

IKMAS WORKING PAPERS
Number 6, January 1997

**FOREIGN LABOUR IN MALAYSIAN
DEVELOPMENT: A STRATEGIC SHIFT?**

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The current phase of economic expansion has been driven by significant increases in factor inputs, particularly capital, with high growth being sustained in the manufacturing, construction and service sectors.... (To) achieve long-term sustainable growth ... the current strategic shift towards more capital and technology-intensive activities with high export orientation, lower import content and high inter-linkages has been stepped up in order to generate maximum value added and export earnings for Malaysia (Bank Negara, 1995: foreword).

Similar sentiments have been expressed in the Review of the Industrial Master Plan 1986-95 (MITI, 1994), in the 1995/96 Economic Report (Ministry of Finance, 1995) and in the Seventh Malaysia Plan 1996-2000 (EPU, 1996). All of these imply that a strategic shift is needed for Malaysia to achieve Vision 2020.

Thus the consensus is that Malaysia will have to undergo an industrial revolution to achieve Vision 2020. What is needed is both: (a) an *upgrading* of existing sectors (from low value-added, low skill to high value-added, high skill); and (b) a *shift* out of low value-added, low skill to high value-added, high skill sectors.

In this paper, I look at the labour market implications of this strategic shift and at the following questions:

- Is Malaysia likely to produce the quantity and quality of skills required for a strategic shift? Are the incentives for the supply of skilled labour attractive?
- Are the investment incentives in existence for such a strategic shift? More specifically, what role does the import of unskilled foreign labour (UFL) play in promoting or impeding a strategic shift?

In trying to answer these questions, I look in Section 2 at the theory of skills provision and the practices in Malaysia; and then I look in Section 3 at the possible effects that the import of unskilled foreign labour (UFL) has on the incentives for, and against skill-intensive investments. Section 2 is brief compared to Section 3 in which the structural role of UFL in the Malaysian economy is examined. The reason for looking in more depth at the effects of UFL is that this is a relatively neglected area in official reports and yet it is an area of considerable importance both theoretically and practically and an area of great controversy in the Malaysian newspapers. The fourth and final section of the paper brings the threads together and draws out some possible policy conclusions.

2.0 The Availability of Skills and a Strategic Shift in Malaysian Manufacturing

2.1 *The skill-intensity controversy*

IN a report dated February 1995, the World Bank caused quite a controversy when it argued that the skill composition of the manufacturing labour force in Malaysia had deteriorated between 1985 and 1991. It claimed that:

One measure of skill intensity of the work force, the ratio of skilled to total workers, has fallen from 0.43 in 1985 to 0.35 in 1991 with a sharp decline registered in electrical machinery manufactures, fabricated metal products and rubber products. (World Bank, 1995: paragraph 8)

The World Bank admitted that the relative definition of skills might give misleading results and that all jobs might be becoming more skill-intensive but to the extent that the categorisation of skills captures the loss of skill intensity over time, the Bank argued that this trend needs to be reversed.

The World Bank's conclusions have been sharply criticised on the grounds that the basis of their comparison is misleading. The argument is that 1985 was a recession year, that many workers were retrenched in that year and that most of the retrenched workers were unskilled. For these reasons, skill-intensity ratios in the manufacturing industry were unusually high in 1985, in which case it is hardly surprising if the skill-intensity percentage fell from 1985 to 1991. Data from the Bank Negara Annual Survey of Companies suggest that between 1992 and 1994, skill-intensities rose quite sharply, except in textiles and chemicals, but Table 1 illustrates the problems of categorising skills since the percentages vary considerably between the sources.

Thus the picture is not as bad as that painted by the World Bank, although this is as much in spite of Government policy as because of it. As I point out later, it is only in the 1990s that policy changes have been made which have much chance of significantly easing the shortage of skilled labour.

In analysing the picture and the policies on skills, it is useful to divide the labour force into three groups as follows: (a) existing workers in existing industries, (b) new entrants to existing industries, and (c) new entrants to new industries.

If we are considering the situation between now and the next century, then the first group is by far the most important. By the year 2000, even with a rapid increase in the Malaysian labour force of between two and three per cent per annum, something like three-quarters of Malaysian citizens now working will still be in the labour force. Thus over the next five

years, the training and skill upgrading of the existing labour force is of much greater importance than the quality of new entrants. Of course in the longer term, new entrants for both existing industries and new industries are more important, since by the year 2020, the majority of the labour force will have been replaced.

	1985	1991	1992	1994
Food	27	31		
Textiles	27	31	69	62
Paper products	41	34		
Chemicals	28	35	56	55
Petrol refineries	48	49		
Rubber products	30	23		
NMMP	27	31	49	62
Basic metals	37	38	48	54
Metal products	39	30		
Electrical M/c	64	37		
- electronics			59	60
- mach./elect.			39	48
Transp.equip.	52	39		
Total	43	35		

Sources: World Bank 1995: 8 (for 1985 and 1991 from the Industrial Survey)
Bank Negara Annual Survey of Companies for 1992 and 1994

2.2 Skills of existing workers in existing industries

As emphasised above, there are acute problems of measuring skills. Nevertheless for analytical purposes, it is useful to classify skills into three groups, namely company-specific, industry-specific and transferable skills.

