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# Malaysia's Manufacturing Sector: Development Issues and Policy Options

(In Three Volumes)

Volume I: Summary Report and Recommendations

April 9, 1981

Projects Department  
East Asia and Pacific Regional Office

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## CURRENCY EQUIVALENTS

Currency Unit - Ringgit (M\$)

1 M\$ = US\$0.45  
1 US\$ = M\$ 2.20

## ABBREVIATIONS

-	BNM	:	Bank Negara Malaysia
-	DRC	:	Domestic Resource Cost
-	EPRs	:	Effective Protection Rates
-	EPU	:	Economic Planning Unit
-	FMP	:	Fourth Malaysia Plan
-	FTZs	:	Free Trade Zones
-	GOM	:	Government of Malaysia
-	ICA	:	Investment Coordinating Act
-	IEs	:	Industrial Estates
-	IIP	:	Index of Industrial Production
-	LIIs	:	Locational Incentives
-	LUR	:	Labor Utilization Relief
-	MIDA	:	Malaysian Industrial Development Authority
-	MIDF	:	Malaysian Industrial Development Finance Co.
-	MIS	:	Monthly Industrial Statistics
-	MTI	:	Ministry of Trade and Industry
-	NEP	:	New Economic Policy
-	PS	:	Pioneer Status
-	QLFS	:	Quarterly Labor Force Survey
-	SACT	:	Special Advisory Committee on Tariffs
-	SEDCs	:	State Economic Development Corporations
-	SMIs	:	Small and Medium Industries
-	TAB	:	Tariff Advisory Board
-	TMP	:	Third Malaysia Plan

## FISCAL YEAR

January 1 - December 31

MALAYSIA

MANUFACTURING SECTOR DEVELOPMENT ISSUES AND POLICY OPTIONS

Volume I

SUMMARY REPORT AND RECOMMENDATIONS

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PREFACE

This report presents an overview of the findings of an Industrial Sector Mission which visited Malaysia from February 18 to March 11, 1980. Two basic objectives of the mission were: (a) to review the past performance and assess the growth potential of the manufacturing sector in terms of its likely contribution to increased output, employment and exports; and (b) to highlight, where appropriate, policies and incentives that will help to ensure that Malaysia's manufacturing potential is fully exploited and the benefits to the national economy maximized.

The present report is intended as a contribution to the preparation of the Fourth Malaysia Plan (FMP: 1981-1985). From the very start the work of the mission was seen as a cooperative effort of the Government and the Bank. Recognizing the collaborative nature of the task, the Economic Planning Unit (EPU) established a counterpart steering committee, drawing its members from the Ministry of Trade and Industry, Treasury, Bank Negara Malaysia, Ministry of Labor, Ministry of Public Enterprises and the Department of Statistics. This committee contributed substantially to the success of the mission both during the formulation of the terms of reference for the study and during the field visit of the mission. Given the tight time schedule set for the preparation of the FMP, the mission focused mainly on highlighting the development issues and the changing role of incentives and policies at this stage of the manufacturing sector in Malaysia.

This mission consisted of the following members:

Fateh M. Chaudhri	- Chief of Mission
Keith Marsden	- Employment Policies & Incentives
Ozay Mehmet (Consultant)	- Labor Market Analysis
Hugo Molina (UNIDO)	- Light Industry Subsectors
Vinod Prakash	- Sector Performance and Prospects
Yung Rhee	- Incentives and Policy Framework
Bertil Walstedt (Consultant)	- Public Enterprises and Heavy Industry

In the processing of this report and in reviewing some of the working papers, Mr. S. Talbot gave substantial support to the mission. Mr. F.M. Iqbal, Senior Field Advisor, UNIDO, also provided the mission with notes on the Institutional Framework for Industrial Development in Malaysia.

A preliminary draft of the report was submitted to EPU in July 1980 and technical discussions on that draft took place with government officials in Kuala Lumpur during August 23-September 1, 1980. Follow-up policy level discussions were conducted by a Bank mission consisting of Messrs. Jaycox, Gould, Tsantis and Chaudhri in January-February 1981. This report reflects those discussions.

This report consists of three volumes:

Volume I : Summary Report and Recommendations

Volume II : The Main Report

Volume III: Annex and Statistical Tables

The following background working papers prepared in connection with the report have been issued individually in white cover and are available upon request from the East Asia and Pacific Projects Department.

1. A Study of Growth Performance and Outlook of the Manufacturing Sector in Malaysia.
2. Incentive Systems and Policies for the Manufacturing Industries in Malaysia.

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MALAYSIA - BASIC DATA - MANUFACTURING SECTOR

	MS billion at 1970 prices					Annual growth rates (%)			
	1971	1973	1975	1978	1980	1961-65	1965-70	1971-75	1975-80
GDP	13.0	15.9	17.4	22.3	25.7	5.6	5.5	7.5	8.1
Manufacturing	1.9	2.5	2.9	4.3	5.3	12.1	9.9	11.3	13.0
% of GDP	14.3	15.8	16.4	19.1	20.5				

Manufacturing Value Added (current prices) (VA = Value added, GO = Gross Output, GO* = Gross Output approximated by Sales of Manufactured Own Products)	Structure of value added (%)		Annual growth rates (%)			Contribution to growth (%)	
	1968	1973	1968-73 GO	1968-73 VA	1973-78 GO*	1968-73 GO	1973-78 GO*
31 Food, beverages & tobacco products	28.0	23.9	15.9	17.8	13.8	27.3	18.3
32 Textiles, clothing & footwear	3.2	6.1	30.2	39.0	26.7	6.7	10.3
33 Wood & wood products	11.8	13.9	23.7	26.0	12.4	12.0	2.0
34 Paper, paper products, printing & publishing	6.7	5.7	18.3	17.7	14.2	3.8	2.6
35 Chemicals, petroleum, rubber & coal products	28.1	21.2	15.2	13.6	17.2	21.8	26.0
36 Nonmetallic mineral products	7.0	5.3	14.8	14.7	20.0	2.7	2.9
37 Basic metal products	2.5	3.7	31.0	32.0	23.0	4.1	2.0
38 Fabricated metals, machinery, etc.	12.4	19.8	30.2	34.0	31.6	20.1	25.8
39 Miscellaneous industries						1.5	10.1
<u>Manufacturing Total</u>	<u>100.0</u>	<u>100.0</u>	<u>19.4</u>	<u>21.6</u>	<u>20.1</u>	<u>100.0</u>	<u>100.0</u>

Manufacturing Employment ('000 no.)	Census		Monthly indus- trial statistics		Annual growth rates (%)	
	1968	1973	1973	1978	1968-73	1973-78
31 Food, beverages & tobacco products	26.7	46.2	23.9	31.3	11.6	5.5
32 Textiles, clothing & footwear	8.8	34.9	29.0	53.1	32.0	12.9
33 Wood & wood products	21.9	44.9	15.0	17.9	15.4	3.6
34 Paper, paper products, printing & publishing	10.9	17.4	11.6	16.1	9.8	6.8
35 Chemicals, petroleum, rubber & coal products	25.8	42.7	35.9	49.4	10.6	6.6
36 Nonmetallic mineral products	7.3	13.0	3.3	5.5	12.2	10.8
37 Basic metal products	3.1	6.8	2.7	4.0	17.0	8.2
38 Fabricated metals, machinery, etc.	20.6	65.9	40.0	85.9	26.0	16.5
<u>Manufacturing Total</u>	<u>125.5</u>	<u>273.5</u>	<u>181.2</u>	<u>290.8</u>	<u>16.9</u>	<u>9.9</u>

