II. Rents and Rent-Seeking in Malaysian Development

Overview of Rents and Rent-Seeking in the Malaysian Economy

In the Malaysian economy, rents and rent-seeking activities have existed since before independence. The development of rents has changed from preserving the interests of the colonial masters to redistributing wealth along inter-ethnic lines and encouraging investments in new productive activities.

Among developing East Asian economies, Malaysia's rent-seeking expenditure over the 1970s and 1980s was the second lowest (after South Korea), with the Indian sub-continents and Thailand having the highest expenditures (Khan & Jomo 2000). Although receiving relatively good reports from international business in subjective corruption measures, other evidence suggests substantial corruption during the 1970s, increasing during the 1980s due to increasing contributions by businesses to politicians, and worsening during the 1990s due to privatization. **Table 6** shows perceived levels of corruption in selected Asian developing economies.

Table 6: Selective Corruption Indices for Selected East Asian Economies

Period	Malaysia	Thailand	South Korea	Bangladesh	India	Pakistan
1980-83	6.0	1.5	5.7	4.0	5.3	4.0
1996	5.3	3.3	5.0	2.3	2.6	1.0

*Key: 10 indicates minimum corruption, while 0 indicates maximum corruption
Source: Mauro 1995 and Bardhan 1997 in Khan & Jomo 2000

The trends in Malaysia suggests combination of rent-seeking processes led by the state, with a few cases of rent-seekers influencing the state, with rent-seeking inputs involving moderate centralized bribes, lobbying, and moderate expenditures by politicians. Most of the rent-seeking processes involve transfer-based rents, usually from the federal government to state governments, state agencies, or selected business elites, where political demands for transfers have been met by a stable set of redistributions.

Hence, rents and rent-seeking in the Malaysian economy have passed through five main stages of development: (1) the colonial stage (pre-independence), (2) the relatively laissez faire period (1960s), (3) the increased government intervention period (1970s), (4) the heavy industrialization period (early and mid-1980s), (5) the deregulation and privatization period since mid-1980s.

The Colonial Heritage (Pre-Independence)

Within the British colonies, Malaya was by far the most profitable colony, and its economy one of the most developed. It was the main financer of British postwar reconstruction with its export earnings. To reduce transportation costs, a few industries were developed under colonialism, mostly involving processing raw materials for export and imports for the market, e.g. beverages.

However, further liberalization of the Malaysian economy has emphasized production for export, instead of building a strong local entrepreneurial class initially producing goods for the protected domestic market. In addition, the British 'divide - and- rule' policy shaped the economic structure, which reflects uneven development among ethic groups.

The Relative *Laissez Faire*

Malaya gained independence on 31 August 1957. In September 1963, Malaysia was formed with the inclusion of Singapore, Sabah, and Sarawak, but later in August

1965, Singapore separated from the federation. Throughout, the British managed to preserve their influence. Apart from pushing for the formation of Malaysia itself, they also managed to protect the property rights of British business interests and preserve the colonial legal and administrative framework within the Merdeka (Independence) Constitution itself. To prevent capital flight, the newly independent government consolidated colonial property rights.

The government, then led by the Alliance, a coalition of the political elite from the three major ethnic groups (Malays, Chinese, and Indians), embarked upon an economic development approach which emphasized economic diversification and industrialization, promoting private enterprise while protecting the economic interests of the ex-colonial power, and encouraging foreign investment inflows. By then, the federal administrative government had transferred authority over land and natural resources to the state governments.

In line with its central economic objectives, the state pursued a modest development strategy, with minimal state intervention to diversify the economy and create suitable conditions for rapid capital accumulation. Import-substituting industries were encouraged, with various incentives offered, including extended tariff protection, infrastructure, and other supportive economic measures.

This trend changed in the second half of 1960s, when the government established the Federal Industrial Development Authority (now Malaysian Industrial Development Authority, MIDA), which marked the change in direction to export-oriented industrialization. In 1968, the Industrial Incentives Act was passed, introducing a different set of incentives to attract more labor-intensive export-oriented industries. Despite limitations in added-value in resource-based industrialization, the palm oil industry managed to develop the world's most advanced refining technology.

Although the economic development approach was intended to protect British interests in Malaya, it also enabled Chinese businesses to consolidate and strengthen their position in the economy. The Constitution included provisions for 'Malay privilege' for the purpose of ethnic affirmative action. This was the first framework for creating and deploying rents along inter-ethnic lines in Malaysia. The government introduced various rural and regional development efforts (to secure crucial political support from rural Malays) and new labor legislation (to replace special regulations introduced during the Communist-led insurgency).

With increased pressure from ethnic Malays to economically enhance the community since the mid-1960s, new public or state-owned enterprises (SOEs) were established. However, this did not cure the worsening inequality between town and country, and between the major ethnic groups. The growing tension peaked during 1969, as reflected by the general election results and riots in May 1969.

