispersion in incomes, and productivity rises more sluggishly. All of these can slow the progress towards equality in the developing countries and they

[27]Anand (1983: 203). Malaysian poor are concentrated among paddy growers and rubber smallholders.

[28]World Bank (1989b).

[29]Ravallion (1988: 59 and 68) suggests that a part of the reason why regional inequality has persisted in Indonesia is that the redistributive INPRES program may have had a "mild aversion to regional equality". See Islam and Khan (1986: 73-96) on Indonesia; details of inequality in the People's Republic of China until the late seventies can be found in Riskin (1987: 225-29), and Lardy (1980). The Northwest and the Southwest of the People's Republic of China experienced a decline in agricultural output per capita as compared to the national average until 1979.

make it harder for the mature economies to maintain their distribution coefficients without a more aggressive use of income transfer programs.

Structural mutation is a tidal force that pushes at the foundations of the economy. But as indicated above, it is relatively weak and overshadowed by other measures. Similarly, the evenness with which wealth, property and education are distributed across the populace at the onset of development has a bearing on the future income profile but its significance diminishes as industrialization progresses.

6. Macro-economic Developments

The faster per capita incomes rise the more quickly poverty will recede, though there is no strict correlation between the changes in incomes and an improvement in the distribution or with a reduction in numbers below the poverty line. As has been noted, economic growth is a necessary but not a sufficient condition for declining poverty.[30] Cross-country statistical tests on a large scale do not uncover strong links running from GDP growth to the incidence of poverty, but individual country studies drawing mostly on the experience of East Asian countries, project a much more persuasive case.[31] Among the developing countries, South Korea, Taiwan and Hong Kong have enjoyed the greatest measure of success at banishing

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[30]Bhagwati (1988) had made a strong case regarding the inverse relation between growth and poverty. He compares the Indian performance unfavorably with that of the East Asian NICs. See also Bhatt (1988: 642). Sri Lanka was often cited as a country that was able to achieve an equitable distribution and a decent living standard for the broad mass of the populace in spite of low growth. This view has been challenged by Bhalla and Glewwe (1986) who show that Sri Lanka had already attained a respectable welfare standard prior to 1960. The food rationing, health and education benefits provided freely between the early 60s and 1977 raised this quite modestly.

[31]Percentage share of agriculture and the primary school enrollment rate were regressed on the percentage of population receiving the lowest 40 per cent of income. The results were as follows:

	Coefficient	*t*
Percentage share of agriculture	0.157	2.17**
Primary school enrollment rate	-0.059	1.44*

$R^2 = .037$, number of observations = 18.

** significant at 95 per cent level

* significant at 85 per cent level

Other explanatory variables tested were inflation; population growth rate; GDP growth rate; percentage share of industry into GDP; percentage share of labour in the population; and percentage share of female labour. The results were insignificant.

The dependent variable, percentage of population receiving the lowest 40 per cent income, is from the World Social Indicators of 1979, for 1975 (or any year in between 1973-78). Independent variables are from the BESD data base. Growth rates and percentage share are averaged over 1973-78. The following countries are included: Bangladesh, Brazil, the People's Republic of China, Colombia, Côte d'Ivoire, Egypt, India, Indonesia, Kenya, Korea, Malaysia, Morocco, Pakistan, Philippines, Sri Lanka, Thailand, Tunisia, Venezuela. See also Fields (1980, Ch. 6 and pp. 240-1) on the relation between growth and equality.

poverty and equalizing incomes. In each instance, income growth, propelled in substantial part by higher productivity, appears to have had a significant role. These countries as well as others such as Thailand and Japan have derived immediate distributional gains from growth because of the manner in which economic expansion was achieved.

Incomes and living standards are hitched to trends in productivity.[32] For a variety of reasons having to do with competition, technology absorption,[33] scale economies[34] and levels of investment in productive assets, an outward oriented growth strategy with manufacturing as the leading sector, yields the largest productivity dividends.[35] In other countries, which pursued an autarkic strategy and growth was driven largely by labour and capital inputs, as in pre-1978 People's Republic of China, poverty lingered even though socialism narrowed income disparities. The weight of the agriculture sector in Brazil and the importance attached to import substituting industrialization, very probably moderated changes in productivity during the decade of rapid growth extending from the mid-sixties. This may explain the persistence of high Gini coefficients, although the quality of the economic gains was one among several factors.

Research conducted in the US affirms the association between the level of economic activity and the incidence of poverty. It is the unemployment during years of slow growth that tends to push people below the poverty line and skews the income distribution.[36] High growth, even when it is accompanied by moderate inflation, powerfully supports an anti-poverty program both directly through its effects on incomes and indirectly by facilitating the financing of income transfers.[37] It is easier to win political backing for welfare programs during spells of affluence. Export oriented development that stimulates productivity is highly attractive in its own right. But policies promoting such development can also, it seems, aid the cause of poverty alleviation.

6.1 Resource Management

Financing the accumulation of capital necessary for rapid growth and generating the funds for welfare programs calls for sound resource management. Establishing a broad based and elastic fiscal system is one precondition. It is needed to support

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[32]Levy (1988: 12) and Levy (1987: 924).

[33]On Korea's approach to technology absorption see Enos and Park (1988), Amsden (1989, Part III) and Kang (1989, Chs. 4 and 5).

[34]The importance of scale economies for export-led growth is analyzed by Chichilinisky and Heal (1986, Ch. 2).

[35]Nishimizu and Robinson (1986).

[36]Unemployment by depressing savings, affects post-retirement welfare as well. Atkinson (1983: 244).

[37]Blank and Blinder (1986).

the current expenditures and capital outlay of the public sector. This is by no means a simple undertaking. Tax payer compliance in most LDCs is weak, income taxes are paid by a relatively small number of companies, the underground economy continues growing at the expense of the formal sector and tax progressivity is hard to enforce. A handful of small countries with a centralized administrative apparatus that is efficient as well as dedicated have done well in fiscal terms but most others have failed this test. In India, Pakistan and even the People's Republic of China, tax evasion is very widespread, the tax base is narrow and tax elasticity small. The tax system does not serve a redistributive function and frequently cannot finance substantial income maintenance and welfare programs.

Faced with revenue constraints on the one hand and political pressure from the poor on the other, governments have been drawn to two kinds of policies. (i) They have absorbed many of the unemployed in the public sector and provided a range of subsidized goods and services. The inevitable budget deficits have been financed through the inflation tax, domestic as well as international borrowing;[38] where possible, by an accelerated drawing-down of natural resources; (ii) They have multiplied the number of public sector corporations offering numerous, well paid jobs. These companies generally survive on the rents created by controls on new entrants, special licensing procedures, a variety of supportive regulations and budgetary allotments.[39] The rents that (partially) underwrite the existence of these entities constitute an inefficient mode of taxation.

A government can accept certain fiscal limits, tailor its redistributive policies so as to stay broadly within the revenue parameters and pursue administrative reforms designed to strengthen its tax raising capacity. Once the share of GDP obtained through taxation increases, welfare efforts can be stepped up. From a long term, growth oriented stand-point this could be the first best strategy and it approximates the one followed by the East Asian newly industrialized countries (NICs). Politically this is not the most popular approach. The tendency is to launch ambitious anti-poverty programs and to use the public sector as a means of generating employment. However, if the ultimate source of better living standards for the broad mass of the public is higher productivity, then premature attempts at redistributing incomes and arresting poverty through a rent- and inflation tax-financed expansion of the public sector, has serious drawbacks.

First, the evidence from quasi-markets as well as socialist economies suggests that a proliferation of controls, while it may increase the flow of rents, seriously damages efficiency. Second, budget deficits and public investment affects private investment negatively through crowding-out as well as the threat of unfair competition.[40] Third, public investment tends on balance to generate lower

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[38]Sachs (1989).

[39]On Malaysia's industrial strategy in the eighties, see Bowie (1988).

[40]Balassa (1988: 14) estimated a negative relationship between public and private investment.

economic returns than private capital spending.[41] Fourth, the savings propensity of the public sector is frequently smaller than that of private industry, hence the expansion of one at the expense of the other can depress savings over the longer term. As savings and investment are closely correlated, a gradual decline in savings propensity can rebound against future growth. Fifth, quasi-tenured public sector employment, at relatively handsome wages, distorts incentives throughout the economy. Public enterprises become wage leaders putting pressure on the costs of private firms. And overmanning in public bodies seriously dilutes effort, which is injurious not only for their own efficiency but also has a demonstration effect on the workers elsewhere. Finally, as India, the People's Republic of China, Brazil and many other countries have discovered, controls, licensing arrangements, regulatory requirements and the rent-seeking ethos are easily introduced, especially in the early stages of development, when resistance to state intervention is minimal. Once these have taken root, and politically influential vested interests have set up alliances with the government, dismantling becomes an enormously unpopular and fiercely resisted task. For the poor, this is doubly unfortunate: an economy rendered sclerotic by controls grows slowly and productivity suffers;[42] furthermore, while the poor benefit from the first round effects of higher public employment, subsequent gains are tenuous as employees seek to maintain their privileges by restricting new entrants. The inefficiency of public enterprises siphons resources from other productive activities and rents arising from various entry barriers frequently transfer income to those who are already affluent and well connected.

Most developing countries have moderate savings rates and limited revenue raising ability. The full mobilization and efficient allocation of savings is essential for maximizing growth and raising productivity. In the early stages, income redistribution through welfare assistance and public sector employment, while often attempted, is costly and produces minimum results. The long-term implications can be serious. Some of the deleterious effects on savings can be avoided in the socialist countries such as the People's Republic of China, which until recently fully controlled all resource flows and within limits, could regulate both savings and investment at will. Countries with abundant national resources can also finance major poverty alleviation programs without encroaching too heavily on private savings or dampening private investment. Other problems associated with large public sectors, whether in the socialist countries or in the natural resource based economies remain.

The policy message is related to the one regarding growth. To the extent that economic expansion lessens poverty, actions that reduce the flow of resources sustaining growth will affect living standards over the longer term. Fiscal caution

[41]See Bardhan (1984, Ch. 8); Gelb *et al.* (1988); Bhagwati (1988); Tanzi (1976) and Anand (1983: 294).

[42]Bardhan (1984, Ch. 4).

makes good macro-economic sense even though it may restrict the freedom to pursue redistributive programs when the tax and social security base is small. As administrative capabilities evolve, revenues can be augmented and it becomes easier to both fund and manage the inevitably complex welfare programs. However, it is advantageous to observe restraint regarding the tax/GDP ratio even where the revenue gathering potential exists, as a negative, presumably incentive related, correlation has been found between growth and the share of taxes in the national product.[43]

7. Sectoral Changes

7.1 Agriculture

Poverty is severest in the rural sector. Too many farmers have little or no land and this depresses incomes. The solution, land reform, has been widely used but with varying degrees of efficiency. It has been most effective in the People's Republic of China, Taiwan and Korea. Soon after the communist government came to power in the People's Republic of China, strong grassroots support was mobilized to place rural property under collective ownership which in one stroke extinguished the class of wealth landlords and flattened the income pyramid, although inter-regional inequality remained as did poverty.

In South Korea and Taiwan land redistribution occurred in two stages: under Japanese occupation in the first half of the century and again following independence in the early fifties. These reforms were highly successful in meeting their objectives because the government actively sought the political support of the peasantry and was able to galvanize rural opinions behind a fair and far reaching effort. The relatively equal distribution of income in Indonesia (Gini coefficient 0.30) can also be traced to the division of land holdings. Land reforms in India, Mexico, Peru, Chile, Venezuela and Bolivia were less effective in reducing poverty. They benefited small farmers and the landless in a segment of the agricultural sector and in many instances, left the very poorest elements untouched.[44]

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[43]Balassa (1988: 12) found a negative correlation between the share of government consumption and GDP growth from a sample of 90 LDCs.

[44]The Japanese Diet legislated land reform in October 1946 (Calder 1988: 251) Calder notes that "Postwar Japanese conservative politicians are distinctive in the intensity with which they have pursued distributive politics as a means of sustaining their political preeminence" (Calder 1988: 256). Since 1949-52 subsidies have been the principal vehicle of support (Calder 1988: 261). Land reform raised the level of equality in South Korea by also eliminating rent payment (Ban, Moon and Perkins 1980: 301). In spite of adequate administrative support, land reform proceeded slowly in Brazil's impoverished Northeast. Landlessness, unemployment and a highly uneven distribution of farm sizes remain the principal causes of poverty and inequality (Kutcher and Scandizzo 1981: 16, 22-25). On the other Latin American countries, see Eckstein *et al.* (1978) and Theisenhusen (1988).

Land reform is a first step,[45] but it alone cannot banish poverty. Over the longer haul what counts is rising labour productivity, better terms of trade for the rural sector and increased employment. Productivity is a function of investment in infrastructure (irrigation facilities can make a vast difference in areas where water is the principal constraint),[46] technological advances and extension. In Taiwan, for example, the basic rural infrastructure was put in place during the colonial period and it served as a foundation for extensive developments in the fifties and sixties. Biological, land augmenting techniques[47] were introduced by the Japanese who also brought agricultural research and extension to the island, but it was the government's ability to capitalize on this through further refinements that enabled Taiwanese peasants to sustain a firm upward trend in productivity.

Such integrated rural development programs have been tried in a host of developing countries with varying results. Chinese agriculture registered only modest advances in productivity until farmers were allowed more latitude in cultivation towards the end of the seventies. In India, gains appear to be province specific, with some of the poorest areas in the central and eastern parts left untouched. Several countries, for example, Malaysia, Brazil and Indonesia, with large plantation subsectors have used investment in infrastructure, research and extension services to achieve dramatic gains in productivity,[48] but the land and capital intensive nature of plantation agriculture limits the distribution of benefits. Nevertheless, new technology does trickle down to smallholders and incomes rise even if the income distribution is slow to change.

Although land reforms provide small farmers with collatralizable assets, their access to formal credit channels is modest and the informal market charges high rates. Without credit they have difficulty acquiring the inputs needed to extract the maximum productivity from the new biological technologies. Hence, the provision of credit to small cultivators is good policy whether the goal is to

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[45]The effects of land reform are dissipated over time unless the more prosperous farmers are induced to invest their savings in assets other than land. How the process has worked in Java is described by White and Wiradi (1989, esp. p. 299). Landlessness will continue to haunt the developing world.

[46]Government investment in rural infrastructure creates employment and in some instances projects are designed specifically with an eye to maximizing the number of jobs in a poor region of the country. The Maharashtra project in India is a famous example. Nearly 16 per cent of Japan's large outlay on subsidies went to agriculture in FY1984. Much of Japan's heavy public works expenditure is concentrated in the countryside, creating jobs and improving the productivity of farmland. These together with favorable tax treatment of land and income have more or less erased income differentials between urban and rural households. (Calder 1988: 235, 240, 241, 243).

[47]Irrigation projects and non-photoperiod sensitive rice strains that permit multiple cropping have the strongest land augmenting effects.

[48]Bhatia (1987) refers also to the spur provided by competition in the world market for plantation crops.

increase production or to lift people out of poverty. Only 20 per cent of Asian farmers can tap the formal system for credit. Just 5 per cent of African cultivators enjoy such access.[49]

Agricultural terms of trade are another important determinant of rural incomes and the scale of poverty. Frequently the prices that farmers obtained are fixed either by government controlled purchasing agencies or in world markets.[50] Few LDCs can significantly influence international prices, but they can and do manipulate payments to farmers on food and a variety of cash crops. Agricultural exports being easy to tax frequently attract taxation, whose incidence can be regressive when the producers are small farmers. By and large, the prices farmers command in these managed markets depend on their political voice. As the socio-economic base of many African governments is urban, they have tended to use marketing boards, dating back to the colonial period, to hold down food prices. It helps secure the political backing of powerful urban labour and industrial blocs. As wages are a large element of total government expenditures, containing food prices relieves fiscal pressures as well. Unfortunately, by weakening agriculture's terms of trade, this depresses farm production and may worsen rural poverty.[51] Where urban and rural political groups are more evenly matched as in India, agricultural terms of trade are less biased and resource transfers from agriculture are small at best.

At the other extreme are countries such as Korea, Taiwan and Japan where the government has traditionally depended on rural political support of numerous small cultivators. As these economies have industrialized, farmers have been treated generously by way of high price supports and subsidies. These policies have reinforced other measures designed to lessen poverty and equalize incomes.[52] The People's Republic of China has moved closer to this position as the liberalization of the economy focussed initially on the rural sector.[53] It represents a marked shift over the Stalinist strategy of the fifties and early sixties, which sought to extract resources from agriculture to finance heavy industry. Indonesian farmers gained from the devaluation of 1985, which dramatically shifted the terms of trade in their favour and has been responsible for falling poverty in the second half of the 1980s. Favourable trends in the Malaysian distribution, along with a decline in absolute poverty since 1984, are also linked to the shift in terms of trade for

[49]Haggblade, *et al.* (1988: 8).

[50]Higher world market prices of agricultural exports strongly affect incomes in the subsector concerned. For an analysis centered on Malaysia see Bhatia (1987).

[51]Bates (1983, Ch. 3) and Bates (1981: 119-129).

[52]The effects of the Government Grain Management Fund on Korean farm incomes are noted in Ban, Moon and Perkins (1980: 305). Rice price supports have also been used in Malaysia for many years, see Anand (1983: 290-1). Japan's agricultural policy and use of price supports are described by Egaitsu (1982).

[53]Riskin (1987: 242-4).

raw material exports. Clearly, price supports can exert powerful leverage. But it is an instrument to be used sparingly as the price distortions introduced can be deleterious for overall economic efficiency.[54]

Over time, nonfarm income has come to represent a rising percentage of total incomes — between 25 and 30 per cent in sub-Saharan Africa, over 40 per cent in Asia.[55] Such diversification provides an escape from poverty and has the potential for increasing income equality. To a large extent, it reflects the workings of forward agricultural linkages, although backward industrial linkages from the manufacturing sector are significant in a few countries. Forward linkages arise from food processing, equipment repair, transport and marketing activities that generate off-farm employment. Agriculture also gives rise to backward linkages chiefly for machinery, metal products, farm chemicals, fertilizers and building materials. These linkages trigger multiplier effects within the rural sector which in turn give rise to employment and higher incomes. Multiplier effects are larger when more of the sector's demands can be met internally. The magnitude of leakages to other segments of the economy depend on the composition of demand and the diversity of rural industry. Where rural customers require products — be they farm inputs or consumer items — that must be imported from urban industries, linkages across sectoral frontiers proliferate but multiplier effects are muted. However, when a rural manufacturing and marketing base exists, leakage is minimized and agricultural development becomes more self-sustaining.[56]

The importance of rural industry and marketing has been frequently noted in studies of poverty. It is encouraged by the sophistication of consumer demand and the modernization of agriculture. The first responds to demonstration effects. Extension and the effective dissemination of new technology paces the spread of new farming methods. The appearance of small rural townships seems to speed the nucleation of industry as does the traffic in ideas and industrial techniques from nearby cities. Manufacturing has infiltrated rural hamlets by way of putting out arrangements: urban producers in Taiwan, Philippines, South Korea and Indonesia have relied on rural labour for the assembly of garments and other light consumer items, helping thereby to embed manufacturing practices.

Education and the inculcation of skills is another important factor. The emphasis on rural education in East and Southeast Asia as well as in parts of the Indian subcontinent has brought added prosperity to the primary sector. New skills have also been infused into the rural economy by migrants returning after a stint in some distant factory or construction site. Pakistan, India, Sri Lanka, Thailand, the Philippines and Egypt have gained from the skilling of their rural workforce

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[54]The scale of protection afforded to agriculture and the effects on resource allocation are estimated by Anderson and Warr (1987).

[55]Haggblade *et. al*. (1988: 10-11).

[56]Haggblade, *et al*. (1988).

on overseas projects. A range of engineering and other skills have also come through military service, most notably in South Korea and Taiwan and other nations with large modern forces.

Entrepreneurship and capital are the two final ingredients in successful rural industrialization. To an extent they go together where capital accumulation is facilitated by the returns from cash crops, kinship networks that mobilize small savings, credit cooperatives or the earnings from migrant work. Taiwanese rural development shows the first three at work. Nonfarm activities blossomed in the People's Republic of China once farmers were given autonomy in the late seventies. The symbiosis between capital and entrepreneurship is apparent in Thailand and the Philippines as well.

As Asian farming has modernized, linkage effects have become more pronounced, leakages have diminished and the size of multipliers have risen. By comparison, African agriculture, which has remained relatively backward, provides less nonfarm employment and the agricultural growth multipliers are in the region of 1.5, or about 60 per cent of the level in the Asian economies for which data are available.[57]

7.2 Industry

Industrial strategy has an important role today in alleviating poverty. Once an economy is past the early stages of development, much of the motive force behind growth is usually drawn from industry and it contributes disproportionately to advances in productivity. Industry is also a major employer[58] and by absorbing labour from the primary sector, it helps relieve pressure on rural household incomes.

By all accounts, outward oriented, state-guided policies have had a definite edge over the kind of import-substituting industrialization adopted by several of the Latin American countries, or even the heavy industry centred approach tried by the People's Republic of China and India. The scope for export-led development may be narrower in the nineties, but in its heyday this had a number of advantages. Light manufacturing and assembly industries allow considerable flexibility in factor substitution and are well-suited for economies with a surfeit of labour.[59] In particular, East Asian industry, by offering an outlet for young female workers,

[57]Haggblade, *et al.* (1988: 35).

[58]Neoclassicists blame low employment generation by industry in LDCs on distorted wages. Labour augmenting technical change and the practice of not equating marginal rates of substitution with wage rental ratios have also been identified as culprits (Pack 1988: 367-9).

[59]Pack has shown that producers have considerable latitude in combining labor intensive with mechanized production methods in plants. (Pack 1988a: 368; and 1987). Growth of employment is related to capital accumulation and capital augmenting technical progress. It is negatively linked to the rate of labor augmentation and wage growth, the elasticity of substitution being assumed to be positive (Pack 1988: 367).

who often have few options, improved income distribution by raising employment and the participation rate.[60]

Entry into foreign markets powerfully encouraged cost and quality competitiveness. By widening sales it also made it easier to exploit scale economies. East Asian producers were induced to explore the latest technologies, adapt them to their factor supply situation and invest heavily in improvement. The absence of high payroll taxes, as in Mexico and Brazil, minimized price distortions that might have interfered with the efficient use of labour. This cycle strongly affected the trends in labour productivity and earnings, the fruits of which are evident all around Asia's Pacific rim.

Once an export bridgehead was secured, a deeper penetration of foreign markets gradually raised profitability and gave exporters the capital to strengthen their current base of operations and diversify into other products. Marketing arrangements and mechanisms for technology transfer that sustained the initial round of exports facilitated this transition. The East Asian countries have also derived much mileage from the attention they have devoted to the sociology of work organization; the micro-economics of inventory management; orchestrating the manufacture and delivery of parts; the fine-tuning of production processes; the exact adaptation of products to the needs of buyers as well as the exigencies of production; a corporate culture tuned to flexibility in an era of very short product life cycles; and the sedulous attention to detail.