Manufacturing Production Index (1968=100)	Weight	June						
		1969	1971	1973	1975	1977	1978	1979
311/2 Food products	16.5	109	112	130	136	162	172	172
321 Textiles	2.2	112	122	197	214	314	356	395
331 Wood & wood products	11.9	108	140	203	190	286	274	303
351/2 Industrial chemicals & products	9.6	112	122	166	155	180	204	235
353/4 Refined petroleum & products	5.0	100	92	99	118	169	189	199
35591 Rubber remilled & latex processed	8.4	107	107	98	82	83	82	70
Other rubber products	6.4	109	132	166	164	196	193	198
369 Nonmetallic mineral products	7.6	112	119	147	161	196	246	261
37 Basic metal products	2.7	144	166	226	228	284	318	318
381 Fabricated metal products	4.2	107	141	243	186	233	292	311
383 Electrical machinery, etc.	2.0	129	189	201	287	432	466	468
384 Transport equipment	2.3	210	282	393	412	481	573	633
<u>Manufacturing Total</u>	<u>100.0</u>	<u>116</u>	<u>138</u>	<u>187</u>	<u>216</u>	<u>284</u>	<u>312</u>	<u>337</u>

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Merchandise Exports (current prices)	% of merchandise exports				Annual growth rates (%)		
	1961/62	1968/69	1973/74	1978/79	1960-70	1973-77	1970-79
<u>Traditional (Primary)</u>	<u>91.5</u>	<u>88.2</u>	<u>84.0</u>	<u>79.5</u>	<u>3.2</u>	<u>18.2</u>	<u>17.7</u>
Rubber	46.8	36.9	30.7	19.9	-1.5	7.7	11.4
Timber	6.2	16.1	17.7	14.0	16.0	11.6	19.4
Palm oil	2.2	3.3	9.0	11.9	14.3	38.5	29.5
Tin	18.1	19.3	13.7	10.5	7.2	17.4	9.5
Crude & partly refined petroleum	3.3	3.7	5.4	15.6	3.2	65.4	39.8
<u>Nontraditional (Manufactures)</u>	<u>8.5</u>	<u>11.8</u>	<u>16.0</u>	<u>20.5</u>	<u>7.1</u>	<u>25.8</u>	<u>25.6</u>
Food products	1.3	1.8	1.9	1.5	7.2	19.7	15.5
Textiles & clothing	+0.0	0.7	1.1	2.2	n.a.	30.4	37.9
Wood products	+0.0	3.1	2.9	2.0	n.a.	3.8	20.0
Petroleum & chemical products	4.4	4.5	2.3	1.4	2.0	0.7	2.8
Electrical machinery	+0.0	+0.0	2.0	9.6	n.a.	73.0	74.5
<u>Total Merchandise</u> (Annual average M\$)	<u>3.3</u>	<u>4.6</u>	<u>8.8</u>	<u>20.5</u>	<u>3.6</u>	<u>19.5</u>	<u>18.6</u>

Merchandise Imports	% of merchandise imports				Annual growth rates (%)		
	1961	1969	1974	1979	1961-69	1969-74	1974-79
<u>Consumption Goods</u>	<u>46.7</u>	<u>31.6</u>	<u>21.6</u>	<u>20.1</u>	<u>-1.6</u>	<u>13.7</u>	<u>9.7</u>
Food, beverages & tobacco	25.6	14.8	9.2	7.6	3.9	11.7	7.1
Consumer durables	6.0	3.7	2.9	4.7	-4.9	17.3	21.9
<u>Investment Goods</u>	<u>17.1</u>	<u>20.6</u>	<u>33.6</u>	<u>30.6</u>	<u>5.6</u>	<u>35.4</u>	<u>9.1</u>
Machinery & transport equipment	8.7	9.8	13.6	12.4	4.8	31.0	9.2
<u>Intermediate Goods</u>	<u>27.8</u>	<u>37.6</u>	<u>40.5</u>	<u>47.1</u>	<u>7.1</u>	<u>24.5</u>	<u>14.7</u>
For manufacturing	7.8	20.1	23.7	28.3	16.1	26.8	15.3
<u>Imports for Re-Exports</u>	<u>8.4</u>	<u>9.4</u>	<u>4.3</u>	<u>2.2</u>	<u>4.6</u>	<u>4.8</u>	<u>-2.6</u>
<u>Total Merchandise</u> (M\$ bln in current prices)	<u>2.8</u>	<u>3.6</u>	<u>10.0</u>	<u>17.1</u>	<u>3.1</u>	<u>22.7</u>	<u>11.2</u>

Direction of Exports	% of total merchandise exports				Manufactured/ merchandise exports		Annual growth rates (%) in 1973-78	
	Manufactures		All merchandise		1973	1978	Mfd.	All merch.
	1973	1978	1973	1978				
USA	23.9	33.6	10.8	18.6	52.5	30.3	33.2	32.0
Singapore	14.6	13.0	23.3	16.2	15.0	24.6	21.0	10.0
Japan	19.6	12.7	18.1	21.7	25.7	18.0	14.2	22.5
Netherlands	3.7	7.6	3.7	5.6	23.6	41.2	44.0	28.5
United Kingdom	7.7	4.8	7.9	4.8	23.2	30.9	13.5	7.1
W. Germany	2.2	4.0	3.8	3.6	14.1	34.1	40.0	17.2
Rest/world	28.3	24.3	32.4	29.5	20.8	25.3	21.0	16.1
<u>Total/World</u> (M\$ bln in current prices)	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>100.0</u>	<u>23.8</u>	<u>30.7</u>	<u>24.5</u>	<u>18.3</u>
	1.8	5.2	7.4	17.1				

MALAYSIA'S MANUFACTURING SECTOR:  
DEVELOPMENT ISSUES AND POLICY OPTIONS

SUMMARY REPORT

A. The Setting

1. According to the available statistics Malaysia has had an impressive record of economic growth during the past two decades and the manufacturing sector contributed substantially to this achievement.<sup>/1</sup> Gross domestic product (GDP) increased at an annual rate of 5.5% during the 1960s, accelerating to 7.5% p.a. (with GNP rising at about 7.0% p.a.) during the 1970s. Manufacturing, growing at a rate of 12% p.a. over the last 20 years, contributed substantially to the employment creation, diversification and overall growth of the economy and also helped reduce the incidence of poverty in the Malaysian society. Although the aggregate poverty gap as a percentage of GDP has been compressed to a level of about 3.0% in 1976, a high proportion of households remains below the poverty line.<sup>/2</sup> Thus in eradicating the remaining poverty and in achieving the other major objective of the New Economic Policy (NEP) - the restructuring of society to achieve racial balance - the manufacturing sector continues to play a pivotal role.<sup>/3</sup>

B. Overall Performance of the Manufacturing Sector

2. Manufacturing activity has outstripped the growth of other principal sectors, raising its share in GDP from about 9% in 1960 to an estimated 20% in 1980.<sup>/3</sup> The available data indicate that during the First Malaysia Plan

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<sup>/1</sup> In analyzing the past performance and quantifying our findings, especially for the recent past, formidable difficulties were faced because of partial or incomplete data series and weaknesses of the manufacturing index. A special annex to this report highlights the inadequacies of the manufacturing data base. Recognizing these problems, the Department of Statistics and EPU have asked the Bank for technical assistance to strengthen the data system and the Bank is providing initial help in this matter.

<sup>/2</sup> "Malaysia: Selected Issues in Rural Poverty," 1980, World Bank, Washington, D.C., pp. 15-17. The poverty gap is defined as the difference between the actual incomes of poverty households and the poverty income line. In 1978, about 55% of households in agriculture and 22% in nonagriculture sectors were living in absolute poverty.

