Getting Malaysia Out of the Middle-Income Trap

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Abstract

The rapid rebound from the Asian Financial Crisis of 1997-1999 helped lead the Malaysian government to predict that the annual GDP growth rate in 2001-2010 would be 7.5 percent, up from the 7.0 percent in the 1991-2000 period. This higher growth rate would be generated by Malaysia's transformation into a knowledge-based economy where Total Factor Productivity (TFP) would increase its contribution to GDP growth to 3.2 percentage points from 1.8 percentage points in 1991-2000. This optimism in 2001 has proved to be ill-founded even before the arrival of the global financial crisis in 2008. The annual GDP growth rate turned out to be 5 percent in the 2001-2007 period. The fact that, in the same period, economic growth accelerated in the neighboring countries of China, India and Indonesia reveals that Malaysia has descended to a much slower growth path.

Malaysia is now caught in the middle-income trap because it is still using the economic growth strategy, the New Economic Policy (NEP), that was formulated in 1970 when the structure of Malaysia's economy and the international economic conditions were very different from today. By being inconsistent with knowledge-led growth, the NEP has caused private sector investment to collapse from 32.7 percent of GDP in 1995 to 9.3 percent in 2007. By focusing too much on the redistribution of income and not enough on the generation of income, NEP rejects meritocracy and institutionalises racism, thereby preventing full mobilization of human resources (e.g denying top leadership positions to Chinese and Indians amounts to employing less than 60 percent of the national talent pool). Ethnic quotas on ownership structure either discourages successful Chinese Malaysian firms from tapping local stock market to fund expansion or drives Chinese Malaysian firms to move their headquarters to foreign lands. This is why, unlike the Taiwan case, there are very few Malaysian firms that have moved from producing import-substituting (import-competing) goods to become major exporters of these goods.

Ethnic quotas on bank loans, business licenses, government contracts, and employment promote corruption throughout society. Side effects of such ethnic quotas include the perpetual infant industry phenomenon, and increasingly frequent rulings by the Malaysian courts on the protection property rights that are at odds with standard practices elsewhere. The NEP undermines high growth by enshrining mediocrity at best and rewarding incompetence in general; provides a social justice justification for corrupt practices; and erodes investor confidence by escalating inter-ethnic tensions.

To escape the middle-income trap, the government must implement root-and-branch reform in many areas (most, notably, the civil service, educational and research institutions, the fiscal system, the state procurement system, the judiciary branch, the police force, and government-linked companies), and puts the culture of excellence at the core of its administration. Only then, would Malaysia get the microeconomic incentives right, get the macroeconomic balances right, and get the governance institutions right in order to transition to a knowledge-based economy.

Key words: Malaysia, middle-income trap, New Economic Policy, institutionalized racism, investment collapse

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The Optimism at the Dawn of the New Millennium that Went Awry

Boosted by the rapid rebound from the Asian Financial Crisis of 1997-1999, Malaysia greeted the start of the new Millennium in 2001 with confidence. The Third Outline Perspective Plan projected that the average annual GDP growth rate in 2001-2010 would be 7.5 percent, up from the 6.7 percent annual growth rate in 1971-1990 period, and from the 7.0 percent in the 1991-2000 period. This higher growth rate would be the outcome of Malaysia's accelerated emergence as a knowledge-based economy. Technological innovations would cause Total Factor Productivity (TFP) to increase its contribution to GDP growth to 3.2 percentage points from 1.8 percentage points in 1991-2000 and 0.9 percentage points in 1971-1990.

Optimism in 2001 Upon Recovery from the Asian Financial Crisis

	GDP	**source of growth (in percentage points)**		
	(percent)	labor	capital	TFP
1971-1990	6.7	2.4	3.4	0.9
1991-2000	7.0	1.7	3.5	1.8
2001-2010	7.5	1.6	2.7	3.2

	investment as percent of GDP		
	total	private	public
1990	33.0	21.9	11.2
1998	25.8	14.4	11.4
2000	25.7	12.6	13.0
2010	28.7	21.4	7.3

Data are from The 3rd Outline Perspective Plan, 2001-2010 (2001) and the Midterm Review of the 7th Malaysian Plan (1999?)