Greater Government Intervention

The government announced the New Economic Policy (NEP) in 1970, with the objective of creating the socio-economic conditions for 'national unity' by eradicating poverty and restructuring society through massive economic redistribution programs. The Petroleum Development Act of 1974 ensured that the central government captured most oil rents.

NEP implementation saw increased state intervention in fiscal resource allocation, public sector ownership, and regulation of business enterprises. This was reflected in the increased establishments and funding of SOEs, mainly statutory bodies (established by special legislation) and private companies (registered under the 1965 Companies Act). Various laws and regulations were also established to increase

Bumiputera participation in the economy. The most important was the 1975 Industrial Coordination Act (ICA), to regulate the growth of manufacturing enterprises.

The ICA provoked much dissent from the Chinese business community, especially with the mandatory ruling requiring a minimum 30 percent Bumiputera ownership for all firms beyond a certain size. Bumiputera participation in government-approved manufacturing projects grew rapidly between 1975 and 1985, despite massive capital flight, (Jomo 1990).

The establishment of SOEs increased public debt, and hence, the government's financial burden, inefficiency was reflected in accumulated losses and hence, wastage of investment resources, thus slowing down economic growth (Kamal & Zainal 1989; Jomo & Gomez 2000). Of 900 SOEs in 1984, only 269 submitted annual returns, with accumulated losses of RM137.3 million (Supian 1988; Jomo & Gomez 2000).

Deregulation and New Regulation

Malaysia met with a severe economic recession in the mid-1980s, following the global recession, tighter international liquidity, higher real interest rates, lower primary commodity prices, reduced international demand for manufactured exports, reduced foreign investment inflows, and the turn to more deflationary fiscal and monetary policies.

Earlier during the height of the 1980-82 international recession, the government adopted counter-cyclical budgetary policies, increasing spending on public sector consumption, investment, and employment, (Jomo & Gomez 2000). After winning the election in April 1982, the government reversed its policies by cutting back on public spending except for government-sponsored heavy industries.

The profligacy of the government during the early 1980s reducts resource availability, constraining public sector investments. By the mid-1980s, dissatisfaction with the government emerged among the more capable Bumiputeras the public and private sectors, mainly large Malay-controlled business groups, questioning government interference in business, hence demanding a less-regulated economy.

The economies of Southeast Asia boomed from the late 1980s, benefiting from increased foreign investments, due to rising production costs, tighter labor markets and environmental regulations in Japan and the first-tier East Asian newly industrialized economies. In Malaysia, deregulation by the government from 1986 and renewed external demand for Malaysian exports attracted investments and further accelerated economic growth.

Acknowledging the problems and limitations of the earlier state-led heavy industrialization policy, the Promotion of Investments Act (1986) encouraged foreign manufacturing investments, with emphasis on technologically sophisticated, export-oriented industries. This resulted to a significant economic recovery from 1987, with an annual growth rate of 8 percent from 1988 to 1997.

When the First Outline Perspective Plan (1971-90) came to an end in 1990,the NEP the objective of achieving 'national unity' was not really achieved, although the poverty level declined impressively from 49 percent in 1970 to 17 percent in 1990, and Bumiputera shares in public listed companies rose significantly from 2 per cent in 1970 to 20 per cent in 1990.

Privatization

With Vision 2020 from 1991, favoring growth, modernization, and industrialization over inter-ethnic redistribution (with greater emphasis on market rather than regulatory measures), inter-ethnic tensions receded. With the 1990s policy of encouraging Malaysian firms to invest overseas, the government reduced intervention and ethnic-bias in the economy.

However, the privatization policy, first announced in 1983, and later formalized in 1985 through the *Guidelines on Privatization* by the Economic Planning Unit (EPU) and later, with the publication of the *Privatization Masterplan* (*PMP*) in 1991, saw once publicly-controlled monopolies transferred to privately-controlled monopolies, mostly secured by a select few, politically influential groups which thus became economically powerful. Such close government-business relations, have been termed *Malaysia Inc.*

In general, the government's objectives/arguments for implementing privatization were: (1) To reduce the government's financial and administrative burden; (2) To increase competition, efficiency and productivity; (3) To stimulate private entrepreneurship, investment, and hence, overall economic growth; (4) To reduce the size of the public sector; and (5) To help achieve the New Economic Policy (NEP) objective of in redistributing wealth to the *Bumiputeras*.