<sup>/3</sup> Sensitivity analysis of alternative rates of manufacturing growth confirms the importance of the growth rate of manufacturing employment to the Government's anti-poverty strategy. See "Malaysia: Growth and Equity in a Multiracial Society," World Bank, 1980, Chapter 3.

the manufacturing sector's contribution to incremental GDP was only half that of agriculture, while during the Second Plan both contributed equally and during the Third Plan the manufacturing sector's contribution (26%) is expected to be twice that of agriculture. The manufacturing sector's success in creating gainful employment has also been impressive, employment growth ranged from 9% to 12% p.a. according to various indicators; thus the share of manufacturing in total employment was raised from about 9% in 1967/68 to 14%-17% by 1978.<sup>/1</sup> Manufacturing exports have contributed substantially to the sector's growth. The share of manufacturing in total exports more than doubled from 8.5% in the early 1960s to about 21% in the late 1970s. New exports like textiles, clothing and electronics contributed about half of manufactured exports in the later years. Consequently, the composition of manufactured exports has dramatically changed from resource-based to non-resource-based activities - from 50:50 in 1975 to about 25:75 in 1979. In terms of the source of growth, increased domestic demand and import-substitution (together) accounted for almost 90% of increased manufacturing sector output during the 1960s. By the late 1960s and early 1970s, manufactured exports grew more rapidly accounting for a fifth of the sector's growth. It is important to note that this shift in the sources of growth toward export expansion has been accompanied by a substantial acceleration in the annual rates of manufacturing value added, full-time employment creation (which was as high as 13% p.a. during 1963-73) and, notwithstanding high and rising employment growth, a considerable improvement in labor productivity from virtually no increase during 1959-63 to about 3% p.a. increase in constant prices during the subsequent 10 years.

3. While Malaysia's manufacturing sector has performed impressively over time,<sup>/2</sup> its growth is about average when compared with that of other East Asian Countries. In terms of the growth rate in manufacturing value added (in real terms, during 1970-77), Malaysia's performance was below that of Korea and Taiwan but better than that of the Philippines and Thailand. However, in terms of export growth (15% p.a. increase in current prices over the last two decades) the other countries have done much better than Malaysia. Also in a group of 88 Third World Countries which increased their manufactured exports at 22% p.a. (in current prices, during 1963-76) Malaysia was slightly below the group average. But more importantly, the country will find it increasingly difficult in the 1980s to cope with the intensively competitive environment abroad and emerging constraints on sector expansion at home (discussed in paras. 5 and 6 below) and tap the

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<sup>/1</sup> Based on Monthly Industrial Statistics (MIS) and Quarterly Labor Force Surveys (QLFS). More details are provided in Chapter I, Section "C" paras. 2.01-2.05 of the main report which also bring out problems of measuring manufacturing sector employment in Malaysia. The difference between 14% and 17% results from adjustments made by EPU/Treasury to QLFS data.

<sup>/2</sup> Given the serious data deficiencies, some of the recent growth may be more apparent than real. See Chapter I, Section B, paras. 1.28-1.34 of the Main Report.

potential of the sector (indicated in section 'D') if it does not start gradually introducing the types of changes in the incentives and policy framework suggested in section 'F' below which aim at providing balanced incentives to importsubstituting and export activities.

### C. Key Issues and Constraints on Sector Expansion

4. The importance of linkages between exports and economic growth has long been recognized. The twin objectives of the NEP (eradication of poverty and restructuring of employment and equity in favor of Malays) have added a fresh dimension to the role of labor-intensive, export-based manufacturing development in Malaysia. These over-riding national goals have served as a perspective against which the Mission reviewed the current problems, assessed future prospects and discussed the need for adjustments in the incentives and policy framework of the manufacturing sector.

5. The outlook for Malaysia's export of manufactures will mainly be determined by the demand for them from industrialized economies, where the growth rate during the 1980s is expected to remain much below the 4% p.a. of the 1960s. During recent years, protectionist pressures in industrialized economies, which account for more than 70% of Malaysia's manufactured goods exports, have continued to be strong, in part due to the deepening and prolongation of the current recession. Also the Malaysian manufactured export base has already expanded nine times since 1971 (in 1979 prices); manufactured exports have relied heavily on Free Trade Zone (FTZ) establishments; and the strength of the recent industrial growth may be exaggerated by the inadequate statistics that are available. Achieving high real growth rates in manufacturing during the 1980s will therefore not be easy.

6. While Malaysia's success in achieving a fairly rapid growth in the national economy within an environment of relative price stability deserves full recognition, the mission feels it necessary to draw attention to a number of weaknesses of the pattern and structure of the manufacturing sector and features of the incentives and policy framework which have a bearing on the sector's future growth and Government's NEP Objective tied to it:

- (a) Malaysia's protective system (which includes tariff protection, investment and import licensing, exemption from import duty and surtax as well as drawbacks and refund of import duties) is administered by the Special Advisory Committee on Tariffs (SACT) on a "case-by-case" basis. The principal rationale behind the existing approach is that protection/incentives are "tailored" to the needs of a firm in a particular subsector and that the system has been serving the NEP objectives of restructuring employment and equity. Available evidence shows that Bumiputras constituted 35.1% of manufacturing employment in 1978 compared with 32.3% in 1967/68 (an increase of only 2.8% over ten years). While the existing system's contribution to employment restructuring is clearly limited, over the years the administration of the system has become complex, has imposed a considerable administrative burden on the Malaysian Industrial Development Authority (MIDA) (which had to review 1,900

applications during 1979 compared to 800 in 1970) and above all, the system has become a major source of anti-export "trade-bias", "subsector-bias" and "firm-bias".<sup>/1</sup> For example, on average the effective protection rate for import-substituting activities has been substantial (about 40% in the 1970s) compared with a negative (-44%) EPR for non-FTZ exporters, resulting in an anti-export bias of about 84%.<sup>/2</sup> Experience in many countries indicates that such biases hinder efficient industrial development because of the serious distortions in resource allocation that they produce in the system. The most important substantive issue is therefore how to reduce these biases, thus restoring a healthy balance between the incentives for import-substituting and exporting activities and among export firms, between FTZ and non-FTZ firms. Reducing biases is a central theme of this report; Section "F" summarizes policy adjustments aimed principally at accomplishing this objective.

- (b) In many subsectors rapid growth associated with import-substituting activities has not been efficient and appears to have been sustained by high effective protection rates (EPRs). For example, in the early 1970s, principal nonfood manufacturing industries having EPRs in excess of 100% were motor vehicles (296%), electric appliances (270%), plastic products (268%), tires and tubes (246%), petroleum and coal products (174%), furniture and fixtures (157%), leather and leather products (112%), television, radio and telecommunications equipment (101%). It is extremely important that EPR calculations be updated to provide an improved basis for tariff adjustments. Also, even though the number of commodities under quantitative restrictions decreased from 53 to 37 during 1974-80, the overall share of prohibited items in total restricted items has increased from 11% in 1974 to 62% in 1980; in addition the duration of the period of restrictions has increased substantially.<sup>/3</sup>

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<sup>/1</sup> Anti-export "trade bias" refers to differentiation in effective protection rates (EPRs) for export trade compared with import-substituting activities, "subsector bias" refers to differentiations in EPRs between various subsectors of the manufacturing sector and "firm bias" refers to different incentives to firms within the same subsector. EPR measures percentage deviation of value added at domestic prices as against world prices.

<sup>/2</sup> Defined as EPR for import substitution minus EPR for exporting activities.

<sup>/3</sup> See Annex Tables 7.10 and 7.11 for details. It is to be noted that the Index of Industrial Production shows high growth rates for some industries for which effective protection or the distortion between domestic and international prices has been high or has gone up. This will tend to bias this index upward (as compared to an index which would attempt to measure the real contribution of manufacturing to the national economy).

