Malaysia’s New Economic Policy, Growth and Distribution: Revisiting the Debate

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Abstract: Malaysia’s New Economic Policy (NEP) has been a subject of intense debate since its inception. Admirers have acclaimed it as unleashing pro-poor growth while critics have labeled it with terms like cancer. Both parties have valid points. The implementation of the NEP has seen growth and addressed distribution, but has also heightened inequality, while the growth rate is diminishing. However, it is difficult to make summary judgments on a policy that has evolved and changed over nearly half a century. It is argued that assessments of the NEP should take into account changes in context as well as the manner in which the NEP has been implemented. Whilst summary judgments are unhelpful, an argument may nevertheless be made that, in common with experiences in many developing countries, a trade-off between growth and distribution exists where affirmative action is translated into ethnic discrimination.

Keywords: Bumiputera, economic growth, income distribution, New Economic Policy, privatisation

JEL classification: E02, E44, G38, H63, J71

1. Introduction

The relationship between income distribution and economic growth has been the subject of ongoing debate. The earlier work by Kuznets (1955) led to the postulation of an inverted U-shaped relationship. Subsequent empirical evidence in Latin America in the 1970s had linked inequality to growth positively, whilst a decade later, the economies of the so-called East Asian miracle (World Bank, 1993) experienced growth with declining inequality. The latest research on the impact of inequality on growth suggesting a negative relationship is also disputed (Li & Zou, 1998; Cingano, 2014). Scholars have also hedged their positions, arguing that income inequality has both growth stimulating, and retarding effects (Petersen & Schoof, 2015) or that the relationship depends on a country’s stage of development (Bruckner & Lederman, 2015).

With respect to income inequality, its sources have become the subject of scrutiny with Stewart’s (2002) explicit recognition of the importance of horizontal inequality (i.e., inequality between groups identified by criteria other than income) alongside the more traditional vertical inequality. To the extent that group identification is socially important, the favourable position enjoyed by one group over another can be much more intractable than vertical inequality (Pellicer, 2009) and can lead to conflict (Langer, 2005).

As major instruments of redistribution, affirmative action programs evoke debate not only on the above lines, but also with emotional appeal or distaste embedded implicitly, if
not explicitly, in the discourse. Malaysia is no different. Of the numerous policies Malaysia
has put in place, none has been more debated, and arguably endured longer, than the
affirmative action program officially known as the New Economic Policy (NEP). This policy,
put in place by then Prime Minister Tun Abdul Razak Hussein in 1971, was in response
to unprecedented racial riots that have since been seared into the Malaysian national
consciousness.

Although having many similarities with affirmative action programs in other countries,
the NEP has distinctive characteristics. Firstly, it is for the benefit of the majority of the
population. Although understandable from the standpoint of post-colonial nations in
which colonial governments sought to favour one group over the other, or adopted the
policy of divide and rule, this runs counter to the general perception of affirmative action
being targeted at a discriminated minority.

Secondly, the instrumentation and implementation of the NEP, here defined
broadly to cover the entire portfolio of affirmative policies and programs, has evolved
to become among the most pervasive in coverage, from education to employment and
asset ownership. Affirmative action is implemented not only through public expenditure
targeted at institutions that serve exclusively this group, the Bumiputera (indigenous
people) but they are also treated preferentially in the selection for tertiary education and
employment, reservation of quotas for housing and shares in listed companies, and the
award of public contracts to their companies. In education, the NEP goes beyond trying
to equalise opportunities to attempting to equalise outcomes through the application of
different standards for admission.

Thirdly, although affirmative action is targeted at improving the economic
circumstances of the disadvantaged group, and progress is usually benchmarked against
the incomes of disadvantaged individuals, the NEP does not use income as the primary
criterion, instead defining disadvantage in terms of a particular racial group, namely the
Bumiputera (mostly Malays), on the grounds that they account for the bulk of those
disadvantaged. As a result, the disadvantaged non-Bumiputera is excluded from the
benefits bestowed by the NEP. Even for the Bumiputera group, personal or household
income is not used as a measure of success. Instead, corporate ownership, not the most
obvious measure of economic wellbeing, is used as the benchmark of effectiveness for the
affirmative action. Achievement or under achievement of the corporate ownership target
of 30% therefore leaves unclear the extent to which economic welfare, measured by the
normal yardstick of income, has improved.

Whatever the benchmark the Government uses, the efficacy of these programs must
be assessed in relation to the NEP’s primary objective, which is to achieve redistribution
without hampering growth. Here, the view regarding distribution has generally coalesced
around it being successful in reducing poverty but less so in curtailing inequality (Roslan,
2001). However, little agreement exists on the impact of the NEP on growth. Arguments
that Malaysia’s high growth performance shows that the NEP is benign with respect to
growth are set against those that are negative.

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1 This broad definition also encompasses its successor the National Development Policy, introduced in 1991
immediately after the NEP ended, and the National Vision Policy, 2001–2010. In terms of affirmative action,
these were little changed.
This paper aims to revisit the latter debate, while also touching on distribution insofar as it affects growth. It is argued that neither of the above arguments are helpful in understanding the NEP’s impact. Having been implemented over four decades, the nature and coverage of the NEP have changed over time. During this period, different external circumstances have also confronted the Malaysian economy, and impacted its growth. Understanding the NEP’s impact therefore requires closer scrutiny of the different phases of NEP implementation.

This paper is structured as follows. The pre-NEP policies to reduce poverty are reviewed in the next section. The implementation of the NEP from 1971 to 1986, when the Malaysian economy went into recession, is discussed in Section 3. This recession brought about market liberalisation until the onset of the Asian financial crisis (AFC) in 1997, which is the subject of Section 4. The post-AFC period is covered in Section 5. This paper is concluded with observations on the NEP and Malaysia’s economic growth in Section 6.