The expectation in 2001 was that things would return quite rapidly back to normal, back to the pre-Crisis period of impressive material growth and structural transformation. For example, projected private investment in 2010 (21.4 percent of GDP) would be at almost the same level as in 1990 (21.9 percent of GDP).

However, this optimism has proved to be ill-founded even before the arrival of the global financial crisis in the last quarter of 2008. Instead of surging to a 7.5 percent growth rate, the average annual real GDP growth rate turned out to be only 4.5 in the first five years of the Second Millennium, and 6.1 percent in the 2006-2007 period. The fact that, in the same 2001-

2007 period, economic growth accelerated in the neighboring countries of China, India and Indonesia certainly makes credible the possibility that Malaysia has descended to a much slower growth path, and would not transition fully to a knowledge-based economy by 2020.

What happened? How could the Malaysian economy get its groove back?

<u>The Big Picture: Stage-Specifc Obstacles and the Need for Constant Re-Invention</u>

The growth process creates new challenges that have to be overcome in order for growth to continue. Each stage of economic development has its own set of obstacles to moving on to the next stage

- Central planning allowed the Soviet Union to urbanize and industrialize quickly to middle-income status in 1970 but could not allow USSR to continue to catch up with USA and Western Europe. The lack of technological innovation in non-military industries and service sectors was simply appalling.
- Bureaucratically-directed interventions in collusion with large private businesses allowed Japan to catch up to the living standards of Western Europe and the USA in 1992. Japan then entered into period of slow economic growth (that bordered on stagnation), in which it is still mired.
- Looking at the policy actions of USSR in the 1975-1990 period, and the policy actions of Japan in 1995-2009 period, it is clear that "doing more of the same (even more intensively)" did not work, and will not work.
- New growth strategies were needed in USSR and Japan in order for them to enter into their respective new growth phases. In the case of Russia, the switch to market allocation and the entrenchment of market-infrastructural institutions (e.g. commercial courts) were necessary to re-start growth.

Malaysia has moved from being a raw commodity exporter to an industrial product exporter, from a banana chip exporter to a computer chip exporter. Malaysia has become a middle-income country, and knowledge-led growth is the next development stage for Malaysia.

The New Economic Policy (NEP) framework of 1970-2009 is inconsistent with knowledge-led growth. The NEP anchor is preventing forward movement on economic and socio-political fronts

- The quantity target of NEP framework is anathema to quality upgrading emphasis of a knowledge-based society.
- A knowledge-based economy requires meritocracy. Institutionalised discrimination prevents full mobilization of human resources (e.g denying education to women amounts to using only half of the brain for thinking; denying top leadership positions to Chinese and Indians amounts to employing less than 60 percent of the national talent pool)
- Ethnic quotas on ownership structure are anti-growth. Ownership quota either discourages successful Chinese Malaysian firms from tapping local stock market to fund expansion or drives Chinese Malaysian firms to move headquarters to foreign lands. This is why, unlike the Taiwan case, there are very few Malaysian firms that have moved from

producing import-substituting (import-competing) goods to become major exporters of these goods.

- Ethnic quotas on bank loans, business licenses, government contracts, and employment promote corruption throughout society. Side effects of such ethnic quotas include the perpetual infant industry phenomenon, "money politics", and increasingly frequent outrageous rulings by the Malaysian courts
- NEP focuses too much on the redistribution of income and not enough on the generation of income. NEP is hence at odds with the basic truth that "a rising tide raises all ships".
- Essentially, by denying existence of the "trickling down mechanism" and the importance of self-help, the over-interventionist NEP undermines high growth by
  - enshrining mediocrity at best, and rewarding incompetence in general
  - providing a social justice justification for corrupt practices
  - undermining investor confidence through concerns about escalating inter-ethnic tensions created by unfair government practices.

The Conditions for a Successful Switch to Knowledge-led Growth

There is now the need for a new vision in order to come up with new policies that will ignite knowledge-based growth. An effective strategy to transit to knowledge-led growth requires the government

- to get the microeconomic prices right
- to get the framework institutions right, and
- to get the macroeconomic balances right.