- (c) Most of the upsurge in manufactured exports has come from Free Trade Zones (FTZs) where national value added is generally limited to direct labor input and some minor services. The FTZ-oriented approach to industrialization was designed to mop up the surplus labor force rapidly; and this earlier objective was achieved quite successfully. But exporting firms in FTZs have (i) few backward linkages to domestic production; (ii) pay less than the full economic cost for facilities in these zones; and (iii) make only limited contributions to skill development, technology transfer, international marketing, and local development of quality control methods. While the contribution of FTZs to the manufacturing sector's employment and gross exports (about one-third in 1978) is quite substantial, it would be desirable to conduct a comprehensive review of their contribution to other areas of national interest mentioned above./1 It would also be appropriate to quantify the extent and usefulness of concessions extended to FTZ exporters relative to other exporters.
- (d) The pattern of manufacturing shows that almost 50% of total manufacturing employment is concentrated in three subsectors: electronics, textiles (including clothing), most of which are in FTZs, and the beverage and food industries. The first two subsectors (employing over 131,000 persons or one-third of the total manufacturing employment) are generally regarded as footloose industries and therefore vulnerable to changes in the international and domestic circumstances./2
- (e) Manufacturing employment has also become heavily concentrated in certain states - Selangor having 38% of the total, Penang, 22%, Johore, 15%; Perak, 12% and Melaka 5% - with all the remaining eight states collectively accounting for less than 10% of total manufacturing employment. The five states, with 90% of manufacturing employment, have about 50% of the total population with per capita incomes above the national average; the percentage of their households in poverty is well below that average. This phenomenon of uneven growth is not unique to Malaysia; but seen against the NEP objectives and the concentration of poverty in certain racial

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/1 The technical discussion mission was told in September 1980, that any further establishment of FTZs would be decided upon in the light of such a review.

/2 The expiry of tax holidays in the near future would require the affected enterprises to pay 45% Corporate Income and Development Tax as soon as the tax concessions end. Since a large block of manufacturing employment is involved, the mission proposals for partial income tax exemptions within the larger framework of policy adjustments in incentives may offer these firms a gradual transition to a taxable regime and sufficient reasons to continue and expand their operations in Malaysia (see Section 'F' below).

groups, this imbalance remains an important issue. This imbalance reflects a need for additional regional dispersal measures and policies to encourage industries to locate in lower income or poverty areas. The Government has already taken certain steps which would facilitate the industrial dispersion process; the mission recommendations in Section "D" indicate possible areas of further policy changes to accomplish this objective.

- (f) The capital-bias of the incentive system is reflected by increased capital intensity; fixed assets per worker were almost stationary around M\$7,000-8,000 between 1968 and 1973 in the whole manufacturing sector, but according to MIDA survey, they rose to M\$21,000 in nominal terms (M\$12,400 at deflated prices) in a sample of firms in 1978 with larger firms showing the higher amounts of fixed assets per worker.<sup>/1</sup> Also, the 1973 census showed that fixed assets per worker in Pioneer Status (PS) firms, which enjoy an array of capital-related investment incentives, were 42% greater than the average for manufacturing as a whole and were higher in 12 out of 14 subsectors. This difference seems to be partly a result of the bias in the incentive system towards larger, capital-intensive establishments. It would be desirable to realign incentives in such a way that their inducement to labor and capital use becomes neutral.
- (g) The number of smaller establishments (employing less than 20 workers), not favored sufficiently by the incentive systems rose by only 900 (from 6,500 in 1963 to 7,400 in 1973) whereas the medium and larger establishments rose by more than 1,300 (from 2,400 to 3,700) during the same period.<sup>/2</sup> There is evidence that the cost per job created in small individual proprietorships in manufacturing was only one-fourth of that in general corporations and public limited companies and one half of that in private limited companies. One critical means of achieving progress toward the NEP objectives would be to encourage new small/medium-scale establishments (SMIs) and to bring the existing smaller establishments into the main stream of development. This mission has suggested changes in the incentive system described in Section "F" which should help smaller firms; but a more detailed study is needed to develop programs specifically for the SMI segment of the manufacturing sector.

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<sup>/1</sup> It would be more appropriate to compare the 1968 and 1973 census data with 1978 census data. Since no data were collected in 1978 on a census basis the mission therefore had no option but to use the sample data.

<sup>/2</sup> While the incentive system favored larger establishments, some owners also feared stricter regulation and restructuring targets enunciated in the Investment Coordination Act, ICA, if they expanded beyond 25 employees. Under these circumstances it is unlikely that many smaller firms graduated to the category of medium-sized firms.

- (h) There continues to be substantial uncertainty about the level, structure and trend in private investment in manufacturing - one of the key variables affecting the growth performance and prospects of the sector. The mission analyzed several indicators of manufacturing investment which strongly suggest that in the wake of the Investment Coordination Act (ICA), 1975, private investment fell substantially (both in real and nominal terms as well as in absolute amounts and in relation to GDP). Other major factors which may have contributed to the substantial fall in investment were the increased investment activity in the early 1970s, the 1974/75 recession among the industrialized countries and political instability in the Region. The ratio of private investment to GDP in 1978 was considerably lower than the 1973/74 level. In the Mission's judgment, private local and foreign investment will remain a critical factor in the growth of the manufacturing sector. The initial anxiety of investors over the ICA appears to have lessened, but a flexible and pragmatic implementation of the ICA remains an important issue. The collection of relevant statistical information on actual investment as against approvals should be given high priority. While private investors do not appear to be worried in general about the NEP targets either in terms of employment or equity restructuring, their confidence is affected adversely when their control of ownership or management gets diluted. Also from the private sector's point of view, "price supervision", which is pursued under the provisions of ICA, is too extensive and the time taken to approve revision in prices is excessive. The above issues directly affecting investor confidence and behavior deserve policymakers' attention during the Fourth Malaysian Plan period.
- (i) The role and efficiency of the public manufacturing sector will also remain quite important to the success of the Fourth Malaysian Plan. In 1977 a total of 49 statutory authorities/corporations were involved in industry, 31 at the federal and 18 at the state level. By end-1977, the public and state bodies held shares in 132 manufacturing companies with a combined share capital of M\$500 million. This is a modest sum but, under the NEP objective, the domain of public enterprise is not limited to a few basic industries; it extends also to medium-sized establishments. Furthermore, assets of the public manufacturing sector would probably grow fourfold by 1990. In addition to filling the information gaps, a number of issues need to be tackled in the public manufacturing sector:

- (i) many public enterprises in Malaysia appear to face difficulties in reconciling the profit objective with a multiplicity of other objectives such as development of new industries, regional development, Bumiputra employment and entrepreneurial development. The mission fully recognizes the importance of the Government's noncommercial objectives but feels that other instruments (e.g., general entrepreneurship development and SSI support programs for additional Bumiputra employment) can be used to achieve these objectives without losing the discipline imposed by the expectation that public enterprises should earn a normal profit on the resources entrusted to them.
- (ii) the question of public enterprises' access to privileged financial sources, and the tendencies toward overemployment together with labor becoming a privileged group in certain public enterprises, have serious implications for their efficiency and profitability, and should be looked into;<sup>/1</sup>
- (iii) in many cases boards of major public companies seem to have serious under-representation of financial and technical experts;
- (iv) there is considerable doubt about the quality of many existing feasibility and project studies;
- (v) investment criteria are not as clear as they could be; and
- (vi) if the State becomes saddled with many unprofitable and uneconomic enterprises, the policy of transferring enterprises to the private sector will be frustrated and the State will risk ending up with a large number of enterprises that are unprofitable and unsaleable. The reform of the public enterprise system is an important, and a difficult task. In section "F" below the mission has suggested an approach to this problem for the policymakers' consideration.
- (j) There are a number of subsector-specific issues and problems which also deserve the attention of policymakers. According to the mission's analysis most of the industries lagging behind or showing deceleration in employment creation and growth rates in real terms (during 1973-78) were resource-based agro-industries