2. The Pre-NEP Period, 1957 to 1971

While affirmative action in Malaysia is invariably associated with the NEP, policy directed at poverty reduction had been in place since the establishment of the Federation of Malaya in 1957.\(^2\) Since the bulk of the poor were Malays, poverty reduction was therefore targeted at them. Also, poverty reduction was accorded much greater priority than diminishing the income gap between rich and poor.

Despite the above, the foundations of ethnic identification and segregation were laid from the very beginning. As elaborated by Chakravarty and Roslan (2005), political segregation took the form of the ‘ethnic bargain’ in which Malays were granted special rights in the federal constitution as one of the conditions agreed to at independence. Economically, the ethnic groups were also occupationally segregated, with Malays largely engaged in farming while the ethnic Chinese (hereafter referred to as ‘Chinese’) were engaged in mining and commerce, and ethnic Indians (‘Indians’) worked on plantations. Geographically, the Malays were rural residents, while the Chinese were largely urban, and Indians worked in rubber plantations. This segregation extended to education, with multi-ethnic government schools co-existing with Mandarin and Tamil vernacular schools. Such segregation served to entrench inter-ethnic differences in average incomes. Whether by residence or occupation, the Malays were the poorest, a factor that likely fuelled perceptions of injustice among them that might have contributed to the race riots of 1969. With respect to education, Malaysia’s education system at that time was elitist, with English being the medium of instruction. Employment in the formal sector depended on mastery over the English language. This put the predominantly rural Malays at a decided disadvantage. To the extent that anti-poverty measures corresponded with affirmative action during this period, identification with the Malays was appropriate because the bulk of the poor were Malays.

The statistics in Table 1 show that Government efforts prior to the NEP have reduced absolute poverty (represented by poverty incidence), although not dramatically, among

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\(^2\) Much of the writing on Malaysia’s poverty reduction efforts begin in 1970 or later, and deal primarily with the NEP (Economic Planning Unit [EPU], 2004; UNDP, 2014; Mohammed, Fauziah, & Suhaila, 2000).
the Malays indicating a degree of success in affirmative action. But this achievement has to be set against a rise in the poverty incidence among the Chinese and Indians, neither of whom were beneficiaries of affirmative action. However, income inequality (measured by both the Gini coefficient and the percentage share of income of the bottom 40% of the group) had risen for all ethnic groups, and fastest among the Malays.

While the focus on inter-ethnic comparison would have missed this fact, identification of poverty alleviation with affirmative action for a particular ethnic group could be justified on the grounds that Malays suffered the highest poverty incidence by far. The inter-ethnic disparity in wealth ownership, represented by the ownership of corporate shares, was much worse for the Malays (Roslan, 2001, p. 6).

Apart from questions about the effectiveness of programs in reducing absolute poverty, the Tunku Abdul Rahman Government’s *laissez faire* approach to economic management during the first decade of the country’s existence has been blamed, implicitly or explicitly, for the rising inequality (Chakravarty & Roslan, 2005). It is certainly true that during this period, the resources devoted to poverty alleviation were less than after 1970 and Government intervention on behalf of the Malays was much less pervasive than when the NEP was implemented. The First Malaya Plan itself was criticised as lacking a cohesive agricultural development program (Rudner, 1975). However, Snodgrass (1980) estimated that the fiscal system redistributed about 3.5% of the national income from non-Malays to Malays in 1968, while Lee (1975) estimated this redistribution to be higher, at 6% in

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**Table 1. Income distribution by ethnic groups in Peninsular Malaysia, 1957 to 1970**

<table>
<thead>
<tr>
<th>Ethic</th>
<th>1957/58</th>
<th>1967/68</th>
<th>1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malay</td>
<td>Mean income, RM/month, 1959 prices</td>
<td>134</td>
<td>154</td>
</tr>
<tr>
<td></td>
<td>Gini coefficient</td>
<td>0.342</td>
<td>0.400</td>
</tr>
<tr>
<td></td>
<td>% share of income of bottom 40%</td>
<td>19.5</td>
<td>17.2</td>
</tr>
<tr>
<td></td>
<td>Poverty incidence</td>
<td>70.5</td>
<td>65.9</td>
</tr>
<tr>
<td>Chinese</td>
<td>Mean income, RM/month, 1959 prices</td>
<td>288</td>
<td>329</td>
</tr>
<tr>
<td></td>
<td>Gini coefficient</td>
<td>0.374</td>
<td>0.391</td>
</tr>
<tr>
<td></td>
<td>% share of income of bottom 40%</td>
<td>18.0</td>
<td>17.0</td>
</tr>
<tr>
<td></td>
<td>Poverty incidence</td>
<td>27.4</td>
<td>27.5</td>
</tr>
<tr>
<td>Indian</td>
<td>Mean income, RM/month, 1959 prices</td>
<td>228</td>
<td>245</td>
</tr>
<tr>
<td></td>
<td>Gini coefficient</td>
<td>0.347</td>
<td>0.403</td>
</tr>
<tr>
<td></td>
<td>% share of income of bottom 40%</td>
<td>19.7</td>
<td>16.3</td>
</tr>
<tr>
<td></td>
<td>Poverty incidence</td>
<td>35.7</td>
<td>40.2</td>
</tr>
<tr>
<td></td>
<td>Chinese : Malay average income ratio</td>
<td>2.16</td>
<td>2.14</td>
</tr>
<tr>
<td></td>
<td>Indian : Malay average income ratio</td>
<td>1.71</td>
<td>1.60</td>
</tr>
</tbody>
</table>

*Source:* Perumal (1989); Snodgrass (1980)

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3 For example, in the First Malaysia Plan, 1966-1970, land development was allocated Malaysian ringgit (RM) 363.6 million, while in the Second Malaysia Plan, 1971–1975, the allocation, at RM908 million, was two and a half times larger (EPU, 1971, p. 68).
1970. The claim of laissez faire therefore has no substance. Besides, income inequality is as much a function of the occupational structure of each ethnic group. Dealing with inequality would have required changing this structure, as well as place of residence. This also raises the question of whether the more pervasive interventions post-1970 did a better job of reducing income inequality.