In this section I do not discuss the provision of skills peculiar to a company since these are of no particular theoretical interest. And I leave the discussion of transferable skills between industries to the end of this section since they raise more general educational issues. Here the discussion is confined to skills which are *specific* to, but transferable *within*, an industry. Call these *vocational skills*. There is some evidence that these industry-specific or vocational skills are important in Malaysia since inter-industry differences in wages are considerable (Table 2).

Table 2: Malaysia - Inter-industry Wage Differences, 1994					
Industry	Managers, Prof.	Technical, skilled	Unskilled	Others	Average
Wages (RM000 pa)					
Chemicals	61	26	12	25	28
Textiles	41	9	7	13	10
NMMI	56	19	7	18	19
Electronics	50	13	8	14	14
Basic Metal	50	18	13	16	20
Machine/Elec.	43	14	9	12	13
Indices (Chemicals =100)					
Chemicals	100	100	100	100	100
Textiles	67	35	57	52	35
NMMI	91	71	63	73	67
Electronics	82	48	69	55	49
Basic Metal	81	70	108	66	70
Machine/Elec.	69	52	72	48	47

Source: Bank Negara Annual Survey of Companies

2.3 Past policy on skill provision in Malaysia and the need for a levy-grant system

I N the past decade, Malaysian government policy on skill provision has changed dramatically. In the early 1980s, government discussions of the economy contained many references to skill shortages but skill development policy was essentially (and excessively) supply-led. The emphasis was on the *quantity* of skilled labour through a combination of manpower planning and the provision of training through public sector agencies. A comprehensive survey of manpower planning had been undertaken in 1973 to cover the needs of the period from 1973 to 1990 and this was followed by a 1980 Master Plan drawn up on the basis of input-output coefficients. In 1986 the Manpower and Training Volume of the Industrial Master Plan (IMP) was based on a target approach using patterns of skill requirements from other countries. However by this time, it was being increasingly recognised that human development policy in Malaysia was too mechanistic and *supply-led* and a reappraisal was taking place.

Thus by the second half of the 1980s, there began to be some re-thinking of skill provision in Malaysia. The IMP had involved close collaboration with industry in establishing needs and in 1986 a sub-committee under the National Development Planning Council (NDPC) was formed to redefine and sharpen the roles of the agencies involved in skill

planning and provision. In 1990, an ambitious Human Resource Development Plan Project was launched and this was followed in 1991 by a report from a Cabinet Committee on training. At about the same time a Working Committee on Human Resource Development (HRD) was set up under the Malaysian Business Council.

Gradually, there had been a change in thinking between the late-1980s and the early-1990s with a reorientation from a supply-led to demand-led approach and with the gradual acceptance of the need for a levy-grant system. I believe that the Malaysian circumstances justified the establishment of a levy-grant system. In a recent paper (Edwards, 1996), it was argued that there are ten logical steps to a levy-grant system. These are summarised in Box A. Put briefly, for a vocational training (VT) system to work well, it is argued that there is a need for *market imperfections*. Without some form of market imperfection, the provision of such industry-specific skills (vocational skills) is likely to be sub-optimal. This argument is not only theoretically sound (Box A) but is also backed up in practice since market imperfections are present in the two countries which are widely considered to have among the most successful VT systems of any in the world. The two countries are Germany and Japan. Their VT systems are summarised, along with those of a number of other countries, in Box B.

Both the German and Japanese systems work within particular political and cultural contexts and are characterised by market imperfections. In Germany the dual system is acknowledged as working well partly because of the structure of the labour market (relatively low apprentice wages combined with a stable accreditation system) and partly because of a market imperfection, namely the corporate pressure exerted jointly by the organisations 'representing' the employers (the Chambers of Commerce) and employees (the Trades Unions). In Japan the system works well because of a market imperfection, namely the company loyalty structure. Employees tend to stay with the same employer for a long time in Japan so that industry-specific skills are the same as company-specific skills. Where such market imperfections are not present, it is important that one is introduced. One way is through state intervention in the form of a levy-grant system. Put simply, market imperfections are inherent to skilled labour markets and vocational training (World Bank, 1995: 107, 108), so that unless another market imperfection is introduced to correct this, a second-best situation will arise. Thus, in Malaysia in the late 1980s, there were widespread allegations of poaching. As a result, and as the World Bank put it:

.... there appears to be some support for the view that Malaysian industry generally under-invests in training (World Bank, 1995: 108).

The World Bank pointed out, on the basis of the 1988 UNDP survey, that there was little firm-based training in Malaysia (World Bank, 1995: 104). It was to encourage firm-based training that in 1987 the Malaysian Government had introduced the Double Deduction Tax Incentive (DDTI) for

training but this did little to counter poaching. The World Bank's assessment is that the DDTI was quite ineffective (as similar schemes had been in other countries, World Bank, 1995, 114) and in 1993, it was abolished except for small manufacturing firms.

Thus, in the early 1990s, training in Malaysia was inadequate and the skills shortage continued. But what change in policy was desirable? It seemed clear that a German-style VT system would not work since, in Malaysia, trade associations and trade unions were weak so that German-style 'corporatism' is absent. Similarly the conditions for an 'apparently laissez-faire' Japanese system are absent. Labour turnover in Malaysia is fast (Pillai, 1992: 11) so that Japanese-style company loyalty is absent.

Hence, in the early 1990s, the conditions in Malaysia seemed to be ripe for the introduction of a levy-grant system which would reduce the incentive for poaching, would inculcate a 'training culture' and would make the system more demand-driven.