Whether, the long term advantages of flexible, labour intensive small-scale, manufacturing operations *a la* Taiwan and Hong Kong, outweigh the benefits garnered by South Korea's giant conglomerates is a moot point.[61] If one were to hazard a guess, the distributional gains from Taiwan's approach may be greater. Flexibility is also an asset in a range of consumer and electrical products along with certain types of machinery with shortening product cycles. But flexibility can only be maintained, as the technological stakes rise, through continuous investment in research, education and skills.

Korea's shift towards larger scale, relatively capital intensive industries, could lead to some widening of income disparities but Korean companies might be financially better placed to compete in the technological race and to weather the periodic business downturn. Over the long term, growth might be slower but it could be more stable.

Imitating the industrial efforts of East Asian NICs might still be the best redistributive policy for small economies such as Malaysia. The People's Republic of China's experience over the past decade has revealed the scope for the export-oriented development of small-scale manufacturing in a large country, where strategy had long favoured the spread of heavy industry for the domestic market.

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[60]Papanek (1988: 55), Scitovsky (1986: 158-160).

[61]Mody (1989).

These new directions have provided millions of new jobs and casual empiricism would suggest that they have profoundly favourable distributive consequences in several of the People's Republic of China's eastern provinces. In Jiangsu and Fujian, in Shandong and Anhui, the rural sector has been transformed.[62] The stirrings of liberalization have begun in India, where a thriving informal sector has materialized in the eighties. Doubtless, this is helping to dent poverty in cities and countryside alike,[63] though it still largely escapes the coarse net of official statistics and foils the efforts of tax collectors. India has exceeded the 3 per cent per annum "Hindu rate of growth" during 1987-9, but Kohli reminds us that liberalization faces an uphill battle as rent seekers and vested interest groups strike back.[64]

In a few of the Latin American countries, principally Chile, the press of economic circumstances has revived interest in export-led development. How far this has influenced the income distribution is difficult to say as statistics for the late eighties are scarce. Absolute poverty may be on the retreat in Chile. Brazil, with a fairly dynamic export sector, has yet to bring its industrial and distributive policies under a hospitable political roof.

8. Social and Institutional Factors

8.1 Labour Market

The functioning of labour markets can have a pronounced bearing on the structure of incomes and their distribution, but labour policies have not figured prominently in distribution programs launched by market economies. Labour market segmentation, whether geographical, occupational or sub-sectoral, exercises a strong influence on distribution. Policies that improve mobility could promote equality. Better transport and communications, freer flow of information together with an increase in urban amenities, enhances geographical mobility. Most developing countries are, bit by bit, adding to the transport infrastructure but urban overcrowding is almost universal throughout the Third World and enlarging the flow of migrants has little attraction. While intra- and inter-industry mobility within the stratum of low paid unskilled and semi-skilled jobs is generally high, resulting in a fair degree of uniformity in wages, higher skilled occupations are a different matter. Unionization, education requirements, experience or other credentials, present serious barriers and lead to sharp divergences in earnings. Unions, especially those in the public sector, have balkanized the labour market in many countries. Through the exercise of their bargaining power, they have been able to win tenurial rights and indexed allowances, which appreciably raise

[62]The spread of small-scale township and village enterprises in the People's Republic of China is analyzed in Byrd and Lin (1988).

[63]This is evident in many countries. Its beneficial consequences for distribution were noted by the ILO in the mid-seventies. See Pack (1977).

[64]Kohli (1989).

the earnings of their members, while restricting employment in choice occupations. By their actions, unions encourage employers to seek capital intensive production methods which worsen the employment picture. Unionization has left its imprint on the economies of India, Brazil and Argentina to name just a few, but union busting as a distributive measure has little political appeal in countries enjoying a measure of electoral freedom.

Unionization is not a major force in the People's Republic of China but socialist labour practices and commitments regarding jobs for urban inhabitants, ensure most industrial workers (and sometimes their children) lifelong employment in a single enterprise. This drastically curtails mobility and ensures that differences in earnings are sheltered from the forces of supply and demand. With liberalization, fixed term work contracts, which stimulate mobility, have energized the labour market. Political sentiments against an unravelling of entrenched rules remain obtrusive, and as in India, the future labour market flows are unclear.

Another element of labour market policies that is relevant for income distribution is the setting of minimum wage guide-lines. Some research in the US suggests that raising minimum wages could move several hundred thousand poor households above the poverty line. The effects of such guide-lines on employment and the wage structure have been much debated and a consensus has yet to emerge. Where these lie above levels determined by market forces, they probably reduce employment and thereby could worsen inequality.[65] In any case, policing wage guidelines is a difficult matter in the industrial economies, enforcing them in developing countries is fraught with greater difficulties.

By imposing rigid controls on labour mobility, wages and employment conditions, the People's Republic of China managed to sustain a fairly equitable income structure in urban as well as rural areas (though inter-sectoral differentials were significant). Such rigidity has its long-term costs. It resulted in great inefficiency in labour use and the penalty in terms of growth foregone must have been high. Other countries, such as Brazil in the late sixties and early seventies, and Korea in the early eighties used incomes policies to contain the costs of manufacturing and arrest inflation. These may have been modestly beneficial for growth but their effects on distribution are quite ambiguous.

8.2 Education

It is likely that education promotes growth in a generalized way as suggested by Edward Denison. It may not make much impression on the core of poverty.

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[65]Opinions are divided over the effects of minimum wage levels. Fishlow has hypothesized that falling Brazilian minimum wages worsened poverty (Fox 1983: 267). Ellwood (1989: 281) refers to an Urban Institute Study which estimates that adjusting the minimum wage in the US for inflation since 1970 would push 200,000 off welfare. Tests by Riveros and Paredes (1988: 19) point to the likelihood of structural unemployment arising from minimum wage legislation.

Employment and training programs for the poor have done little to reduce pre-transfer poverty in the US. Similarly, the effects of work-training for school drop-outs are evanescent. But education in the sense of trainability, education that allows individuals to participate more fruitfully in the evolution of industrial society, and education that enables an economic system to move along an ascending curve of affluence by absorbing fresh ideas and technologies, is certainly one of the most important instruments first in the effort to do away with poverty, next in trying to achieve greater income equality.

Research on the industrial countries and studies of the East Asian NICs, both rigourous and impressionistic, points towards the economic value of education. Aside from the gains in worker productivity, the deepening of managerial, engineering and scientific skills permits allocative and x-efficiencies that radically improve levels of corporate performance. It is becoming increasingly apparent that the competitive margins of Japanese manufacturers derive in significant part from the quality of the workforce.[66] While industries in Europe and the US have shrunk and laid off workers under the pressure of imports from developing countries, Japanese producers drawing on their reserves of skill and education have partially deflected foreign threats, pushing productivity several notches higher.

The East Asian experience underlies the importance of education.[67] It also shows, that increasing the supply of educated manpower will eventually depress the returns to education, unless the human capital is effectively utilized and its productivity enhanced through innovations in products, processes and most decisively, in the world of work. Education needs to be complemented with industrial policies that increase the effective demand for trained manpower in parallel with the growth in supply.

All this has been conventional wisdom for some time and so it is surprising that governments have evinced little enthusiasm for spending on education, perhaps because the lags tend to be long.[68] Resources allocated to this sector are distributed regressively: too much for higher education, accessible to a privileged few, and too little for primary education that would aid the poor. An urban bias also deprives the needy rural populace of vital primary schooling. Furthermore, education policies frequently do not take cognizance of the private costs of public school. Transport, books, clothing and the time spent away from household or

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[66]Trends apparent in the developed countries suggest that higher levels of education will be required of those seeking well-paid jobs in the service sector during the decade of the nineties (Edsall 1988: 94).

[67]Papanek (1988: 65-74) and Scitovsky (1986: 140). The former also draws attention to labour foce participation by women.

[68]Rivlin (1975: 11-12). Sawhill (1988: 1093) also comments on the smallness of results in the near term.

farming chores can impose insuperable burdens on the poor. And borrowing to pay for schooling is an option available to very few.[69]

8.3 Women and the Family

Rather belatedly perhaps, the research on distribution has come to recognize the centrality of the family and the role of women.[70] Future life chances depend to a considerable extent on family circumstances and income level. Poor families cannot afford good schools or provide children with either the home atmosphere or the help they require to extract the most benefit from formal training. This can be a serious handicap. In Africa, the institution of the extended family redistributes income among its members.[71] Similar institutions among Indian trading communities (e.g., the Marwaris) permit a pooling of resources that has been vitally related to their successes in industry and commerce. Chinese kinship networks have been equally adroit in bringing together entrepreneurship and the community's capital. The difference between the African and the Chinese institutions is that the former only help to even out consumption patterns, whereas the latter combine a redistributive function with a developmental role.

Perhaps the aspect of family economics that is of most interest pertains to women. A rising proportion of households in the developed countries are headed by women. They are often among the most poverty stricken, and their predicament affects the current living standards and future income prospects of a large number of children. Poor households headed by women are also joining the ranks of the indigent in developing countries, although it is male migration that is usually to blame and not divorce or the desire of the young as well as the old to live independently, if necessary in straitened conditions. Seasonal migration was always commonplace in rural areas, but males from the poorer farming regions are now often absent for extended periods. While such migration results in reasonably well-paid industrial sector jobs, it generates in many cases only a trickle of remittances, which are unstable or insufficient. The families left behind eke out a bare existence on minimal resources which affect nutrition, schooling and morbidity.[72]

Where women can earn a livelihood through farming or from off-farm occupations, poverty can be kept at bay. In several African countries, for example, women are active in food processing, retailing and handicraft industries.[73] They are also an important source of agricultural labour. The economic role they have carved for themselves helps them to sustain living standards in the absence of

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[69]Jimenez (1986).

[70]Rivlin (1975: 7), Haggblade, *et al.* (1988: 12).

[71]Haggblade, *et al.* (1988: 10).

[72]Folbre (1986: 25).

[73]Horenstein (1989).

menfolk. But in South Asian countries women are handicapped by a variety of cultural practices and institutions. They can be barred from working outside the home; their right to inherit land or other property is often restricted by customary law; they receive little education; because they cannot put up the collateral, they face difficulty in obtaining credit for farming activities; and even though women shoulder much of the burden of child-raising, they may have scant say in the regulation of fertility.[74]

Family size and poverty are linked and the dependency ratio also seems to have a negative effect on household savings, which in turn has a bearing on life cycle poverty. East Asian experience suggests that the ebbing of poverty and the demographic transition go together. Countries that are able to bring population growth rates down from the 2.5-3.5 per cent per annum to below 2.0 per cent find it easier to cope with poverty, and trends in savings more favourable toward growth emerge. A shrinking cohort size can mean better employment opportunities in the future as competition is curtailed. Hence, a fall in fertility serves to raise the living standards of older generations and shifts upwards the lifecycle incomes of their children.[75]

Lowering some of the barriers that impede the entry of women into the job market and narrowing sex related wage differentials would boost family incomes and lessen the pinch of poverty. Higher rates of female participation and greater sexual equality in the marketplace have lifted living standards in the West and to a lesser extent in the NICs.[76] It is the variance in labour force participation which explains some of the inter-group differences in poverty in Pakistan, India and Malaysia.[77] Altering customs and modifying institutions is a slow process. The public sector can hasten the pace by setting an example that other segments of the economy will eventually be persuaded to follow.[78] But as these efforts to draw women into the workforce proceed, a parallel drive to raise women's educational attainments will be necessary. Female literacy is closely correlated with family limitation and with improved health of children.[79] It therefore diminishes childbearing responsibilities and at the same time improves the chances of employment. No doubt, other industrial and labour market policies must be

[74]Folbre (1986: 30-3).

[75]Easterlin (1980).

[76]Kuo (1981: 105) for Taiwan.

[77]Muellbauer (1987: 45) on Malaysia.

[78]Career paths that lead to managerial positions would help elevate the status of women in the economic domain. Provision of childcare facilities on a wide scale as in the People's Republic of China would give them added freedom.

[79]Folbre (1986: 17), Birdsall (1988). Cochrane (1988: 5-7) notes that under seven years of education is in some instances linked to higher fertility because of its effects on breast feeding, but education in excess of seven years seems to lower fertility significantly.

marshalled to ensure that the demand for female labour emerges, as has happened in East and Southeast Asian countries, but education, at least, creates the supply potential. Women acquire options; they can, over time, make a start at ascending the ladder of occupations; and with smaller families, household per capita incomes can improve irrespective of the mothers' working status. It is important not to exaggerate the links between education and fertility. Women in Bangladesh, India and Pakistan depend on surviving sons for old age security.[80] So long as pension schemes with a universal coverage remain a distant prospect, fertility will be slow to decline.

9. Transfer and Welfare Programs

The variety of transfer programs in use world-wide is impossible to review in the compass of a few pages. Many approaches have been tried and experimentation goes on. The targeting of narrowly defined poverty stricken groups became popular in the early seventies and is still actively debated. Meeting the basic needs of the "bottom 40 per cent" was fashionable in the latter parts of the seventies but interest appears to have waned. The world is still groping towards the most efficient and supportable arrangements, with the industrialized countries leading the way. A quick look at the experience of some of the developed countries can help to isolate the main issues that the developing countries are beginning to confront as their development proceeds and which they will have to wrestle with in the decades ahead.

The redistributive function is performed mainly by transfers associated with pensions, disability payments, medical insurance, unemployment benefits, aid for children, housing programs and nutritional assistance. All except the last two are not specifically designed to reduce poverty but to maintain the incomes of workers and their dependents in the face of fluctuating earnings or certain unforeseen events. Nevertheless, they do serve as a buffer against poverty for the most vulnerable elements in society.

To put the story very simply, most countries tend to follow a well defined path. Two groups that do not fit my stylized description are the socialist countries and the small, oil rich economies. Initially, there is an attempt to provide minimum guarantees for old age and disability for certain politically influential groups such as the military, the civilian bureaucracy and the personnel of the major public enterprises.[81] This is gradually widened, to cover the industrial labour force and

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[80]Birdsall (1988: 517). Dependence of the aged on economic support from their children, especially in the rural areas of the People's Republic of China, explains the failure of the one child policy. The *wubao* (Five System Guarantees) operated at the village level does provide social security to the old and the needy, but its coverage is small, only 3 million in 1985.

[81]This is the pattern observed in Latin America where social security provisions were introduced in the early decades of the century (Mesa-Lago 1986: 135-8 and Mesa-Lago 1983: 84).

eventually the entire working population.[82] Over time, the scale of benefits is increased and the range of income transfers widened with the inclusion of medical and unemployment insurance. The last stage involves moving from social security to welfare proper with the provision of housing allowances, children's benefits and food stamps.

This progression upwards from a minimalist program seems to be associated historically with a number of developments. That is, socio-political demands for income transfers lead to legislation supporting a program of significant dimensions after three conditions are met:

a) The country has experienced a sustained period of prosperity which makes social security seem affordable, apart from being socially desirable.
b) The state apparatus has developed to a point where the financing and administering of social security are feasible. In very crude terms, there is a certain threshold level of the tax/GNP ratio which must be crossed before a credible program is in the cards.
c) Life expectancy,[83] urbanization, and industrial development have reached a stage where a substantial segment of the populace stands to gain from pension schemes; there is, in addition, a sizable and relatively well paid industrial workforce which seeks employment insurance and is prepared to contribute towards this scheme. To put this rather differently, it should be possible to operate the economy at high levels of employment before social security fits comfortably into the picture. In addition, benefits must accrue to a large number of the non-poor before it wins broad political support.

The progression of the social security system from early beginnings to maturity will also pass several financial milestones. At the very outset, when the base is narrow and political support limited, earned entitlements financed from contributions during an individual's lifetime are the rule. At the second stage, earned entitlements are likely to be paid for through earmarked taxes. Eventually the benefits provided to the working population can come from general taxes rather than special levies.

That said, there is no rule which can tell us when and how far a country should wade into social security or how it should defray the costs.[84] In a sense there has

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[82] It is a slow process. Even in Latin America, the overall coverage is under 50 per cent and for the majority it is less than 25 per cent. (Mesa-Lago 1986: 35).

[83] Entwisle and Winegarden (1984) found that government pension expenditures in developing countries during the early seventies were a function of the old age dependency ratio, percentage of GDP from agriculture, life expectancy, log of GDP per worker and the total fertility rate.

[84] In Brazil, for instance, social security is financed, in part, through sales taxes (Mesa-Lago 1983: 92). Mesa-Lago's work suggests that in the majority of Latin American countries both the methods of raising revenue for social security and the benefits tend to be regressive (Mesa-Lago 1983: 90-91).

to be the economic and social stage setting which ensures potential financibility and generates a demand. Next, there is the question of what is appropriate, given the structural characteristics of the economy, administering capacity, the degree of poverty, the conditions of the poor, and the direction of certain social trends. Trends which seem most relevant are: first, to what extent are families willing to support aged parents; second, which is not unrelated to the first, do women work. A relatively poor country, at an early stage of industrialization, with a weak, state organization, which suffers from rural poverty, cannot really think in terms of social security or elaborate welfare schemes. The bare minimum must suffice. The farther a country departs from this condition, the more relevant social security becomes. Whether it will require targeted anti-poverty programs, above and beyond insurance for the elderly, the disabled and unemployed, will depend very much on the nature of the poor, the various other macro-, structural and institutional forces at work and the poverty profile.

9.1 Social Security in Industrialized Countries

From the experience of developed countries it appears that income transfer programs can be a potent way of combating poverty. The pre-transfer incidence of poverty in the US was 24 per cent in 1983, while after transfers were factored in just 13 per cent of the populace fell below the poverty line. However, transfer programs are extremely expensive, absorbing 10 per cent of the US GNP in 1981.[85] They are also subject to much leakage. Only 38 per cent of the benefits reached the poor in the US, 54 per cent in the UK.[86] By narrowly targeting the most economically vulnerable groups, costs can be brought down and leakages minimized but the administrative costs of means-tested programs are steep — 5.2 per cent to 15.4 per cent in the UK as against 3.5-3.8 per cent for other programs.[87] Determining the incomes of the targeted population is exceedingly difficult and this drives up the administrative costs. Nevertheless, the mood in the West is leaning in this direction and the share of means-tested programs is expanding.[88] The initial gains with income transfer programs are substantial but in the developed

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[85]Danziger *et. al.* (1981).

[86]Kanbur (1987: 121).

[87]Kanbur (1988: 121). Costs are even higher in the Latin American countries because of excess personnel, inefficiencies and the high salaries paid to staff. They range from 2-6 per cent in Venezuela and Guatemala, to 10-12 per cent in Mexico and Brazil, to 14-16 per cent in El Salvador and Panama. (Mesa-Lago 1983: 97).

[88]Means-testing is most extensively used in the US and Canada and least in Israel and West Germany; Sweden and the UK lie in between (Hauser 1987: 201). Means-testing discourages the poor from seeking aid; first, because of uncertainty regarding eligibility; second, because it gives rise to administrative hurdles the poor are often unwilling to tackle; and third, by emphasizing, for some, the stigma of seeking public largesse (*Washington Post*, 1989). See also Atkinson (1983: 264).

countries, the advance has not slowed to a crawl. Income distribution in the US was virtually unchanged for two decades and poverty was at a two decade high of 13.5 per cent in 1987. Further reductions may depend on the future of growth and productivity.

In both the US and the UK pensions account for the lions share of transfers.[89] When combined with Medicare for the elderly, it encompasses 60 per cent of the expenditures in the US.[90] As populations in the Western nations age, the share of social security annexed by pensions could continue to grow.[91] Income redistribution primarily aids those in older age brackets, though significant amounts also find its way through food stamps, child support and housing allowances to households headed by women. Indexed social security benefits have greatly diminished poverty among the elderly. As this group is expanding rapidly, the apparent bias may not be unreasonable but, at least in the US, some of the cost has been borne by the children of the poor.[92]

9.2 Problem Areas

The cost of income maintenance programs, the difficulties with targeting and the lopsidedness of benefits are three of the concerns that have surfaced, but a number of others can be identified which are relevant for developing countries.[93]

First, there are the incentive effects touched upon above. Financing a program that will lift appreciable numbers from the limbo of poverty generally involves steep rates of taxation on the better-off and social security levies on wage-earners. Initiative and risk-taking behaviour are hobbled and either tax-payer resistance forces a partial reversal as in the US, or tax evasion becomes institutionalized, or the growth of employment can be curtailed. Incentives also affect the means-tested recipients of benefits, who are subject to very high marginal tax rates. These

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[89]This is also the case in the Latin American countries that were among the first to introduce social security. For instance, 80 per cent of the expenditure in Uruguay is on pensions. (Mesa-Lago 1986: 141).

[90]Kanbur (1987: 116).

[91]Exactly this trend, that is, the rising share of pension in social security is already apparent in the People's Republic of China.

[92]Becker and Murphy (1988: 9).

[93]The investment of pension funds in secure assets, yielding adequate real returns is a course that governments confronted with budgetary stringencies do not always choose to follow. This, of course, means grave problems in the future. It is not enough to just establish a pension scheme. Ensuring that the resources flowing into it will be safeguarded is an equally important long-term responsibility. Mesa-Lago has pointed out that in Latin America, "social security reserves have usually been squandered or, in the best of cases, have not borne the expected profits due to three reasons: the pernicious effects of chronic inflation; the poor development of capital markets, and the low yields of investment." (Mesa-Lago 1983: 96; and Mesa-Lago 1986: 144-5).

discourage them from seeking work, as any income earned involves a substantial loss in transfers. Lower rates mean even higher program costs.

A second source of worry is the relationship between labour supply and social security. Pension schemes can encourage early retirement and unemployment insurance can lengthen periods of idleness. These do matter, but an exhaustive review of the US literature suggests that the withdrawal of labour is fairly small.[94] The matter is not closed and developing countries have yet to test these waters.

Social security schemes could depress private savings that are accumulated in anticipation of retirement needs. Theories of savings behaviour are ambiguous on this score and empirical investigations have not provided a clear answer. Again, on balance, a mild negative effect is likely.[95] Several researchers have noted the implications of the counter-factual; most old people need support as their own savings are generally insufficient. If the state does not provide pensions, relatives must bear the costs, which eats into their savings.[96] LDCs must be on their guard once they begin expanding the social security net.

Finally, pensions along with benefits for children, housing and food supplements have led to a change in living arrangements that can magnify poverty. Social security has enabled old people and young single mothers to live apart from their families for the sake of independence, even if it involves settling for an existence below the poverty line.[97] Other factors are also influencing household formation but the welfare system does seem to conspire against family stability.