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<sup>/1</sup> The technical discussion mission was told that the forthcoming plan would show reduced allocations to State Economic Development Corporations (SEDCs) and would urge most public enterprises to tap commercial banking sources rather than rely on Treasury funds.

such as remilling and processing of rubber, coconut oil, rice milling, pineapple canning, wood processing, etc. The principal causes of this general phenomenon in resource-based industries are discussed in Part Two of the report but should be studied further.<sup>/1</sup> Also the contribution to growth of the manufacturing sector by the capital goods and machinery subsector has remained very small - 3 to 5%. These industries deserve more support because they are typically efficient at a relatively small scale of output, are labor intensive, have strong backward and forward linkages, and are "carriers" of technological change. The mission feels strongly that it would be helpful to prepare comparative advantage indicators for key subsectors based on up-to-date calculations of effective protection rates and domestic resource costs. Pending the completion of such studies, the mission has tentatively indicated areas, on the bases of technical capabilities of firms and unit cost information on the various products, in which the Malaysian manufacturing sector appears to have a comparative advantage over the next few years (see Section "D" below). The general incentives and policy framework should then encourage activities with greater comparative advantage because this will permit the country to realize more of its economic potential. This is discussed further in section "F" below.

#### D. The Outlook and Potential for Growth

7. In the mission's judgment, Malaysia should make greater efforts to exploit its apparent natural comparative advantage (e.g. in wood processing, rubber and palm oil products). This should however be done within the normal framework of incentives discussed in this report and without any reliance on special subsidies for raw-material processing activities. Malaysia exports about 98% of its natural rubber (almost 50% of the world exports) and processes the remaining 2%. According to the UN Trade Book, the export level of its rubber products (SITC-62) even in current dollars has remained low and almost stationary around US\$20 million a year (during 1975-77) despite

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<sup>/1</sup> Principal problems and constraints facing some resource-based subsectors tentatively identified by the mission in Part Two of the report are: Wood Processing: lack of technology for better recovery rates, poor productivity, low capacity utilization, small kiln drying facilities; imbalanced distribution of forestry concessions and processing facilities; Rubber: need for improved technology and greater mechanization, shortage of labor at technical and professional levels, insufficient overseas marketing of manufactured products; Palm Oil Processing: imbalance between fruit production, crude oil capacity and refining facilities; poor facilities for labor at processing sites, inappropriate relationships between crude oil and refined oil prices, insufficient search for nontraditional markets and inadequate prices received from existing buyers.

government's encouragement and the apparent scope for further downstream processing of the abundant supply of natural rubber into tires, tubes, automotive parts, industrial rubber hoses, rubber gloves, etc./1 Similarly, the further processing of wood (into specialized panels and products) for domestic use associated with the construction industry and for exports offers considerable scope for expansion particularly in collaboration with foreign investors using improved technology and improved management/marketing skills. Also, in view of substantial imports of processed food (almost M\$1 billion out of total imports of M\$11 billion in 1977) there appears to be a considerable growth potential for the domestic market. Subsector studies might indicate possibilities for efficient import-substitution and export potential. Similarly, the scope for further processing of palm oil into margarine, ghee and other products appears to exist. As a first step, it would be desirable to establish a task force consisting of technical subsector experts, project economists, financial analysts and knowledgeable, aggressive sales persons who should first review the constraints on expansion identified in this and other reports and study ways of removing existing obstacles to further downstream processing of these natural resources by the private sector. The questions of differential tariff on processed and crude products in importing countries and government's taxation rates should also be looked into. The mission does not believe that any special subsidies or incentives are required to promote these activities but if there are general difficulties, (e.g., due to forestry concessions, problems, available technology, skill deficiency, and other issues), the Government should help private investors in overcoming them. In many of these resource processing industries, Malaysia's collaboration with other countries of the region like Korea and Japan who lack these natural resources but have extensive technological and marketing/management skill should be of great mutual benefit and encouraged as a matter of policy by the Government.

8. In some of the current high export industries like textiles, the scope for further expansion of the knitting and garment segments (requiring smaller investment and fairly simple technology) appears to be substantially greater than in other segments of the industry. The domestic demand for textiles is expected to grow at about 9-10% p.a. but for exports the Malaysian Government will have to put considerable effort in quota renegotiation and development of new markets (like the Middle East). In the electronics and electrical industry (E&E), the process can be expected to proceed further from the initial phase of simple assembling operation to products embodying more advanced technology (including the necessary research and development which a M\$ 2 billion industry can perhaps afford) and participation in international marketing thereby internalizing the intangible gains (transfer of technical and marketing knowledge) and deepening the industrialization process. This should result in consolidating the base of E&E industry and helping to further the economic and efficient import-substitution process described below.

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/1 During the same period Korea was able to raise the level of comparable rubber exports from US\$90 (1975) to US\$160 million (1977).

9. Simultaneously with export orientation strong domestic market expansion will remain a powerful source of growth in the industrial sector. Many products needed basically by the poorer segments of the population have had reasonably good supply in the past few years. Beyond that, increased incomes and improved living standards for the majority of the population will result in the growth of domestic demand for many household appliances such as kitchen equipment, vacuum cleaners, hair dryers, sound equipment, cooking ranges, color TVs, refrigerators and air conditioners. Domestic demand for many consumer durable goods may reach a level in the 1980s at which local production with some exportable surplus in certain cases may become economic, resulting in further efficient import substitution (IS) particularly in collaboration with the technical and marketing skills of foreign investors. Additional IS should also become feasible in a number of other technically sophisticated products such as various-sized cables, telecommunications equipment (through joint ventures), telephone exchange components, cold storage equipment, coastal ships and ship repairing. Most of these activities would not require more than the average level of protection given to infant industries in general.

10. Also with the domestic market and exports rising rapidly, the outlook for the packaging material industries is quite favorable; in tin can making, particularly, upgrading and rationalizing the operations of 6-7 small can manufacturers should reduce the present high cost through technological improvement.

11. Similarly, the growing demand for building materials is also expected to provide considerable impetus to the manufacturing sector. Infrastructure, public sector building, schools, hospitals, and the rapidly expanding housing industry will require domestic supplies of construction materials such as structural steel, bars, wires, cement, bricks, sawn timber, plywood and panels, sanitary ware, tiles, etc. With new mortgage facilities now available (for 25 years) the building boom is likely to continue, providing a strong long-term demand for local material supply (90 to 95% of materials are supplied locally because of "natural" protection given by weight and shipping costs).

12. On the basis of limited information available to the mission, Malaysia's competitiveness with respect to some heavy industries, like the proposed fertilizer plant producing 1,500 tpd, more than half of which is expected to be taken by the other ASEAN countries, looks reasonable. But, given the existence of extensive price and import restrictions on steel products, it is difficult to obtain a clear view of Malaysia's prospects for steel production and the competitive strength of the existing industry. In respect of major additions to capacity currently under consideration, the mission feels that, on the basis of its rough calculations, Malaysia's production of bars and rods from a new plant would be over 20% more expensive than imports. A new integrated mill producing flat products would face an even greater cost and competitive disadvantage. On the more general level, given the known quantum of oil and gas resources, it may appear that relatively energy-intensive industries like aluminum, fertilizers, heavy

chemicals, methanol refining, cement, paper and pulp, etc., have favorable chances of promotion in Malaysia compared to many other countries in the region. However, before committing substantial resources to these capital- and energy-intensive industries, it would be desirable, indeed essential, to evaluate project proposals in these various activities at international prices and in economic/social terms. Excessively heavy inducement to energy-intensive industries would run counter to government's energy conservation schemes and might make less efficient technology look attractive which, in the longer run, would jeopardize the favorable energy balance that Malaysia enjoys at the present time.