2.4 *The operations of a levy-grant system in Malaysia*

SO it was that in 1992 a levy-grant system (a Human Resources Development Fund) was set up in Malaysia under a Human Resources Development Council (HRDC). The main aims of the HRDC were to increase the supply of highly skilled workers; to cultivate a training culture among the employers; and to accelerate the process of technology transfer (HRDC, 1994: 52)

The HRDC operates a Human Resources Development Fund (HRDF) which came into operation in 1993. A levy of 1 percent of payroll is imposed compulsorily on large employers in manufacturing, on small, medium and large in the service industries and optionally on small and medium industries (SMI) in manufacturing. The aim is to provide a floor to training.

Grants are provided (for training Malaysian citizens only) up to the amount of the levy but they only finance part of the expenditure so that if the employers receive grants equivalent to their levy, they will spend more than their levy on training. Steps have been taken to encourage training by small companies by reducing the bureaucracy, by providing help with training plans and by introducing joint training schemes. Thus various grant schemes are in operation. The amounts granted under the various schemes are shown in Table 3.

The table shows that, between July 1993 and mid-March 1996, grants had been allocated in respect of just over 800,000 trainees. The number assisted has risen rapidly each year with expenditure now (1996) running at about MR100 million a year and financing about 650,000 trainees -- equivalent to about a third of total manufacturing employment in 1995.

Box A THE TEN LOGICAL STEPS TO A LEVY-GRANT SYSTEM

Start with 4 assumptions;

1. Competitiveness = $f(\text{costs}) = f(\text{total factor productivity})$
2. For a given capital intensity, productivity (and wages) = $f(\text{skill in labour force})$
3. Skill in labour force = $f(\text{training, qualifications})$
... and from 2 and 3....
4. Productivity (and wages) = $f(\text{training, qualifications})$
Therefore, from 4, there is an incentive for both employers and employees to promote training and the acquisition of qualifications. But these incentives are conditional on how the particular labour market works and on **who finances the acquisition of skills/qualifications.**
Is it...
 5. **the employee?**
 - * by taking a 'low' wage apprenticeship or;
 - * by paying for the training outside the workplace (assuming the qualification is widely accepted)
 - ... or is it
 6. **the employer?**
 - * this is the more likely, the lower the training costs, the more the skills are specific to the employer and/or the slower the labour turnover from the employer

From 5 and 6 it follows that if there is

 - * no low-wage apprenticeship system... and....
 - * no certainty of the value of the qualification
 - ... and if....
 - * the skills are not firm-specific and there is a high rate of labour turnover
 - then
7. Training is likely to be **socially sub-optimal** and there will be an incentive for free-riding, 'poaching' or 'cherry-picking'
Solutions?
8. **The Government provides and pays for the training**
 - * advantages; such central (supply-led) provision...
 - can take advantage of any economies of scale in training;
 - may be able to 'pick winners' (anticipate new skills)
 - * disadvantage;
 - the training may be 'supply-led' and not match the needs of the employers (whether in the public or private sectors)
9. **Employers provide but government pays for the training**
 - * advantage;
 - more incentive than under 8 to provide 'suitable'(demand-led) training but....
 - * disadvantage;
 - problems of 'moral hazard' (the employer may over-supply at the cost of public finance) or, if the skills are employer-specific, the government may be supplying skills which the employer would have provided anyway.

So...
10. **is a levy grant system the final solution?**
 - * a levy-grant system is where either employers or the state (or both in close conjunction) provide the training but where employers pay for the training through a payroll levy or tax and are then reimbursed through grants to cover part or whole of the cost of 'approved' and certifiable training
 - * advantages;
 - training is 'demand-led';
 - there is an incentive for firms to adopt a 'training culture' since they have to pay for training anyway
 - * disadvantages;
 - problems of bureaucratic expense in ensuring that the training is 'approved', that is, that the training has been provided at the right level

Box B

ALTERNATIVE TRAINING SYSTEMS

(see Edwards 1996 and Lynch 1993)

Germany

* 'dual' system of apprenticeships with VT taking place at vocational schools and at work. Reckoned to be one of the best systems of VT in the world. Employees know that the qualifications will matter since the system is stable and supported by strong organisations of employers and unions. Employers are encouraged to train because of low net costs (wages of apprentices are low), of the pressure from organisations and of the long-term structure within which they operate. German employers are said to be locked into a 'high-skill equilibrium' (producing high-skill, high-value-added goods) (Casey, 1991; and Steedman, 1993)

Japan

* high standard of basic education especially for 'bottom half'; VT builds on this; very good on-the-job training; employers encouraged to do this because of low job turnover especially for large employers. Thus a paradox that the **system works well only because of a major market 'imperfection', namely low job mobility** (Dore and Sako, 1989).

Malaysia

* as for Sri Lanka (see below) until 1993 when a levy-grant system came into operation

Singapore

* levy-grant system (Skills Development Fund) set up in 1979; provides grants for in-house and public training programmes; for training in new skills; for training for the educationally-disadvantaged; and for group training schemes. Emphasis on employer-led programmes to encourage the creation of suitable skills. SDF has played a major role in restructuring Singapore into high value-added manufacturing (Ashton and Sung, 1994 and Edwards, 1996).