The majority of developing countries provide the poor with income supplements through food rations, subsidized health, transport and education services, housing benefits or child support. Some of the more affluent ones such as Brazil and Uruguay, which entered this field earlier in the century, extend pension benefits to more than half of the work force. The East Asian NICs including the People's Republic of China, are also crossing the threshold into centrally administered programs including retirement benefits and health care. Unemployment insurance has been tackled by the fewest: two low income countries, Ghana and the People's Republic of China (since 1986) and four lower middle income ones.[98] South Korea introduced social security legislation in 1973, allowed it to lie

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[94]Danziger *et. al.* (1981) and Sawhill (1988) survey the evidence.

[95]Peter Diamond has cautioned that the historical data subjected to statistical tests are drawn from various stages in the development of social security in advanced countries. It may give no inkling as to what could happen in a developing economy where the motivations are quite different (Skidmore 1981: 6). Mesa-Lago (1986: 144) summarizes the conflicting evidence on the relationship between social security and savings in Latin American countries.

[96]Danziger *et. al.* (1981).

[97]Rivlin (1975: 5). Social security plus economic opportunity has been associated with rising rates of divorce and the relatively low rates of remarriage by women in the developed countries (Becker and Murphy 1988: 13-14).

[98]"Social Security Programs Throughout the World — 1987", US Department of Health and Human Services, Social Security Administration.

dormant for a decade and a half and has recently revived it. All of them face or are beginning to encounter, the administrative, fiscal, incentive and social problems listed above. With welfare spending swallowing close to 9 per cent of GNP in Brazil, the fiscal burden is beginning to tell (see Table 1), particularly on the ailing, debt ridden economies. A few of the NICs and the People's Republic of China are now approaching a stage when a substantial number of workers will be retiring and life expectancies are such that they will require pension support for many years. In fact, generous schemes in Brazil and Kuwait encourage retirement once the statutory work period requirements have been met. At the same time, pension benefits are on the way to becoming a necessity because weakening family ties and mobility are depriving old parents of a financial anchor. South Korea and the People's Republic of China have rapidly expanding economies and large cohorts in prime working age categories which gives them breathing space in which to fund pension schemes. Countries like Egypt, Brazil and Ecuador are in a less happy macro-economic situation and may have to be frugal in legislating benefits.

Other phenomena becoming noticeable in the developing world is poverty among women who are household heads and the large number of children in the ranks of the poor. Three of every five Brazilian households headed by women live in poverty. Fifty-four per cent of children fall into this category.[99] These statistics are by no means unusual. Attending to the needs of women and children require programs of a particular kind: training, childcare, counselling and nutritional assistance. They are administratively expensive, subject to leakage and it is frequently hard to push women ensconced on welfare programs out of their plight and into the mainstream of the employed. It is a problem that will test the social services of the LDCs just as it has in the West, but the incidence of female household poverty can become so severe that it cannot be ignored for long.

10. Growth and Redistribution

When income maintenance programs were being discussed at the turn of the century, universal coverage was the philosophical goal. These earlier hopes have been dashed. Means-testing and narrower targeting are very much in the air. Financial imperatives will ensure that unemployment insurance, nutrition supplements and housing programs will have to follow the targeting route.[100] The

[99]Fox (1983: 269); World Bank (1988c); and Fields (1980: 55). The risk of widowhood rises with age and as life expectancies, especially of women, lengthen, the likelihood that she will become a household head increases (Visaria 1980: 58).

[100]The issue of targetting food programs for the benefit of rural poor is of importance in Brazil which has several schemes. It is also of concern in India although total direct expenditures are equal to 0.16 per cent of GDP in 1986-7 and has been analyzed by Subbarao (1989: 76-7). He emphasizes the need to reach the critically malnourished. Problems with targetting are discussed by Glewwe and Kanaan (1989).

TABLE 1

Central Government Social Expenditure (as a percentage of GNP)

Country	Education		Health		Housing & Welfare*		Total	
	1972	1987	1972	1987	1972	1987	1972	1987
1. Bangladesh	1.39	1.29	0.47	0.61	0.92	1.20	2.78	3.10
2. Nepal	0.61	2.21	0.40	0.92	0.06	1.24	1.07	4.37
3. Tanzania	3.41	1.73	1.42	1.19	0.41	0.36	5.24	3.28
4. Zambia	6.46	3.34	2.52	1.89	0.44	0.93	9.42	6.17
5. India	0.26	0.49	0.17	0.34	0.36	1.03	0.78	1.86
6. Pakistan	0.20	0.56	0.19	0.19	0.54	1.86	0.93	2.61
7. Sri Lanka	3.30	2.53	1.63	1.75	4.95	3.79	9.88	8.07
8. Indonesia	1.12	2.11	0.21	0.36	0.14	0.41	1.46	2.88
9. Philippines	2.18	2.43	0.43	0.74	0.58	0.51	3.19	3.69
10. Ecuador	3.69	3.99	0.60	1.19	0.11	0.15	4.40	5.33
11. Malaysia	6.20	...	1.80	...	1.17	...	9.17	...
12. Mexico	1.89	1.97	0.59	0.30	2.88	1.93	5.35	4.20
13. Brazil	1.44	...	1.17	...	6.09	...	8.70	...
14. Korea, Rep	2.84	3.18	0.22	0.40	1.06	1.25	4.12	4.84

Note * includes social security.

Source: Percentage shares of education, health, and housing to total expenditure and percentage share of total expenditure to GNP are from World Development Report 1989 pp. 184-5 Table II. GNP at current prices in local currency is from Bank's BESD data base.

dilemma in the industrial as well as the developing countries is that political support for welfare programs wanes when substantial segments of the non-poor and middle classes do not derive benefits. Some regressivity in education and health spending may be a price that must be paid, and a measure of leakage tolerated. Thus, the quest for economy leads to targeting, but too sedulous a targeting quenches the enthusiasm of those who pay for welfare. Each country will have to find its own middle ground.

As stated earlier in the paper, income maintenance and welfare programs are vital instruments in the effort to improve distribution and eradicate poverty. However, they are most willingly tolerated when the economy is strong with unemployment on the decline. It is in these robust periods that benefits increase. Lean times lead to a reversal. Clearly the macro-economic and sectoral programs are in the lead when it comes to redistribution with transfers and welfare expenditure playing a critical supplementary role.[101] Furthermore, the political appeal of passive income support does not endure, whereas those programs that promise to move people off welfare are easier to sell over the longer term.[102]

Redistribution and welfare must be viewed in the context of overall macro-economic and development strategy. The cost and effort of alleviating poverty or lessening inequality, could be greatly reduced if from the outset planners approached industrial, agricultural, institutional and macro policies keeping the distribution goal in the forefront. It is expensive to try and retrieve the distributional errors of development strategy by means of income transfer programs. As all nations have learned, the political and social damage wrought by inequality cannot be ignored or sidestepped. At the same time, political resistance from higher income groups impose limits on transfers. For a time socialism seemed to offer a way of absorbing the political discomfort arising from redistributive policies. But the sheer magnitude of the economic penalty incurred is forcing the reform minded socialist countries to view open unemployment and unequal incomes as inevitable in their drive to ameliorate fiscal burdens, increase flexibility and sharpen incentives for workers and entrepreneurs alike.

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[101]Atkinson (1989: 213).

[102]Ellwood (1989).

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DISTRIBUTIONAL POLICIES AND PROGRAMMES: THE MALAYSIAN EXPERIENCE

Zainal Aznam Yusof

This paper reviews the broad progress that has been achieved by the NEP and assesses the impact on alleviating poverty and reducing income inequality.

1. Introduction

One of the few issues that can interest many and excite some is concerned with the benefits of economic development; in particular, who has been getting the benefits of development? Economists have long wondered whether there is any predictability or inevitability about development and the distribution of income, and beginning with Kuznets (1955), much interest has been focussed on assessing whether in the early phase of development the distribution of income tends to worsen and improves only at a later stage in the development process.[1]

Serious interest in questions on equity and distributional issues in Malaysia really began just after the May 1969 racial riots. The concern then was not just with poverty and income inequality, but with the sensitive ethnic dimensions of economic imbalances, especially the disadvantaged position of the Bumiputera *vis-a-vis* the non-Bumiputera. With independence in 1957, the Federation of Malaya, as it was known before the formation of Malaysia in 1963, embarked on a long period of growth and development. Post-independence Malaysia's development strategy was based on a *laissez-faire* approach to development. Up to the end of the 1960s the state confined itself mainly to its traditional role, that is, the provision of basic utilities, infrastructure, education, health and other social services, but it was active and interventionist in the agricultural sector. While it had a substantial involvement and presence in the agricultural sector through agriculture and land development, it left the non-agricultural sectors, especially industry and commerce, to the non-Malays especially the Chinese and foreign interests. Meanwhile, the United Malays National Organization (UMNO), the Malay political party within the Alliance, dominated the political life of the nation.

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[1]The literature has become extensive. See, for example, Adelman and Morris (1973) and Ahluwalia (1976).

This was the essence of the "Bargain of 1957", a social contract which guided the political economy of post-independence Malaya up to 1969.

Without doubt the May 1969 racial riots marked a watershed in post-war development in Malaysia. Economic factors, it was argued, played a considerable part in contributing towards the sentiments and events which launched the New Economic Policy (NEP) in 1971. An immediate result of the May 1969 racial riots, and subsequent political developments, was the formulation of the NEP, an explicit policy statement on equity matters with its two-pronged objective of eradicating poverty irrespective of race and the restructuring of society to correct the identification of race with economic function. Later incorporated into a twenty-year Outline Perspective Plan 1971-1990 (OPP), the NEP laid out explicit ethnic equity targets.

The full record and account of progress in equity and restructuring since the launching of the NEP and how development programmes and policies have had an impact on poverty and income inequality remain to be written. Available evidence, and they are scanty and patchy, suggests that the record has been remarkably encouraging; the level of poverty has come down sharply and the distribution of income has improved since the launching of the NEP. Even more encouraging is that despite the severity of the recessions in the early 1980s, with their adverse impact on the growth of the Malaysian economy (the nadir was reached in 1985 when growth declined by one per cent), and the very sharp reductions in public development expenditure together with structural adjustments, deregulation and liberalization measures that were introduced, the poverty situation did not deteriorate.[2]

The purpose of this paper is to review the broad progress that has been achieved in the NEP and then to assess the impact of the distributional policies and programmes on alleviating poverty and reducing income inequality. Lack of data will constrain the review and assessment and much of it will be based on official statistics. It will be more in the spirit of a general tour. The next section of the paper summarizes the background of the NEP. The evidence on poverty alleviation, the restructuring of society and the distribution of income since the NEP will be taken up in the third section. Next, the types of distributional policies and programmes are dealt with. Some of the main lessons from the Malaysian experience in dealing with the equity issue will be taken up in the concluding section.

2. The Malaysian Equity Problem: The New Economic Policy

A useful place to start discussing distributional issues is the NEP. In the Second Malaysia Plan 1971-75 (SMP), it was stated that the overriding objective of the

[2]For an account of the experience of Third World countries in coping with the recession and its effects on the standard of living, see Cornia, Jolly and Stewart (1987).

two-pronged NEP is the achievement of national unity:

> The plan incorporates a two-pronged New Economic Policy for development. The first prong is to reduce and eventually eradicate poverty, by raising income levels and increasing employment opportunities for all Malaysians, irrespective of race. The second prong aims at accelerating the process of restructuring Malaysian society to correct economic imbalances, so as to reduce and eventually eliminate the identification of race with economic function. This process involves the modernization of rural life, a rapid and balanced growth of urban activities and the creation of a Malay commercial and industrial community in all categories and at all levels of operation, so that Malays and other indigenous people will become full partners in all aspects of the economic life of the nation.

The most controversial distributional target, the thirty per cent Bumiputera ownership target, was also mentioned:

> The Government has set a target that within a period of 20 years, Malays and other indigenous people will manage and own at least 30 per cent of the total commercial and industrial activities in all categories and scale of operation. The Government has also stipulated that the employment pattern at all levels and in all sectors, particularly the Modern Rural and Urban Sectors, must reflect the racial composition of the population.

How were all these grand targets to be achieved? It was emphasized that development will be undertaken in such a manner that in the process of growth and expansion, it would make maximum contribution to the achievement of national unity. It was also recognized that economic development by itself would not solve the manifold problems of a pluralistic society.

The dimensions of the equity problem were gradually highlighted in the various development plans and their mid-term reviews. Income statistics showed that the "modern urban sector" was characterized by high average incomes, while the "modern rural sector" and the "government sector" had medium incomes and the "traditional urban sector" and the "traditional rural sector" low incomes. Employment statistics showed that the Malays were employed largely in traditional rural activities characterized by underemployment, such as padi farming, fishing and rubber smallholdings, and that they were not well represented in the higher level managerial, professional and technical jobs. The non-Malays on the other hand were preponderant in the urban areas, on estates, as factory workers, shopkeepers and construction workers. They dominated the higher paying occupations.

For the first time statistics on the extent of corporate ownership by ethnic groups was presented, and it was a revelation that the Malays owned only about 1.5 per cent, the Chinese 23 per cent and foreign interests 62 per cent. This confirmed how bad the position of the Malays was, and, surprisingly, it showed that the Chinese did not own or control much of the economy. The dominance of foreign investment was also unexpected.

There were, however, no comprehensive statistics on wealth. A novelty in the SMP was the information assembled to show the imbalances in ownership and control of wealth. In terms of acreage, the plan reported that of the total of about 4.2 million acres of rubber land in West (Peninsular) Malaysia at the end of 1970, about 37 per cent were owned by Malays, 42 per cent by non-Malays and 21 per cent by foreigners. For estates, in the same year, about half of the acreage was owned by Malaysians, and half by foreigners. No Malay owned rubber estates. Of the over two million acres which were then under rubber smallholdings, Malays and non-Malays had about equal ownership. Foreign interests owned about three-quarters of the oil palm and coconut estates in Peninsular Malaysia, with the remainder being owned by non-Malays.

Additional insights into the magnitude of ethnic economic imbalances were reported in the Mid-Term Review of the Second Malaysia Plan 1971-1975 (MTR) which was published in 1973 and which included the OPP. Data derived from the *Post-Enumeration Survey* (PES) of the *1970 Population Census* showed that the top ten per cent of households accounted for about forty per cent of total household income, while the share of the bottom forty per cent of households was only about twelve per cent. Income imbalances between the rural and urban areas and between the races were also wide. For example, in 1970, the average mean monthly household income of the Chinese household ($387) was more than two times that of the average income of the Malay household ($179).

An important change in conceptualizing ownership imbalances was introduced in the MTR. There was a clear shift to focus more attention on the ownership of share capital in the corporate sector. Recognizing that "ownership and control of wealth or asset is an important source of household income", the MTR went on to state that "an important element in this regard is the ownership of capital in the corporate and non-corporate sectors of the economy". For the first time, passing reference was made to the concept of wealth. Wealth was to include financial as well as physical assets, including land. But the importance of ownership of one type of financial asset, that is, equity or share capital was especially emphasized for "as the economy develops and modernizes, and as the country's financial structure becomes increasingly sophisticated, the key to the ownership and control of wealth will be through ownership of the equity capital of various enterprises. The Government will, therefore, take effective measures to enable Malays and other indigenous people to expand their ownership of share capital". This implied that the original, and much broader, vision of restructuring the ownership of wealth had now been narrowed, although with the right qualifications and reminders.

There were other changes too. In the SMP no ownership targets were made for the other Malaysians and foreign interests. The OPP rectified that and indicated that by 1990 Malaysians would own about 70 per cent of the total share capital of limited companies with Bumiputera (Malays and other indigenous people) owning at least 30 per cent, other Malaysians 40 per cent and foreign interests the remaining 30 per cent. Within a period of twenty years Malays and other indigenous people would own and manage at least thirty per cent of the total commercial and industrial activities of the economy in all categories and scales of operation as the "desired racial pattern in share ownership". It also reassured the other interests that "the attainment of the growth targets of the Perspective Plan will enable non-Malay ownership of share capital to expand by nearly 12 per cent per year and to increase its share of the total to over 40 per cent by 1990...." The growth of Malay ownership was seen to take place at the expense of foreign interests; "in relation to total share capital, however, the expansion for Malays and other indigenous people... will involve a sizeable decline in the share of foreign interests from 61 per cent to about 30 per cent during the period". This elaboration gave official birth to the famous "30:40:30" ownership restructuring target for the NEP.

For employment, there was to be a restructuring of the pattern of employment and the target was to have, by 1990, one that would reflect the ethnic composition of the population at all levels, with full employment to be attained by 1990. In contrast to ownership and employment restructuring, there were no targets set for the creation of a Bumiputera Commercial and Industrial Community. Specialized agencies, termed "trust agencies", such as Perbadanan Nasional (PERNAS), Majlis Amanah Rakyat (MARA), State Economic Development Corporations (SEDCs), Urban Development Authority (UDA), Federal Industrial Marketing Authority (FIMA), Bank Bumiputera, and later Permodalan Nasional Berhad (PNB), were entrusted with the responsibility of providing a variety of support and assistance to the Bumiputera. These agencies, which either invested on their own or had joint ventures in various industrial and commercial activities, provided financial and technical assistance, consultancy services and conducted training courses.

It was only by the mid-1970s that additional statistics were available to show the extent of poverty and these were published in the Third Malaysia Plan 1976-1980 (TMP) (Anand 1983). The TMP introduced yet another long-term target: the incidence of poverty would be reduced to about 16.7 per cent by 1990 from its level of 49.7 per cent in 1970. If the target was reached an estimated 514,000 households would be in poverty in 1990 compared with 792,000 in 1970. The admission that almost half (49.3 per cent) of the total number of households in 1970 were classified as officially poor, that is, with an income below the "poverty line" was a rather startling revelation, despite years of respectable growth. All these distributional targets were predicated on the assumption that the growth rate would be of the order of eight per cent per annum over the OPP period.

There were no illusions about the difficulties of reaching for national unity but the importance of economic imbalances was acknowledged, as "National unity is unattainable without greater balance among Malaysia's social and ethnic groups in their participation in the development of the country and in the sharing of the benefits from modernization and economic growth".

3. Growth, Poverty, Income Inequality and the New Economic Policy: Accounting of Performance

In this section the record of growth and the trends in poverty and the distribution of income will be summarized. As always, the lack of the right kind of statistics have constrained efforts at a more detailed and critical assessment. Also an analytical assessment of the relationship between growth and equity has not been done so that establishing the causality, if this is possible, between growth, poverty and income distribution, or putting forward hypotheses to explain the record, is made all that more difficult. Much reliance has to be placed on official statistics as they are the only available set of consistent statistics whatever their limitations. Statistical credibility does matter a great deal especially in the Malaysian context because of the very sensitive nature of the subject.[3] It is not simply just a matter of what has happened to Bumiputera, Chinese or Indian poverty levels and to income inequality but what has been happening to inequality, not only between the Bumiputera and non-Bumiputera but also within each ethnic group. The ethnic dimension has, however, always been of paramount importance.

3.1 Growth: Rapid and Sustained

The Malaysian economy has succeeded in sustaining a relatively high level of growth over the post-1970 period and it is expected that the growth rate of the economy over the 1971-1990 period will be close to about seven per cent per annum, just below the targeted eight per cent. Growth was much lower in the 1980s than in the 1970s, largely because of the recession in the early eighties. During the past eighteen years (1971-1988), the economy grew at about 6.5 per cent per annum, averaging 5.8 per cent during the 1981-85 period; the remaining half of the eighties is also expected to reach the same level of growth. These growth rates show a much better growth performance for Malaysia when compared to other Third World countries. The "industrial market economies" (USA, UK, France, Germany and Japan) grew at 3.6 per cent per annum during the 1980-86 period. These rates were well above the average growth rates for the "Upper Middle Income" countries (such as Brazil, Yugoslavia and South Korea).

Growth in income was also more than satisfactory over the post-1970 period when per capita gross domestic product (GDP) grew at 5.1 per cent per annum during the 1970s and an estimated 4.0 per cent in the 1980s. Again these rates exceeded the performance of many other Third World economies.

3.2 Alleviating and Reducing Poverty

What has been the record on poverty and the distribution of income? Consider poverty first. The record on alleviating poverty has been a remarkable one as

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[3]A sub-committee on statistics and methodology of the National Economic Consultative Council (NECC) is looking into the whole question of the statistics relating to the NEP.

absolute poverty has declined from about half (49.7 per cent) in 1970 to about 17 per cent in 1987, and with economic recovery and growth rates reaching about 8 per cent in 1988, 7.6 per cent in 1989 and possibly 6.5 per cent in 1990, the level of poverty is expected to decline further, possibly to about 14-15 per cent by 1990.

Different approaches and different measurements will show different levels of poverty. On an internationally comparable approach, using the equivalent purchasing power ratios estimated by Kravis and associates instead of official exchange rates, and a poverty line of 200 "International Comparisons Project" dollars — the level of the 46th percentile for the Indian case — the results show a low incidence of poverty for Malaysia in 1975 of about 12 per cent:[4]

	Percentage of population in poverty in 1975	
Country	*Using Kravis's adjustment factors*	*Using official exchange rates*
Malaysia	12	8
Korea	3	6
Chile	11	9
Taiwan	5	4
Brazil	15	8
Philippines	33	29
Sri Lanka	14	10

Something needs to be said on the measurement of poverty because of some scepticism on the official estimates of poverty.[5] The traditional distinction between "absolute" and "relative" poverty is still helpful.[6] Absolute poverty is measured by taking a poverty line income and then estimating the proportion of households, or individuals, that fall below the line. It is what goes into the poverty line that attracts considerable interest. Officially, "poverty has been defined and measured on the basis of the prevailing standard of living in the country..." and "...an income sufficient to purchase a minimum food basket to maintain a household in good nutritional health and the conventional needs in respect of food, clothing and footwear, rent, fuel and power, transport and communications, health, education and recreation" (Fifth Malaysia Plan, p. 83). Beyond these general

[4]The methodology and results are reported in Ahluwalia, Carter and Chenery (1979).

[5]For an account of how poverty can be measured see, for example, Sen 1981 and Anand 1983. The official approach is reported in the various five-year development plans. For examples of a sceptical view, see *Malaysian Business*, August 1-15, 1989.

[6]See Sen (1989).

statements there is little else to go by. Only recently has the poverty line been revealed and for 1987 they are as follows:

	Income ($)	*Family size*
Peninsular Malaysia	350	5.12
Sarawak	429	5.24
Sabah	533	5.36

Using a per capita poverty line, that is, taking the size of household into account gives a lower incidence of poverty.