13. Our discussion in this section has indicated that a substantial stimulus to manufacturing would come from the expansion of the domestic market and that there appears to be considerable scope in efficient import-substitution and in the present labor-intensive, export-oriented activities. Malaysia's interest in establishing very large, capital-intensive projects has to be studied more carefully by competent technical and financial analysts before large sums are committed to largely nonreversible investments. The following section briefly reviews the elements of the future development strategy and policy options which in the mission's judgment would help Malaysia solve some of the problems and issues mentioned above and constitute first steps in determining the nature of its comparative advantage and realization of its growth potential over time.

#### E. The Broad Development Strategy and Priorities in its Implementation

14. This and the next section discuss the mission's main recommendations. In summary, the mission's ideas which are further elaborated in the following paragraphs highlight the need for action on several fronts. With regard to general issues, the mission assigns high priority to skill development, transfer of enterprises to Bumiputra commercial/financial entities and to institutional arrangements for critical evaluation of larger public sector investment projects in the manufacturing sector. In adjusting the incentives and policy framework, first priority should be given to broadening the access to incentives enjoyed by the FTZ-based firms to other exporters, linking of the FTZs with the rest of the economy and developing a scheme to consolidate the various investment related tax incentives into a partial income tax exemption mechanism. More comprehensive changes in the import protection mechanism are highly desirable but would be feasible only in the medium and longer term when the results of a number of follow-up, detailed studies, mentioned in Annex I to the Volume are available. These studies, together with a deeper analysis of certain key subsectors, are essential for sound policy changes but they will take considerable time even if conducted most expeditiously. One of the biggest difficulties is the weak data base which continues to hamper review of past performance and analysis of policy initiatives. The mission assigns very high priority to this task and urges the GOM to devote increased resources and experts to improvement of the industrial data so that reliable and recent statistics will be available by the time the third-term review of the FMP takes place in mid-1983.

15. Before discussing certain specific changes in the incentives and policy framework, some general policy issues need to be considered in this section.

- (a) In terms of the general development strategy, the mission's analysis shows that despite a fairly rapid growth in employment, not all the slack has disappeared. There is still evidence of considerable underemployment and poverty in rural areas, open unemployment is down but still around 5-6% and following higher participation by the female population the labor force continues to grow at a rapid pace of 3.5% p.a. There is a large pool of low productivity jobs in agriculture and elsewhere in the economy which has to be transformed into higher productivity jobs in the manufacturing sector. In pursuit of the NEP objectives more Malays need to be absorbed in the manufacturing sector.<sup>/1</sup> In addition, the one-third of present manufacturing jobs that exist in footloose industries are vulnerable to relocation decisions by employers. It is, therefore, doubtful if the general development strategy at this stage of Malaysia's development should continue to provide greater stimulus to capital-intensive than labor-intensive operations. Both should be accorded equally favorable treatment.<sup>/2</sup>
- (b) Despite the dominant concern for employment opportunities, there are many industry, location and skill specific labor shortages. In the mission's judgment, the most acute scarcities appear to be in the categories of skilled workers and technical and managerial personnel, particularly among the Malay population. The highly skilled occupations carry scales of pay which are 10 times higher than rates of pay for laborers (compared to a ratio of less than 5:1 in advanced countries). Relieving this pressure requires enlarging the supplies of skilled manpower through expanded

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<sup>/1</sup> There has recently emerged some shortage of labor on certain rubber and oil palm estates in certain locations like Penang and for certain industries like electronics. But most of this is perhaps due to labor market segmentation. This points to the need for further labor market segmentation studies and labor market policies which should help improve labor mobility.

<sup>/2</sup> The recent 35-40% salary increases for civil servants will have an upward impact on wages in the private sector and may induce certain enterprises to consider labor-saving devices for certain categories of work on a selective basis.

training schemes. In the mission's judgment this task can be accomplished by narrowing the gap in the rapidly growing economy between the capacity of the existing training institutions to develop new skills and the demand for qualified personnel and more importantly, by involving private industry much more than at present and inducing in-firm training facilities (and experience) through a system of tax credits granted to employers undertaking an approved in-plant training program. This policy initiative could be introduced quickly. In order to make the training and skill development experience more relevant to industry needs, joint public/private sector programs are essential. A variant of this program could be part-training by public sector institutions and part-apprenticeship by selected private sector firms with final examinations being administered by both of them. The in-plant training tax credit should be available to all firms starting with a certain flat minimum of the incurred training expenditures, with additional credit of say 5% or 10% each to firms located in development areas or firms meeting the employment or equity restructuring targets or perhaps 10% additional credit to encourage especially small-sized firms./1

- (c) The public manufacturing sector (both at the Federal and State levels) has proliferated its activities and the number of unprofitable ventures particularly those undertaken by SEDCs has multiplied. Government priority at this stage should be to take stock of events and consolidate its experience, considering further actual investment in the establishment of only key, pre-selected industries based on soundly conceived and economically feasible projects (as discussed above). The viability and profitability of the public manufacturing enterprises will be crucial for efficient use of resources and achieving the Fourth Plan growth and NEP restructuring objectives. In this context, the newly created Heavy Industries Corporation (HIC)/2 should not only mobilize capital and restrict its operations to a few basic industries complementing private sector activities; it should also promote a new professionalism throughout the project cycle, particularly for public sector projects requiring large investments and long gestation periods. For existing light industry enterprises in the public sector, the government strategy should seriously consider

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/1 For more details see Chapter II, paras. 2.28-2.33.

/2 The technical discussion mission was told that initially the HIC will deal with steel, aluminum, cement, small engines, methanol and engineering support projects and that it will require substantial institution-building support in the present formative stage of its operations.

taking them out of the civil service as soon as possible and making them responsible to a new State Industrial Enterprise Corporation which should: (i) become accountable for financial returns on state investments and try to achieve maximum transparency regarding financial and economic results in the public enterprise system, complementing usual accounts with performance auditing; (ii) establish pay scales and employment conditions in public enterprises in line with enterprises of similar size in the private sector; and (iii) appoint board members from among recognized financial and technical experts in private industry. As a general strategy, the Government should pay much greater attention to the question of transfer of enterprises to the private sector, otherwise the present trend will result in the creation of a permanent rather than transitory state presence in the industrial sector.<sup>/1</sup> This underscores the importance of substituting a consolidated approach for the piecemeal approach now being followed by public enterprises in an effort to develop Bumiputra entrepreneurship.

#### F. Proposed Changes in the Industrial Incentives and Policy Framework

16. Both public and private enterprises have key roles to play in the growth of the manufacturing sector. Besides achieving efficiency in public enterprises and taking action on broader tasks mentioned above, the Government should establish an incentives framework which is unrelated to ownership (whether in the public or private sector) but rather looks at the characteristics of each industry and the country's comparative advantage at this stage of the manufacturing sector development. As indicated in section C above, some constraints on sector expansion have emerged and achievement of the past growth rates, particularly if the structure of incentives remains unchanged, will be a very difficult task. In order to achieve comparable growth rates it will be important to reorient and adjust the incentive framework to: (a) improve upon the sector's efficiency in light of the changed international circumstances and identifiable constraints on its expansion; (b) continue to stress neutrality of incentives as between labor- and capital-use; (c) improve the regional dispersion of industry; and (d) broaden the export base and promote its linkages to the domestic economy.

17. Most importantly, the more recent export-oriented development strategy that the Malaysian policymakers have rightly pursued during the 1970s should be continued during the Fourth Malaysia Plan (FMP) period, with even greater vigor and increased attention to the backward linkages of the manufactured-goods export industries to local small- and medium-scale

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<sup>/1</sup> A scheme is already being prepared by the Ministry of Public Enterprises to transfer many public sector enterprises to the private sector during 1981.

industries. Since the manufacturing sector has been singled out for a critical role in the alleviation of poverty and generation of gainful employment and since the limited domestic market alone cannot sustain its momentum, the growth in outward-looking manufacturing output and exports will remain critical for achieving the NEP objectives. Improved backward linkages to local small and medium-scale industries would broaden the manufactured goods export base, consolidate the development process and stimulate overall economic growth. To this end it would be important to adjust the current incentive system so as to reduce and eventually eliminate its existing biases./1 The policy changes summarized below are basically aimed at providing balanced incentives for import-substituting and exporting activities and for labor and capital use in the manufacturing sector.