Sri Lanka

* state-led system of VT; huge proliferation of training centres with few connections to industry. Therefore training not appropriate; large drop-out rate; levy-grant system under consideration (Edwards, 1996)

USA

* most VT done through full-time further education following High School; highly decentralised system; high drop-out rates; large under-educated, under-class. Little incentives for employers to do training because of high job-mobility. Some, recent, discussion of the introduction of a levy-grant system (Lynch, 1993)

UK

* apprenticeship system to 1964 which did not work well partly because of high wages for apprentices; in 1964 levy-grant system but only allowed to operate without much change until 1973; increasingly since the 1970s training linked to unemployment and in the 1990s training arranged through Training and Enterprise Councils (TECs). Many changes and considerable instability. The unstable framework discourages employees from undertaking training. Training financed by the state; little incentive for 'short-termist' employers to train and poaching risks high; UK in 'low-skill equilibrium'; paradox of the need both for change and stability (Dolton, 1993; Finegold and Soskice, 1988).

By far the most important scheme, in terms of expenditure, is the SBL scheme which is an *ad hoc* one under which either in-house or external (domestic or foreign) trainers can be used. The next most important scheme is the PLT (Annual Training Plan) scheme which is designed to provide grants to applicant companies within the framework of pre-approved training plans. PROLUS and PERLA are pre-approved training provider programmes and PERANTISAN is the HRDC's apprenticeship scheme.

Table 3: Grants from and Number of Trainees Assisted by HRDC from July 1 1993 to mid-March 1996							
Scheme	1993 (i)	1994	1995	1996 (ii)	Total (rounded)	No. of trainees	Grant per trainee (RM)
Grants (RMmn)							
SBL (iii)	2.4	37.1	73.4	16.5	129	565	229
PROLUS (iv)	0.7	5.8	8.1	2.0	17	35	474
PLT (v)	0	4.9	3.5	4.9	13	197	68
PERLA (vi)	0	0	3.8	0.9	5	10	470
Perantisan	0	0	0	neg	neg	neg	760
Total	3.1	47.8	88.8	24.3	164	807	203
Number of trainees (000)							
	25	294	320	168		807	
Grant per trainee (RM)							
	124	163	278	145			203

Source: HRDC interview, March 1996

Notes:

(i) from July 1 1993

(ii) until 15th March 1996 only

(iii) SBL = Skim Bantuan Latihan

(iv) PROLUS = Skim Program Latihan Yang Diluluskan

(v) PLT = Skim Pelan Latihan Tahunan

(vi) PERLA = Skim Perjanjian Latihan Dengan Penyedia Latihan

The HRDC is widely thought to have made good progress but, the World Bank complains about a low take-up rate (1995: 117) and reportedly there have been numerous complaints in the surveys carried out for the New Industrial Master Plan about delays in the processing of applications. The World Bank has alleged that the HRDC is understaffed (World Bank, 1995: 121) while others (in interviews) have alleged that a major problem is that the HRDC (like the administration of the Skill Development Fund in

Singapore) has been too cautious, is not sufficiently encouraging the adoption of computerised applications and is generally too 'bureaucratic'. A common argument is that, since the firms are merely getting their 'own money' back in grants, the HRDC should be prepared to take greater risks and to worry less about whether the training schemes are totally 'appropriate'. However the HRDC is still in its infancy and it is changing. The pre-approved schemes were introduced to cut out some of the 'red tape' and at the end of 1995 the application procedure for SBL was simplified. Also since end-1995 a scheme (SLB) has been in operation designed to tackle issues of economies of scale in training and labour indivisibility by providing for joint training by a number of employers.

It is clear that by 1992, with the establishment of the HRDF, there had been a switch in emphasis to training at the level and at the behest of the firm. The buzz words had become demand-driven and, more recently clusters. Demand-driven to make sure that the training is what the firm wants and clusters to try to ensure that the linkages and external economies are maximised.

The model is now the Penang Skills Development Centre (PSDC) and attempts are being made to emulate this in other parts of Malaysia (see MITI 1994: 100). However reproducing the PSDC model may be difficult since Penang is something of a special case. It has a concentration of electronics companies whereas industrial specialisation in the Klang Valley, Johor and other industrial parts of Malaysia is less marked. Nevertheless the principle of close liaison between firms and government/trade association-inspired training initiatives is now firmly accepted. In general, the Trade Associations in Malaysia are not geared up to play a 'corporatist' role although some steps have been taken recently in the Plastics and the Textiles/Apparel Industry (MITI, 1994: 86) to strengthen Trade Associations.

2.5 *The longer term - new entrants for existing industries*

It is clear then that with the formation of the HRDC in 1992, Malaysia has been making good progress with in-service training, which in the short run, should have the highest priority. When we come to look at the longer term and at new entrants to the labour force, the issues are quite different. It is clear, from the experiences of the OECD countries and from studies of the social rate of return from education, that the lower levels of education (primary and secondary) are extremely important. In this respect Malaysia's record would appear to be good (Table 4) although the education system in Malaysia is criticised for continuing to have an excessive bias towards the arts subjects (MITI, 1994: 108; World Bank, 1995: 91).

At the higher levels of education, it is clear that if the system is to be responsive to the needs of existing industries, it needs to be well-integrated with them. On the other hand if the path to this is thought to be privatisation of the higher education system (as advocated by World Bank, 1995), then the accreditation issue becomes all-important. For young people to make

the necessary sacrifices in training and education, they have to be assured that their training will be recognised. This means that their training must lead to qualifications which will be accepted by potential employers. This is particularly true of vocational skills for new entrants where the recognition of qualifications becomes a major issue. In this respect the coordination and accreditation bodies (the recently-created National Vocational Training Council (NVTC) and Higher Education Council) play a vital role. If the accreditation policy is not right at this level, the system will be under considerable strain. In its report, the World Bank (1995:92) argued that the NVTC needs to be given more staff and powers to be effective and it raises the possibility that a National Vocational Training Law be enacted (similar to that in Singapore) to give the NVTC more power.