Relative poverty can be measured, for example, by taking the average income of, say, the bottom 40 per cent or 25 per cent of the population and then estimating the number of households or individuals below the relative poverty line.[7] The median as a proportion of the per capita income has also been put forward as a measure of relative poverty.[8] The advantages of these approaches have been well documented and there are other suggestions for alternative or complementary measures of poverty.[9]

The incidence of urban and rural poverty, shown in Table 1, declined over the 1970-87 period, and although poverty was still higher in the rural than the urban areas and the bulk of the poor were in the rural areas, the profile of overall poverty appears to show some signs of changing. The share of the urban poor has increased: in 1976 the urban poor formed about 12.4 per cent of the total poor households, increasing to 16.8 per cent in 1984 and to 17 per cent in 1987. Also surprisingly, the level or "intensity" of poverty, as measured by the difference between the mean incomes of the urban poor and rural poor households, was marginal.

All states, as far as we can tell, enjoyed declining levels in poverty up to 1984. As the effects of the recession worked through, not all states enjoyed declining levels; poverty increased in Terengganu, Wilayah Persekutuan, Negeri Sembilan, Selangor and Sabah between 1984 and 1987 and their level of income fell too. The concentration of the poor has also shifted since the mid-1970s, with the share of the poorest states (Kedah, Kelantan, Perlis and Terengganu) increasing from 42.3 per cent in 1976 to 44 per cent in 1987, and the share of the more developed urbanized states (Penang, Selangor and Wilayah Persekutuan) increasing from 14.3 per cent in 1976 to 16.7 per cent in 1987. These broad statistics suggest that in Peninsular Malaysia there were two trends, the first showing an increasing

[7] See Ahluwalia, Carter and Chenery (1979) for an example of measuring relative poverty.

[8] See Atkinson (1975).

[9] See Sen (1981) and Atkinson (1975).

concentration of poverty in the poorest states, and the second, of a rising share of the total poor in the more developed and urbanized states of Peninsular Malaysia. In Sabah and Sarawak, compared to their level of income, the level of poverty was high: in 1987 Sarawak ranked third and Sabah fifth in terms of the level of income but fifth and second, respectively, in terms of the level of poverty.

Five poverty groups accounted for the bulk of the poor. Rubber smallholders, padi farmers, coconut smallholders, fishermen and estate workers accounted for a sizeable proportion of the total poor: 36 per cent in 1984 and a third in 1987. Alleviating poverty among padi households appears to be a difficult task as by 1987 about half of the padi households were still below the poverty line, and they still had the distinction of having the highest incidence of poverty. Double-cropping of padi reduced poverty but the effects were not dramatic.

All ethnic groups recorded a fall in the incidence of poverty although there were large differences in the levels between the major ethnic groups. By 1987, the Bumiputera still had the highest incidence of poverty (23.8 per cent) followed by the Indians and the Chinese. Although the comparisons are not that accurate (because of the use of a per capita income poverty line), in Peninsular Malaysia, the level for the Bumiputera had declined from about 46 per cent in 1976 to about 24 per cent in 1987, while for the Chinese it fell from about 17 per cent to 8 per cent and for the Indians, from 27 per cent to 10 per cent over the same period. Poverty in the country has become increasingly a Bumiputera phenomenon. In 1976 about three-quarter of the poor were Bumiputera but by 1987 their share had increased to about eighty per cent. This seems to suggest that in many of the states, especially in Kedah, Kelantan and Terengganu, poor Malay households have increased.

It may well be useful to raise the question as to which ethnic group, on the average, is now the poorest. Additional probing will be required but it may well be that in a number of states, especially in the urban areas, the mean income of a poor Chinese household could be very close to that of a Bumiputera household. The evidence points to the fact that the average income of the poor household in the urban areas, where the Chinese predominate, is now close to the average income of the rural poor, where the Malays predominate. Besides, in Selangor, Negeri Sembilan and Wilayah Persekutuan, where the proportions of Chinese are the highest, not only has the incidence of poverty increased but also the average income of the poor has declined in absolute terms.

The ethnicity aspects of poverty in Sabah and Sarawak differ slightly from that of the states in Peninsular Malaysia. The incidence of poverty for Bumiputera in Sabah increased over the 1984-87 period, with no change for the Chinese and a sharp reduction for the Others. By 1987, the Bumiputera accounted for about 97 per cent of the poor households compared to 91 per cent in 1984. In Sarawak poverty fell for all races although the Bumiputera, as in Sabah, accounted for the bulk of the poor, about 91 per cent in 1984 and 1987.

Table 1
Peninsular Malaysia: Incidence of Poverty by Rural–Urban Strata, 1970, 1976, 1984 and 1987

Stratum and target group	1970 Total number of households ('000)	1970 Total poor households ('000)	1970 Incidence of poverty ('000)	1976 Total number of households ('000)	1976 Total poor households ('000)	1976 Incidence of poverty ('000)	Incidence of poverty (%)
Rural	1,203.4	705.9	58.7	1,400.8	669.6	47.8	24.7
Rubber smallholders	350.0	226.4	64.7	126.7	73.8	58.2	42.7
Padi farmers	140.0	123.4	88.1	187.9	150.9	80.3	57.7
Estate workers	148.4	59.4	40.0	–	–	–	19.6
Fishermen	38.4	28.1	73.2	28.0	17.6	62.7	26.1
Coconut smallholders	32.0	16.9	52.8	19.3	12.4	64.0	46.2
Other agriculture	144.1	128.2	89.0	528.4	275.4	52.1	–
Other industries	350.5	123.5	35.2	510.5	139.5	27.3	–
Urban	402.6	85.9	21.3	530.6	94.9	17.9	8.2
Agriculture	–	–	–	24.8	10.0	40.2	–
Mining	5.4	1.8	33.3	4.5	0.5	10.1	–
Manufacturing	84.0	19.7	23.5	55.3	9.5	17.1	–
Construction	19.5	5.9	30.2	84.7	6.1	17.7	–
Transport and utilities	42.4	13.1	30.9	53.2	9.1	17.1	–
Trade and services	251.3	45.4	18.1	242.0	33.7	13.9	–
Activities not adequately defined	–	–	–	116.1	26.0	22.4	–
Total	1,606.0	791.8	49.3	1,931.4	764.4	39.6	18.4

Sources: Government of Malaysia, *Fifth Malaysia Plan 1986–1990* and the *Mid-Term Review of the Fifth Malaysia Plan 1986–1990*, Kuala Lumpur: National Printing Department.

Table 1 (continued)
Peninsular Malaysia: Incidence of Poverty by
Rural–Urban Strata, 1970, 1976, 1984 and 1987

1984				1987			
Total poor households ('000)	*Mean income of the poor ($M)*	*Overall mean income ($M)*	*Incidence of poverty (%)*	*Total poor households ('000)*	*Mean income of the poor ($M)*	*Overall mean income ($M)*	*Incidence of poverty (%)*
402.0	208.0	824.0	24.7	403.2	224.0	853.0	22.4
68.5	220.0	520.0	42.7	83.1	238.0	535.0	40.0
70.5	196.0	406.0	57.7	44.4	222.0	462.0	50.2
6.7	221.0	632.0	19.6	4.9	225.0	670.0	15.0
10.7	262.0	672.0	26.1	10.7	251.0	633.0	24.5
16.4	251.0	514.0	46.2	11.7	275.0	492.0	39.2
–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–
81.3	205.0	1,541.0	8.2	82.6	228.0	1,467.0	8.1
–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–
–	–	–	–	–	–	–	–
483.4	208.0	1.1	18.4	485.8	225.0	1,074.0	17.3

Sources: Government of Malaysia, *Fifth Malaysia Plan 1986–1990* and the *Mid-Term Review of the Fifth Malaysia Plan 1986–1990*, Kuala Lumpur: National Printing Department.

3.3 Restructuring Employment

Demographic and population changes have altered the magnitude of the task to restructure the ethnic pattern of employment. It will be more difficult than originally envisaged. When the OPP was formulated, the Bumiputera accounted for slightly more than half (53 per cent), Chinese 35 per cent and Indians a tenth of the total population of Peninsular Malaysia. On a Malaysia-wide basis, that is including Sabah and Sarawak, the percentages differ slightly. When this is done, by 1990, the Bumiputera share of the population will be probably closer to 70 per cent.[10] If we use this projected 1990 ethnic breakdown of population as a basis for assessing the progress in employment restructuring, then the rate of progress has not been that rapid. Table 2 shows what has been happening to employment restructuring over the last 20 years or so. There are limitations to the data: some are for Peninsular Malaysia and some for Malaysia as a whole, but the story is not distorted very much whichever part of the country is considered.

There is no denying that employment has been restructured but not to any great extent. More Bumiputera have moved into the modern and high paying sectors, that is, the formal sector. However, if the stringent criterion, that the employment pattern should reflect the ethnic composition of the population at all occupational levels, is employed, then progress has not been that dramatic. By the end of the decade (1990), it is estimated that the Bumiputera will account for about three quarters of those employed in agriculture, a little more than two-thirds in government services (69 per cent) and about 44 per cent in manufacturing. The "Bumiputeraness" of agriculture and of government will not change very much. During the 1970s, out of a total of about a million jobs created in Peninsular Malaysia, about 204,500 jobs were generated by the primary sector, and out of this about 58 per cent were taken up by the Bumiputera. This trend was continued during the 1980s. Bumiputera made inroads into the secondary sector and they accounted for about half (279,800) of the new jobs (573,000), particularly in manufacturing, created during the 1970s. For the 1980s, for Malaysia, a slightly lower percentage, 51 per cent, of the new jobs (561,200) were taken up by the Bumiputera (287,600). Government continued to provide an entrenched labour market for Bumiputera: in the 1980s as much as 97 per cent (198,000) of the new jobs (203,000) were allocated to the Bumiputera.

This is even more apparent when one looks at occupational restructuring. Although the supply of Bumiputera professionals and skilled labour has increased, the Bumiputera are still disproportionately represented in the lower unskilled categories, and have made only marginal advancements into the professional and technical occupations. By 1975, they accounted for 48 per cent of those employed in this category (a large percentage of whom were teachers and nurses) compared

[10] See Table 4-1 of the Mid-Term Review of the Fifth Plan for the estimated population breakdown in 1990.

Table 2
Malaysia: Employment by Sector and Ethnic Group, 1980 and 1990
('000)

Sector	1980										1990									
	Bumi-putera	%	Chinese	%	Indian	%	Others	%	Total	%	Bumi-putera	%	Chinese	%	Indian	%	Others	%	Total	%
Agriculture, forestry, livestock, and fishing	1396.9	73.10	313.4	16.40	185.3	9.70	15.3	0.80	1910.9	100	1481.3	75.20	297.4	15.10	179.3	9.10	11.8	0.60	1970	100
Mining and quarrying	27.2	33.96	43.8	54.68	8.5	10.61	0.6	0.75	80.1	100	13.8	35.29	21.3	54.48	1.2	3.07	2.8	7.16	39.1	100
Manufacturing	308.8	40.90	380.8	50.43	60.7	8.04	4.8	0.64	755.1	100	509.1	44.00	524.2	45.30	119.2	10.30	4.6	0.40	1157	100
Construction	105.6	39.08	144.3	53.40	17.3	6.40	3	1.11	270.2	100	174.5	42.90	199.7	49.09	27.7	6.81	4.9	1.20	407	100
Electricity, gas, and water	20.8	67.10	3	9.68	7	22.58	0.2	0.65	31	100	32.9	70.60	5.9	12.66	7.4	15.88	0.4	0.86	46.6	100
Transport, storage, and communication	110.2	52.60	73.3	34.99	24.9	11.89	1.1	0.53	209.5	100	142	52.01	94.5	34.62	34.9	12.78	1.6	0.59	273	100
Wholesale and retail trade, hotels and restaurants	249.5	36.90	373.9	55.29	50.1	7.41	2.7	0.40	676.2	100	409.1	34.70	680.2	57.70	83.7	7.10	5.9	0.50	1179	100
Finance, insurance, real estate, and business services	28.9	36.91	43.3	55.30	5.8	7.41	0.3	0.38	78.3	100	95.7	43.38	84.7	38.40	34.9	15.82	5.3	2.40	221	100
Government services	389.2	59.13	195.8	29.75	64.2	9.75	9	1.37	658.2	100	587.3	68.20	193.8	22.50	75	8.71	5.1	0.59	861	100
Other services	87.9	59.63	42.3	28.70	15.3	10.38	1.9	1.29	147.4	100	238.6	66.91	84.9	23.81	31	8.69	2.1	0.59	357	100
Total employed	**2725**	**56.57**	**1614**	**33.51**	**439.1**	**9.12**	**38.9**	**0.81**	**4817**	**100**	**3684.3**	**56.60**	**2187**	**33.59**	**594**	**9.13**	**44.5**	**0.68**	**6510**	**100**
Labour force	2921.3	57.18	1679.4	32.87	468.1	9.16	40.1	0.78	5108.9	100	4035	57.26	2319.4	32.92	645.7	9.16	46.4	0.66	7047	100
Unemployment	196.3	67.23	65.5	22.43	29	9.93	1.2	0.41	292	100	350.7	65.33	132.8	24.74	51.4	9.58	1.9	0.35	537	100
Unemployment rate	6.7		3.9		6.2		3.0		5.7			8.7		5.7		8.0		4.1		7.6

Source: Government of Malaysia, *Mid-Term Review of the Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: National Printing Department.

with 47 per cent in 1970 in Peninsular Malaysia. An overwhelming proportion of the Bumiputera are still in agricultural occupations and their share by the end of the decade, will remain at about three-quarters, the same level as at the start of the NEP. Bumiputera representation in key selected occupations has not shown very rapid progress as by 1990 they are estimated to form only about 46 per cent compared to about 44 per cent in 1980. When the proportion of registered professionals (such as doctors, architects, engineers and lawyers) are taken into account their under-representation is even more glaring: by the end of 1988, only a quarter of these registered professionals were Bumiputera, compared to 58.4 per cent and 14.3 per cent for the Chinese and Indians, respectively. All these findings can be summarized by the Duncan index of segregation which measures the extent of changes in the degree of occupational segregation.[11] Over the ten year period, 1980-1990, the surprising finding is that the Duncan index has increased from about 75 in 1980 to an estimated 84 in 1990, indicating that the degree of occupational segregation has increased.

3.4 Restructuring Ownership of Wealth

The interest and controversy in restructuring the pattern of ownership of wealth has dwarfed all other aspects of the NEP. Official sources, as shown in Table A1, indicate that there has been progress in the accumulation of share capital by the Bumiputera. Their ownership has increased from about 4 per cent in 1971 (M$279.6 million) to an estimated 20 per cent in 1990 (M$21,796 million), while Other Malaysians, mainly Chinese, have increased their share from 34 per cent in 1971 (M$2,233 million) to about an estimated 57 per cent in 1990 (M$ 63,124 million), and foreign residents have seen their share reduced to an estimated 23 per cent (M$26,326 million) in 1990 compared to 62 per cent (M$4,051 million) in 1971. These conclusions have been hotly disputed, especially by the other Malaysians, who argue that the statistics are somewhat fudged and stacked, unfairly, against the Other Malaysians and that it just cannot be right that the Bumiputera ownership is substantially lower than Other Malaysians. Including nominee companies and "locally controlled companies" under "Other Malaysians" naturally will inflate their proportion and all this statistical sleight of hand is misleading.[12] No solution appears to be in sight but one way out in reckoning ethnic breakdowns is simply to take out the offending "nominees" and "locally

[11]The Duncan index is derived as follows: $\Sigma[1(b)_i - 1(nb)_i]$ where 1(b) is the percentage of Bumiputera employed and 1(nb) is the percentage of non-Bumiputera employed, respectively, in a given set of occupations. The value of the index ranges from 0 (identical percentages) to 100 (complete segregation).

[12]In this running controversy, it pays to read the footnotes to the tables on ownership in the five-year development plans. They may seem innocuous but are really pregnant with information.

controlled companies", or if they are retained, to be apportioned by some acceptable rule, and re-estimate the ownership position. When this is done, rough estimates suggest a lowering of the share of Other Malaysians and a slight increase of that of the Bumiputera in limited companies but hardly inflating enormously the share of the latter.

If the large and listed companies are assessed, the Bumiputera have a slightly higher ownership stake in these companies. This is certainly not the end to the story. When control is introduced there could be a shift in the controlling position of the various ethnic groups throughout the economy, though in which particular direction it is difficult to foresee. Officially, and superficially, there is a reluctant admittance that when ownership and control are taken into account, the Bumiputera position appears a little better: they appear to control quite a bit of the banking, plantation and mining sectors. The precise extent of the corporate sector that is under control of the various ethnic groups is shrouded in mystery; the interlocking ownership structures, cross-holdings and nominee companies produce a Byzantine maze. When wealth is the issue it becomes even more complex. Wealth could cover a wide range of assets, tangible and non-tangible assets. Share capital is only a part of financial wealth. Tangible wealth includes land (agricultural and non-agricultural) and reproducible assets (dwellings, equipment, inventories, livestock and consumer durables). Valuation of these assets must be done if one is to have some sense of the value of the stock of wealth. There has been no such undertaking over the past years, so one is simply left very ignorant on the ownership of wealth in the economy.[13]

3.5 Entrepreneurial Development: Creating a Bumiputera Commercial and Industrial Community

Measuring, or assessing, the performance of entrepreneurship is not an easy task. How does one go about measuring success in creating a Bumiputera commercial and industrial community? "Input" and "output" indicators will have to be pieced together for a rudimentary assessment. The inputs that have gone into building up Bumiputera enterprises in commerce and industry have been very substantial, and one only has to look at the size of the financial allocations given to agencies such as MARA, PERNAS, SEDCs and UDA to be impressed by the financial resources that have gone into supporting the programmes of these trust agencies. Other input indicators such as the amount of loans and credit given out by financial institutions, also to the Bumiputera, tell the same story. Output indicators, a shorthand for performance and track record, however, tell a different story. On the basis of the performance of enterprises owned by trust agencies and private

[13]One survey, cited in the *Malaysian Business*, August 1-15, 1989, of listed companies on the KLSE has reported that when the "net worth" of the companies are taken into account, the Bumiputera share amounted to 35 per cent.

Bumiputera, the development of Bumiputera entrepreneurs has not been very impressive. A large number of companies in which the Government has interests has performed poorly and the prospects for salvaging them remain bleak. The recession years in the early eighties have affected badly Bumiputera enterprises, and the seriousness of the problem is shown by the fact that a rehabilitation fund for Bumiputera enterprises has been set up to assist enterprises in difficulties. A bright spot certainly has been the growing cadre of Bumiputera professionals in the economy who have managed to be ensconced in various sectors of the economy. Despite this, the stock of well-qualified Bumiputera managers remain dismally in short supply.

3.6 Income Distribution

The brief review of what has been happening to poverty, employment and ownership restructuring and Bumiputera entrepreneurial development can be brought together within the framework of the distribution of income. What has happened to the distribution of income? The statistics in Tables 3, 4, 5, 5A and 5B summarize the general trends in the distribution of income. Limitations of data severely limit how far and how much can be said on this sensitive topic and all that is said will be based on the income statistics that have been published in the five-year development plans and mid-term reviews.

There is a consensus that the distribution of income worsened, that is widened, and the level of poverty also increased in Peninsular Malaysia, between 1957-1970.[14] During the 1970s there had been little change in the distribution of household income but with some indications of a slight widening.[15] Evidence suggests that in Peninsular Malaysia inequality widened during the first half of the 1970s (1971-76) and from then on improved up to 1987. Taking the 17-year period as a whole with 1970 and 1987 as the terminal years, the distribution of income showed an improvement. Households in the bottom 40 per cent of the population increased their share of total income from 11.4 per cent in 1973 to 13.8 per cent in 1987. The three year period 1984-87 must be seen in the context of the recession years when growth slowed down.

What happened to the distribution of income in Sabah and Sarawak in the seventies remains uncertain but it is unlikely that it had improved. In the eighties, inequality narrowed but it was still higher when compared with Peninsular Malaysia. The profiles of rural and urban poverty seemed to be different in these two states. Inequality in both states seemed to be higher in the rural areas than in the urban areas by 1987. Rural inequality had increased probably up to the

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[14]See, for example, Snodgrass (1980), Lee (1975) and Tan (1982). On the difficulties with income statistics and whether anything can be said at all for the 1957-1970 period, see Anand (1983).

[15]For some views on what has been happening to income distribution, see Jomo and Ishak (1986).

Table 3
Peninsular Malaysia: Household Income of Bumiputera and Non-Bumiputera ($ per month)
1970-1987
(in constant 1978 prices)

Ethnic group		1970	1973	1976	1979	1984	1987	Average Annual Growth Rate (%) 1970-84	1970-87
Bumiputera	mean	276	334	379	474	616	614	6.2	4.9
	median	192	225	256	228	420	433	7.4	6.3
Non-Bumiputera	mean	613	720	811	864	1029	969	4.0	2.9
	median	401	453	495	576	738	682	4.8	3.5
Total	mean	423	500	565	668	792	760	4.6	3.8
	median	266	383	344	475	523	522	5.8	4.8

Sources: Government of Malaysia, *Fourth Malaysia Plan 1981-1985*, *Fifth Malaysia Plan 1986-1990* and *Mid-term Review of the Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: National Printing Department.

Table 4
Malaysia: Income Share of Top 20%, Middle 40% and Bottom 40% of Households by Stratum, 1984 and 1987
(%)

Household group	Peninsular Malaysia Total	Urban	Rural	Sabah Total	Urban	Rural	Sarawak Total	Urban	Rural
					1984				
Top 20%	53.2	52.1	49.5	54.6	51.7	52.8	54.8	54.2	51.5
Middle 40%	34.0	34.5	36.4	32.6	35.0	33.4	33.2	33.0	35.3
Bottom 40%	12.8	13.4	14.1	12.8	13.3	13.8	12.0	12.8	13.2
					1987				
Top 20%	51.2	50.8	48.3	52.6	49.4	52.2	52.3	49.2	51.3
Middle 40%	35.0	35.0	36.7	34.1	36.0	34.0	34.2	35.9	34.4
Bottom 40%	13.8	14.2	15.0	13.3	14.6	13.8	13.5	14.9	14.3

Sources: Department of Statistics, *Household Income Surveys*, 1984 and 1987.
Note: For Sabah, data includes the Federal Territory of Labuan.