The pursuit of laissez faire would suggest the adoption of a ‘growth first strategy’ that should produce rapid growth. Yet, growth during this period, about 6% on average, was lower than in the 1970s. A reason for this could be that as Malaysia was moving towards export orientation, it could be expected that both policy and contextual factors had an impact on growth. This was indeed the case. From the perspective of policy, Malaysia’s efforts to diversify away from its dependence on rubber and tin saw it embark on a phase of import substitution industrialisation (Ariff, 1998). It was not until the 1970s that constrained by its small domestic market, the Government reversed it to embrace an export orientation. Thus, it was the import substitution strategy that contributed to restraining growth. At the same time, Malaysia’s growth still depended on export proceeds from its two primary commodities of rubber and tin. In the 1960s, growing production at home, and increasing competition from synthetic rubber saw natural rubber prices fall as shown in Figure 1. This also impacted Malaysia’s economic growth in the 1960s. On balance, any failure to achieve poverty alleviation and distribution objectives should not be blamed entirely on the Tunku Abdul Rahman Government.

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4 This view was also expressed by Yotopoulos (1981).
5 This strategy was implemented under three five-year development plans – the First Malaya Plan (1956–1960), the Second Malaya Plan (1961–1965), and the First Malaysia Plan (1966–1970) (Rokiah, 1996, pp. 32-36).
3. Early Years of the NEP, 1971 to 1986

The 1969 race riots were a defining moment in Malaysian history not only in that the event was unprecedented but also because of its aftermath that brought about the NEP in 1971. The twin thrusts of this policy were poverty eradication and economic restructuring so as to eliminate the identification of ethnicity with economic function. Announced at the launch of the Second Malaysia Plan (1971-1975), the strategy was of ‘redistribution with growth’ with no group to feel any sense of loss or deprivation. Growth was to be achieved by integrating with the world economy, a reversal of the import substitution strategy that was in place. The redistribution goal was to be realised by aggressive use of the public sector, imposition of quotas and preferential treatment for **Bumiputera**, coupled with restrictive licensing practices. Important components of the NEP were the imposition of a rigid education quota for **Bumiputera** in a broad-based education system as well as changing the medium of instruction from English to Bahasa Malaysia. These were seen as vital because the elitist education system inherited from the British at independence disadvantaged the largely rural Malays because the best schools were in the cities and instruction was in English.

Assessing the NEP during this period requires answers to two questions: (1) was high growth achieved?, and (2) was redistribution successful? With respect to the first question, high growth averaging 8.3% was indeed achieved in the decade of the 1970s, but tapered off after 1980. Shari (2000) argues in favour of dividing this period into three sub-periods, the first two spanning the 1970s, and the third, the first half of the 1980s.

In the first sub-period, high growth was indeed achieved, thanks to the move towards export orientation that brought labour-intensive industries like textiles and electronics assembly to Malaysia. The average growth rate during this period was 7.1% as shown in Table 2. The implementation of the NEP was also in its early days and it would have taken a while for the effects of the Policy to be felt (Heng, 1997, p. 268; Shari, 2000, p. 115). Early NEP interventions were also seen in the market where state enterprises embarked on new ventures rather than intervening with existing private enterprises.

In the second sub-period that spanned the second half of the 1970s, the economy continued to grow rapidly, averaging 8.6% over the period. Even though this period saw firm-level interventions through the provisions of the Foreign Investment Committee and Capital Investment Committee, and the Industrial Coordination Act (ICA) (1976), the NEP had a benign impact on growth. This could be due to the specific NEP interventions themselves. These took the form of the imposition of equity quotas for **Bumiputera** and the aggressive acquisition of foreign owned assets. These takeovers were still done through the market, and any economic distortion that resulted was not large. At the

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6 Heng (1997, p. 263) also argues that until his retirement in 1974, Tan Siew Sin, in his capacity as Finance Minister, in concert with Thong Yaw Hong, Director General of the Economic Planning Unit, Prime Minister’s Department, worked to protect Chinese interests from encroachment by the NEP.

7 The most famous example was that of the Guthrie Group, a British company with plantations in Malaysia, which was the subject of a Malaysian takeover engineered by then Prime Minister Mahathir Mohamed at the London Stock Exchange in 1981 (Mauzy & Milne, 1999, p. 139).

8 Market takeovers were less distortionary than nationalisation because the former relied on market prices whereas the latter could be accomplished arbitrarily.
same time, 100% exporting firms, established through foreign direct investment (FDI), were exempted from direct and indirect taxes. They were all foreign-owned, so that non-
Bumiputera local enterprises did not feel threatened. The ICA, however, was a different matter. The ICA targeted firms with domestic sales of 20% or more. Although direct tax breaks were minimised, incentives for export orientation (investment tax allowances and tariff rollbacks) remained in place. Growth was also helped by discovery of oil and gas. Thoburn (2011, p. 49) notes that petroleum production began offshore from the East coast of Peninsular Malaysia in the mid-1970s. With high oil prices in 1973 and 1974, oil accounted for 24% of the value of Malaysia's exports, twice that of tin.