#### Broad Directions and Priorities of Policy Adjustments

18. As mentioned in para. 6(a) above, the case-by-case approach adopted in granting exemptions has created most of the differential incentives and should be replaced gradually by automatic and simple rules which are based on coherent overall and subsectoral development strategies applied uniformly to all firms. For this, coherent subsectoral development strategies are essential, and streamlining of the incentive framework should be initiated immediately. The first priority of the reform should be to: (a) move towards the establishment of a free-trade regime for all non-FTZ export industries (direct as well as indirect exporter); and (b) widen the criteria and expand preshipment export credits, covering financial requirements for imported intermediate inputs and domestic purchases to all export industries. Since these reforms would be neutral to those exporters already included in the scheme (e.g., FTZ-based establishments), they could be implemented without much difficulty. The second priority should be to: (c) develop and implement a scheme which would consolidate various tax incentives into a single partial tax exemption system providing relatively balanced incentives to labor and capital use and promoting certain NEP objectives; (d) introduce training (or skill formation) incentive schemes; and (e) conduct a comprehensive review of the import tariff structure aiming at a low range of tariff rate for most mature industries and temporary infant-industry protection tariff rates for a small number of carefully selected infant industries, justified and based again on subsectoral development strategies. The transition from one regime to the other should be gradual. Since these reforms would inevitably reduce some subsidies being received by certain firms, careful planning and time-phasing as well as

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/1 See footnote 1, page 4 above for the categorization of these biases.

development of support programs for the affected subsectors are required to minimize any side effects of the transition from one policy regime to another.<sup>/1</sup> The main policy changes mentioned above are elaborated individually in the following paragraphs.

#### Specific Recommendations

19. Tariff exemptions and drawbacks on intermediate and capital goods imports (direct or indirect) for use in the production of manufactured exports should be general rather than confined to a few selected firms mainly owned by multinationals in the FTZs. Also the rule that only those exporting all of their production qualify for drawbacks is quite rigid and should be replaced by a proportional rule; i.e., if 40% of outputs produced by imported inputs are exported, then 40% of imported inputs should receive tariff exemptions. On the other hand, tariff exemptions granted on imported intermediate inputs and capital goods for use in manufactured-goods production for the domestic market should in general be eliminated because there are already considerable incentives available through the (final product) tariff mechanism. The tariff exemptions and drawbacks for export-related activities should be granted automatically, based on simple and efficient administrative procedures. In order to include indirect exports and indirect imports in the above, considerable follow-up work is needed to develop an administrative scheme.

20. Export Credit. In order to provide balanced incentives for exports as against import-substituting activities, the current preferential pre-shipment export credit system should be substantially expanded to cover all manufactured export related production activities, including indirect exports and indirect imports (of intermediate inputs) for use in production of exportables. The current maximum ceiling, 50% of the export value, would perhaps be considerably short of the amount of critically required funds for intermediate input imports and local purchases particularly if small and medium-scale exporters are to be encouraged as a matter of policy. In order to administer export credits for indirect exporters, an efficient scheme, such as the local letter of credit (L/C system) being used in other countries, should be considered.

21. Partial Income Tax Exemptions for Exports or Industries in Development Areas. The existing incentives have had limited success in stimulating exports of non-FTZ firms and in achieving regional dispersion of industries even after years of experimentation with the Pioneer Status (PS) incentives, Labor Utilization Relief (LUR) and Export Allowances. It would

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<sup>/1</sup> Actual consideration and implementation of these broad policy changes will require a number of follow-up policy studies, mentioned in Annex I, Volume I, which would probably take 2 years for completion and involve 2-3 consultants.

be desirable to consolidate and replace these measures by a partial income tax (including development and excess profit taxes) exemption scheme (e.g. a flat exemption rate; 1/2 or 1/3 of the normal rate) granted to direct and indirect exporters, and industries located in development areas (existing as well as new firms).<sup>/1</sup> Tax exemptions should be proportional to export shares. The partial income tax exemption scheme for export industries could be implemented for about 10 years within which the deepening of export industries by acquiring technology and broadened backward linkages should be achieved. Also, an attempt should be made to consolidate gradually the various investment-oriented incentives (ITC, IKA, ADA, RA and Accelerated Depreciation Under "Export Incentives")<sup>/2</sup> which were developed on an ad hoc basis, have become overcomplex and seem to have favored capital-intensive operations. Such a scheme should again favor export industries as a means of offsetting the existing imbalance in incentives resulting from the present protection regime, particularly for the non-FTZ firms.

22. Training and Skill Development Incentives. Under this scheme, an additional deduction from taxable income of a constant fraction (say 1/2 or 2/3) of the value of labor training expenses incurred for upgrading labor skills should be allowed. Labor training expenses should include annual capital expenditures associated with training facilities, in addition to current expenditures as well as scholarship or other expenses involved in skill development. The latter incentives will be especially important for small- and medium-scale industries which tend to be more labor intensive, need technical skills and otherwise are unable to take advantage of such an incentive.

23. Review of Import Protection Structure. For reforms of the incentive system in the medium to long term, a more recent estimation of the effective protection rates should be started and a comprehensive review of the import tariff structure should be initiated, aimed at establishing a rational and simplified tariff structure. A narrow range of low tariff rates

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<sup>/1</sup> Profit or income-related tax incentives have the advantage of inducing firms to become profitable. The Industrial Development Authority in Ireland has made extensive use of this scheme. Profits made on export sales of goods made in Ireland have total relief from Irish taxation until 1990.

<sup>/2</sup> ITC, Investment Tax Credit; IKA, Increased Capital Allowance; ADA, Accelerated Depreciation Allowance; RA, Reinvestment Allowance.

should be considered for the already mature import-substitution industries./1 On the other hand, higher infant industry-protection tariff rates should be applied, temporarily, to a handful of carefully selected infant industries. Such selection should be based on coherent sectoral development strategies and a careful evaluation of each infant industry's capabilities and growth potential./2 The concept of "PS industries" or a list of "priority products" is too broad to be directly applicable for such selection. Such a comprehensive review is highly desirable because the import protection reviews over the past years appear to have been done on an ad hoc and piecemeal basis. Furthermore, there are some indications that the level of, and variations in, the sectoral effective protection rate may have increased in recent years. This should be confirmed by updating the outdated previous studies. In order to measure the social cost of promoting exports or of protecting import-substituting industries, it will also be desirable to calculate the Domestic Resource Cost (DRC) estimates.

24. The proposed tariff review and subsector strategies should be based on up-to-date sectoral effective rates and domestic resource cost of various activities. In order to maximize the effect of protection, an innovative scheme by which the retention and duration of protection is tied to an infant industry firm's performance in export of protected products is advisable. In particular, such a scheme should be seriously considered for products which have already been protected by import quotas for long periods, lest they should become permanent infants. Starting with the proposed review of the import protection structure, the case-by-case review system of tariff adjustment and quota restrictions (now being basically initiated by private firms' requests) should be replaced by periodic

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/1 See para. 6(b) for effective protection rates enjoyed by certain industries. The proposed changes would in fact involve an "evening-out" process in which some tariffs would be lowered while others (or subsectors with potential comparative advantage) will be raised.