Privatization, and its associated feature of *Malaysia Inc.* or close government-business relations, has been partially credited as the main contributor to the success of the Malaysian economy. However, not all interventions (especially those oriented to redistribution) enhanced productivity. Many cases, mainly in the course of ethnic redistributive measures, saw abuses that undermined the ostensible objectives of privatization, including bailing out loss-making companies, funding unprofitable investments/projects, favoritism in tender procedures, and political motives. Such collusion is also said to have led to moral hazard, reflected in the bailing out of loss-making 'crony' companies, funding of unprofitable investments/projects, favoritism in tender procedures, and political approval for mergers and acquisitions.

The privatization policy was supposed to reduce the government's financial and administrative burden, by one-off revenues (from the sale of public assets) and government equity sales, transfers of outstanding debts (to the private sector), and capital expenditure savings (the *PMP* claimed that the government has saved RM16.83 billion by listing previous SOEs). However, this claim overlooked the losses, due to compounded valuation (i.e. minus depreciation) and undervalued sales of public assets. In addition, the fact that only profitable ventures were privatized leaves the public sector with loss-making ventures, thus increasing the public sector's fiscal burden.

High investments and high economic growth were also attributed to the privatization policy. Among the key indicators were increases in the Kuala Lumpur Stock Exchange (KLSE)'s market capitalization by RM201.09 billion with the listing of 13 privatized SOEs by June 1992, expanding to RM 572.260 billion by September 2003, and the release of resources for corporate expansion. However, the extent of this claim is limited, as most major privatization exercises only involved partial divestiture, with the government still remaining as the controlling shareholder (by maintaining a 'golden share'). In addition, liabilities (by which the government guarantees certain minimum revenues for the privatized companies), and the increase in demand for private debt and equity capital.

Various government agencies have been used as 'vehicles' to rescue loss-making companies. When Time dotCom was listed on the Kuala Lumpur Stock Exchange (KLSE) during its initial public offering (IPO) exercise in March 2001, only 12% of the stock was subscribed by independent investors (68.6 million out of the total of 571.7 million shares), while the rest was underwritten by 10 Malaysian banks, and ultimately by several government-controlled funds, the Employees Provident Fund (EPF) and the Armed Forces Welfare Fund. During the first three days after its flotation, the stock fell from its IPO price by 31%, causing the EPF to incur a reported paper-loss of RM105 million.

Numerous claims have credited privatization with increased competition, efficiency and productivity. However, the measures involved deregulation, management restructuring and performance-based incentive schemes with privatization per se. Previously public monopolies were transformed into privatized monopolies, or virtual monopolies such as Malaysian Airlines, Tenaga Nasional, Pos Malaysia, and Telekom Malaysia.

With lower customer welfare (due to increased user costs) there is little evidence that efficiency and productivity has improved. More generally, privatization had adverse welfare implications for consumers, especially the poor, public sector, and employees. The *PMP* claimed that privatization has considerably reduced the size of the public sector, which was transferred to the private sector.

Privatization's biggest success was said to be in achieving the New Economic Policy (NEP)'s goal of redistributing wealth to *Bumiputeras*, and consolidating the *Bumiputera* commercial and industrial community (BCIC), with at least half the allocation of privatized entities' share issues to *Bumiputeras*. However, these economic rents were generally not actually effective in accelerating industrialization and promoting *Bumiputera* entrepreneurship.

Most privatization exercises often but not always bestowed the assets at discounted prices to several politically well-connected, *Bumiputera*, beneficiaries at the national expense. Privatization thus strengthens this rentier elite. Some opportunities for rent-seeking had efficiency-enhancing consequences for the economy. However, the economic rents were not actually effective in accelerating industrialization and growth, as most privatization exercises favored politically well-connected interests. In several instances, proper tender procedures were waived in favor of companies controlled by close-friends, associates or relatives of these well-connected figures.

Meanwhile, some state interventions within the economy and rents have enhanced accumulation, diversification, and industrialization, mainly by improving productive capacity. For example, export duty on crude palm oil induced refining capacity investments. In addition, performance criteria have effectively ensured achievement of policy objectives improvement in efficiency in some ventures (Jomo & Gomez 2000). The magnitude and nature of these rents did not undermine accumulation in the 'internationalized' sectors of the economy, but instead ensured rapid growth (Rasiah 1996; Jomo & Gomez 2000). Rents provided incentives, especially for foreign investors to relocate production to Malaysia.

When massive short-term capital inflows, partly attracted by good macroeconomic performance, were suddenly reversed in 1997, its adverse impacts on the balance sheets of financial institutions and firms resulted in credit contraction and a collapse in domestic demand, subsequently led to the 1997-98 major financial crisis, which adversely affected many of the major closely-related corporations. Subsequently after the 1997-98 financial crisis, the privatization policy has been reversed with the 're-nationalization' of these poorly performing and highly indebted companies, such as the UEM-Renong group, Malaysian Airlines, and the Lion group, which were absorbed by the government's national asset management facility, Pengurusan Danaharta Nasional.