

The environment for foreign direct investment (fdi) essay sample

[Finance](#), [Investment](#)



The environment for foreign direct investment (FDI) has become very competitive and it is important for countries to critically examine their investment policies and ensure their relevance and effectiveness in attracting and benefiting from FDI. Foreign direct investment (FDI) has the potential to generate employment, raise productivity, transfer skills and technology, enhance exports and contribute to the long-term economic development of the world's developing countries. More than ever, countries at all levels of development seek to leverage FDI for development, including Malaysia.

Malaysia has made the transition from being an essentially primary commodity producing economy over the last three decades to one in which manufacturing contributes more than 30 per cent of annual GDP and the overwhelming majority of exports. This transformation has been facilitated by an export-led investment strategy, in which FDI from more developed nations has played a key role.

To accelerate its economic transition, Malaysia has launched various policies and programmes with varying degrees of success. This paper examines the role and impact of both the FDIs and domestic investments on Malaysia's actual economic growth and development. They will be linked to exports, employment, and domestic equity levels. It should be noted that most of the requirements Malaysia has applied have been "voluntary" in nature in that they have been used as conditions for the receipt by the investor of an incentive or other advantage.

Research Methods

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To find data and information on FDI in Malaysia, as well as its role and impact on the economic growth and development, a lot of reading was done, namely of

- * Malaysia's economic policies since independence in 1957
- * Malaysia International Trade and Industry reports
- * UNCTAD publications
- * Malaysian Industrial Development Authority (MIDA) reports
- * MIDA website (<http://www.mida.gov.my>)
- * Bank Negara Malaysia Annual reports of various issues
- * Multimedia Development Corporation website (<http://www.mdc.com.my>)
- * and other academic publications (listed in the bibliography)

Analysis of Information and Data

In order fully to understand the role and impact of FDIs in the Malaysian context, it is important to place the analysis in the broader context of the country's evolving approach to economic development. Malaysia's policies have comprised a complex mix of restrictions, requirements and incentives. After independence in 1957, Malaysia passed through a stage in which the focus was on import-substitution. This was followed by the passing of the Investment Incentive Act in 1968 to encourage labour-intensive, export-oriented industrialization and employment generation.

Several other related policies and programmes were also introduced, notably the Free Trade Zone Act (1971) for the attraction of export-oriented TNCs. This Act led to the establishment of 10 zones offering subsidized infrastructure, expedited customs formalities and freedom of import duties and export taxes. made the issuance of licences for industrial activity conditional upon compliance with the New Economic Policy guidelines stipulating 30 per cent Malay share of corporate ownership. In the 1980s, a period of heavy industrialization was pursued to further economic diversification, increase local linkages, promote Bumiputera small and medium-sized enterprises (SMEs) and to upgrade the country's technological capacity. The heavy industrialization programme took the form of new joint venture projects between state-owned enterprises and foreign (mostly Japanese and Korean) partners in automotives, motorcycle assembly, steel, cement, fertiliser, petrochemical and other industries (Felker and Jomo, 2002).

The economic downturn of the mid-1980s seriously affected Malaysia's development plans and led the Government to encourage more public-private cooperation. Various incentives for private sector participation were introduced to support other policy efforts in a more liberal direction. FDI was given more attention and new ventures were granted more generous treatment and flexibility with regard to foreign equity participation, especially in export-oriented industries. In 1985, the Industrial Master Plan identified three policy instruments for increasing technology capability: research manpower, institutional arrangements (such as industrial parks),

and R&D incentives. Twelve priority sector development plans were announced as part of a comprehensive strategy.