For the Chinese, the impact of ICA was felt not only directly, but also through heightened Malay competition in sectors they used to dominate (e.g., retail, transport, and construction) (Heng, 1997, p. 273). Chinese family businesses opted to remain small to avoid the need to comply with the ICA while the opportunistic among them entered

Table 2. Growth and income distribution by ethnic groups and residence in Peninsular Malaysia, 1970 to 1985

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income share of bottom 40% of households</td>
<td>11.5</td>
<td>11.1</td>
<td>11.9</td>
<td>12.8</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>264</td>
<td>514</td>
<td>693</td>
<td>1,095</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.513</td>
<td>0.529</td>
<td>0.508</td>
<td>0.480</td>
</tr>
<tr>
<td>Average growth rate (%)¹</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income share of bottom 40% of households</td>
<td>13.1</td>
<td>11.8</td>
<td>12.4</td>
<td>14.1</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>200</td>
<td>392</td>
<td>550</td>
<td>824</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.469</td>
<td>0.500</td>
<td>0.482</td>
<td>0.444</td>
</tr>
<tr>
<td>Urban</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income share of bottom 40% of households</td>
<td>12.2</td>
<td>11.9</td>
<td>12.3</td>
<td>13.4</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>407</td>
<td>830</td>
<td>975</td>
<td>1,541</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.503</td>
<td>0.512</td>
<td>0.501</td>
<td>0.466</td>
</tr>
<tr>
<td>Urban:rural average income ratio</td>
<td>2.04</td>
<td>2.12</td>
<td>1.77</td>
<td>1.87</td>
</tr>
<tr>
<td>Malay</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income share of bottom 40% of households</td>
<td>13.4</td>
<td>11.7</td>
<td>12.9</td>
<td>13.3</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>172</td>
<td>345</td>
<td>492</td>
<td>852</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.466</td>
<td>0.506</td>
<td>0.488</td>
<td>0.469</td>
</tr>
<tr>
<td>Chinese</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income share of bottom 40% of households</td>
<td>14.7</td>
<td>12.6</td>
<td>13.4</td>
<td>14.2</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>394</td>
<td>787</td>
<td>938</td>
<td>1,502</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.466</td>
<td>0.541</td>
<td>0.470</td>
<td>0.452</td>
</tr>
<tr>
<td>Indian</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income share of bottom 40% of households</td>
<td>15.0</td>
<td>14.6</td>
<td>14.4</td>
<td>15.9</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>304</td>
<td>538</td>
<td>756</td>
<td>1,094</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.472</td>
<td>0.509</td>
<td>0.460</td>
<td>0.417</td>
</tr>
<tr>
<td>Chinese:Malay average income ratio</td>
<td>2.29</td>
<td>2.28</td>
<td>1.90</td>
<td>1.76</td>
</tr>
<tr>
<td>Indian:Malay average income ratio</td>
<td>1.76</td>
<td>1.55</td>
<td>1.54</td>
<td>1.28</td>
</tr>
</tbody>
</table>

Source: Shari (2000)
into joint ventures through ‘Ali-Baba’ deals (Heng, 1997, p. 276). Beginning in the late 1970s and running through the third sub-period (1980 – 1986), the share of manufacturing in GDP stagnated. Private investment also suffered. Chinese and foreigners’ share of paid-up capital of approved manufacturing projects had fallen to only 27.3% and 28.6%, respectively, while state enterprises stepped up to compensate for the former’s retreat, to account for 44.1% of the above paid-up capital (Yasuda, 1991). State enterprises went into non-traditional areas of business to grow the Malay managerial class. At the same time, the Government provided support to grow a class of Malay small and medium enterprises (SMEs) by providing restricted entry as vendors, suppliers, dealers, and contractors. State enterprises, financed by public funds, substantial public expenditure, partially by government borrowings, were involved. Public sector support notwithstanding, economic growth moderated, averaging only 4.5% between 1981 and 1986 compared to 8.6% in the previous five years.

The third sub-period came to a close when the Malaysian economy went into a brief but sharp recession in 1985 and 1986. This recession was blamed on low commodity prices (Mohammed et al., 2000) but they had been soft since the early 1980s9, and prudent fiscal management could have contained the adverse impact on the economy.10 Instead, the Government adopted an expansionary fiscal stance (Athukorala, 2010; Thillainathan, 2011). Thillainathan (2011, p. 107) reported on the fiscal deficit more than doubling from an average 6.6% of gross national product (GNP) in the 1970s to 14.8% over 1981 to 1983, and still a high of 7.4% over the period 1984 to 1986. The GNP share of total debt also escalated from 108% to 253% over the 1980 to 1986 period, while that of the public sector increased even more strongly from 50.3% to 132.5% during the same period. The expenditure binge was intended to support the NEP’s restructuring objective, but the burgeoning state enterprises sector, with both federal and state-level organisations that started new businesses and acquired existing ones were poorly governed, sustained increasing losses, and also crowded out the private sector.11 Hence the 1985 and 1986 recession was merely a tipping point, the culmination of a crisis that had been building for at least half a decade.

From the perspective of distribution, the first sub-period saw overall income inequality rise as shown in Table 2. This rise applied to all ethnic groups and to all locations (rural and urban) reflecting, as already indicated the limited impact of the first years of the NEP. The income gap between urban and rural residents increased, but that between the Chinese and Malays remained stable, and between the Indians and Malays fell. In the second sub-

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9 Mohammed et al. (2000, p. 17) report that as a result of falling prices, export receipts from rubber declined from USD 1,215 million in 1980 to USD976 million in 1981, tin export receipts from USD421 million in 1985 to USD171 million in 1986, and palm oil price from USD424 per tonne in 1984 to USD289 per tonne in 1985.
10 Healthy budgetary surpluses built up in the 1970s should have permitted the accumulated rainy-day fund to cushion the economy during downturns or natural disasters. Instead, considerable public resources were used for corporate takeovers, successful and botched. The takeover of Guthrie at the London Stock Exchange in 1991 is an example of the former while the Maminco fiasco in the early 1980s is an example of the latter. Malaysia also made wrong speculative bets on the pound sterling between 1992 and 1993 (Asian Sentinel, 2012).
11 Lim (2011, p. 17), citing other sources, notes that in 1984, only 269 out of 900 state enterprises submitted annual returns and these sustained heavy losses. It was unlikely that those that did not report did any better.
period, with increasingly aggressive affirmative action, income inequality within each
group fell, as did the urban-rural and Chinese-Malay average income gaps (Shari, 2000, p.
15). This improvement continued into the third sub-period.