Country	% of relevant age-group enrolled in....			Per capita GNP (1995) (US\$)
	Primary	Secondary	Higher	
Bangladesh	60	18	5	220
India	92	41	9	320
Sri Lanka	103	63	5	640
Indonesia	118	42	7	880
Philippines	106	65	33	950
Thailand	97	30	20	2410
Malaysia *	99	53	6	3480
South Korea	96	75	32	8260
Singapore	115	71	11	22500

Source: World Bank 1995: 23 and 1996, Table 1

* Malaysia's enrolment at the higher education level rises to just under 9% if students studying overseas are included.

2.6 *The Longer Term - New Entrants for New Industries*

WHEN we come to consider the problem of *new* entrants for *new* industries, the situation becomes even more complicated. On the supply side, transferable skills and 'creativity' become more important and the emphasis should be on filling the gaps at the higher end of the skills spectrum. However, Malaysia has no equivalent of the High-end Skills Programme which was introduced in Singapore in 1993 and designed to support the government's cluster development strategy (SDF, 1994/95: 16). Presumably such a programme will be introduced in Malaysia once the cluster industries are identified by the new Industrial Master Plan. The

principle of targeting and of a selective industrial policy has been endorsed in the Review of the IMP (MITI, 1994: 29).¹

2.7 *Summary on Skills Provision*

IN the 1990s, Malaysia has taken great steps forward in the institutional structure for the supply of skills. This is particularly true when we look at the immediate problem of the training and retraining of the *existing* labour force. Questions remain unanswered at the level of *new* entrants both for existing industries and for new industries, but good progress has been made in the policy on skills provision for the immediate future in Malaysia. By contrast, considerable problems are posed by the import of unskilled foreign labour (UFL) which is discussed in Section 3.

3. **Unskilled Foreign Labour (UFL) and the Malaysian Economy**

3.1 *Much Concern, But Little Analysis in Official Circles*

AS stated earlier, a drive towards industrial maturity has been in full swing since 1990 with the launching of the Second Outline Perspective Plan (OPP2, 1991; see also Rasiah, 1996: 14, 15). At the same time, there has been a heavy reliance on imported foreign labour with most of it being semi-skilled or unskilled.

In 1996, this issue is very much in the news as far as the popular press is concerned, but its prominent position in the newspapers contrasts with something of a neglect in official policy discussions. In the newspapers, in 1996, the issue of 'illegal settlements' being set up by or for UFL was particularly prominent. In March 1996, the Selangor State government was reported as identifying eight illegal settlements covering 23 hectares in the Hulu Langat District, south of Kuala Lumpur, which it had ordered to be torn down (Star, March 21 1996) and a few days later, the demolition of an illegal settlement by Ampang Jaya Municipal Council, east of Kuala Lumpur, was given much publicity (see New Straits Times, 24 March 1996). However, in the same paper on the next day, the Menteri Besar of Perlis State in the north of the Peninsular was reported as saying that the state government had no plans to evict immigrants from an illegal immigrant settlement at a FELDA scheme at Mata Ayer, as FELDA settlers there were facing a labour shortage (New Straits Times, 25 March 1996).

This inconsistency in the policy on 'illegal settlements' by foreign labour would seem to be a more general reflection of the inconsistency of government policy in the 1980s and 1990s towards the entry and role of

¹ The new Industrial Master Plan was due to be published at the time (July 1996) that this paper was being completed.

UFL in Malaysia, a point which has been emphasised by Azizah (1995 and 1996), Pillai (1992 and 1995) and World Bank (1995: 79). In the 1996 Budget, levies imposed by the government on the employment of foreigners were doubled, but this increase is likely to encourage a switch from legal to illegal entry, unless stringent penalties are enforced on the employers of illegal foreign labour.

The policy inconsistency is perhaps not surprising considering how little official analysis there has been of the problem of UFL. This lack of analysis is in sharp contrast with the official concern that has been expressed about the problem. For example, the Ministry of Finance's Annual Report on the Malaysian economy stated that:

The labour market continues to tighten in 1995 with the economy virtually operating at full employment. This has resulted in significant employment turnover as well as pinching of staff, leading to wage pressures. While the Government has allowed the recruitment of foreign labour to ease the labour shortage, this measure cannot be sustained on a long-term basis as the size of foreign labour is already large, estimated at more than 1.2 million against the nation's total work force of about 8 million (Ministry of Finance, 1995: 39).

As we shall see, the figure of 1.2 million is probably an underestimate. However, even at this level, there are seen to be major problems as the MoF Report went on to point out:

A prolonged reliance on foreign labour can generate social and political problems as well as give a wrong signal to industries that they can continue to rely on foreign labour without having to undertake strategic adjustments in moving towards labour-saving production technology (Ministry of Finance, 1995: 39).