Table 5
Peninsular Malaysia: Mean Monthly Household Income of the Top 20%, Middle 40% and Bottom 40% of Households by Ethnic Group and Stratum, 1984-1987
(in constant 1978 prices)

Ethnic group/ stratum	*1984 Mean income ($)* *Top 20%*	*Middle 40%*	*Bottom 40%*	*Total*	*1987 Mean income ($)* *Top 20%*	*Middle 40%*	*Bottom 40%*	*Total*
All ethnic groups	2110.00	674.00	252.00	792.00	1948.00	665.00	262.00	760.00
Bumiputera (B)	1600.00	536.00	205.00	616.00	1542.00	547.00	217.00	614.00
Chinese (C)	2776.00	947.00	381.00	1086.00	2478.00	910.00	381.00	1012.00
Indian (I)	1914.00	699.00	322.00	791.00	1819.00	692.00	325.00	771.00
Others (O)	5310.00	1551.00	233.00	1775.00	7530.00	1118.00	222.00	2043.00
Urban (U)	2907.00	962.00	370.00	1114.00	2640.00	909.00	367.00	1039.00
Rural (R)	1478.00	542.00	210.00	596.00	1460.00	554.00	225.00	604.00
*Disparity ratio (C/B)	1.74	1.77	1.86	1.76	1.61	1.66	1.76	1.65
*Disparity ratio (I/B)	1.20	1.30	1.57	1.28	1.18	1.27	1.50	1.26
*Disparity ratio (O/B)	3.32	2.89	1.14	2.88	4.88	2.04	1.02	3.33
*Disparity ratio (U/R)	1.97	1.77	1.76	1.87	1.81	1.64	1.63	1.72

Source: Government of Malaysia, *Mid-term Review of the Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: National Printing Department.
Note: * The disparity ratio is the ratio of two mean monthly household incomes.

Table 5A
Sarawak: Mean Monthly Household Income of the Top 20%, Middle 40% and Bottom 40% of Households by Ethnic Group and Stratum, 1984-1987
(in constant 1978 prices)

Ethnic group/ stratum	*1984 Mean income ($)*				*1987 Mean income ($)*			
	Top 20%	*Middle 40%*	*Bottom 40%*	*Total*	*Top 20%*	*Middle 40%*	*Bottom 40%*	*Total*
All ethnic groups	2064.00	627.00	226.00	754.00	2136.00	699.00	275.00	817.00
Bumiputera (B)	1332.00	474.00	188.00	531.00	1581.00	547.00	233.00	629.00
Chinese (C)	2949.00	1093.00	445.00	1205.00	2761.00	1093.00	465.00	1175.00
Others (O)	9793.00	5354.00	758.00	4403.00	6291.00	3318.00	706.00	2863.00
Urban (U)	3703.00	1126.00	438.00	1366.00	3082.00	1123.00	466.00	1252.00
Rural (R)	1585.00	544.00	204.00	616.00	1816.00	609.00	252.00	707.00
*Disparity ratio (C/B)	2.21	2.31	2.37	2.27	1.75	2.00	2.00	1.87
*Disparity ratio (O/B)	7.35	11.30	4.03	8.29	3.98	6.07	3.03	4.55
*Disparity ratio (U/R)	2.34	2.07	2.15	2.22	1.70	1.84	1.85	1.77

Source: Government of Malaysia, *Mid-term Review of the Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: National Printing Department.

Table 5B
Sabah: Mean Monthly Household Income of the Top 20%, Middle 40% and Bottom 40% of Households by Ethnic Group and Stratum, 1984-1987
(in constant 1978 prices)

Ethnic group/ stratum	*1984 Mean income ($)*				*1987 Mean income ($)*			
	Top 20%	*Middle 40%*	*Bottom 40%*	*Total*	*Top 20%*	*Middle 40%*	*Bottom 40%*	*Total*
All ethnic groups	2443.00	729.00	285.00	894.00	2187.00	709.00	276.00	832.00
Bumiputera (B)	1660.00	593.00	256.00	672.00	1545.00	579.00	250.00	641.00
Chinese (C)	4335.00	1703.00	688.00	1823.00	3766.00	1611.00	673.00	1677.00
Others (O)	5554.00	1825.00	540.00	2054.00	3528.00	1635.00	667.00	1627.00
Urban (U)	3643.00	1230.00	470.00	1409.00	2972.00	1081.00	440.00	1203.00
Rural (R)	1957.00	619.00	256.00	742.00	1935.00	630.00	255.00	741.00
*Disparity ratio (C/B)	2.61	2.87	2.69	2.71	2.44	2.78	2.69	2.62
*Disparity ratio (O/B)	3.35	3.08	2.11	3.06	2.28	2.82	2.67	2.54
*Disparity ratio (U/R)	1.86	1.99	1.84	1.90	1.54	1.72	1.73	1.62

Source: Government of Malaysia, *Mid-term Review of the Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: National Printing Department.

early eighties (1984) and remained at about that level until 1987, with urban inequality falling. Inequality in the rural areas in both states is higher in the rural than in the urban areas. The disparity ratios suggest that the level of inequality is higher in both states, especially in Sarawak, compared to Peninsular Malaysia.

The other two dimensions of inequality which have to be noted are inequality by stratum, that is, between the urban and rural areas, and between (including within) the ethnic groups. Inequality in Peninsular Malaysia in the urban areas at the beginning of the NEP was much higher than in the rural areas but towards the end of the 1980s, the rural-urban inequality gap narrowed, although overall, inequality was still higher in the rural areas.

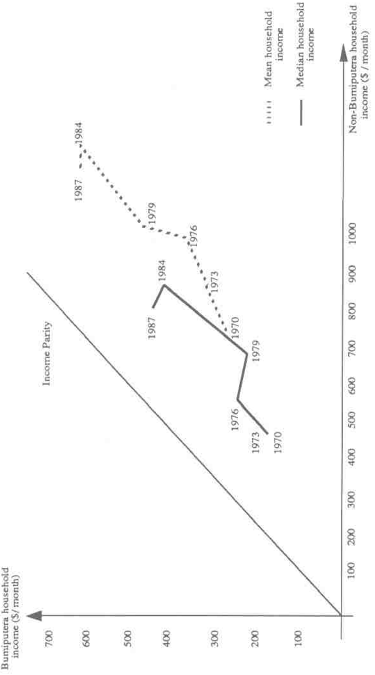
Growth has enabled all races to raise their income levels but at different rates, with the Bumiputera average household income growing at a higher rate than non-Bumiputera income. In 1970, Malay mean monthly household income was about 44 per cent of Chinese income and 56 per cent of Indian income, but by 1987 it had increased to about 61 per cent of Chinese income and 80 per cent of Indian income. This results in a Chinese:Malay income disparity ratio of 2.29 and a Indian:Malay disparity ratio of 1.77 for 1970 and 1.65 and 1.25, respectively, for 1987. Figure 1 shows the behaviour of inter-ethnic income imbalances for Peninsular Malaysia. There are no comparable data to show the trends in the ethnic income disparity ratio for Sabah and Sarawak. In 1987, the mean monthly household income of the Bumiputera was about 38 per cent of Chinese average income giving a disparity ratio of 2.6, and in Sarawak, Bumiputera average household income was about 53 per cent of Chinese average income giving a disparity ratio of 1.87.

Although evidence on the trends in intra-ethnic income inequality is difficult to come by, the available data suggest that over the 1970-87 period, inequality among the Bumiputera had increased and that the level of inequality was higher than among the non-Bumiputera by the end of the decade. In 1987, the disparity ratio (constant 1978 prices) between the top 20 per cent of households and the bottom 40 per cent of households for the Bumiputera was 7.1 compared to 6.5 for the Chinese and 5.6 for the Indians.

Some notions of inequality are not captured by ratios. Absolute differences can indicate a different dimension of inter-ethnic income imbalances. The data show that in 1970 the absolute difference in mean monthly household income (in constant 1970 prices) between the Chinese and Malays in Peninsular Malaysia was about M$222, increasing to M$350 in 1979, M$470 in 1984 and falling to M$398 in 1987. Thus, over the 17-year period the absolute difference in Chinese and Malay household income increased by almost 1.8 times.

Ethnic income imbalances are even more glaring when income levels by decile groups are compared within each ethnic group. In 1987, for all ethnic groups, the average income of the richest group, the top 20 per cent of households, was about 7.4 times that of the poorest group, the bottom 40 per cent of households,

Figure 1
Peninsular Malaysia: Household Income of Bumiputera and non-Bumiputera
(in constant 1978 prices)
1973-1987



Sources: Department of Statistics, *Household Income Surveys*, 1984 and 1987.

giving an absolute income difference of M$1,686, while the income of the middle class, the remaining 40 per cent, was two and a half times as much with an absolute income difference of M$403. The absolute difference in average incomes between the Chinese and the Bumiputera households in the top 20 per cent in Peninsular Malaysia was about M$936 and the comparable figures for the next 40 per cent and bottom 40 per cent were M$363 and M$164, respectively. The absolute income imbalances between the Bumiputera and Indians were smaller when compared with the Chinese: M$277 for the top 20 per cent, M$145 for the mid 40 per cent and M$108 for the bottom 40 per cent. In Sabah and Sarawak the absolute income imbalances, especially in Sabah, were larger than in Peninsular Malaysia.

4. Distributional Policies and Programmes

Before summarizing the policies and programmes it will be useful to note the strategy that was part of the NEP. What was the basic thrust of the development strategy in Malaysia for the NEP? The option chosen can be dubbed as the "redistribution through growth" strategy. The thinking behind the strategy was that development would be undertaken in such a manner that, in the process of growth and expansion, it would make maximum contribution to the achievement of national unity. An important provision of the strategy was for an interventionist state. This was a major departure from the previous approach to development but the SMP reassured that:

> "The Government will participate more directly in the establishment and operation of a wide range of productive enterprises. This will be done through wholly-owned enterprises and joint ventures with the private sector. Direct participation by the Government in commercial and industrial undertakings represents a significant departure from past practice. The necessity for such efforts by the Government arises particularly from the aims of establishing new industrial activities in selected new growth areas and of creating a Malay commercial and industrial community."

Achieving ethnic economic balance would have to be on the basis of "active participation" and through an expanding economy, and the elements of this strategy included the modernization of the rural sector, education, urbanization and regional balance.

Growth, it was recognized, was indispensable if progress was to be made on the equity front, but there was also a willingness to forgo some growth for the sake of equity. The "welfare function" had changed. There was, in hindsight, little discussion on options for development strategies; the generally *laissez faire* "trickle down" development strategy in the pre-1970 period was discredited and banking on market forces was simply no longer an acceptable option. It was this distrust of the past approach based on *laissez faire* values that provided the ideological push, and dictated the types of distributional policies and programmes that became acceptable.

It is helpful to make a distinction between two broad types of policies. First are those policies which have, in intention, broader economy-wide effects. The second type encompasses policies which are sectoral and tend to be more specific to certain areas in the economy. For the macro-type distributional policies, two policy instruments were used: quotas and prices. For the second type of policies and programmes, I think five major areas deserve attention: state intervention, or government in the economy; education and employment; capital and assets accumulation; agriculture and land development and industrial development.

The use of quotas has been the most pervasive policy instrument for redistributive purposes. Essentially, the idea is simply to impose some quantitative conditions on economic activities before they are allowed to function, or with conditions to meet the quota after a reasonable lapse of time. The examples are abundant: a percentage of the share capital to be reserved for Bumiputera, Other Malaysians and foreign interests (30:40:30 per cent, respectively); a certain quantitative profile for employment (reflecting the ethnic composition of the population at all levels); fixed proportions for Bumiputera and non-Bumiputera in university enrollment, distributorships, business premises, shophouses and loans. The desirable "outcome" or target has essentially become an important guiding principle in allocating the quota, the most famous of which has been the "at-least-30 per cent Bumiputera ownership of wealth". This target has in many instances been the basis for the allocation of resources reaching almost a threshold of about 30 per cent of everything.

Quotas have by no means been static. Sometimes another "layer" of quota is imposed, as for example, when state governments add on additional percentage points for the share capital of business premises to favour the residents of a particular state. There can also be "intra-ethnic quotas"; the requirement that a certain proportion of the settlers in a Federal Land Authority (FELDA) scheme should come from the state that is providing the land for the development scheme is such an example. Another is the Amanah Saham Unit (ASN) ceiling limit of $50,000 for unit trusts.

Quotas can be imposed, therefore, on both the demand and supply side. Enrollment quotas hit the supply side while employment on the basis of population shares takes care of the demand side. They are not symmetrical in the sense that, in this example of human capital and labour, enrollment at the tertiary level of education ignores proportional equality, that is, the enrollment criterion does not use the ethnic share in total population, while for the demand side, that is, employment, proportional equality is the final objective.

What are the likely effects of using quotas? Much will depend on the extent of their punitiveness, that is, whether transgressors are punished or otherwise. One effect is that the rush to fill the quotas has affected "quality", in a very broad sense. Enrollment criteria, because numbers matter, can and has, been lowered to fill in Bumiputera in the tertiary educational institutions. Additional entry conditions may be imposed to give a slight advantage to the preferred group and this may, or may not, always work. Language proficiency is one additional condition that will assist in filling the quota though that is not its intention. On the demand side, quality is affected when less qualified Bumiputera are employed to fill in the employment quota slots. Rational employers can minimize likely losses by "window dressing", that is, use Bumiputera labour in job slots which are less crucial or in the less critical areas. For capital, some quality in investment is lost if less commercially suitable Bumiputera are allocated the shares, or when "front-men" investors or "Ali-Baba" type investors receive the reserved shares or are brought in by investment partners who prefer relatively dormant Bumiputera investors.

The regulation of prices has also been used for redistributive purposes and is a useful way of channelling resources to a selected clientele. There are items which are subjected to price controls, such as those that cover essential commodities and guarantee a minimum price for padi. For padi, this has been an important "safety net" for the lower income groups and padi farmers and amounts to almost a scheme for guaranteeing a minimum income (at least a substantial portion of income) for the padi farming households. The price of capital is, to some extent, also regulated: the price of shares that are to be listed on the stock exchange are not freely determined by the capital market as the Capital Issues Committee (CIC) has a say in the final pricing of shares to be issued to shareholders, including the shares to be allocated to Bumiputera by companies which are undergoing restructuring. "Arms-length" and negotiated prices between willing buyers and willing sellers are always suspected of not really reflecting the "true" prices of the shares and usually a revaluation is conducted by government valuers. As the share prices tend to be lower than what usually are recommended by the companies, they tend to be oversubscribed, implying that they have been under-priced. Some houses and business premises for Bumiputera are sold at slightly lower prices and Bumiputera contractors applying for government contracts usually have a slight "price" advantage. The cost of loans to the Bumiputera under a number of loan schemes is also subsidized, and so the cost of capital to them is lower than for others.

Incentives have also been used, but to a limited extent, as a policy instrument for redistributive ends. Overall, under the Industrial Coordination Act, there has been an overlapping between the granting of investment incentives and the influencing of investors to comply with the targets for employment and ownership meeting the NEP conditions. But there have been specific distributive fiscal incentives encouraging establishments to have proportional equality in employment, encouraging investors to have at least 30 per cent Bumiputera ownership and distributorships and encouraging manufacturing plants to locate in the less developed areas. Many companies had enjoyed these fiscal incentives to restructure their employment and ownership structure. However, there have been some "perverse" effects in the sense that the original aim, as far as it can be fathomed, was to encourage the non-Bumiputera companies to restructure but the benefits had been enjoyed, substantially, by Bumiputera companies. These incentives have since been discontinued.

Consider now the micro-level policies and the distributive programmes which have been implemented. Few details will be mentioned here as these programmes have been reported in the various five-year development plans and the mid-term reviews. A very significant strategy and policy thrust for the NEP was in the assigned role of the state in industrial development. This represented a radical shift in development thinking in post-war Malaysia. The premise of the policy shift was quite simply the mistrust of the reliance on free enterprise and the workings of market forces. The state as an entrepreneur became increasingly fashionable and the seemingly unlimited resources, aided by the revenues from oil, made it appear so easy. There was a tremendous sense of optimism: state expansion took a number of forms. Public enterprises in numerous sectors of the economy, especially in manufacturing and commerce, and government interests in banks, increased throughout the seventies and spearheaded state intervention in the economy. The decade saw the strengthening of existing agencies, the establishment of a number of public enterprises and trust agencies such as MARA, PERNAS, SEDCs, UDA, Bank Bumiputera, Bank Pembangunan, FIMA, PNB, and rising public sector investment in other private corporations. Regional authorities that would give the push to improving regional balance were also established. These agencies in turn gave birth to hundreds of companies (an estimated 900) that were involved in a variety of economic activities. For the SMP, the total public sector development expenditure allocated amounted to \$10,255 million, increasing to \$36,722 million for the Third Malaysia Plan, \$80,331 million for the Fourth Malaysia Plan and a reduced allocation of \$57,512 million for the Fifth Malaysia Plan.

With rare exceptions, the record of public enterprises has been quite dismal. Shielded by competition, amply protected with preferential access to finance and other resources, public enterprises have fulfilled the low expectations of critics of government intervention in the economy. Sustaining state intervention in the economy has demanded substantial financial resources. However, the supply of financial resources in the 1970s to finance the growth of the public sector has not been the key limiting factor. Instead, the supply of able and qualified manpower has been a major constraining factor in the performance of public enterprises. But the "financial crunch" arising from the recession years of the early 1980s forced a very sharp cutback in public spending. Wastage had been quite rampant among many public enterprises due to the lack of clear accountability and control.

The phenomenal growth of the state during the decade of the 1970s had been fostered by a belief in a seemingly unlimited supply of financial resources and excessive optimism with the capabilities of the state as an entrepreneur. A mixture of vested interests, combined with the use of public enterprises as a source of patronage and employment opportunities for bureaucrats, made it difficult to check the rapid growth of such bodies. At the same time, the growth of the public enterprises in each state through the SEDCs, for example, made it difficult to co-ordinate and control the expansion of the activities of government in industry and commerce, resulting in duplication and waste. The number of unprofitable subsidiaries of public enterprises is a measure of this failure.

Policies and programmes for education and employment, or what is now fashionably called "human resources development", occupied a strategic part in the distributive programmes. Faith in educational advancement as a means of raising the income of the Bumiputera has a long history. Much of the worry and concern was over the supply of educated and trained manpower to meet the needs of the growing economy and the restructuring of employment in industry and commerce. As has been mentioned earlier, educational policies and programmes were supposed to take care of the supply problem, while employment would deal with that of demand.

There has been, during the past two decades, a tremendous growth in number of educated Bumiputera. There is no doubt the quota policy together with the expansion in higher education, especially university education, succeeded in increasing the supply of educated Bumiputera. Far more Bumiputera now are educated in the sciences, a major worry at the beginning of the NEP. Yet, these successes have bred new worries and problems, the most outstanding of which is the concern with the quality of the educational system and the quality of the educated manpower, Bumiputera as well as non-Bumiputera. Rapid expansion and the need to incorporate a variety of exigencies have stretched the educational system, and declining educational standards have raised the spectre of an entrenched decline in the quality of manpower. There is also the mismatch of manpower. And the overhang of the educated unemployed, especially degree holders, is a reminder of the labour problem.

On the demand side, the hiring quota has become the key policy instrument for providing the Bumiputera with non-agricultural jobs. The quota takes for granted that there are discriminating employers, that is, those who have a "taste for discrimination" and are therefore not ethnically blind. The quota has in fact had an impact, getting more Bumiputera into jobs in the modern sector, but it has also had some unintended effects. There is substantial overcrowding of Bumiputera in the unskilled occupational groups and, as mentioned earlier, occupational segregation is still very much alive, because it is always easier and less painful to restructure the lower level occupations. It is the height of folly to expect non-Bumiputera employers to drastically alter their higher level occupations, and the supply reason for not filling in the top-level occupations, that is, a shortage of qualified Bumiputera, was the erstwhile scapegoat. The workings of the internal labour market also provide ample opportunities for the employer to indulge in his labour tastes. Even so, it seems that the scale of establishments appears to have something to do with the hiring of Bumiputera labour: the larger the establishment the more Bumiputera are employed, a hardly startling revelation.

Capital and asset accumulation occupied a disproportionate amount of attention. Quota policies worked, to an extent, but with all sorts of costs. The policies and programmes were quite simple and clear: encourage and regulate the private sector to ensure that Bumiputera have at least 30 per cent of the share capital of limited companies. There were two overlapping concerns: (a) the low level of Bumiputera income and savings, and "different" investment preferences, and (b) the "get rich quick windfall" worry, or retention failure, because the Bumiputera would sell-off their shares as soon as they receive their quota. Both problems, it was believed, could be solved in an institutional swoop: create an institution that would acquire shares on the behalf of Bumiputera, and then re-allocate these shares to Bumiputera on condition that the recipients cannot sell them off on the open market, that is, create a parallel capital market with a trustee investment company providing the link with the local capital market. PNB fulfilled all these functions and by the end of the 1980s, more than two million Bumiputera had become shareholders of PNB Amanah Saham Nasional, a unique unit trust scheme reserved only for the Bumiputera.

All this was complemented by another parallel track for capital accumulation, the strategy of taking-over foreign-owned companies by trust agencies. Acquisition of foreign companies had some advantages: it was faster, it was there for the taking, and less politically sensitive. The other option was to take-over Chinese corporations. In not going along this sensitive route, there was an element of self-selection in the take-over strategy.[16] The strategy of taking-over foreign companies was bold and costly; the take-over of Guthrie Corporation, for example, amounted to about \$1.2 billion, and the take-over of Harrisons and eight other related companies, \$800 million.

Agricultural and industrial policies and programmes played an important part in the package of distributional policies and programmes. Essentially, the approach was to accelerate the growth of both sectors and to promote "intersectoral shifts" in the economy, so as to enable the absorption of Bumiputera, who were in traditional, low income, and low productivity agricultural activities, into modern, high income, and highly productive industrial sector activities. Urbanizing the Bumiputera was also part of this development package. These broad strategic and policy thrusts seemed to have, to a very large extent, worked. There is, I think, little that was new or radical about the agricultural programmes that were implemented. Agricultural and land development programmes were pushed hard after 1970 but it was, essentially, more of the same. In the SMP,

[16]Recall the recent take-over bid of Multi-Purpose Holdings Bhd. by Hume Industries Bhd.

FELDA's land development target was set at 1.2 million acres and it exceeded its target. More land came under oil palm but rubber continued to be cultivated in the land schemes. In the second half of the 1970s, about 886,000 hectares were developed by FELDA and 31,000 by the Rubber Industry Smallholders Development Authority (RISDA), while other schemes were developed as joint-ventures.

The apparently successful land development formula gradually revealed some of its costs. Settler policy was prone to be too patronizing; settlers moved into an almost quasi-turnkey land development project and settling-in, despite hardships, was made easier. The costs of land development were increasing, due largely to shortage of relatively accessible land. The "second-generation" problem, a phenomenon reflecting the change in preferences of the children of settlers became increasingly worrisome. The administrative costs of FELDA were also hefty. Growth and structural changes in agriculture led to the emergence of labour shortage in some areas and occupations.

Industrialization helped alleviate poverty by absorbing the poor rural households, and aided restructuring by absorbing the low income Bumiputera households into the modern sectors. The rapid growth of labour-intensive manufacturing industries, particularly electronics and textiles, beginning in the early 1970s, played an important part in creating substantial employment opportunities during the 1970s; as many as 496,700 new jobs. In the 1980s, 402,000 new jobs were created by the manufacturing sector so that by the latter part of the 1980s, the manufacturing sector (which contributed to a quarter of the GDP) was larger than the agriculture sector. The earlier scepticism that industrial growth would bring disproportionately larger benefits to the non-Bumiputera seemed to have been dispelled, mainly impelled by the need to accelerate the growth of new job opportunities in view of the high rate of unemployment. Inequality in the manufacturing sector along with commerce was higher than in the other sectors, but industrialization has helped the Bumiputera to increase their income. However, the regional dispersal of industries was not a great success.