Despite slow economic growth during the early years of the Master Plan period, most of the defined targets were achieved (MITI, 1986-1995). To give a further fillip to the Industrial Master Plan, the Promotion of Investment Act of 1986 was enacted to develop priority industries identified in the Plan. Under this Act, the Labour Utilisation Relief incentive was abolished and pioneer status incentives were delinked from capital investment criteria. In addition, tax incentives introduced for training, R&D and reinvestment complemented the Promotion of Investment Act. Other instruments to promote industrial development included exemption of import duty on raw materials, tariff protection for certain industries and financial and credit assistance. The Second Industrial Master Plan, 1996-2005 extended the Plan's approach beyond export manufacturing operations towards more locally-integrated clusters. Emphasis was shifted to encourage supporting industries, including the services sector. This Second Plan also focused on integration of manufacturing operations along the value chain through investments in R&D and design capability, development of integrated supporting industries, packaging, distribution and marketing activities.

Discussion of Findings

1. Export

In 1991, a broad reform of Malaysia's investment policy regime was carried out by phasing out tax incentives for exports and reducing the scope of the

pioneer status. However, full tax exemptions were granted to investments in specific higher technology and strategic sectors. Incentives were increasingly tied to technological deepening, exports and domestic sourcing of inputs. Applications for pioneer status were to be more rigorously screened using four broad criteria: value added of 30-50 per cent, local content levels of 20-50 per cent, depth of technology and linkage effects (Felker and Jomo, 2002). However, the East Asian financial crisis in 1997/98 spurred Malaysia to further liberalization. Restrictions on foreign equity in most new manufacturing investments were lifted regardless of export orientation (National Economic Recovery Plan, 1998). Exemptions from import duties were granted to imports of machinery and equipment locally unavailable, as well as to all inputs used in export production while a “hands off” attitude towards existing foreign investors’ compliance with the terms of their investment licences was explicitly declared (Felker and Jomo, 2002). Finally, to conform with the WTO TRIMs Agreement the local content requirement was removed in 2000.

For more than three decades, export growth has been an integral part of the development strategy of Malaysia. Since the early 1970s, a combination of favourable tax incentives, special zones and various export requirements have been used to induce TNCs to use the country as an export platform. Although the types of export oriented industries that qualified for incentives changed over the years (for example, from labour-intensive to high technology), the main goal has been the same: to industrialize via exports.

In 1968, under the Investment Incentives Act, tax exemptions were given to export-oriented industrial investments. Export oriented manufacturing was given a further boost under the Second Malaysia Plan, 1971-75, with more generous and effective incentive schemes. In the early days the key incentive for labour-intensive and export oriented investments was the establishment of free trade zones and, later, the granting of licensed manufacturing warehouse status. In the 1970s, ten free zones were established to attract FDI seeking to assemble and export electronics products as well as textiles. These initiatives also provided subsidized infrastructure and duty-free imports of raw materials, intermediate products as well as equipment for the purpose of manufacturing and exports of products.

With the Promotion of Investment Act, new incentives contingent upon export performance were introduced. In particular, the pioneer status tax holiday replaced the Investment Incentives Act and offered a five-year tax holiday, with an extension of five more years for selected productive activities, including export-oriented FDI. The link to export performance was abolished in the 1990s, partly in response to WTO obligations (UNCTAD, 2002, pp. 206- 207).

Export requirements were also linked to equity requirements. For instance, with some exceptions, investments that produced more than 80 per cent of products for export were allowed 100 per cent foreign ownership. This export requirement prevailed until 1998.

These policies appear to have contributed to a dramatic structural change in Malaysian exports, with the share of manufactures in total merchandise exports rising rapidly from 12 per cent in 1970 to 85 per cent in 2001. However, manufactured exports only displayed their rapid expansion after the mid-1980s. Furthermore, the exports of manufactures were heavily biased towards the electrical and electronics industry, which started to dominate manufactured exports during the 1980s. In 2001, that industry accounted for more than 70 per cent of manufactured exports. The increased exports, however, had a more limited positive impact on Malaysia's trade balance, as imports of

capital and intermediate goods also expanded fast. It was only after 1997 that the trade balance improved significantly.