Other official sources also express concern with the large-scale use of UFL but there has been little detailed analysis of the role and, as far as economic restructuring is concerned, the positive or negative effects of foreign labour (whether legal or illegal) on the economy. The Bank Negara's 1995 Annual Report also expressed concern about UFL being an obstacle to upgrading but again there was no detailed analysis of the problem. Similarly the Mid-Term Review of the Sixth Malaysia Plan, issued in December 1993, described the share of foreign workers as already high and stated that "*the use of foreign labour should not be regarded as a permanent solution to overcome the tight labour market situation*" (EPU, 1993: 52). However, once again no further analysis was presented. Most recently, the Seventh Malaysia Plan 1996-2000, also expressed concern about the use of foreign labour when it stated that:

As a short term measure the government has allowed the import of foreign labour for certain sectors of the economy to relieve the problem of labour shortages. However the long term solution to this problem lies in utilising labour more efficiently and productively. This would require reducing the demand for labour through labour-saving techniques and processes. In this regard, the nation must move up the ladder of production from labour-intensive and assembly type of processes towards more capital- and technology-intensive as well as knowledge-based industries and processes (EPU, 1996: 7).

However, once again there was no detailed analysis of the effect on the economy of imported foreign labour. In the remainder of this section I attempt to do this by looking at the effects of UFL on the restructuring of the Malaysian economy -- to see, in other words, the extent to which the import of foreign labour is an aid or an obstacle to bringing about a 'strategic shift' in the economy. However first it is important to define immigrant labour and to discuss the growth and size of the problem.

3.2 *Unskilled Foreign Labour (UFL): What is it?*

WHAT is foreign labour? In Malaysia there is a distinction between 'expatriate' labour and other foreign labour. 'Expatriate' labour is skilled, technical and professional labour earning RM1200 and above per month who are issued with Employment Passes (*Pass Penggajian*). Unskilled and semi-skilled foreign workers are issued with Temporary Visit Work Passes (*Pass Lawatan Kerja Sementara*) (Pillai 1995: 228).

Work passes are issued in Peninsular Malaysia by the Department of Immigration but in East Malaysia, immigration is under the responsibility of Sabah and Sarawak and for immigration into East Malaysia less detailed figures are available (Pillai, 1992: 15). In general, work passes are valid for three years (initially for two, renewable for a further one) and are not renewable (except for maids). Permits are given only for individual workers, not families (Pillai, 1995: 228). Delays in processing permit applications by the Ministry of Human Resources and the Immigration Department have been long (up to two years) and in October 1994 a one-stop Task Force was set up to speed up the process. The only regularly published data on immigrant workers in industries are in the Establishment Surveys, although in these Surveys the number of foreign workers is thought to be understated (World Bank, 1995: 61).

3.3 *Foreign Labour in the Malaysian Economy: How many?*

THERE is a long (and painful) history of the import of foreign labour into Malaysia. Under British colonialism, labour was imported like a commodity to work in the tin-mining and rubber estate sectors (Edwards,

1977). In general, following Independence in 1957, information on foreign labour imports was sparse until the 1980s. In 1968, the Employment Restrictions Act required employers in certain identified sectors to obtain work permits for their foreign workers and this resulted in the removal of a "large number" of Indian and Chinese workers (Nayagam, 1992: 478). However, this had little effect on production because of the labour surplus in the economy at the time and because a switch was being made between rubber and the relatively less labour-intensive oil palm.

It was in the 1980s that 'labour shortages' emerged and the 1987/88 Labour and Manpower report of the Ministry of Human Resources stated that in the mid-1980s there were about half a million illegal migrants in Malaysia (Nayagam, 1992: 479). Other estimates of 'illegals' for the mid-1980s ranged between half a million and a million (Nayagam, 1992: 479).

By the early 1990s, Nayagam estimated that there were more than a million migrants in Malaysia, most of them illegal and with them being split more or less evenly between Peninsular and East Malaysia (Nayagam, 1992: 479). For 1991, the World Bank's estimate of foreign labour was 1.14 millions (World Bank 1995: 59), whereas the Seventh Malaysia Plan estimated foreigners in the labour force in Malaysia to be 290,000 in 1990 (EPU, 1996: 110).

The estimates of foreign labour in Malaysia now (that is in 1995/96) vary even more widely. Earlier in this paper, I quoted the Ministry of Finance as saying that the total of foreign workers in Malaysia in 1995 was about 1.2 millions. The same total, consisting of half a million 'legals' and between 500,000 and 700,000 'illegals' (New Straits Times, April 5 1996), has been estimated by Azizah Kassim of the University of Malaysia. Other estimates of foreign labour in the mid-1990s vary from 0.5 million to 2.5 millions. The US Embassy's economic report on Malaysia in 1994 put the number of foreign workers at 2 millions with half of these being illegals (World Bank, 1985: 61, footnote). A recent report for the Ministry of Human Resources by consultants at the University of Malaya estimated total foreign labour in 1993/94 to be 1.04 millions or about 14 percent of total employment which was given as 7.6 millions (UPUM, 1995: 1). It seems that UPUM's estimate relates to Malaysia as a whole rather than to Peninsular Malaysia, even though for the most part the UPUM report was devoted to a discussion of foreign labour in Peninsular Malaysia only. In a recent article, Pillai reported that in September 1994 the number of Temporary Visit Work Passes issued and current for unskilled and semi-skilled foreign workers was 563,000 (Pillai, 1995: 228). If we add in about 61,000 'expatriates', then the total of 'legals' was about 624,000. If we further assume that the legals are about 33 to 40 per cent of the total, then the total number of foreign workers in Malaysia is 'now' (1995) about 1.7 millions.