Thus for the first decade and a half of its implementation, redistribution was indeed
achieved but at the cost of increasing distortions to the economy. It is therefore hard to
disagree with Lim’s (2011, p. 17) assertion that the NEP achieved its twin goals of poverty
reduction and restructuring, but at a high cost, with the 1985 and 1986 recession its most
obvious manifestation.

4. Between Two Crises, 1987 to 1997
The Malaysian economy plunged into its 1985 and 1986 recession notwithstanding that
the long boom in the US began in the early 1980s (Taylor, 2009). Public sector finances
were in an acute state as a result of excessive reliance of the Government on borrowings
and spending to support growth (in the face of weak external demand in the late 1970s
and early 1980s), as well as to finance its ambitious distribution program that led to a
ballooning of its deficits and debt and to a bloated and poorly managed public enterprise
sector. The Government had therefore no choice but to turn to the private sector through
privatisation, but with the original objective of NEP emerging intact. This took the form
of a program of ownership liberalisation and privatisation as well as a reform of the tax
system (through a big cut in the tax rate on a phased basis), and of the labour market. The
focus of ownership liberalisation was the manufacturing industry. Foreigners were now
allowed to own 100% of shares in a manufacturing firm compared to only 30% before so
long as it exported at least 50% of its output (whereas the export requirement before was
set at 80% and above) or employed at least 350 persons (whereas employment was not
given any weight before).

The Government also embarked on privatisation to provide a more favoured access
of the Bumiputera community into privatised activities. These privatisation exercises
afforded the Government an alternative way to realise its goal of increasing Bumiputera
participation in equity ownership and management. To that extent it reduced the risk
and cost arising from a forcible redistribution of the shares of the non-Bumiputera group
in the private sector, as had been the case under the ICA until then. However, much of
this transfer consisted of sales to Malay entities close to the political leadership, thus
embedding further patronage networks in the name of the NEP (Gomez & Jomo, 1997).
This undermined the effectiveness of the privatisation program and made it a risky
undertaking.

At the same time, the opening up of the education sector to private sector participation
increased the opportunities of non-Bumiputera students in higher education. Admission
into the new privately-licensed and operated educational institutions of higher learning

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12 Jomo and Wee (2004, pp. 13-14) report that even in 1987, “…almost half the 1,148 enterprises – mostly
subsidiaries and associated companies of state enterprises – were still in the red, involving a net loss of
RM1.9 billion. Some 562 companies had losses totalling RM7.5 billion, while another 446 had profits of RM5.6
billion, with the remainder inactive or in the process of closing down. Total public sector investments in the
1,148 companies came to RM15.3 billion, or about 71% of the total paid-up capital of RM21.5 billion, with the
state holding at least half the equity in 813 of these companies.”
was not subject to admission quotas. These institutions thus increased opportunities for non-
_Bumiputera_ students, but in no way reduced the share of places set aside for _Bumiputera_ students in the public sector educational institutions. Although the cost of private higher education was at market rates, and much higher than the subsidised fees charged for public education, this improved access to education greatly reduced the level of dissatisfaction among the non-_Bumiputera_ community when public education was the main choice and access was highly restricted, and which had led many better-off non-
_Bumiputera_ to study and settle overseas (World Bank, 2011).

Thus, ownership liberalisation and privatisation programs saw, and likely led to a substantial increase in private investment, to a reduction in talent outflow and to higher economic growth. The share of foreigners in paid-up capital of approved manufacturing projects jumped from 28.6% during the 1976 to 1986 period to 61.3% during the 1987 to 1990 period, whereas the share of state owned enterprises (equity held in trust for Malays) fell from 44.1% to 18.2% over the corresponding period (Yasuda, 1991, pp. 240-41). The GDP share of private investment also increased dramatically from 16.6% between 1976 and 1986, to 19.1% between 1987 and 1990, and to 29% between 1990 and 1997. With respect to the boost in economic growth, Malaysia’s average annual growth rate over 1976 to 1986, when enterprise level intervention was at its height, averaged 6.35% per annum compared to 7.6% during the post-liberalisation 1987 to 1998 period, the latter period including the worst crisis year. If 1998 is excluded, average growth rate in the post-liberalisation period would have been 8.93%. The jump in private investment was not only in manufacturing but also in education, health care, electricity generation, telecommunication, toll roads, light rail, as well as in water & sewage. In some sectors such as electricity generation, telecommunications, and education, privatisation ventures were a big success, but in others such as those in toll roads, light rail, water & sewage, they were much less successful.

The ownership liberalisation that was in place for export-oriented firms and its further relaxation in the post 1986 period was the critical factor in boosting export-oriented manufacturing in Malaysia. In the absence of such liberalisation, the multinational corporations would have gone to other member countries of the Association of Southeast Asian Nations (ASEAN) or elsewhere. Additionally, the Plaza Accord which led to a big appreciation of the East Asian currencies, and in particular the Yen relative to the United States dollar (USD), reinforced the comparative advantage of Malaysian exports. The member countries of the ASEAN, including Malaysia, became more attractive for East Asian investments given their low cost base, and that their currencies were linked to the USD.

Such ownership liberalisation and privatisation as well as the Plaza Accord boosted long-term private capital inflows (including FDI) into manufacturing and other sectors that were not open hitherto to the private sector. These same factors also boosted short-term (or portfolio) capital inflows into the Malaysian equity market but there was much less inflows in the form of foreign currency loans (unlike in Thailand and Indonesia). These capital flows into the emerging markets were also boosted by the collapse in 1989 of

13 Computed from Malaysia Treasury Economic Reports of various years.
the Soviet Union and the end of the Cold War. In the euphoria brought about by heady economic growth that earned the country membership into the World Bank’s High-Performing Asian Economies (HPAEs), few could imagine that such a state of affairs could not be sustained for long.