"**Getting the Microeconomic Prices Right**" means that the government has to reduce significantly its interference in the price-setting mechanism by withdrawing the near-monopoly status enjoyed by government-linked companies and by firms affiliated with families of prominent politicians. The federal and state procurement systems should be open tender systems, and the licensing of small businesses (e.g. taxis) should be race-blind. The price-setting mechanism should be an economic instrument of resource allocation and not a political instrument of rent disbursement.

The greatest price distortion is the growth tax on firms imposed by the New Economic Policy (NEP). Until June 30, 2009, the following situation was true, with some exceptions, under the label of ownership restructuring by race:

- a non-Malay firm that wants to tap the Malaysian stock market in order to grow has to sell 30 percent of its total equities at a discounted price to Malay individuals selected by the government; and
- when, in the future, this firm seeks to tap the stock market a second time to finance further growth it would have to sell 30 percent of its (expanded) total equities at a discount to government-designated Malay individuals <u>if</u> those favored Malay individuals in the first round had taken profits by selling all the shares to non-Malay investors. A firm has to show that Malays owned 30 percent of the firm every time that it has a new stock issue.

On June 30, 2009, this NEP tax on firm growth was reduced, and additional fundraising by already-listed firms would be exempted from this NEP growth tax. At the time of the listing, the firm has to allocate to the Malays 50 percent of the shares offered to the public. Since the minimum offer to the public is 25 percent of the share, 12.5 percent is the minimum proportion of shares that would have to be sold at a discount to the Malays.

Corruption and political patronage are the main obstacles to "getting the prices right". Issues of social equity are more efficiently addressed through direct income transfer programs (like access to medical coverage, access to education scholarships) rather than through indirect allocation of rents generated by legal restrictions.

"**Getting the Framework Institutions Right**" means reform of the key economic, social and political institutions to modernise the governance framework. Specifically, the large-scale institutional reforms undertaken in Indonesia after the dismissal of President Soeharto should be studied for possible relevance to Malaysia, e.g. the decentralization of a significant amount of economic policy decision-making to the provinces, and the structure of its new anti-corruption agency.

There must be a larger number of independent policy research centers to generate and test ideas of how to move Malaysia to its next stage of economic development. To ensure satisfactory progress on the road to a knowledge society, Malaysia cannot rely primarily on just one think tank, the Economic Planning Unit (EPU). The "home biasness" of EPU and the Federal government is evident in the over-concentration of federal-subsidized projects, educational institutions, and industrial development in the Klang Valley.

There has to be a wider national dialogue right now on the government's economic policy framework and the regional aspects of the national development strategy. The last such national dialogue was in 1969 when Malaysia was in a more primitive stage of economic development. It violates common sense to expect the policy framework adopted then, the NEP framework, to still be effective (not to mention, optimum) forty years later. The drastic growth slowdown in the new millennium reveals that new framework institutions and new policy instruments are needed now to manage the Malaysian economy better.

Malaysia should study the regional outcomes in China's post-1978 reform experience:

- the decentralization of policy-making on economic issues allows each province to promote investment initiatives that are in line with the comparative advantage of each province;
- the empowerment of local decision-making led to growth competition among the provinces that accelerated economic development, and to positive cross-provincial spillover effects; and
- the empowerment of local decision-making requires that each province has considerable autonomy in local public finance, i.e. local revenue is not just allocation from central government, it is also based on local sources. This independent fiscal base enables the local government to respond to the particular infrastructure bottlenecks of the region quickly, and avoid the lengthy process of seeking central budget allocation.

Everyone talks about the 1957 compact among the races in Malaysia but what has been forgotten is the other social compact made to enable the formation of the Federation of Malaysia: the compact among the states. Because of prolonged rule by the National Front at the Federal level and in almost all of the states, federal-state relations have been reduced to mostly intra-UMNO bargaining (and for a brief time span in the case of Penang, there was intra-coalition bargaining).

State rights have largely disappeared in economic policy-making. This is best exemplified by the absence of a meaningful revenue base for each state, e.g. Trengganu's oil resource income is almost entirely expropriated by the Federal government, and, even then, Trengganu's share of the oil income has also not been reliably transferred to the state government of the day. Since the Federal Government has monopolised revenue collection and rendered state development expenditures near-totally dependent on federal allocations, Kelantan has long been punished for its political exceptionalism despite of it being a low-income state.