Of the 'legals' referred to by Pillai, a breakdown by *country* source is available for only 339,000 (1995: 230). Of these, 66% come from Indonesia, 23% from Bangladesh and about 7% from the Philippines (Pillai,

1995: 230). A majority of the 'illegals' in Peninsular Malaysia (but not in Sabah) is also thought to come from Indonesia (Pillai, 1992: 15). An analysis by *sector* is available for 490,000 foreign workers with 30 percent being issued passes for construction, 8 percent for manufacturing, 30 percent for plantations and 20 percent for others, mostly 'domestic maids' (Pillai, 1995: 229). Just over half of the 'legals' have their passes issued in Kuala Lumpur (Pillai, 1995: 228). As of September 1994, just over 60,000 passes had been issued for Sabah and Sarawak and yet it is estimated that the total number of foreign workers in these East Malaysia states is well over half a million.

The Seventh Malaysia Plan gave a figure for foreigners in the labour force in Malaysia in 1995 of 650,000 (EPU, 1996: 110). It is clear then that there are wide-ranging estimates of foreign labour working in Malaysia over the past decade. In this paper, the following estimates are used: for 1985 500,000; for 1990 one million; and for 1995, 1.7 million. If these estimates are accurate, it means that foreign workers are 'now' (in 1995) just under 20 percent of total employment, compared to about 14 percent in 1990.

If the figures for the total employment of foreign labour are difficult to pin down, this is even more true of the sectoral composition of foreign labour.

Within the *agriculture, forestry and fishing (AFF)* sector, foreign labour is thought to be most prevalent in forestry and estate agriculture, although there are various reports of the use of foreign labour in padi cultivation (for example, Ikmal, 1992). For example, Thai workers are reported to migrate into northern Malaysia seasonally to work in the rice and sugar harvests. It is also reported that these employers do not have to pay the foreign worker levy on this 'seasonal' labour (World Bank, 1995: 63).

In the plantation sector, there were reports of 'labour shortages' from the late 1970s and in the 1980s and the plantation owners began to release details of the shortages that they claimed to face (World Bank, 1995: 71). Labour turnover was high with the United Plantation Association of Malaysia (UPAM) estates losing over a fifth of their workforce in 1985 (Narayanan, 1992: 4). These shortages and high turnover were in the face of the relatively high unemployment of the early 1980s so it is hardly surprising that, with the relatively low unemployment of the early 1990s, the shortages became even more acute. In the 1980s, the average wages of rubber tappers and oil palm harvesters were not far below unskilled wage rates in industry (Narayanan, 1992: Table 3) but the wages were less assured and the conditions of work were considered to be inferior on the estates (Narayanan, 1992: 5).

The Seventh Malaysia Plan estimated that the 'other' (mostly foreign) labour in the AFF sector in 1990 was 175,000 or about 10 percent of the total labour force (EPU, 1996: 78,79). In 1990, Narayanan estimated that foreign labour made up about 10 percent of the agricultural workforce (1992: 7), but if forestry is included the percentage is almost certainly

higher. In 1995 the estimates by the Seventh Malaysia Plan of foreign labour in the sector was 273,000 or about 19 percent of the 1.43 million total (EPU, 1996: 78,79) but this seems to be an underestimate and it is likely that the foreign labour force (including illegals) in the AFF sector was between 30 percent and 40 percent of a sectoral total of 1.8 millions, with a very high 'illegal' proportion.

By contrast, in the *manufacturing* sector, the proportion of 'illegals' in the foreign labour force is widely thought to be relatively small, though increasing. Industries reported to be using significant proportions of foreign labour are electronics, textiles, machinery and engineering, non-metallic and mineral products and wood-based industries. A 1995 report by MITI estimated the proportion of foreign workers to be 10 percent of the total in 1993. For 1995, the Seventh Malaysia Plan's estimate was 7 percent of the total (EPU, 1996: 78,79). My estimate is 13 percent of a total labour force in manufacturing of 2.2 millions.

Acute labour shortages were claimed to be faced by the *construction* industry in the late 1970s and early 1980s (Gill, 1988: 228) and immigrant labour was increasingly used. In 1987 the Construction Workers Union (CWU) estimated that about 60 percent of the total workers in the industry were foreign (Gill, 1988: 227) though the Establishment Survey paints a different picture with non-Malaysians given as only 15 percent of the workforce throughout the 1980s (World Bank, 1995: 73). However recent estimates are even higher than the proportion claimed by the CWU with the proportion said to be as much as 80 percent, at least of the unskilled and semi-skilled portion, whereas the 7MP's estimate for 1995 was 14 percent (7MP, 1996: 78,79). The 7MP's estimate would seem to be far too low and a more reasonable estimate of foreign labour in the construction industry is between 30 percent and 40 percent of a total workforce of just under 900,000.

The picture of the employment of foreign labour in the *other sectors* of the economy is even more hazy than in the agriculture, forestry and fishing, manufacturing and construction sectors. In mining and quarrying and the utilities (electricity, gas and water) the number of foreign workers is thought to be negligible. The Seventh Malaysia Plan gives the number of foreign workers in the transport, storage and communications sector as about 5 percent of the total employment in the sector. This is almost certainly an underestimate with the truer percentage being about 15 percent. In the wholesale and retail trade sector, the Seventh Malaysia Plan's estimate of the percentage of foreign workers is six, again probably an underestimate with 15 percent being more realistic. By contrast, the Seventh Malaysia Plan's estimate for the Finance sector is probably about right at 3 percent.