The expansion of manufactured exports was closely correlated with a rapid increase in the volume of FDI approved. Of the FDI flows into Malaysia, the electronics industry accounted for a major part. As a result, Malaysia's share of world electronic components exports increased from almost nothing in 1970 to about 10 per cent in 2000. Meanwhile, export-oriented FDI was also received in textiles and apparel, wood and wood products, chemical and chemical product and rubber products.

The creation of free trade zones and incentives contingent on exportation was important in this process but not the only determining factors. Foreign firms were also attracted by the availability of low-wage labour, reasonable infrastructure facilities and political stability. The export requirements and

related incentives exerted their greatest influence on FDI in the electronics and textiles industries, which are not based on the presence of natural resources and are therefore more mobile. Over time, export manufacturing has moved beyond the free trade zones partly in response to incentives granted to encourage industrial dispersion.

At the same time, it is difficult to assess how important the export requirements were in encouraging inward FDI. Exports may well have increased even without such requirements since most of the FDI came mainly to take advantage of lower costs precisely for exports to markets in the United States, Japan and Europe. For such investments, Malaysia was an attractive and profitable production site. Even recent export-oriented foreign investors like the Dell computer company, which came to Malaysia in the mid-1990s, testify that they picked this country as its Asia-Pacific centre “because of proven infrastructure, proven management talent, supplier base and pioneer status incentives” (interview). Although they were obliged to export 90 per cent of their output to retain full ownership that was never an obstacle, mainly because production at the outset was intended for regional and global markets, rather than for Malaysia.

2. Employment

A key development objective of attracting FDI to Malaysia has been to create new employment. In 1970, the share of Bumiputeras in manufacturing employment was only 29 per cent. In the second prong of the New Economic Policy, a target was set to increase this ratio to 50 per cent by 1990. A shift

towards the promotion of labour-intensive industries was initiated in the late 1960s and continued up to the early 1990s. Employment requirements were introduced in 1972 with the introduction of the Labour Utilisation Relief incentive. It provided increasingly generous tax exemptions for pioneer status industries the greater the number of full-time employees. Under the Industrial Co-ordination Act, the manufacturing licence had ethnic composition requirements attached at all levels of employment to encourage firms as far as possible to recruit more Bumiputera workers at all levels. The employment requirements continued into the 1990s.

Manufacturing employment grew dramatically from 318, 000 in 1970 to 2, 126, 000 in 2000, corresponding to a doubling of its share to 23 per cent of total employment. This contributed to a reduction of unemployment to below 4 per cent. Since the economic downturn that began in 2000, however, a number of TNCs in electronics have decided to relocate some activities from Malaysia (notably to China), with a resulting increase in unemployment. Data on investments approved by the Malaysian Industrial Development Authority (MIDA) show that of the 7, 385 approvals granted between 1972 and 1986, only 90 (just over 1 per cent) received the Labour Utilisation Relief incentive. Furthermore, these 90 projects generated a mere 16, 749 job opportunities, as compared with the more than 730, 000 jobs created from projects approved during the same period. This, however, does not necessarily mean that the Labour Utilisation Relief incentive was ineffective. Rather, since projects can only enjoy the pioneer status or the Labour Utilisation Relief incentives, most projects were aimed at acquiring the more attractive

pioneer status. According to information from MIDA the unemployment rate was 3.6% in 2001 and is estimated to be 3.5% for 2002.

While it was relatively easy for firms to comply with requirements to increase overall Bumiputera participation, ensuring that Bumiputera were adequately represented at various levels of employment has been more challenging. Still, interviews with both foreign and local firms have shown that conscientious efforts were taken by many companies also to recruit Bumiputera employees, at the higher levels, but often with limited impact. In the absence of detailed national statistics, employment data for industries located in Penang can serve as an illustration. In Penang, Bumiputera employment is mainly concentrated in the lower hierarchies. Although significant improvements were registered in the supervisory category, Bumiputera representation at the managerial level remains low. While the employment requirements may have incurred some cost concerns, interviews and other evidence do not indicate that they have deterred FDI in Malaysia. Firms need workers, and since the Bumiputera ethnic ratio is higher, it stands to reason that anyway they would generally hire more Bumiputera workers. The entry of Bumiputeras into the manufacturing labour force also helped to keep wages down during the expansion phase.