It was not. A decade after the 1985 and 1986 recession, the period of growth was brought to a halt by the 1997 Asian Financial Crisis (AFC). For Malaysia, the AFC was in some ways a reprise of the 1985-1986 recession. While the external circumstances differed, Malaysia’s economic collapse resulted from heightened vulnerabilities brought about by policies that were related to the implementation of the NEP. These vulnerabilities arose from a lax Government guarantee of splurging private investment expenditure on massive infrastructure projects contracted out to Bumiputera companies in the patronage network. Such patronage also made for easy credit from banks, themselves closely linked to the Government because of takeovers by Bumiputera interests in the name of the NEP (Athukorala, 2010). Easy credit was also facilitated by a stock market bubble that drove stock valuations to stratospheric levels. Following on the attack on the Thai baht in July 1997, capital flight led to the crash of the Kuala Lumpur Stock Exchange and the RM. In the initial months of the AFC, the fatal mistake made was to tighten macro policies and clamp down on credit as well as policy flip-flops (including mid-stream rule changes) (Thillainathan et al., 2002; Thillainathan, 2011). Thus one consequence of the pursuit of activities in the name of the NEP was to render the economy vulnerable to external shocks. Clearly, the lessons from the 1985 and 1986 recession were not learned.

Within the reform agenda, the most radical, as well as the weakest initiative was privatisation. Its design and structuring minimised the expected benefits and made the privatised entities very vulnerable to economic shocks. Privatisation afforded the Government an alternative way to realise its goal of increasing Bumiputera participation in equity ownership and management. However, as noted much of this ownership stake consisted of sales to Malay entities close to the political leadership. In a number of the sectors, such as in transport (toll roads, light rail, aviation & shipping), water & sewage activities as well as in the automotive industry, the ownership change was accompanied only by a limited opening up of the market to new entrants, price regulation, and over-gearing both at the enterprise level as well as at the shareholder level supported by the Government’s step in obligation to bail out debt holders (in the event the franchisee failed to operate the privatised entity on a going concern basis) (World Bank, 1999; Pua, 2011. It is therefore little wonder that the other stated aims of privatisation, namely increasing efficiency and the role of the private sector, were not really achieved.

As for the privatised entities, their success or failure depended on the extent to which they were still protected, their exposure to currency or maturity mismatches, extent of gearing and price control to which they were subject to, as well as on the nature of their financing arrangements. With the massive depreciation of the RM during the AFC, currency mismatches led to bankruptcy. Also, with the collapse in share prices, PLCs that had relied on convertible bonds for the repayment of their loans faced financial distress as only those with strong cash flows were able to roll over or raise new loans. The collapse of the business empires of several high fliers during the AFC crisis can be attributed to their over-reliance on financing that was marked by currency or maturity mismatches, or dependence on asset sales to repay loans. During the crisis, many highly capital intensive
infrastructure companies failed. Examples were the developers and operators of toll roads and mass transit rail projects. This was primarily because of the over-gearing, inadequate or slow pace of cash flow generation, and their failure to refinance their loans. The maximum tenure of these loans fell far short of the typically long life of the operating assets of these businesses. This exposed the borrowers to refinancing risk and hence bankruptcy. Some privatised corporations, especially those in the transport and automotive sectors performed so poorly that the Government had to bail them out or renationalise them.

The economic reforms of the 1987 to 1997 period, in particular the ownership liberalisation and privatisation ushered in a period of rapid growth. This was brought to a halt in 1998 when the Malaysian economy succumbed to the AFC as it had by then become vulnerable to the crisis. This from the investment boom and asset market bubble unleashed by the economic reforms and fuelled by big capital inflows into the economy and rapid credit growth as well as by the poor structuring of some of its major privatised Bumiputera initiatives, in particular those involved in undertaking the country’s major infrastructure development projects. Also, as aforementioned, the crisis was made worse by its gross mismanagement, partly deliberately for political reasons (Thillainathan, 2011).

If the record of growth during this sub-period has been impressive, what have been the trends in poverty reduction and income distribution among the Malays, a key objective of the NEP? The overall and rural-urban poverty and income distribution trends during this period are shown in Table 3. The rural data could be considered to apply to the Bumiputera community while the urban data would include an increasing proportion of the Bumiputera.

There was a significant monotonic increase in mean household incomes regardless of residence, undoubtedly reflecting the impressive economic growth during this period, but a V-shaped pattern in income inequality with both the Gini coefficient, and the

<table>
<thead>
<tr>
<th>Table 3. Household income level and income distribution by residence in Malaysia, 1987 to 1997</th>
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<tbody>
<tr>
<td>Total</td>
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<tr>
<td>Income share of bottom 40% of households</td>
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<tr>
<td>Mean household income (RM)</td>
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<tr>
<td>Gini coefficient of income</td>
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<tr>
<td>Rural</td>
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<tr>
<td>Income share of bottom 40% of households</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
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<tr>
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<td>Income share of bottom 40% of households</td>
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<td>Mean household income (RM)</td>
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<tr>
<td>Gini coefficient of income</td>
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<tr>
<td>Disparity ratio</td>
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<tr>
<td>Urban:rural</td>
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<tr>
<td>Chinese:Bumiputera</td>
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<td>Indian:Bumiputera</td>
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Source: Ragayah (2011, Table 9.7)
Income share of the bottom 40% of households improving initially and then deteriorating. Without resorting to a decomposition analysis, it seems fairly clear that the source of inequality was more rural-urban income inequality than from inequality within rural and urban household groups. The urban to rural income ratio, unchanged from 1987 to 1990, rose sharply in 1995, and further still in 1997. The income ratios between Bumiputera and other communities exhibited a similar pattern, but the increase in disparity was not nearly as sharp.