5. Conclusion

This brief tour of the Malaysian experience in dealing with distributional problems has been, by choice, selective and incomplete. Inevitably, for such a wide subject, I had to impose some severe self-constraints. Nevertheless, I think, the Malaysian experience is an interesting and engaging development story with some warts and some lessons that might be useful for other economies that are faced with a similar set of developmental problems. Is the Malaysian experience *sui generis*? I very much doubt this to be so. Although the full story has yet to be told, the broad evidence is so far, I think, quite robust for some generalizations to be made. Some lessons are worth taking note.

First, the Malaysian experience suggests that economic growth has made a big difference to the level of poverty and inequality in the economy. Growth has been beneficial and it has, as far as we can tell, not been immersing for the poor. Second, somehow Malaysia has also succeeded in the slow growth and lean years of the early 1980s, when growth declined dramatically. In cushioning the impact of slow growth and the cut-back in development expenditures on the poor households, absolute income declined but the effects appear not to have hit hard on the poor in the economy. Structural adjustments and liberalization have, so far, not shown any negative impact on poverty. All these need to be assessed and looked into more closely. Third, the state had an important hand in the growth and equity story over the last twenty years or so. For an intractable plural society with layers of segmentation, and with the twenty-year agenda of societal restructuring, the other options would have appeared to be too soft. But for all its veneer of "radicalism", the state's role in many respects, I think, has had more in common with a reformist movement rather than a radical one. Even so, its activities required substantial resources and, in the overworked phrase, political will. There was, for example, no land reform to speak of, if that is an indicator of radicalism. Also there was no nationalization, in the traditional sense of the word, of economic enterprises, but much concern, to a large extent, with market transactions in taking over and restructuring companies. Fourth, there is no guarantee that in a plural society like Malaysia, success in bringing down the statistically defined levels of poverty and inequality in income would improve race relations. That says something about growth, development and their influence on race relations: there is no guarantee that high growth, low poverty and narrowing inequality would do wonders for race relations. Finally, there is an intriguing and nagging question. Was the "timing" of the NEP good? That is, was the economy already in an "income equalizing" phase, so that the policies and programmes worked because the phase made it easier?

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Table A1
Malaysia: Ownership of Share Capital (At Par Value) of Limited Companies, 1971-1990
($ million)

Ownership group	*1971*	*%*	*1980*	*%*	*1985*	*%*	*1990*	*%*	*Average Annual Growth Rate (%) 1972-80*	*Average Annual Growth Rate (%) 1986-90*
Malaysian residents	*2,512.80*	*38.28*	*18,493.40*	*57.04*	*57,666.60*	*73.97*	*84,920.70*	*76.32*	*20.90*	*8.00*
Bumiputera individuals and trust agencies	279.60	4.26	4,050.50	12.49	14,883.40	19.09	21,796.20	19.59	31.40	7.90
Bumiputera individual	168.70	2.57	1,880.10	5.80	9,103.40	11.68	15,084.20	13.56	23.50	10.60
Trust agencies	110.90	1.69	2,170.40	6.69	5,780.00	7.41	6,712.00	6.03	39.00	3.00
Other Malaysian residents	2,233.20	34.02	14,442.90	44.55	42,783.20	54.88	63,124.50	56.73	18.80	8.10
Chinese					26,033.30	33.39	36,116.00	32.46		6.80
Indian					927.90	1.19	1,297.10	1.17		6.90
Others					987.20	1.27	1,044.80	0.94		1.10
Nominee companies					5,585.10	7.16	9,517.90	8.55		11.30
Locally controlled companies					9,249.70	11.86	15,148.70	13.61		10.40
Foreign residents	*4,051.30*	*61.72*	*13,927.00*	*42.96*	*20,297.80*	*26.03*	*26,325.80*	*23.66*	*13.30*	*5.40*
Share in Malaysian companies	2,159.30	32.90	7,791.20	24.03	12,672.80	16.25	17,284.80	15.53	14.20	6.40
Net assets of local branches	1,892.00	28.82	6,135.80	18.93	7,625.00	9.78	9,068.00	8.15	12.30	3.50
Total	*6,564.10*	*100*	*32,420.40*	*100*	*77,964.40*	*100*	*111,273.50*	*100*	*16.70*	*7.90*

Source: Government Malaysia, *Mid-Term Review of the Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: National Printing Department.

Table A2
Peninsular Malaysia: Disparity Ratio and
Absolute Income Imbalances (1970-1987)
(in constant prices)

Year	*Disparity ratio*[1]			*Absolute income imbalances*[2]		
	C/B	*I/B*	*C/I*	*C-B*	*I-B*	*C-I*
1970[3]	2.3	1.8	1.3	222	132	90
1973[3]	2.2	1.7	1.3	252	143	109
1976[3]	2.3	1.6	1.5	303	132	171
1979[3]	1.9	1.5	1.2	269	159	110
1984[3]	1.8	1.3	1.4	294	110	184
1984[4]	1.8	1.3	1.4	470	175	295
1987[4]	1.6	1.3	1.3	398	157	241

Sources: Government of Malaysia, *Fourth Malaysia Plan 1981-1985*, *Fifth Malaysia Plan 1986-1990* and *Mid-Term Review of the Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: National Printing Department.

Notes: [1]The ratio of the mean monthly household income among the three major ethnic groups where C = Chinese, B = Bumiputera and I = Indian.
[2]The difference between the mean monthly household income of the three major ethnic groups.
[3]Data in constant 1970 prices.
[4]Data in constant 1978 prices.

Table A3
Peninsular Malaysia: Employment by Occupation and Ethnic Group, 1970
(percentages)

	Ethnic Group			
Occupation	*Bumiputera*	*Chinese*	*Indian*	*Others*
Professional and technical	47.0	39.5	10.8	2.7
Administrative and managerial	24.1	62.9	7.8	5.2
Clerical and related workers	35.4	45.9	17.2	1.5
Sales and related workers	26.7	61.7	11.1	0.4
Service workers	44.3	39.6	14.6	1.5
Agricultural workers	72.0	17.3	9.7	1.0
Production, transport and other workers	34.2	55.9	9.6	0.3
Total	51.8	36.6	10.6	1.0
Population proportion	52.7	35.8	10.7	0.8
*Proportional equality index of employment by occupation**				
Professional and technical	0.89	1.10	1.01	3.38
Administrative and managerial	0.46	1.76	0.73	6.50
Clerical and related workers	0.67	1.28	1.61	1.88
Sales and related workers	0.51	1.72	1.04	0.50
Service workers	0.84	1.11	1.36	1.88
Agricultural workers	1.37	0.48	0.91	1.25
Production, transport and other workers	0.65	1.56	0.90	0.38
Total	0.98	1.02	0.99	1.25

Source: Government of Malaysia, *Fourth Malaysia Plan 1981-1985*, Kuala Lumpur: National Printing Department.

Note: *The proportional equality index is calculated by dividing the percentage of the ethnic group employed in each sector/occupation by the ethnic proportion in the population.

Table A4
Peninsular Malaysia: Employment by Occupation and Ethnic Group, 1980
(percentage)

Ethnic Group *Occupation*	*Bumiputera*	*Chinese*	*Indian*	*Others*
Professional and technical	53.7	32.6	11.9	1.8
Administrative and managerial	28.7	62.5	6.1	2.7
Clerical and related workers	52.4	36.6	10.4	0.6
Sales and related workers	32.1	60.1	7.6	0.2
Service workers	54.0	33.7	11.5	0.8
Agricultural workers	69.5	18.1	11.4	1.0
Production, transport and other workers	43.7	44.6	11.3	0.4
Total	53.0	35.3	10.9	0.7
Population proportion	55.1	33.9	10.3	0.7
*Proportional equality index of employment by occupation**				
Professional and technical	0.97	0.96	1.16	2.57
Administrative and managerial	0.52	1.84	0.59	3.86
Clerical and related workers	0.95	1.08	1.01	0.86
Sales and related workers	0.58	1.77	0.74	0.29
Service workers	0.98	0.99	1.12	1.14
Agricultural workers	1.26	0.53	1.11	1.43
Production, transport and other workers	0.79	1.32	1.10	0.57
Total	0.96	1.04	1.06	1.00

Source: Government of Malaysia, *Fourth Malaysia Plan 1981-1985*, Kuala Lumpur: National Printing Department.

Note: *The proportional equality index is calculated by dividing the percentage of the ethnic group employed in each sector/occupation by the ethnic proportion in the population.

Table A5
Malaysia: Employment by Occupation and Ethnic Group, 1980
(percentages)

Occupation	*Ethnic Group*			
	Bumiputera	*Chinese*	*Indians*	*Others*
Professional and technical	53.7	33.8	10.3	2.1
Administrative and managerial	28.6	63.6	4.9	2.7
Clerical and related workers	52.3	37.9	8.9	0.9
Sales and related workers	31.1	62.0	6.7	0.2
Service workers	55.4	33.4	10.0	1.2
Agricultural workers	73.5	16.9	8.8	0.8
Production, transport and other workers	45.5	43.9	10.1	0.5
Total	56.6	33.5	9.1	0.8
Population proportion	55.1	33.9	10.3	0.7
*Proportional equality index of employment by occupation**				
Professional and technical	0.97	1.00	1.00	3.00
Administrative and managerial	0.52	1.88	0.48	3.86
Clerical and related workers	0.95	1.12	0.86	1.29
Sales and related workers	0.56	1.83	0.65	0.29
Service workers	1.01	0.99	0.97	1.71
Agricultural workers	1.33	0.50	0.85	1.14
Production, transport and other workers	0.83	1.29	0.98	0.71
Total	1.03	0.99	0.88	1.14

Source: Government of Malaysia, *Mid-term Review of Fourth Malaysia Plan 1981-1985*, Kuala Lumpur: National Printing Department.

Note: *The proportional equality index is calculated by dividing the percentage of the ethnic group employed in each sector/occupation by the ethnic proportion in the population.

Table A6
Malaysia: Employment by Occupation and Ethnic Group, 1990
(percentages)

	Ethnic Group			
Occupation	*Bumiputera*	*Chinese*	*Indians*	*Others*
Professional and technical	55.6	30.3	12.1	2.0
Administrative and managerial	27.5	66.6	5.0	0.9
Clerical and related workers	55.1	35.2	9.2	0.5
Sales and related workers	38.2	55.7	6.0	0.1
Service workers	59.0	29.4	10.4	1.2
Agricultural workers	75.6	16.4	7.5	0.5
Production, transport and other workers	45.8	42.3	11.3	0.6
Total	56.6	33.6	9.1	0.7
Population proportion	61.9	29.4	8.1	0.6
*Proportional equality index of employment by occupation**				
Professional and technical	0.90	1.03	1.49	3.33
Administrative and managerial	0.44	2.27	0.62	1.50
Clerical and related workers	0.89	1.20	1.14	0.83
Sales and related workers	0.62	1.89	0.74	0.17
Service workers	0.95	1.00	1.28	2.00
Agricultural workers	1.22	0.56	0.93	0.83
Production, transport and other workers	0.74	1.44	1.40	1.00
Total	0.91	1.14	1.12	1.17

Source: Government of Malaysia, *Mid-term Review of the Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: National Printing Department.

Note: *The proportional equality index is calculated by dividing the percentage of the ethnic group employed in each sector/occupation by the ethnic proportion in the population.

A MATRIX FOR CONSIDERING POLICY OPTIONS AFTER 1990

Yong Poh Kon and Lim Lin Lean

This paper attempts to clarify basic ideas about restructuring and distribution of growth. It seeks to develop a systematic framework that considers both these issues and which would describe clearly the options and directions of the post-NEP economic policy.

1. Introduction

The very active discussion of Malaysia's economic options after 1990 shows that we Malaysians are attempting to arrive at some kind of social contract in which we seek a just, equitable and efficient aggregation or resolution of our economic interests. To date, much of the debate has had strong racially-biased overtones because of the preoccupation with a system of forced restructuring based on a political formula for ethnic shares of the economic pie. Rather than quibble over past achievements or shortfall of the restructuring targets under the New Economic Policy (NEP) or suggest a political compromise for dividing up the Malaysian economy in the future, what this paper attempts to do is to clarify some basic ideas and principles which could help us consider more systematically the sort of economic and social system that should evolve in the coming decades. While these are nascent ideas that do not represent a complete answer to the economic challenges ahead, we hope that your reactions and suggestions at this academic forum will help to shape them further, and perhaps into tangible economic strategies.

The paper discusses how these principles have been interpreted or put into effect in the Malaysian economy over the past two decades. It then translates them into a matrix of possible options open to Malaysia for determining its future economic scenario(s). This matrix is based on a classification of different sectors of economic endeavour by type: those amenable to government intervention aimed at guaranteeing market and those characterized by parameters that leave outcomes highly risk-related or uncertain, and a classification of various approaches that could be used to influence the outcomes: from exclusionist or quota-based policies, to needs and means tests, to free market competition and liberalized policies based on meritocracy. We then go on to consider the implications of moving from the interventionist/discriminatory to the freely competitive quadrants of the matrix. The last part of the paper suggests that there should be an independent commission to help determine and monitor the types of activities and policies that go into the different quadrants of the matrix.

2. Distinguishing between Opportunities and Outcomes

One of the main reasons why it is necessary to begin by setting out some fundamental principles is because implicit in any consideration of distributional issues is some normative judgement about equality or justice. When we talk about a just and fair society for all Malaysians, or when we consider how the economic pie should be divided whether among individuals or ethnic groups, our redistributive preferences obviously vary widely, shaped by where each of us are on the income and wealth scale and by what we see to be an "optimum" distribution at a point of time or an "improvement" over time. It would therefore be appropriate to begin by reminding ourselves that justice as a form of fairness does not imply a case for absolute equality, but that existing inequalities need to be understood in terms of principles agreed in advance.

> "The equality which all thinkers emphasize as desirable is not equality of capacity or attainment, but of circumstances, institutions and manner of life. The inequality which they deplore is not inequality of personal gifts, but of the social and economic environment.... Their view, in short, is that, because men are men, social institutions — property rights, and the organization of industry, and the system of public health and education — should be planned, as far as is possible, to emphasize and strengthen, not the class (and, we should add, race) differences which divide, but the common humanity which unites them" (Tawney, 1964).

Perhaps the most fundamental principle we should agree upon is that while there should be equality of opportunity, there cannot be equality of outcomes in any society or economy. A government can attempt to give equal opportunities or to take steps to equalize the starting out point for all its citizens, but it cannot guarantee all end results or market outcomes. The underlying consensus behind the NEP was that the Bumiputera community was handicapped *vis-a-vis* the other communities in the country in terms of initial access to basic economic and human resources and that such inequality should be redressed through giving them equality of opportunities but there was never any agreement, explicit or implicit, to assure specific market outcomes, especially at the micro-level.

The concept of equality of opportunities however, needs to be clarified. Inequalities exist because the dynamic processes which produced them have made them that way; these dynamic processes are the interplay of two main sets of factors: personal factors pertinent to an individual and group factors due to the context or environment in which the individual has to live and compete. The personal factors relate to innate ability, intelligence, ethnic group membership, work and savings ethics and attitudes, etc. While public policies may not be able to change innate abilities, they can have an important influence on acquired personal factors like education and skill, and work and savings ethics and attitudes. It is important, therefore, that in attempting to equalize opportunities for the disadvantaged through modifying the environment, positive attitudes and ethics are reinforced. The environmental factors, on the other hand, are shaped by long historical processes and public policies; but since world and market environments are inherently insecure even tight controls and regulations may not be able to guarantee specific outcomes.

In pursuit of the equality-of-opportunities ideal, several ideas are basic but worth reiterating:

i) First, people should not be penalized for the accidents of birth. We do not choose to be born Malay, Chinese, Indian, Iban or Kadazan nor can we choose our innate characteristics that might make for economic success or non-success — these are the *strict parameters* that cannot be changed by public policies. Similarly, current generations should not be penalized for the events of history — we cannot quote the mistakes of our colonial past nor the date of arrival of our forefathers in this country to justify perpetuation of new forms of discrimination.

ii) Of course, human qualities are not completely innate — they rest partly on elements subject to the individual's motivation to make an effort to seize available opportunities or to apply himself in various fields of human endeavour. There are certain variables strictly open to deliberate choice of the individual. It is these choice variables that can be influenced by public incentives/disincentives. Education is clearly a crucial factor that determines both an individual's opportunities and how he responds to these opportunities.

iii) How individuals respond to opportunities differs; businessmen, for example, could make the most of their own entrepreneurial or creative energies, or they may attempt to lobby for a more restrictive environment to reduce competition and to use administrative protection or regulations to assure themselves of outcomes with an element of economic rent. They could concentrate on genuine economic enterprise or on political dealings, work within the "system" or attempt to influence the system to their own advantage. In attempting to influence the "choice variables", the task of public policy should therefore be to motivate individuals to be economically efficient rather than to rely on political patronage.

iv) There is no genetic evidence that intelligence and qualities of leadership, industry or sloth are the domain or prerogative of any ethnic group — there is a randomness in the distribution of such qualities within any given population. The concern should therefore be for inter-personal and intra- rather than inter-group inequalities, for poverty reduction irrespective of race rather than for racial shares.

The rationale for attempting to equalize opportunities should be founded on the tacit or explicit understanding by all members of the society that glaring disparities are unjust, unfair or inefficient in terms of the common or national good. Given the fact of inequality of personal factors, the challenge becomes how to offer equality of treatment in the environment. In this context, the rules of allocation and the rules of distribution have to be distinguished. In a *laissez faire* economy, the market would be the allocation device. But with state intervention, deliberate rules or regulations determine the allocation or distribution of economic benefits (or burdens) among persons or groups in the society. Rules of allocation defining *who should be eligible for or have access to* benefits, such as a means or needs test for agricultural subsidies or scholarships, would be adequate if the aim is to ensure an equal head start for everyone in a particular field of human endeavour (which is what true equality of opportunity is all about). But such rules of allocation may not guarantee the final distribution of the particular benefit or burden. Very strict rules of distribution (or redistribution) — reservation of certain rights or privileges, exclusionist policies, inflexible quotas, tax structures — would be needed if the intention is to protect and guarantee a particular distributional outcome of *who actually has what and how much*.

Yet, there can be no true justice in equality of opportunity on the basis of rigid rules of distribution. To attempt to guarantee a distributional outcome by enforcing rules of distribution rather than offering equal access to opportunities would in the longer term deny some individuals the full benefits of their personal potentials and the society the benefits of their entrepreneurship, creativity, initiative, hard-work, etc. It is along these lines that the restrictive aspects of the NEP, especially on the competitive environment in Malaysia, need to be reviewed:

> "Equality of opportunity obtains in so far as, and only in so far as, each member of a community, whatever his birth, or occupation or social position, possesses in fact, and not merely in form, equal chances of using to the full his natural endowments of physique, of character and of intelligence" (Tawney, 1964).

It is also from these perspectives that we have to be clear about what have been rules of allocation and what have been rules of distribution under the NEP, and what should be the appropriate rules for the post-1990 era — have we been trying and should we try to offer equality of opportunity or to force equality of outcomes?

Following from the above discussion, it is necessary to emphasize that there are different types of outcomes in the economic system. Certain economic activities can be isolated from inherent market risks by government intervention so that their outcomes can be pre-determined with a certain amount of certainty. But others hinge on innate characteristics of individuals and on how they respond to opportunities or are subject to unavoidable risk elements, so that the end results are uncertain. The distinction is crucial because it does away with the erroneous assumption that greater and greater government intervention in the market can guarantee quantitative targets for market outcomes in all types of economic activities.

3. Self and the Environment

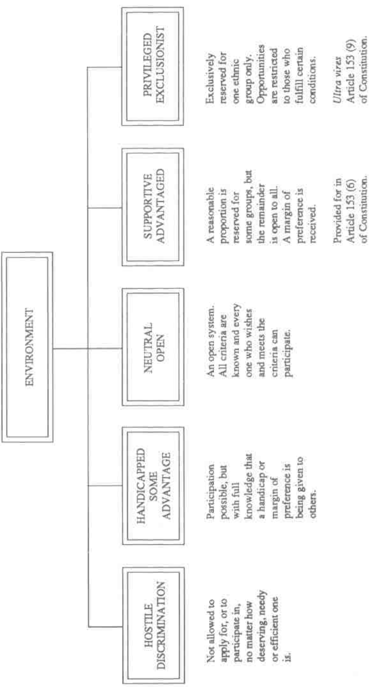
Given that opportunities and outcomes in any society or economy hinge on personal and environmental factors, government intervention has focussed on modifying the parameters of the economic and social environment. Environmental factors can compensate for, substitute for, or exacerbate the inequalities inherent in personal characteristics. Deliberate attempts to manipulate the environment, such as NEP restructuring, could move Malaysia either toward or away from what the "common good" would dictate as greater equality or other desirable objectives. It is therefore important to understand the types of environments that could interact with personal factors to influence economic outcomes.

Environmental factors, as shown in Figure 1, can be thought of as either neutral, supportive or discriminatory in terms of how they are likely to influence economic opportunities and outcomes. The neutral environment would be one where opportunities are open to all and the rewards from these opportunities are granted on the basis of merit. Neutral environmental factors would essentially be consistent with a *laissez faire* system. In the 1960s and early 1970s, the Malaysian economy was based very much on competitive markets and limited intervention by government. The government role was limited to the provision of infrastructure, law and order and social services, and economic success was seen as the concern of private individuals and not the direct responsibility of government. Since then, with the NEP, the system has shifted from a traditional market-oriented economy to a regulated mercantilist/corporatist economy (Kasper 1988). In the last few years, the increasing calls for greater liberalization and deregulation of the Malaysian economy represent attempts to neutralize the environment for carrying out business activities.

The other boxes in the diagram incorporate rules of allocation or rules of distribution which represent attempts (differing in degree of coercion or restriction) to equalize the environment for the Bumiputera to bring them on par economically with the non-Bumiputera. Certainly, they reflect a shift away from free market forces and a greater government role and intervention. The environment could be one supportive of the Bumiputera community, with a reasonable proportion of economic opportunities reserved for the Bumiputera or giving them an advantage through allowing a margin of preference, as for example, in loans and tenders. The rationale for the supportive system is to offer some privileges or head start to the least economically advantaged so as to balance out initial weaknesses. These privileges are, however, not meant to perpetuate new forms of inequalities or, worse yet, to ensure dominance of one group over another.