The recent comprehensive cancellations by the Federal government of promised infrastructure projects in Penang makes it appear that Penang is now slated for the Kelantan treatment. In the past decade, Penang has been receiving an annual allocation from the Federal government that is much less than 20 percent (more often, about 10 percent) of the amount that it turned dutifully over to the Federal treasury.

The longevity of PAS in controlling Kelantan suggests that the practice of starving an opposition state of development funds is not a very efficacious way to win the hearts and minds of voters. Voters have ideals and these ideals are not always for sale.

While it is not certain that starving Penang even more of development funds would return the state to the *Barisan Nasional* fold, what is certain is that the growth rate of Malaysia would be lowered because there would now be a reduction in the positive spillover effects from Penang to the neighboring states of Kedah and Perak. This prediction is based on the experience of exceedingly large positive spillover effects on these two states from the establishment of semi-conductor manufacturing firms in Penang in the 1970-2000 period. Trickling down is an economic phenomenon that cannot be denied -- a rising tide lifts all ships.

Federal-State fiscal relations has to be put on a more even keel so that the Federal government can no longer engage in white elephant type of mega-projects concentrated in the Klang Valley at the expense of economic development in areas with even higher growth potential, e.g. it is hard to justify the expenditure on Putrajaya on development grounds (how does Putrajaya add to the national production capacity or facilitate national production?). "Getting the center-state fiscal institution right" is important for raising the average national growth rate and for promoting equitable development in Malaysia.

The fundamental driver behind knowledge-led growth is the size of the pool of national talent. The enlargement of the national pool of talents and full utilization of this national pool are necessary to enable knowledge-led growth to begin and to be sustained. One "Bill Gates" will generate 100,000 high-paying jobs for his fellow citizens. To allow a "Bill Gates" to blossom in Malaysia, leadership within the pool of talents has to be based entirely on merit. The global nature of the market for talented people means that a Malaysian-born "Bill Gates" might not stay in Malaysia and create the 100,000 high-paying jobs if he has to suffer the incompetent leadership of mediocre talents.

Initiating and sustaining knowledge-based growth requires pushing talent to reach its potential, and this requires that

- education not be primarily used as a political instrument for nation building but be primarily used as an economic instrument for greater prosperity;
- the special nature of talent be acknowledged, and the international competition for it also be acknowledged, by making the deployment of talents race-blind; and
- the culture of excellence be clearly endorsed and promoted by the government (i.e. the true "*Malaysia boleh*" spirit be instilled into national life).

"**Getting the Macroeconomic Balances Right**" means that macroeconomic management should be guided by:

- fiscal balance
- investment balance
- balance in budget priorities
- external balance

Fiscal balance is the most basic element in preserving domestic price stability. Budget surpluses are the norm in the above-trend part of the business cycle, and budget deficits are the norm in the below-trend part of the business cycle. A zero net budget balance is generated over the entire business cycle.

If a substantial part of the budget revenue is obtained from the extraction of exhaustible mineral resources, then:

- there should be a net budget surplus over the entire business cycle so that a fund is available for the use of the future generations after the mineral resource is depleted.
- the mineral resource revenue should be used almost entirely for physical and human capital formation, i.e. the role of the budget is to transform the stock of mineral wealth into investments that generate high income streams. (Human capital formation refers to both investments in education and training and investments in health improvement.)

Investment balance refers to the private-public composition of investment. The engine of long-term growth is private sector investment, and public sector investments should be limited to investments in

- infrastructure projects that are too large for private capital to finance and that would enable a large amount of private investments to follow;
- poverty-alleviation projects that increase the income-generation capacity of the poor e.g. low-cost public housing when mortgage markets are still underdeveloped, provision of improved educational and health facilities, micro-credit schemes
- environmental restoration and protection

<u>Composition of Investment by Ownership in Malaysia</u>

(actual value of category as % of GDP)

	1990	1995	2000	2005	2007*	*2010** <u>*target*</u>
total investment	**33.9**	**45.7**	**25.6**	**20.0**	**21.1**	***22.5***
private investment	**21.9**	**32.7**	**12.8**	**8.9**	**9.3**	***10.6***
public investment	**12.0**	**13.0**	**12.7**	**11.2**	**11.8**	***11.9***