Ragayah (2011, pp. 232-239) explains the initial decline in inequality in terms of the implementation of rural development programs and improved access to education for the Bumiputera, export-oriented industrialisation leading to rising wages, and restructuring of equity ownership. However, (Ragayah, 2011, pp. 234-235) states that rural development programs, to which considerable development expenditure was committed, were not particularly effective while the equity restructuring exercise fell short of the 30% target.

For the increase in inequality, anecdotal evidence presented by Ragayah (2011, pp. 239-244) included the decline in the agriculture sector, stagnation in the growth of wages for manufacturing with the entrenchment of the low cost labour model for manufacturing, rising urban poverty from rural-urban migration receiving inadequate Government attention, and ‘state-government-party collusion’, an euphemism for state capture through crony capitalism-based corruption about which much has been written (Abdul Rahman, 2008; Gomez & Jomo, 1997; Meerman, 2008).

More fundamentally, the disparity ratios show that changes in inter-ethnic inequality matters far less than rural-urban inequality. An exclusive focus on the former, even if effectively implemented, would have missed the major sources of inequality.

5. Post-AFC, 1998 Onwards

The AFC proved to be another watershed for the Malaysian economy. The heady growth of the late 1980s and early 1990s never returned when the AFC ebbed. From 1999 to 2006, Government statistics show that the annual growth averaged only 5.4% compared to 7.6% over the period between 1987 and 1998. Even before the onset of the AFC, FDI that used to make Malaysia a favourite destination had dwindled. In 1999, the World Bank reported a net FDI of USD3.9 billion, while the average for the period 2000 to 2004 was under USD3 billion a year. The growing attraction of countries like Indonesia and Vietnam is making the competition for FDI much tougher for Malaysia. Furthermore, Malaysia’s maintenance of a low cost labour platform for manufacturing through imported cheap labour places it at a competitive disadvantage against countries like Cambodia, Indonesia and Vietnam with their pools of low cost labour. Yet, Malaysia’s poor human capital base prevents it from moving up the production value chain.

Domestically, private investment has fallen. As a share of GNP, it averaged only 10.5% per annum during the period between 2000 and 2010 compared to 24.7% in the period between 1987 and 1997. This investment rate is even lower than the 16.2% achieved in the NEP period between 1971 and 1990. Low private investment was the result of crowding out by the resurgence of the State’s role through government-linked companies (GLCs). This came about by the ultimate failure of the 1980s privatisation program due to crony capitalism spawned ‘private’ Bumiputera companies that were poorly managed “and barely disciplined for corrupt or unproductive actions, especially
for rent-seeking, sub-contracting, and profiteering off assets acquired at a discount” (Gomez, Satkunasingam, & Lee, 2015, p. 115). The AFC, by destroying many major Malay capitalists and conglomerates, left the Government with little choice but to re-enter the market through renationalisation and increased state ownership. By the Government’s own admission, GLCs accounted for 37% of market capitalisation on Bursa Malaysia in 2010 (National Economic Advisory Council, 2010).

Low private investment has been compounded by capital outflows, both legal and illicit. On the former, the Asian Development Bank’s Menon (2012, pp. 7-8) notes that “outflows of capital from Malaysia started increasing sharply after the AFC, and have grown to a point where Malaysia has been a net exporter of capital since 2005.” He also referenced the latter. “…There is evidence that capital flight has also increased of late. Dev and Curcio (2011) estimate that illicit capital outflows have more than tripled between 2000 and 2008, rising from about USD22 billion to USD68 billion annually, for a cumulative total of USD291 billion over this period. This places Malaysia only behind the PRC, the Russian Federation, Mexico, and Saudi Arabia with respect to illicit outflows”. Such data has prompted Menon (2012, p. 8) to speculate that “both foreign and domestic investors are simply abandoning Malaysia.”

There could be several factors as to why economic liberalisation that had been so successful became decidedly less so after the AFC. The answer likely lies in the AFC exposing the vulnerabilities that had not been remedied when liberalisation occurred. These included investment liberalisation not going far enough because Malaysia is still saddled by a dualistic investment policy regime, with GLCs not only becoming so pervasive that they were crowding out private investment, but also being largely exempt from the kind of corporate governance applied to the genuinely private sector. Menon (2012, p. 10) estimated that GLC dominance was highest in the utilities sector (93% of the industry’s operating revenue), and in the transportation and warehousing sectors (about 80%), but was also more than 50% in the plantation, banking, information and communications technology, and retail trade sectors. Menon’s (2012) comment that “this is highly unusual for a country representing itself as an open, modern, and market economy” can hardly be disputed.

Aside from GLCs, economic dualism has arisen from the fact that while there has been a relaxation of ICA, this has not been so with respect to some domestic market oriented activities. The NEP-hand was shown once again in continued control of those economic activities which were used to promote Malay ownership, management, and employment. A clear example in manufacturing is the automotive industry, which continued to be heavily protected with high tariff and restrictions on foreign entry. Many activities in

14 Annual illicit capital outflows are about ten times net incoming FDI. In their 2003–2012 update, Dev and Curcio (2011) estimated Malaysia’s average annual illicit outflow was an even higher at USD39.5 billion compared to the figure for 2000 to 2009. Malaysia retained fifth spot.

15 While the automotive market has witnessed the entry of foreign brands, the licensing regime has ensured that models that competed with domestic manufacturers Proton and Perodua were kept out, and if allowed in, were obliged to charge higher prices. As for imports, the Approved Permit (AP) system limited their entry and ensured that only a privileged few benefited. Even with the coming into effect of the ASEAN Free Trade Area in 1992 which mandated the lowering of tariffs, tariffs were replaced by excise duties to ensure the same structure of discriminatory pricing against imports remained intact.
infrastructure and services including such activities as aviation, financial services, and power generation are also subject to ownership restrictions.