Although the reservation of reasonable proportions is provided for in Article

Figure 1
Types of Policy Environments
Confronting Those Engaged in Economic Activities



153 (6) of the Malaysian Constitution,[1] the issue is what would represent "reasonable proportions". While it might be reasonable to have representation in a particular economic sector of at least half but not exceeding the share of that particular ethnic group's overall population proportion of the state or country, it would be unreasonable to reserve the total sector exclusively for that community. What should also be noted is that the reservation of reasonable proportions was defined in the Constitution to refer only to positions in the public service, government scholarships and education and training, and permits and licences for a trade or business as required by Federal law; and that they were originally meant (in the Reid Commission Report) to end fifteen years after Independence. They have, instead, been extended in the NEP until 1990. The question, now, is whether they should be extended further in the post-1990 era, for how long and whether the extension should be final.

For the public environment to be supportive rather than discriminatory in terms of promoting true equality of opportunities, other elements are essential. The policies intended to help the disadvantaged group(s) must be temporary in nature, with the time frame for support clearly spelled out. The quantum of support must be public knowledge; and where the quantum of support was initially large, this should be reduced over time ideally to a point where the supported group(s) or individuals can stand on their own and be economically viable units. We emphasize this point because it is crucial that affirmative action or supportive policies do not end up creating a subsidy mentality, dependency syndrome or constant reliance on a "safety net" provided by the Government.

Many of the provisions under the NEP have been based on pre-determined proportions including: the 55:45 ethnic formula for admission into institutions of higher learning; the provision that 30 per cent of the value of all government public works be allocated to Bumiputera contractors; the stipulation that all public works contracting companies must have a majority or at least 51 per cent of the board of directors, equity holdings and workers who are Bumiputera; insistence on 30 per cent Bumiputera equity as the condition for full exemption from the import duty on raw materials and components; the stipulation that approval for new company acquisitions needs to be obtained from the Foreign Investment Committee (FIC) and/or Capital Issues Committee (CIC) and that at least 30 per cent of shares be reserved for Bumiputera; and the reservation of at least 30 per

[1]Article 153 (6) states that "where by existing federal law a permit or licence is required for the operation of any trade or business the Yang di-Pertuan Agong may exercise his functions under that law in such manner or give such general directions to any authority charged under that law with the grant of such permits or licences, as may be required to ensure the reservation of such proportion of such permits or licences for Bumiputera and natives of any of the States of Sabah and Sarawak as the Yang di-Pertuan Agong may deem reasonable; and the authority shall duly comply with the directions".

cent of new housing schemes for Bumiputera applicants before approval for development is given.

These various reserved proportions which represent increasing intervention of the Government in economic markets have been justified as assisting the efforts of the Bumiputera to catch up with the other ethnic groups in the country. But obviously where the proportions reserved are not "reasonable" or where opportunities are denied to those who do not conform to the mandatory individual company restructuring rulings, these same policies would represent a hostile or discriminatory environment.

A glaring case in point is the obsession with share ownership proportions at the level of individual firms. Although the 30 per cent Bumiputera share of corporate equity is supposed to be a global target, the insistence that each and every company must have 30 per cent Bumiputera shareholding before applying for public listing, and the direct intervention by the Capital Issues Committee (CIC) on pricing of shares are hostile to genuine non-Bumiputera and foreign investors. Not only have such policies deterred productive investments and turned away genuine entrepreneurs, they have also resulted in share acquisitions being viewed by even the man in the street as a sure money spinner. Such practices are classified under the hostile environment also because the insistence on the quantitative ownership target may actually detract from support for the ingredients necessary to create a dynamic Bumiputera business community able to compete on an equal footing with others, both nationally and internationally. Ownership of share capital is an insufficient factor for control of true economic power. The issue is whether it is better to own a small share or even no share and acquire the necessary know-how through active involvement in the operations of the enterprise, or to own a larger share as a "sleeping" partners.

Where Article 153 (6) has been misinterpreted or abused, an environment which is privileged/exclusionist for one ethnic group but hostile/discriminatory for others arises. Such is the case where business opportunities, permits or licences are reserved exclusively for the Bumiputera community, or direct government participation in economic activities has crowded out both Bumiputera and non-Bumiputera private sector involvement. Examples of such exclusionist policies are very wide-ranging: government tenders valued below M$50,000 which are confined to Bumiputera contractors only; government tenders where 51 per cent Bumiputera equity is insisted upon for firms submitting tenders; reservation of forwarding agents licences for Bumiputera only; the handling of government travel only by Bumiputera travel agents; reservation of permits to operate petrol stations built by petroleum companies exclusively for Bumiputera; licences for land transportation of petroleum issued only to Bumiputera; licences for the importation of reconditioned and used car vehicles reserved only for Bumiputera. Yet these provisions under the guise of the NEP are strictly a violation of Article 153 (9) of the Constitution which states that "nothing in this Article shall empower

Parliament to restrict business or trade solely for the purpose of reservations for Malays and natives of any of the states of Sabah and Sarawak".

The establishment and expansion of the Permodalan Nasional Berhad (PNB) — which has been described as the greatest feat of socio-economic engineering (Merican 1988) — and other Non-Financial Public Enterprises (NFPEs) have resulted in public sector dominance in the Malaysian economy (Merican, 1988), both in terms of direct government involvement in setting up industrial production capacities and in the aggressive acquisition of productive assets which are supposed to be held in trust for the Bumiputera community. In so far as private individuals can in no way match the resources and power of these government institutions (many of which are giant monopolies), genuine entrepreneurs, whether non-Bumiputera, Bumiputera or foreign, may have felt the serious effects of being crowded out. Employment in the NFPEs has also been confined mainly to the Bumiputera. Even where it has no direct participation, the Malaysian Government has intervened in private sector investment and enterprise, for instance, through the Industrial Coordination Act (ICA). The ICA, which stipulates industrial licensing and imposes on businesses certain quotas for Bumiputera equity share and employment, certainly represents a significant step away from the traditional *laissez faire* economy.

Counter-imaging the privileges accorded to the Bumiputera on the basis of their original handicap in the economy are the various forms of discrimination suffered by those not receiving these privileges. Whereas the two boxes to the right of Figure 1 show the environment from the perspective of the Bumiputera community, the two boxes to the left of the diagram reflect the economic framework for the non-Bumiputera. It must be remembered that one man's privilege is another's handicap, so what is a privileged environment to one community would be discriminatory or hostile to others. Clearly, the economic environment would be hostile/discriminatory to the non-Bumiputera if they are not allowed to apply for economic resources or assets, including shares, permits and licences, or if they are barred from participation in certain economic fields purely on the basis of ethnicity, irrespective of their other personal qualifications or abilities. While the non-Bumiputera acknowledge that some assistance had to be given to the Bumiputera for the success of the NEP, the environment is truly hostile to them when they are not only deprived of access to new opportunities but also suffer an actual erosion of their legitimate economic interests.

The non-Bumiputera and foreign business communities would have probably tolerated a reasonable handicap if they were not totally excluded from various economic activities. To help provide a supportive environment for active Bumiputera participation in the economy, the non-Bumiputera had to be prepared to operate, at least within a certain time frame, under certain known handicaps, such as the cross subsidy on the preferential interest rates on loans to Bumiputera or accepting the preference or percentage margin given by the Malaysian Government to tenders quoted by Bumiputera contractors and suppliers of government goods.[2] The non-Bumiputera wishing to bid for such government tenders had to be aware and ready to give handicaps of fixed percentages to their Bumiputera competitors and to plan their strategies accordingly.

What is obvious is that for the common economic good and for national unity in the country, the two extremes of Figure 1 should be avoided. The hostile/discriminatory environment that results in deprivation or a sense of loss among any single community is not conducive to racial harmony, while at the same time, the privileged exclusionist policies are *ultra vires* Article 153 (9) of our Constitution. They go against the principle of true equality of opportunities and, more important, they breed severe distortions and inefficiencies in the Malaysian economy. Instead of enhancing the development of individual potentials and creative innovation, they foster reliance on political lobbying, patronage and cronyism. Businessmen divert their energies to gaining an element of rent (through politically-created scarcities) rather than building up profits. It is now well verified (not just from Malaysian but also international experience) and documented, that excessive government participation and regulations sap economic dynamism and innovation, endanger international competitiveness and retard overall economic growth:

> "In the West, it is now being increasingly realized that the growth of government and government intervention was counter-productive, and that there cannot only be market failure, but also government failure, in achieving industrial and overall economic growth. Moreover, the realization is spreading that the profit-driven, decentralized, entrepreneurial search for new market opportunities and new products and processes tends to be more promising than the administratively driven, centralized approach of governments. Experience in affluent and developing countries alike has shown that most relevant economic knowledge is decentralized and changeable, so that it cannot be captured and used centrally. Moreover, political/administrative considerations easily divert economic entrepreneurship into lobbying and other unproductive activities. This diversion then results in fewer productive jobs and less output" (Kasper 1988, pp. 11-12).

4. A Matrix of Options

On the basis of the above discussion, it is possible to set out a matrix of our post-1990 economic options. In Figure 2, the x-axis classifies the sectors of economic activity or human endeavour by the possibility of fixing and guaranteeing market

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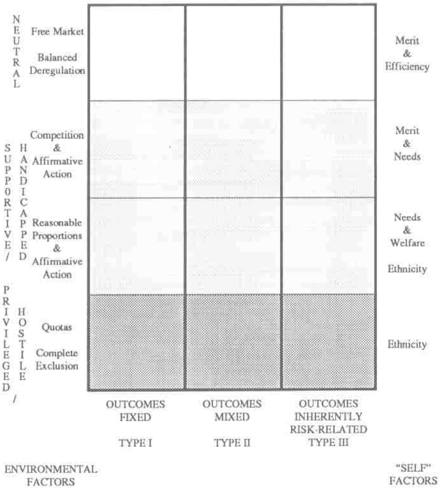
[2]These preference margins are as follows:

For supply of goods valued:	Preferential Rate
Below $50,000	10.0%
Between $50,000 - $100,000	7.5%
Between $100,000 - $1 million	5.0%
Above $1 million but less than $5 million	2.5%

Figure 2
A Matrix of Post-1990 Options



outcomes. It is extremely crucial to underscore the distinctions between different types of outcomes because policy makers have generally failed to recognize that not all economic outcomes can be controlled, that most outcomes are highly risk-related and insecure and that all that can be attempted is to offer equality of opportunities. It is this lack of recognition that has been behind the dogged insistence to increase government intervention and tighten regulations in the belief that pre-determined distributional targets can thus be achieved. The y-axis shows the range of possible approaches that could be used to influence the environment in relation to the type of economic and social sectors that Malaysians think should evolve in the future.

The left-hand column of the matrix would therefore represent those economic activities whose market outcomes can be pre-fixed as more or less certain — these are the activities where environmental factors, rather than personal factors, exert a dominant influence and government intervention could guarantee the outcomes (so that the rules of allocation would correspond to those of distribution). In the bottom left-hand quadrant of the matrix, government interventions to guarantee market outcomes would be effective through some of the exclusionist policies or fixed quotas described above. For example, timber or toll concessions would guarantee sure profits for the privileged concessionaires. Entry into civil service employment could also be considered under Type I outcome since there is essentially no retrenchment and therefore the guarantee of a stable job (though perhaps not of promotion). Land alienation is another example — government provision of land guarantees a source of future income for the beneficiaries. The government-created and operated monopolies should also be classified under this type of outcome (though, as the performance of some of the NFPEs has demonstrated, even for these profits cannot be assured). Those awarded turnkey or privatization projects, especially if they are not through open tender systems, are also assured of market success (the "overnight millionaires").

The right-hand column of Type III activities, on the other hand, encompasses those sectors of inherent market risks and insecurity, where the determining factors for success are more dependent on the "self" or personal factors. Government interventions in the form of quotas, for instance, justified in the past as attempts to offer equality of opportunities to everyone starting out in the sector, cannot ensure the market outcome. Issuance of manufacturing, business, liquor, freight forwarding or export licences, for instance, are not tickets to economic success. Profit or gain (and certainly the quantum of gain) cannot be guaranteed in activities where there are large numbers of small to medium-size competitors. Entry into institutions of higher learning would also fall into the Type III classification of outcomes. While quotas could be used to determine entry into universities, the outcome in terms of graduate performance would depend on personal motivation and effort.

The middle row in the matrix represents those economic activities where the outcomes are likely to be mixed; the chances of economic success are heavily bolstered by government intervention, though still not an absolute certainty. The enterprises likely to fall into this row would have oligopolistic characteristics, or be heavily regulated or limited by special licensing. Examples would include banking, finance and insurance companies where the number of licences issued is limited and operations are tightly regulated; capital intensive industries such as steel and cement manufacturing which enjoy heavy tariff protection; the awarding of large government tenders or contracts (where the probability of making profits is high); and at the other end of the scale, transport haulage and taxi licences which restrict entry into these service sectors and create artificial scarcity.

Under the NEP, policy makers and planners appear to have thought along the rows of the matrix only but have not considered the columns. They have operated mainly along the bottom row of the matrix only, with reliance placed heavily on discriminatory and restrictive government intervention and the substitution of political decisions for competitive market forces. In so far as there has been a failure to recognize and accept the inherent uncertainty of economic outcomes, there has been in effect the collapsing of the three columns of the matrix into one — Type I only, and the use of increasingly stringent regulations in an attempt to force the outcomes of essentially Type III activities. Assumptions such as equating licensing of industries with the granting of concessions or equating share ownership with the creation of a Bumiputera business community have led to the reliance on quotas and other discriminatory policies which have constricted rather than equalized opportunities and which have ended up not achieving the desired growth and distributional objectives. Worse yet, individuals themselves scramble to get into the bottom left-hand quadrant through political and even unethical means — "knowing who" has become more important than "knowing how", and the non-competitive economic order has been a fertile environment for corruption, kickbacks, market manipulations, non-secured loans, and other unsavoury business practices.

Which quadrant of the matrix should represent the socio-economic option for the post-1990 era and how we should move from one quadrant to another over time are the crucial decisions facing all Malaysians. To decide, we need to be clear about the relations between the controllable and non-controllable parameters of the dynamic system, about which end of the matrix we wish to move towards and about what each quadrant implies not only in terms of strategies needed but also the implications for the Malaysian economy, the nation as a whole, the various ethnic groups and individuals. We should also determine the appropriate time frame for the operationalization of any particular set of options.

We could, as under the NEP, continue to be concerned with attempting to guarantee outcomes rather than opportunities and to be fixated with quantitative targets. If this is the choice, we would continue to operate along the bottom row of the matrix in a non-competitive economic order, with the focus still on quotas for different ethnic communities in various economic sectors. The more extreme or exclusionist the quotas fixed, the more our future economic scenario would be depicted by the bottom left-hand quadrant. But if on the other hand, our concern is to equalize opportunities, while recognizing that markets are inherently insecure and involve a high degree of risk or uncertainty, the move would be toward the right of the matrix. However, if we operate only along the bottom row, the right-hand quadrant cannot be seen as an option that equalizes economic opportunities, even if the outcomes are accepted as uncertain. The bottom right-hand quadrant engenders a fundamental discrepancy, if not a self-defeating structure. Equality of opportunities cannot be offered through restrictions or the creation of a hostile environment — by the very definition, there cannot be equality of opportunity by using quotas to discriminate solely on the basis of race.

In so far as the feeling is that the Bumiputera have not yet caught up in the economic race, and that they still need assistance to get into the mainstream of socio-economic activities and have a fair share of economic opportunities and materials assets, the principle of reasonable proportions could still be applied. But rather than relying on fixed quotas to force economic restructuring, the approach should emphasize incentives rather than disincentives. For instance, rather than a closed government tender system or the CIC dictating share allocations and pricing, tax incentives in terms of lower tax rates or directional bank lending and preferential interest rates or preferential margins in government tenders (scaled according to the size of the tenders) for firms which have restructured or show at least reasonable proportions of ethnic representation[3] could still achieve the same objectives through choice rather than coercion and help to free some of the controls that have hampered private initiative and investments.

To protect the legitimate interests of the other ethnic groups in the country, it would be necessary to replace the discriminatory environment with a supportive one. The options for a supportive environment, however, cannot be found in the bottom quadrants; we have to move to the upper quadrants where the emphasis is on clear definition of beneficiaries based not merely on ethnicity but on principles of need, merit and efficiency. Rather than the over-concern with ownership of share capital, it is crucial to shift the focus to economic dynamism, increased productivity and employment growth which should be much more effective in closing the income gap between the ethnic groups.

There are essentially two sets of options for providing a supportive environment — to work towards reasonable proportions of representation in different economic sectors on the basis of household or individual needs and welfare considerations, or to attempt to give due weight to both needs and merits in deciding who should be the beneficiaries of government policies and allocations. Moving upwards from the bottom row of the matrix, the aims shift increasingly to restoring economic efficiency and socio-political justice and to improving total social welfare in the country. Each successive upper row of options should represent

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[3]As an example, a business tax incentive structure could be based on the following:

Proportion of Bumiputera Contents	Tax Rate
0 - 10%	35 + 5
10 - 29%	25 + 5
30% and above	20 + 5

and the preferential interest rate for Bumiputera loans could be in the region of 20 per cent lower than the market rate.

increasingly lesser economic distortions than the growth-hampering racially-discriminatory approach. A clearer definition of the rules of allocation also leaves less scope for misinterpretation or misapplication of government policies by civil servants and helps ensure that these policies/programmes actually reach those for whom they are intended.

The set of options based on needs and welfare would, in effect, shift the emphasis from ethnic restructuring to poverty eradication. Over the almost twenty-year period of the NEP, while inter-ethnic inequalities and even absolute poverty levels have been dramatically reduced, the gaps between the rich and the poor remain unbridged, if not widened. A supportive environment should, therefore, increasingly focus on affirmative actions for the poor irrespective not only of race but also of region and political affiliation. The attraction of this row of options is that it will help to ensure that the truly underprivileged and powerless in the society are the targets for policy. Defining access to or eligibility for a reasonable proportion of reserved privileges, government assistance programmes, newly created government assets and the like, on the basis of properly administered economic need or means tests, will still be of special benefit to the Bumiputera since they make up the larger proportion of the poor. If their basic needs can be met and their incomes raised, the economic position of the Bumiputera would be that much stronger — at least much stronger and more resilient than if the concern were for creating instant Bumiputera millionaires (Muzaffar 1989). The welfare-oriented approach would also avoid the injustice of associating the problems of poverty only with the Bumiputera community, and have the added advantage of being cohesive rather than divisive from the national unity point of view.

In considering the needs and welfare row of options, it is necessary to distinguish between efforts to augment economic productivity of the poor and those intended merely as hand-outs to the poor. To raise economic productivity of the poor, affirmative action programmes should stress efforts to build up the human resource potential and self-reliance of the poor. In other words, efforts should be focussed not only on the environment for the poor but also on improving the individual potential and attitudes of the poor. Providing the poor with access to adequate farm land, credit facilities, educational and skill training, infrastructural support for informal sector activities and for small- and medium-size industries, would be an economically sounder approach especially in the long-term as compared to a hand-out approach. While offering financial subsidies may be justifiable for the truly destitute groups in the society, as far as possible the subsidy approach should not be the option selected because it tends to encourage an unhealthy and persistent reliance on hand-outs, does not give the poor the incentive to pull themselves up by their own bootstraps and can lead to a sense of deprivation among those segments of the poor who do not enjoy the same privileges.

Over time (certainly by the end of this century) the basis for allocation could shift gradually to reduce the proportion based on needs and welfare considerations to give due recognition to individual merit and increasingly restore competitive markets in various sectors of the Malaysian economy.[4] In moving into the top two rows of the matrix, the scenario would involve a doing away with "big government" policies, a dismantling of the regulatory framework (certainly a serious reconsideration of the role of the ICA and CIC and a recognition of the importance of letting the market fix the price of shares), a reduction of government involvement in economic production (especially unproductive gross capital formation), a reorientation by government away from the "big stick" to a "carrot" approach for influencing private sector activities, and a concomitant restoration of the dynamic role of the private sector (implying the need to ensure that in the process of privatization, less efficient monopolies as compared to public ones are not created). Just as there is no gain where no risk is taken, so a move to the higher risk, freely competitive quadrants may offer the prospect of much higher gains for Malaysia, especially in the international arena.

The over-concern with ownership of share capital should certainly be redressed. Not only has the forced restructuring of share ownership constrained private investments, squandered government financial resources and not fostered Bumiputera entrepreneurship, a 30 per cent target of corporate wealth actually does little for improving personal income distribution or reducing racial income inequalities. While "cheap shares" introduced unrealistic windfall gains for a fortunate few, dividends or the actual returns to investments normally account for little or nothing of the household income of the majority of the population, especially of the poor. A shift of focus to economic dynamism, increased productivity and employment growth should be much more effective in closing the ethnic income gap and in improving personal income distribution, than an emphasis on share ownership quotas.

An option that encourages excellence, productivity and hard work and emphasizes growth and international competition appears to be finding increasing favour with those concerned with the erosion of Malaysia's domestic and international economic position especially relative to some of the neighbouring countries, and with the fact that Malaysia is now one of the more heavily indebted nations in the world. Whatever the underlying reason(s) — whether it be recognition of the rigidities and stifling effects associated with the regulatory framework of the NEP and the excessive costs of government intervention and involvement, or awareness that Malaysia will have to make every effort possible to cope with increasingly aggressive international competition and economic instability, or subscribing to the stabilization and structural adjustment prescrip-

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[4]For example, while the Government may provide at the initial stage of introduction, free or subsidized new seedlings, fish fry for aquaculture, fertilizers and the like, the second time around that supplies are needed, payment should be imposed as a means of encouraging the poor to put these activities on a commercial, self-paying (and therefore, more efficient) basis.

tions associated with supply-side economics, or simply recognizing that without economic growth there is nothing or little to redistribute or restructure — the urgent call from increasing number of segments of Malaysian society has been for the revitalization of the economy through a growth-oriented, more dynamic, competitive and cost-effective approach. Particularly from the perspective of Malaysia's position in the global economy, the arguments are persuasive. To successfully compete for foreign investments and expand export markets in the context of increasingly intense international competition, the globalization of financial markets and the internationalization of technology, Malaysian cannot afford to maintain her regulatory structures when the international tide is one of deregulation and economic liberalism and her neighbouring countries are fast emerging as serious economic threats. Bitter and costly experiences have proven that state bureaucracies and interventionism cannot guarantee productive capital formation, economic growth, or productive employment. Certainly, Malaysia's unemployment problem needs an urgent solution. Deregulation may also help stimulate the growth of small- and medium-scale industries which should also promote entrepreneurship, while their generally greater labour intensity and more efficient use of capital resources are what this country needs.

At the same time, a restoration of competitive economic structures and private initiative need not imply that the most disadvantaged in the society will be left to fend for themselves. The growth-oriented strategy does not preclude measures to ensure that the dire poor (based on increasingly stringent needs and means tests) will continue to receive assistance, so that economic growth will not be at the expense of widening inequalities between the haves and the have-nots.