Data are from 7th, 8th, and 9th Malaysia Plan (MP), and 9th Midterm Review (MTR)
* For 2007 and 2010, private and public investment figures are computed from the 2005 values in Table 2-3 in 9th M-P and their 2006-2007 and 2008-2010 growth rates and the GDP growth rates in Table M-1 in 9th MTR. Total investment is the sum of these two estimates

In the above table on the amount of investment by ownership, we note that:

- private investment = domestic private investment + foreign investment + investment by government-linked companies (GLC) like Petronas and Khazanah
- public investment = investment funded by the Malaysian government budget

The recent investment balance situation does not augur well for the sustainability of high growth. Over the 1990-2005 period, the share of private investment has fallen relative to the share of public investment. Private investment fell from 21.9 percent of GDP in 1990 to 12.8 percent in 2000, and 8.9 percent in 2005, before rising slightly to 9.3 percent in 2007. The respective figures for public investment are 12.0 percent, 12.7 percent, 11.2 percent, and 11.8 percent.

The three worrisome features of the above table are, in increasing order of worrisome-ness:

- the significant fall in the amount of total investment between the 1990-1995 period and the 2000-2007 period (a drop of 17.6 percentage points of GDP);
- the substantial fall in the share of private investment in the (declining) amount of total investment between the two periods (a drop of 11.9 percentage points); and
- the precipitous decline in the absolute amount of private investment between two periods (a drop of 17 percentage points of GDP).

In the 2000-2007 period, the amount of private investment was smaller than the amount of public investment – a rare situation in a capitalist economy! The private sector was already not playing the leading role in Malaysia's growth before the global economic crisis hit in the second half of 2008.

The phenomenon of public investment being counter-cyclical and private investment being cyclical is understandable. However, because the 2000-2007 period is not a recessionary period in the global economy, the slowdown in the Malaysian growth rate, and the continual rise in the share of public investment in this period are unhealthy symptoms. They suggest an escalated use of public investment spending to deal with a slowdown in trend growth caused by a slowdown in private investment spending.

This use of public investment to make up for a permanent decline in private investment is not a sustainable macroeconomic strategy (otherwise, Japan would not still be in its state of prolonged economic stagnation). The real and only sustainable way to return to the high growth path of the past is for Malaysia to rekindle private investment spending.

Prime Minister Mohd. Najib's announcement on June 30, 2009 of the relaxation of racial quotas on the ownership structure of firms is a step in the correct direction to boost private investment in Malaysia. What decides the effectiveness of Najib's measures, however, is not whether the investment regime in Malaysia in July 2009 is more liberalized than the investment regime in July 2000 but, rather, how much more business-friendly is the investment regime in Malaysia today compared with the investment regimes in Indonesia, Thailand, China, and India today.

The investment-strangulating Industrial Coordination Act (ICA) of 1975 is still untouched. Najib has only changed some interpretations of ICA by the government agency (Foreign Investment Committee) that implements the ICA. To make a more credible change in Malaysia's investment climate, Najib should also significantly relax the ICA (better yet, repeal it) in order to neutralise the twin developments that investment capital has gotten more mobile, and that the neighboring countries have greatly improved their investment incentives in the last decade.

In order to return Malaysia to the high growth path and realise Mahathir's 2020 vision, Prime Minister Mohd. Najib will go beyond just the relaxation of the investment component of Mahathir's NEP framework. Najib will need to adopt a non-ideological policy framework that recognises the importance of race-blind criteria in:

- promoting business expansion,
- fighting poverty,
- promoting regional development, and
- managing knowledge-generation centers and knowledge-transmission institutes.

To attain the knowledge-based economy, Najib must lead the country:

- first, to acknowledge the importance of knowledge spillovers in spurring growth and of economic trickling down in spreading growth. If Penang has good growth potential, its realization of that potential will benefit the rest of the country through positive spillovers.
- second, to strengthen international competitiveness through merit-based criterion in personnel selection and through fair economic competition among firms. Otherwise, outstanding foreign and domestic talents who are needed to become a knowledge-based economy will not flow into Malaysia, and, if they do, will not stay put in Malaysia.