A second factor, and a likely more damaging one given its longer-term impact, is the compromised education system that produced human capital of dubious quality (Athukorala & Wagle, 2011; World Bank, 2013). Quality problems have arisen from the entrenched ethnic stratification in the education system that emphasised national unity over merit. Findings of a 2009 survey of students admitted into engineering from those with the *Sijil Tinggi Perlajaran Malaysia (STPM)*, which is the Malaysian equivalent of the British form 6 and has multi-ethnic representation, and *Program Matrikulasi* Malaysia with mostly *Bumiputera* students revealed that 62% of STPMs holders were A grade students in their first year of engineering study compared to only 14% from the latter group (Nopiah, Zainuri, Asshaari, Othman, & Abdullah, 2009). The difficulty of retaining talent, combined with brain drain cited earlier, has only made matters worse.

The impact of redistributive policies, many of which have been discussed above, has been mixed on income distribution. A comparison of the incomes for 1997 shown in Table 3 with those for 1999 shown in Table 4, found the AFC’s impact to be more severe in the urban sector where the mean monthly household income fell 7.8% from RM3,357 to RM3,103, but the rural mean household income actually increased slightly. Neither did the AFC hurt income distribution with the income share of the bottom 40% improving for both rural and urban households. Moving beyond 1999, rural income distribution improved in 2002, before reverting to the 1999 situation. For the urban households the situation was the opposite with the Gini coefficient deteriorating before partially recovering. However, the income shares of the bottom 40% increased for rural households while remaining stagnant until 2004 for urban households.

The interesting finding, shown in Table 4, is the performance of the total population. The income share and the Gini coefficient of the bottom 40% deteriorated until 2004

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<tbody>
<tr>
<td><strong>Total</strong></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income share of bottom 40% of households</td>
<td>14.0</td>
<td>13.5</td>
<td>13.5</td>
<td>14.8</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>2,472</td>
<td>3,011</td>
<td>3,249</td>
<td>3,686</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.443</td>
<td>0.461</td>
<td>0.462</td>
<td>0.441</td>
</tr>
<tr>
<td><strong>Rural</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income share of bottom 40% of households</td>
<td>15.6</td>
<td>16.1</td>
<td>16.6</td>
<td>17.3</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>1,718</td>
<td>1,729</td>
<td>1,875</td>
<td>2,283</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.427</td>
<td>0.409</td>
<td>0.414</td>
<td>0.424</td>
</tr>
<tr>
<td><strong>Urban</strong></td>
<td></td>
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<tr>
<td>Income share of bottom 40% of households</td>
<td>14.8</td>
<td>14.7</td>
<td>14.6</td>
<td>15.1</td>
</tr>
<tr>
<td>Mean household income (RM)</td>
<td>3,103</td>
<td>3,652</td>
<td>3,956</td>
<td>4,356</td>
</tr>
<tr>
<td>Gini coefficient of income</td>
<td>0.416</td>
<td>0.439</td>
<td>0.444</td>
<td>0.427</td>
</tr>
<tr>
<td><strong>Disparity ratio</strong></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Urban: rural</td>
<td>1.81</td>
<td>2.11</td>
<td>2.11</td>
<td>1.91</td>
</tr>
<tr>
<td>Chinese: Bumiputera</td>
<td>1.74</td>
<td>1.80</td>
<td>1.64</td>
<td>1.54</td>
</tr>
<tr>
<td>Indian: Bumiputera</td>
<td>1.36</td>
<td>1.28</td>
<td>1.27</td>
<td>1.20</td>
</tr>
</tbody>
</table>

*Source: Ragayah (2011, Table 9.7)*
before recovering somewhat in 2007. The variance between this result and those for rural and urban sectors can be explained by the growing rural-urban disparity. Rural income disparity peaked in 1999, fell in 2002, picked up again between 2004 and 2007, before reaching the 1999 level again by 2007. Urban inequality, however, was higher for the entire period between 2002 and 2007 than it was in 1999. This stood in sharp contrast to the inter-ethnic income gaps, which fell during this period. As with the period before the AFC, the NEP’s focus on ethnic inequality would have done little to address overall inequality especially as the Bumiputera are moving increasingly to urban areas.

6. Conclusion

Much has been written and heatedly discussed, about the NEP during the nearly half a century of its existence. However, a balanced assessment of the whole policy must take into account the changes that have taken place by way of policy implementation, as well as of how well each objective was addressed. In terms of the latter, despite the use of a horizontal inequality criterion (ethnicity) to benchmark what is essentially a vertical inequality (income) issue, there is no question that poverty was significantly reduced and income distribution improved, at least until the turn of the 21st century. The reversal since then appears to have emanated from the growing importance of rural and urban income differences. Overall, the NEP has met its distribution objective, despite the use of a dubious yardstick (equity ownership) that underestimates this achievement.

The original objective of achieving redistribution without impacting economic growth was not achieved. State interventions like quotas that distorted market signals had brought not only reduced growth, but the country into a recession in the mid-1980s, which necessitated the restoration of the private sector’s role. In an environment where favourable external factors helped to boost economic growth, as experienced during the decade between 1987 and 1997, it was easy for the NEP’s defenders to sweep the growth-distribution trade-off under the carpet. However, this trade-off would manifest itself more clearly after the AFC when these factors no longer existed. Even during the heydays of growth, the implementation of the NEP was such that while equity and asset transfers were implemented, their recipients never acquired the entrepreneurial skills to maintain, let alone grow them. Instead reliance on political patronage bred a system where a strong state presence in the background served to undermine corporate governance. The result of this mix has heightened Malaysia’s vulnerability during times of economic crises.

References