3. Domestic Equity

Domestic equity requirements were introduced under the Industrial Co-ordination Act in 1975. With this, manufacturing companies with shareholder funds of more than RM 250,000 or employing at least 25 full-time staff, had

to obtain a manufacturing licence. In this context, equity conditions could be imposed, for example, to encourage Bumiputera ownership. As stated in the Midterm Reviews of the Second Malaysia Plan: the “ Malay share of total paid-up capital in pioneer companies was only 6% [...] To ensure that significant progress is made [...] the Government has now stipulated that at least 30% of the equity of all approved companies, except those that are export oriented will be reserved for Malays and other indigenous people.”

The equity requirement was relaxed in connection with the East Asian financial crisis. As a result, new foreign investors can now hold 100 per cent equity, irrespective of the level of exports. This applies to applications received between 31 July 1998 and 31 December 2003, and to the expansion of companies that had been licensed before 31 July 1998. It also applies to companies previously exempted from having a manufacturing licence, but that now have funds of RM 2.5 million or have engaged more than 75 full-time employees. The relaxation does not, however, apply to specific activities where Malaysian SMEs have capabilities and expertise.

As most investments in the 1970s and 1980s were attracted by low production costs for export activities, most TNCs could easily fulfil the 80 per cent export requirement to avoid the domestic equity requirement. Thus, for many investors, the 30 per cent domestic equity requirement was not a deterrent. For TNCs coming later, self-selection may have occurred, as Malaysia makes its equity conditions explicit in its investment promotion. Import-substituting FDI has had to comply with the requirements and has often experienced difficulties finding domestic (Bumiputera) investors in

such instances, foreign companies have had to rely on government institutions like the state economic development corporations to take up the Bumiputera equity.

The more recent Multimedia Super Corridor initiatives to attract technology investors appear to have been relatively successful. According to the Multimedia Development Corporation, as of 15 July 2002, 105 676 Multimedia Super Corridor status companies had been approved, of which more than 200 were foreign owned and some 50 companies considered “ world-class”. The two largest activities among Multimedia Super Corridor companies were focused on related software development.

Inward FDI in Malaysia has resulted in important technology transfers. This has been most visible in the electronics cluster in Penang, in which leading local supporting industries have managed to absorb and adapt to the high quality practices and standards applied by TNCs and the rapid technical innovation in the global electronics industry (for example, Rasiah, 1995; 1999). As a result, the most successful local supporting industries today fully comply with international standards and produce components, machinery and equipment for TNCs, not only in Malaysia but also elsewhere. Other studies report encouraging signs of technology taking root and of diffusion of expertise, more so in the Penang region than in the Klang Valley (Lai et al., 1994; Narayanan et al., 1997).

The Malaysian policy has fostered rapid economic growth based on an expansion of manufactured exports. This has been paralleled by

achievements in the social area, including a reduction of poverty, a more ethnically balanced industrial labour force and distribution of income.

Conclusion

The Malaysian case shows that FDI can play an important role in the process of economic and social development, and that government policies and institution-building efforts have a prominent function in this process. As a small economy, its desire to enforce strict requirements on investors entering the country had to be balanced against the risk of negatively affecting the attractiveness of the location. This has been a delicate balancing act. In Malaysia, the Government has been more than willing to be proactive. Beyond the desire to fulfill the country's development ambitions, it has been responsive to the needs and views of the private sector.

In conclusion, in some ways, FDI has contributed towards the industrialization and growth of the economy and helped to realize the social restructuring objectives considered necessary for social and political stability. Still, in some parts of the Malaysian economy, the inflow of FDI has resulted in transfers of technology and the establishment of innovative activity. The export-oriented industrialization involving a continuous inflow of FDI and the generation of employment has been instrumental in transforming the economic structure of Malaysia into what it is today. (3005 words)

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