Creating Malaysia's Place in the World Economy: The Best is Yet to Be

It must be admitted in public discussions that ownership restructuring has not been without considerable costs. Malaysia's internationally competitive manufacturing sectors are precisely those sectors that have been exempted from the ownership requirements and are dominated by direct foreign investors. Local Malaysian firms, as is usually the case in most countries, have started by concentrating on the domestic market; hence they have been subject to ownership restructuring throughout their history. Some have grown and prospered under the requirements of laws such as the ICA, but the number of these firms that have grown to be truly international is not large.

Given the drop-off in foreign direct investment, Malaysia now needs to look locally for entrepreneurial talents to keep Malaysian industries internationally competitive. The problem is that the incentive structure in place to stimulate foreign direct investors is not available to encourage new sources of local entrepreneurial talent. There exist fast-acting solutions to the present economic malaise and to the long-run problems of maintaining high growth and increasing international competitiveness, but considerable statesmanship and political skill will be required to overcome resistance to the quick-relief solution of jettisoning the NEP framework.

These are extraordinary times in Malaysia, and extraordinary political leadership is important. Part of extraordinary leadership is the political courage to assess objectively whether the continuation of the race-based programs and the industrial policies has more to do with ensuring political patronage than with providing "infant industry protection" to "disadvantaged" *Malay* professionals and businesses. If holding onto political power is the real motivation behind these policies, then the economic costs from a rigid ICA are not serving the cause of social justice, which is the defensible motivation behind the race-based policies. A fast-growing and fiercely competitive economy will do more to enrich the Malay community than state-generated rents can ever hope to do.

Naturally, assessments differ as to whether the Malay professional and entrepreneurial classes are now able to compete with non-Malay Malaysians. On the eve of the 1999 elections, in a speech to government officials, Mahathir rejected the arguments for meritocracy advanced by some successful Malays:

> "[With the implementation of meritocracy] the Malays and the *bumiputras* will become manual workers and will not be able to hold high positions they are holding today. ...Let us not think that we have reached this level because of our own ability. "

Although there is disagreement over the readiness of the Malays to compete, there is agreement that the government subsidies retard the progress of Malays toward parity in competitiveness with the non-Malays and, equally important, toward parity in competitiveness with the rest of the developed world. The only way to become truly competitive is learn through competition. It is now time to throw away the crutches that are getting in the way of the Malay entrepreneurs and the economy advancing faster.

The NEP framework is, of course, not the only high obstacle to growth (although it is probably the most damaging obstacle). Other key pillar economic institutions that need reform urgently include the judiciary system, the law enforcement bodies, the education institutions, and the public finance system. Some of the legal rulings of the Malaysian courts have been so "pioneering" in nature (e.g. the buyer of a stolen property is allowed to keep the property) that the legal protection of property has been weakened in the eyes of investors.

The recent embarrassing incident of the anti-corruption agency and the commercial police division arresting members of each other calls out for immediate implementation of the recommendations of the Royal Commission on Police Reform proposed in 2004. The recent spate of mysterious deaths of people during their detention and interrogation by the police and the anti-corruption agency is suggestive of physical abuse and authoritarian arrogance that have gotten out of control. This seeming rule-by-terror supplemented by the continual deterioration in the maintenance of law and order (topped off by often capricious legal rulings) cannot help but discourage foreign and domestic investment.

The fiscal system has to be decentralised extensively to reflect the federalist nature of Malaysia. Fiscal federalism would empower local development initiatives, promote a growth competition amongst the states, and reduce the ability of the federal government to engage in white elephant construction projects. The wisdom in the old adage that “two minds are better than one” will be multiplied by 7 times when the 13 states are unshackled in their courting of investment projects and in the protection of their local ecological systems.

A knowledge-based economy stands on many pillars. It requires the government to implement root-and-branch reform in many areas (most, notably, the civil service, educational and research institutions, the fiscal system, the state procurement system, the judiciary branch, and government-linked companies). Only with the adoption of a new policy framework that puts the culture of excellence at its core, would Malaysia then have institutional pillars that would be strong enough to support the growth of a knowledge-based economy; and would there then also be the hope for Malaysia that the best is yet to be!

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