5. Fitting Activities and Policies into the Matrix

What this paper has attempted to emphasize is that in considering our post-1990 options, we have to not only assess the various possible strategies but also to be cognizant of the types of activities that can or cannot be influenced by these strategies. In other words, we need to think not only of the rows in Figure 2 but to expand our thinking to both the rows and the columns and to view the options as an entire matrix.

As a final illustration of this point, Figure 3 is presented. If we exclude the bottom row of the matrix from our future set of options (implying that we agree that ethnic politics should not be basis of economic policies), then Figure 3 shows how we could usefully relate policies and likely outcomes for different types of activities to ensure more realistic and effective planning. For instance, the recognition that manufacturing is an activity where outcomes are highly uncertain especially in the international arena means that licensing for manufacturing enterprises should be placed within the top right-hand quadrant where there are no restrictions on the number of licences or conditions of operation — anyone wishing to compete should be free to compete and their success or failure is a

Figure 3
Fitting Activities and Policies into the Matrix

NEUTRAL	Free Market Balanced Deregulation		* Banking and Finance licences * Privatization schemes * Large tenders * Civil service promotion	* Manufacturing industry * Service industry * Mining leases	Merit & Efficiency
SUPPORTIVE / HANDICAPPED	Competition & Affirmative Action	* Scholarships * Civil service intake	* Taxi licences * Transport haulage licences * Smaller tenders	* Entry into universities & colleges	Merit & Needs
	Reasonable Proportions & Affirmative Action	* Land alienation * Agricultural subsidies			Needs & Welfare Ethnicity
PRIVILEGED / HOSTILE	Quotas Complete Exclusion				Ethnicity
		OUTCOMES FIXED TYPE I	OUTCOMES MIXED TYPE II	OUTCOMES INHERENTLY RISK-RELATED TYPE III	
ENVIRONMENTAL FACTORS					"SELF" FACTORS

matter of their own efforts. A freely competitive environment for manufacturing operations would help ensure that entrepreneurs are kept on their toes to be productive and internationally competitive. On the other hand, since land alienation guarantees ownership of a physical resource and a continuing stream of income and would be a fundamental resource for the rural poor, the appropriate rules of allocation should be based on needs and, if required, reasonable proportions to ensure fair representation of all ethnic groups. Subsidy measures especially should have strictly administered needs or means tests to ensure that they go to the intended beneficiaries.

Scholarships would also guarantee the recipients a monetary subsidy for a certain period and would clearly be of special assistance to the poor, but this type of affirmative action should have a proper weightage between needs and merit — the greater the weightage given to merit, the greater the chances are that the outcome is not just a guaranteed subsidy but individuals with the education/training and motivation to help themselves thereafter. Scholarships are not placed in the needs quadrant because it is important to avoid a "hand-out" mentality. But what is also crucial to realize is that whereas the scholarship grant is an assured subsidy, entry into university or college is no guarantee of passing out with a degree. In other words, even when the allocation of places of the institutions of higher learning is based on merit and needs, there cannot be insistence on pushing the outcomes into the left-hand quadrant. Civil service intake too should balance the principle of reasonable proportions with that of meritocracy.

At the other end of the scale, especially because privatization schemes, government concessions or large tenders are more or less sure-profit activities, the most efficient place for them should be in the top row of the matrix — to ensure that they are not viewed just as get-rich quick activities allocated on the basis of political patronage, and more importantly, to make sure that such enterprises are efficiently operated for the common good and in the most cost-effective manner, they should be opened up to free market competition as much as possible. But in so far as the allocation is based on competition and merit (for instance by doing away with the system of closed government tenders), outcomes are no longer guaranteed; hence these activities move into the middle rather than left quadrant of the top row of the matrix. Smaller government tenders, could, however, be allocated partly on the basis of need or reasonable proportions to give a handicap to the disadvantaged attempting to start out in the field.

For activities where the outcomes are likely to be mixed, decisions on where to place them in the matrix should be based on two types of considerations. For activities such as banking, finance and insurance, restricted licensing has created cartellized or oligopolistic structures, with ownership of such licences becoming the source of wealth and the object of political lobbying rather than true entrepreneurship. Giving out such licences more freely on a merit basis would stimulate genuine economic competition which is crucial in view of the increasing internationalization of financial and capital markets. For other smaller scale activities where licensing still restricts free entry, such as taxi and transport haulage licences, a proportion could be allocated on the basis of needs. Civil service promotion is also classified in this middle top quadrant because the only justifiable basis is merit; a civil servant has to earn the promotion, not merely be given it as a means of achieving some quantitative targets.

Figure 3 is obviously not exhaustive. But we hope that the matrix can stimulate more systematic thinking about the different types of economic activities which require different rules of allocation. What Figure 3 does show is that the top left-hand quadrant is not a realistic option; in a freely competitive environment, market outcomes cannot be guaranteed, just as the bottom right-hand quadrant cannot offer equality of opportunities on the basis of quotas or exclusionist policies. Locating more and more activities in the upper right-hand quadrant offers the potential of more dynamic economic growth and international competitiveness and a more solid basis for genuine entrepreneurship.

A final point is that the matrix underscores the importance of clearly defining outcomes, ethnicity, needs, merit and efficiency. There must be a higher body or independent commission to help determine whether particular economic activities have Type I, II or III outcomes and to establish the appropriate criteria for what constitutes needs, merit and efficiency. Such an independent commission should also handle grievance procedures, help to instill confidence in the system among all segments of the society, monitor progress and deviations in implementation of the selected options and suggest flexible modifications in the light of changing circumstances.

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Commentary

Tan Tat Wai

Discussion on income distribution in Malaysia has often been focussed at a detailed level, arguing the non-achievements of the New Economic Policy (NEP). Criticisms have been showered on the supposedly and continuing high level of poverty, the failure to achieve the 30 per cent corporate share distribution target and the lack of Bumiputera representation among businessmen. There has been very little discussion on whether the interpretations and perceptions of, and the policy prescriptions arising from, the NEP are actually consistent with its present formulation. Naturally, there has been even less attention paid to the inherent dichotomy within the NEP and the need to balance some of the differing priorities embodied within the NEP. In that sense, the three papers in this session have been extremely interesting: their subject matter span a wide range and each paper has attempted to address key conceptual issues.

Equalization of Opportunity and Equalization of Outcome

Dr. Zainal Aznam started his paper with the observation that the western mode of economic development emphasizes the provision of equal opportunity while the socialist world stresses equality of outcome. This observation might have been true many years ago. Today, however, the capitalist economy has already adapted some policies for better equalization of outcomes while the socialist economy is deviating from the targetted equalization of outcomes.

In reality, what constitutes equal opportunity itself is open to debate. Precisely because the western economic system, as it was originally known and conceived, could not really provide for equalization of opportunity, the industrialized world today has built in welfare systems and minority group opportunity equalization programmes. The introduction of some elements of socialism and the welfare system into the industrial economies has created new problems: welfare recipients take for granted the benefits they receive as rights when they are really benefits. Dr. Shahid's paper highlighted the disincentive effect on growth and productivity arising from such confusion between benefits and rights.

On the other hand, has the socialist system really achieved equalization of outcomes? Socialist countries were, to a large extent, able to promote both growth and equalization of outcome in the initial years. But today, the more entrenched socialist countries exhibit stagnation in growth and privileges are accorded to selected elites, thus departing from equality. The key difference between the socialist world and the capitalist one to reward the elites lies only in the way the elites are selected and the manner in which they are rewarded. However, the elite group and class differentiation exist side by side in both environments.

In short, how can economists come up with a good mix of policies to ensure as good an equalization of outcomes through as good an equalization of opportunity as possible? Society needs equalization of opportunity to provide the incentive for productivity and hence improvement in the standard of living. But society also requires equalization of outcomes to reduce social stratification, to induce the feeling of sharing in success to protect the fruits of growth and development. History has shown that equalization of opportunity independent of outcome or vice-versa will both invite longer term instability. In Malaysia, or for that matter any other country that wants to address the question of income equality, these two issues must always be dealt with. If society achieves equality but had a large share of poverty, what is the point? On the other hand, if the country keeps growing with no distribution of income, again, what is the point?

Perception of Income Equality

When we talk about income distribution, there is no one single measurement that can tell the whole story. And indeed as society changes, as income rises, people's expectations differ. When people are in such abject poverty that starvation is always not far away, probably the most important measurement is the absolute level of poverty. But as the people become a bit more affluent, and they have enough to eat and enough to wear, the issues become a nice house, and the need for a car. But then, it is no longer poverty or the absolute level of income, but the relative wealth distribution that becomes important.

In the last two decades, South Korea and Taiwan have been the two most successful economies in terms of growth and development. (Singapore and Hong Kong are excluded because these island economies are really exceptions, hence their experiences are not easily generalized to other countries). Both South Korea and Taiwan have seen their incomes rise very rapidly with a relatively good record of income distribution as well. And yet today, both their peoples are very unhappy. The South Koreans are fighting against exploitation because of the inadequate filter down effect. In the case of Taiwan where the income distribution is better, the gripe is mainly in pollution and environmental issues.

A Matrix Income Distribution Issues

In most countries, income distribution refers to the sharing of income and wealth between people at the top and the people at the bottom (liken to a pyramid). In the few cases where discussion on income distribution deals with distribution by ethnic groups, there is usually a very big majority owning and controlling income and wealth. But not in Malaysia. Here in Malaysia, the proportions of the majority and the minority are relatively close. Secondly, the majority had until recently owned and controlled an insignificant amount of wealth. Thirdly, foreigners owned and controlled a high share of wealth through a vast number of agents from the minorities. Therefore, income distribution issues need to be represented more as a matrix than as a pyramid. There exists not just a vertical axis where distribution must be by income class, but also a horizontal axis where distribution by ethnic groups is also fundamental. In such a unique situation, the problems of distribution are far more complex and the solutions must be different and creative.

The New Economic Policy of Malaysia: How Many Prongs Should There Be?

The New Economic Policy (NEP) was coined in precisely such an environment to address both these two axes. Therefore, it has two prongs. The first prong is eradication of poverty regardless of race and the second prong is a restructuring of society. When the NEP was formulated in about 1970, the perception was that the Chinese were all rich and the Malays were all poor. Therefore, a restructuring of society to reduce ethnic stratification by economic function and wealth was perceived to be necessary for growth and harmony. In reality, and with hindsight, the issues that have unfolded over the last eighteen years after the NEP show that the restructuring of society should be further separated into two aspects. The first is equalization of job distribution so that the Bumiputera are not all in the rural areas, in agricultural jobs or in the civil service but also in manufacturing, in services, in high paying jobs and in professional and managerial jobs. The second aspect is the ownership and control of wealth under the famous 30 per cent, 40 per cent, 30 per cent formula for the Bumiputera, non-Bumiputera and foreigners, respectively.

In the last decade, there have been countless assertions, claims and counterclaims, on whether the Bumiputera have attained the 30 per cent share of wealth and whether enough has been done to give the Bumiputera their fair representation at various job levels. Using official Government statistics published in the various Five-Year Plans, Mid-Term Reviews and so forth, the prevailing sentiment among the Bumiputera is that they are far from achieving the 30 per cent wealth target. They have been calling for an even faster pace of restructuring. A minority, whose ranks are swelling, are even asking for a 50 per cent share of wealth. On the other hand, the non-Bumiputera document that the 30 per cent target is either at hand or has already been attained, and the Government is doing too much, too fast for the Bumiputera by carving too much from the non-Bumiputera by using unfair policy implementation.

Many economists avoid the issue by saying that data is poor and inadequate. In reality, data is never adequate. It is the skill and duty of an economist to create proxies for, and to be objective in, measurement. Malaysian data is already far better than most developing countries and some developed countries as well. For example, Dr. Zainal Aznam commented that the footnotes to the specific Tabloid in the Five-Year Plans or their Mid-Term Review allow for a clearer approximation than the Tabloid itself. The Government, and failing which the economists, owe it to the people, Bumiputera or non-Bumiputera, to very clearly segregate data so that no confusion or misrepresentation exists on interpretation. This is because the whole issue is extremely sensitive, with the Bumiputera thinking that the Government is not doing enough if there is a significant shortfall from the 30 per cent target and the non-Bumiputera thinking that the Government is intentionally overstating the non-Bumiputera share. All that the Government and economists need to do is to reclassify the Tabloid and its footnotes into "Bumiputera, Chinese, Indian, foreign and others", instead of lumping company minority holdings, nominees and trustees into another Malaysian category. Once this reclassification is done the Bumiputera shareholding would exceed 20 per cent for sure and probably come rather close to 30 per cent. The corresponding foreign share would also rise with a drop in the non-Bumiputera, non-foreign share to about 40 per cent level. In short, the target is already close to achievement and all done in a remarkable 18 years!

Take a very simple mathematical illustration and assume a social experiment is possible to constrain the non-Bumiputera to grow at a real rate of 6 per cent per year, while allowing the Bumiputera to grow at 10 per cent. This 4 per cent differential growth rate means that it will take 20 years before the Bumiputera can narrow a gap that was 2:1 to 1:1. So to narrow a gap where in 1970 the Bumiputera owned less than 2 per cent of the economic pie to 30 per cent within 20 years, is an extremely ambitious task which requires a very huge growth differential between the ethnic groups! Thus, if Malaysia achieved an increase in Bumiputera share to 25 per cent or even just 20 per cent in a mere 18 years regardless of recession or economic boom, it is one hell of an achievement! If the target is set too high, the people will be misled and the leaders and elites would have created an unnecessarily difficult and divisive task for the nation and its people.

Unfortunately, that in itself still does not answer the issue of equality and restructuring. This is because the Government created the Amanah Saham scheme to distribute the shares it acquired on behalf of the Bumiputera to a wide spectrum of the Bumiputera. Although this act of redistribution ensures better income and wealth distribution, it triggers another problem: wealth is not concentrated among a few and thus does not encourage the development of Malay businessmen. The lack of Bumiputera businessmen has also been a bone of contention.

Thus, if the issues are reviewed in depth, the second aspect of the second prong of the NEP (that is, ownership and control) really has two areas of emphasis. The first area of emphasis is the ownership of wealth, such as shares, land and things like that. The second is the question of who controls, especially who has the biggest pool of entrepreneurs. Therefore, it is imperative to ask: of all the prongs, aspects and emphases, which should be accorded the highest priority?

Malaysia may achieve the wealth-share target without achieving the entrepreneur "quota". If the sharing of wealth target is paramount and overwhelming, fine and good. On the other hand, if the entrepreneur quota is more fundamental and important to the Bumiputera, then perhaps the way in and speed at which the share is redistributed to the Bumiputera need to be different, so that more Bumiputera businessmen have the chance to blossom. To a large extent, the achievement of a high share of total wealth by the Bumiputera will not reduce controversy and race relationships unless the confusion is cleared up and people's aspirations clarified, affirmed and agreed. Otherwise, the issue will permeate back and forth causing endless confusion and acrimony.

Unlike creating a large pool of farmers, workers, technicians or even professionals and managers, the creation of businessmen is probably the most difficult and time consuming, with a very high rate of attrition. It takes a person who wants *to take risk* to become a successful businessman, whether it is big business or small business. And yet, if the Government creates very cushy and very secured jobs for the Bumiputera, especially for those who are well educated, the risk taking spirit just cannot be there. Why should a person who has a very good and steady job take the plunge and go into a high risk business venture? In other words, the objective of rapidly creating a pool of high income Malay professionals runs directly contrary to the objectives of creating a lot of Malay businessmen in as short a time as possible. In this regard, the contrast of Singapore with Hong Kong, Taiwan, South Korea and Japan is educational. Singapore has a relatively small pool of indigenous businessmen and Singapore's economic development is largely dependent on foreign investment. Why? One of the strongest reasons is that Singapore's pay scale for executives is the best in Asia after Japan.

So, unless we are very clear in our minds which one of the objectives is the most important and therefore define accordingly the time perspective and the measures, we are not doing justice to our own objectives. In truth, our own long term objective is to improve our standard of living regardless of race.

From the foregoing discussion, it is clear that the issue of equality in outcome and opportunity in Malaysia is neither a pyramid nor a dichotomy, but a matrix. Thus, the matrix proposed by Dr. Lim Lin Lean and Mr. Yong Poh Kon is rather interesting. Perhaps it will be far more fruitful to use it as a new basis for deliberation and discussion on how to pursue income distribution and restructuring.

Moving from philosophical issues to the more mundane one of reviewing historical experience, Malaysia's experience seems to run contrary to other countries. Dr. Zainal raised a couple of very interesting and useful points. Firstly, he said land reform does not appear to be a necessary precondition to growth and distribution in Malaysia, contrary to conventional wisdom. Land reform may neither be a necessary nor sufficient condition for growth and distribution for a land surplus country.

But how many countries are as lucky as Malaysia with a large land resource relative to a small population? As long as there is surplus land to open up for farming, land reform is not required for the time being. But really can you wait? Without land reform but new land development, Malaysia is beginning to see agricultural land lying fallow. This is a waste for the country. Can Malaysia afford this waste?

Dr. Zainal also thinks that Malaysian development differs from other countries in another interesting way. The experiences of other countries show that during a recession, income distribution worsens but Dr. Zainal summarized figures to indicate that income distribution, at least among races, seems to improve during times of recession although intra-group distribution seems to worsen. Let us examine this assertion in greater depth by looking at the problem along both the vertical and horizontal axes.

Why does Malaysia's experience run contrary to Kuznets' cross sectional study which shows that income distribution will worsen before improving as income starts to grow? Why have, in particular, the Malays been more immune to the recession? Dr. Zainal's tables show very clearly that during the last recession, the mean income and the medium income did not drop for the Malays whereas those for the Chinese did. In other words, income distribution by race improved during the recession because the non-Bumiputera suffered more during the recession. We can ask two questions:

1) do we want a better income distribution by race if it comes not from improvement by every one but decline by one group?
2) why are the Bumiputera more immune to recession?

I think the answer to the first question must be a no on ethical and equity grounds.

The answer to the second lies largely in the poverty eradication programmes, in particular the land development programmes and farm-gate subsidies. It is such policies and programmes, not the restructuring ones, which have supported Bumiputera power in times of recession. Indeed, the first prong of the NEP is not new. Ever since the independence of Malaysia, eradication of poverty and rural development programmes have always been key elements, if not the most important elements, in Malaysia's development policy. Since oil palm takes four years to grow, rubber six years and then it takes three to four more years to reach full production, the gestation is very long. Such rural development programmes continued to be implemented even after the introduction of the NEP and this is really the most important element of the poverty eradication programme. Thus by the mid-1980's when the deep recession struck, the increased productivity induced by these rural development programmes cushioned the incomes of the rural lower-income group against some of the effects of the drop in commodity prices. In contrast, large numbers of urban workers were laid off creating a widening gap between those who remained employed and those who did not. The urban employees are largely the non-Bumiputera while the rural farmers are largely the Bumiputera, and therein lies the explanation for Dr. Zainal's observation that income distribution improves during the recession.

During the NEP, although the rural development programmes continued, their importance was de-emphasized, not in absolute monetary terms, but in relative terms. Apart from the rural development programmes, there were other policies and objectives to be addressed specifically for restructuring. Large sums were allocated for the purchase of shares and the start-up of Government companies. However fortunate or affluent Malaysia may be, her funds are limited. We cannot afford to push for a high pace of poverty eradication concurrently with a very ambitious restructuring programme. Malaysians should ask ourselves very specifically — are we more interested in poverty eradication or are we more interested in restructuring society, and if restructuring of society is selected, which emphasis is more important. This specific focus on priorities in the context of limited resources is important.

The world is changing at a very, very fast pace. In the past, labour has always been more mobile than capital. But today, with technology to help move capital and immigration rules to stifle labour movements, capital has become far more mobile than labour. Moreover, among labour, information is flowing so much faster, transportation is so good, it is much easier for the elite, who are less subjected to immigration rules, to migrate today. So Dr. Shahid has suggested to us that even in the developed countries, precisely because of this kind of mobility, the upper one fifth of society is becoming increasingly reluctant to support welfare programmes and subsidies to the bottom one fifth. In his verbal presentation, he further generalized that any sort of welfare programme must really be spread amongst a broad spectrum of the people before it can get support. He also suggested that the relatively more wealthy are more willing to support the subsidies of the welfare programmes in times of affluence.

When Malaysians attempt to address the issue of a balance between poverty eradication and restructuring, both of which involve subsidies and transfers, it is very important to take into account these two observations by Dr. Shahid on factor mobility and the willingness by the more affluent to support subsidies. In short, we have to deal with the perceptions of people in order to retain capital and key skilled labour. If Malaysia wants to develop, she needs all the local capital she can find and all the skills she can retain. While there is no denial that an inflow of foreign capital is both beneficial and desirable, it cannot replace or supersede local investment. This is because foreign investments are not all long term: some can run away at short notice. At any rate, no country that treasures its independence and wants stability can be over-reliant on foreign investment. Consider the case of Thailand, which after two or three years of very good inflow of foreign investment, now wants to control the flow. Malaysia can be no different.

If Malaysia does not attempt to foster local investment and address the perception of its skilled personnel, an out-migration of its valued capital and skilled personnel will run contrary to Malaysia's long-term goal of raising the standard of living *with* improvements in distribution. Without retaining skills, foreign investments cannot be retained even if the initial flow is strong. Indeed, the United States could reach today's prosperity because it had an open door policy, and continues to absorb large numbers of skilled migrants. In contrast, in Europe, tighter control of migration with the aging of population has given rise to labour constraints which in turn is seen to constrain the long-run growth rate of Europe which lags behind the US.

So, can Malaysia afford not to face the issues of priority objectively, and address the perceptions of its people, be it Bumiputera or non-Bumiputera in a clear and unbiased manner? Can Malaysia grow to be a rich country with 45 per cent of the population feeling aggrieved at the lack of equal opportunity? Can Malaysia afford to pour money into restructuring programmes only to have 55 per cent of its population be informed incorrectly that the equalization of outcome is a big failure, as they have been told consistently now for some years, contrary to data? I think not. Therefore, we have to try to strike a balance between the equalization of outcome and the equalization of opportunity. Free competition does not work because it is not the same as equal opportunity. Lady Luck has a role to play in one's life and society has to counteract, to some extent, without killing the bonus/incentive effect of hard work and effort. If one is unlucky and is born into a very poor family, one has to start working at a very young age to support the family and would probably have had no chance to acquire a university education. So unless society intervenes to give one some chance to acquire that education, there is not true equal opportunity. But, on the other hand, Malaysia cannot really afford to equalize outcome at all cost; the question and the challenge is to define the extent of intervention and subsidy so as to equalize, to some extent, the unequal opportunities due to Lady Luck and history without excessive emphasis on equality of outcome. To do that, we must leave the simple world of dichotomy and the pyramid. The matrix approach is at least a fresh and interesting new way to address the issues which have thus far been over simplified.