/2 In this respect the "positive list" system should be replaced by a "negative list" mechanism. The negative list should include the known activities in which the country's comparative advantage is not clearly established and in which the demand studies show that domestic markets are saturated and exports encounter severe market limitations abroad. The activities not included in the negative list should automatically receive incentives offered by the Government. The negative list would be updated periodically to reflect changes in comparative advantage and market conditions.

subsector reviews jointly conducted by MIDA and MIDF /1 to be initiated by the Government as part of a periodic overall review of the development strategy and industrial policies, preferably as part of the preparation of each new development plan.

#### Broad Effects of Proposed Measures

25. First of all, the proposed policy changes would eliminate virtually all discrimination among firms within the same subsector, i.e. the "firm bias" stemming from PS incentives and ad hoc discretionary tariff exemptions. The unconditional and automatic granting of tariff exemptions or drawbacks on imported (directly or indirectly) inputs used for export production (directly or indirectly) would put virtually all export-related activities in a free trade regime, making their effective protection rate almost zero across the board as against the present negative one and eliminating the bias between FTZ and non-FTZ based firms. The broadened preferential export credits and partial income tax incentives to be granted to all export-related activities would result in about a 10% effective incentive rate, according to a rough estimate. Together with a new low range of tariff rates applied to most mature import substitution industries (assuming no exemptions on their imported inputs), the effective incentive rate would be close to their nominal protection rate, and the remaining anti-export trade bias would be small. Such a minor "trade bias" can easily be compensated for by the Government's increased assistance to exporters in the field of overseas information-gathering and dissemination and technology-learning tasks. The minimization of anti-export trade bias would accelerate manufactured goods exports based on Malaysia's comparative advantage and with closer backward linkages, these exports would then become a powerful vehicle of manufacturing sector growth during the 1980s. The tariff differentiation will be reduced drastically to only two categories: mature industries and infant industries with potential comparative advantage.

26. The proposed changes should enlarge the role and increase the influence of MIDA in the country's industrial development strategy. Once the administrative burden and staff involvement in "case-by-case" systems are eliminated, MIDA will have more resources for critical policy-advising and policy-making activities, such as the preparation of sectoral development strategies, updating of effective protection rates, reviews of the "negative list", calculations of domestic resource costs and suggestions for and analysis of incentive policy changes. In turn, it may be able to participate (in collaboration with the recently established Heavy Industry

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/1 Because of its heavy involvement in long-term financing, MIDF has developed intimate knowledge of the strengths, weaknesses, principal problems and prospects of the various subsectors. In the preparation of the sector development strategy, it is necessary that MIDA and MIDF together with EPU conduct them jointly and in consultation with the manufacturers' associations in these areas.

Corporation) in very careful project appraisals for a small number of giant projects tied with direct foreign investments or large public sector funds in which the need for an economic and social benefit-cost analysis is imperative. A "package deal" concept would be useful only for these exceptional projects not in estimating and providing the required incentives in an integrated way, but in reviewing their efficiency and evaluating their social and private profitability. Furthermore, the rest of MIDA's resources could be effectively directed toward other important tasks (such as technology transfer, demand analysis of major products and overseas marketing) that are critical for the promotion of manufactured exports during the 1980s. All of this will contribute to a broadened export-led, efficient industrial sector growth which remains a linchpin of the Government's poverty eradication and NEP-based development strategy.

### Concluding Remarks

27. Both the general development strategy and proposed changes in the incentives and policy framework discussed in sections "E" and "F" will contribute not only to a rationalization of the protection mechanism by promoting economic import-substitution as well as export-competitiveness of manufacturing activities in Malaysia but, together with changes suggested in the management of the public manufacturing sector, these will greatly improve the overall efficiency of the manufacturing sector. An export-propelled manufacturing strategy with widespread domestic linkages will in turn generate more employment in the manufacturing sector, increase the incomes of persons engaged in these activities and promote regional dispersion of industry. But more importantly, the proposed measures, by overcoming the identifiable constraints on sector expansion and by maintaining the sector's overall growth performance, would encourage private local and foreign investment and facilitate the achievement of the employment and equity restructuring targets of the NEP with minimum frictions in the multiracial society of Malaysia.

28. This report has highlighted a number of policy changes. Some policy recommendations can be implemented rather quickly but more comprehensive changes in the import protection mechanism, investment incentives and certain subsector-specific issues would be feasible only in the medium- and longer-term when the results of a number of follow-up studies are available. In-depth discussion of these various issues enabled the Bank and the Government to reach an agreement on a program of follow-up studies, which during the next 18 months or so would provide the Malaysian policy makers with the minimum necessary threshold of information on which informed decisions regarding important policy changes could be based. These studies are listed in Annex I to this volume of the report. These studies will be conducted by GOM officials with the assistance of international experts in key areas. At GOM's request, the Bank staff is giving help in the initiation of studies and will assist in monitoring the progress and interpreting the results of these studies for possible actions that GOM might consider for realizing the fuller potential of the manufacturing sector.

MALAYSIA

FOLLOW-UP INDUSTRY SECTOR STUDIES FOR POLICY FORMULATION

AND IMPLEMENTATION

Type and Nature of Studies	Responsible Agency	Participating Agencies
I. Updating the Effective Protection Rates (EPRs) using the 1979 or 1980 data, at the same level of disaggregation as the Rabenau or Edwards' study which present EPRs for 1973 so that ideas for two-tier tariff reforms could be firmed up.	EPU	MIDA Treasury, EPU Bank Negara Malaysia (BNM)
II. (a) Evaluating the efficiency and quantifying the net effective subsidy implied by the existing export promotion measures (e.g. per-shipment export credit, export allowance, tariff exemption, duty drawback etc.) and reviewing the effectiveness of institutional support to exporting activities; and	EPU	MIDA Department of Statistics (DOS) Treasury
(b) Studying the FTZ based firms' net contribution to such objectives as exports and foreign exchange earnings, employment and skill development, domestic value added, transfer of technology and marketing knowledge and studying ways of linking them with local firms. Also the relative effectiveness of Licensed Manufacturing Warehouses (LMWs) and FTZs to objectives mentioned above would be compared.	EPU	BNM, Treasury MIDA
III. Studying the possibilities of consolidating the various existing investment incentives, viz: Investment Tax Credit, Increased Capital Allowances, Accelerated Depreciation Allowance, Reinvestment allowance, and replacing them with a partial income tax exemption scheme that is neutral between labor-and capital-use and that would promote more powerfully the restructuring and Regional dispersion objectives assigned to the industrial development process.	EPU	MIDA, Treasury
IV. Calculating the Domestic Resource Cost (DRC) estimates in order to measure the social cost of promoting exports or of protecting import-substituting industries and development ideas about the country's comparative advantage in the production of various commodities in the future.	EPU	MIDA Department of Statistics (DOS) Treasury
V. Initiating in-depth subsector studies of:	MIDA/ EPU	Malaysian Industrial Development Finance (MIDF) Co. Relevant Research Institutions and Manufacturers Organizations
(a) Machinery and Electrical Industries (EMIs);		
(b) Rubber processing; and		
(c) Building materials industries		
VI. Studying the ways to strengthen the existing industrial sector data base with respect to the census of Manufacturing Industries, Annual quarterly and monthly manufacturing surveys, Commodity classification of Manufacturing and Distributive Trade Industries, the coverage and re-weighting of the Industrial Production Index, Import and Export unit value indices, the management, operational and processing methods currently adopted for obtaining data and timely availability together with their relevance to policy formulation and users needs.		

Note: Studies listed under I, II and III are basically four components of a comprehensive study aimed at determining the quantum of effective incentives and Study IV is essentially designed to establish the social profitability or comparative advantage of manufacturing activities at subsectoral levels. Ideally, these studies should be conducted under the aegis of one agency and the same counterpart team to be aided by the guidance of an experience international expert on trade policy matters).