The net effect is that the number of foreign workers in all sectors other than the AFF, manufacturing and construction sectors is probably about half a million workers (about 12% of the total employment in those

sectors) whereas the 7MP's estimate is about 200,000 workers (or about 7%).

It is clear that there is considerable uncertainty about the number of foreign workers in the various sectors of the economy and in the Malaysian labour force as a whole. However from my research, it seems likely that the total foreign employment figure of 1.2 millions in the 1995/96 Report of the Ministry of Finance is a considerable understatement as is the total foreign employment figure of 0.7 millions given in the Seventh Malaysia Plan. As stated above, a more reliable estimate for 1995 would seem to be 1.7 millions.

3.4 *Factors Determining the Migration*

CLEARLY there are 'push' and 'pull' factors. As far as migrants from Indonesia (by far the biggest source of supply of foreign workers) are concerned, the 'push' factor is the growing difference in income between Indonesia and Malaysia. In 1994, the average per capita GNP (at official exchange rates) of Malaysia was 4.9 times as high as that of Indonesia (World Bank, 1996: Table 1). The gap in average per capita incomes was US\$2,600.

Since, over the past ten years (1985-94), the Malaysian economy has grown only slightly more slowly than that of Indonesia, the real absolute gap in per capita incomes of the two countries has increased by something like US\$1,000. The growing gap explains the 'push' factor but the rapid growth in Malaysia and a growing labour shortage provide the 'pull' factor. One indication of the labour shortage in Malaysia is the rate of unemployment which fell from about 8 percent in 1970 to just under 6 percent in the early 1980s, to 5 percent in 1990 and to the present (1995) figure of just under 3 percent (Pillai, 1992: 1; Ministry of Finance, 1995: Table 6.1). Equally importantly, alongside this drop in 'open' unemployment, there was probably a sharp fall in underemployment. By the mid-1990s the whole Malaysian economy was at full employment, assuming that the present unemployment rate represents 'frictional' unemployment.

These pressures in the Malaysian labour market mean that there is pressure in the system for employers to employ illegal foreign labour and to dodge the levies and charges which are incurred on the employment of legal foreign labour. And of course from the viewpoint of migrants, there is a similar incentive to dodge the admission procedures and the authorised recruitment channels and to enter the labour force illegally (for details of levies, charges and procedures, Azizah, 1996; Pillai, 1992 and 1995; World Bank, 1995: 38, 39; New Straits Times, April 5, 1996)

However, it is worth emphasising that the figures are sketchy and the information on foreign employment unreliable. Does this matter? Yes, it does. It matters not only because the import of foreign labour is an

3.5 *The Effects of Foreign Labour: The Assertions*

SUCH a growth in the import of foreign labour is an obvious cause for concern in social, political and infrastructural terms. Less obviously, while promoting the growth of the economy in the short run, the import of unskilled foreign labour may be an obstacle to the restructuring of the economy and therefore an obstacle to its long-run growth. It is on these effects that this paper focuses but first we look at the more general assertions about the role and effects of foreign labour, as follows:

1. Foreign labour is *harmful* because of the strain imposed on the physical infrastructure and on the social services (housing, medical services, etc) and because it uses these services without paying for them.
2. Foreign labour is *harmful* because of its depressing effect on the wages of the poorer, unskilled households in Malaysia and the likelihood that it will increase income inequalities.
3. Foreign labour is *beneficial* since it expands the domestic market for goods and services and is more likely to enable economies of scale to be achieved in the Malaysian economy.
4. Foreign labour is *beneficial* because by providing cheap labour in the non-traded goods sectors, it lowers the relative prices of these goods and therefore makes the production of Malaysian traded goods more internationally competitive. On the other hand it is considered *harmful* because by lowering the price of unskilled labour, it discourages a move towards the structural upgrading of the economy.
5. Foreign labour is *beneficial* because it serves as a counter-cyclical instrument in the Malaysian economy, dampening wage and price inflation during boom times but can be 'exported' during recessions so reducing the social and political strains associated with recession.
6. Foreign labour is *beneficial* since the value added generated by it far outweighs the remittances paid overseas;
7. Foreign labour may cause *harmful* political effects in as much as foreign workers are deliberately used to change the ethnic and political 'balance' of the population.

Discussion of arguments 1, 5, 6 and 7 can be found in other sources such as Pillai (1992: 16-21), Pillai (1995: 231, 232) and World Bank (1995: 64-70). As far as argument 6 is concerned, the World Bank's estimate is that foreign workers generated something like 12 percent of

Malaysia's GDP in 1993, with their contribution being less than their proportion in the labour force because of their concentration in relatively low value-added activities (World Bank, 1995: 64). On the assumptions that 1.7 million foreign workers receive an average RM300 a month and that they remit on average one-third of this, their remittances overseas would amount to RM 2 billion a year (also Pillai, 1995: 231). However, in connection with this, three points need to be emphasised: firstly, this does not constitute a loss to the economy since the foreign workers' contribution to value added far outweighs this remittance total; secondly, these remittances do not necessarily represent net savings for the foreign workers since the remittances are often wholly or in part used to repay recruiting agents in the labour exporting country; and thirdly, even the balance of payments effects may be positive both because of the foreign workers' contributions to exports or import substitutes and because part of the remittances may be spent on goods produced in Malaysia.

As far as argument 1 is concerned, the World Bank reverses the argument that foreign workers make use of public services without paying them by pointing out that insofar as foreign workers have received an education in their 'home' countries, it is the Malaysian economy which is not paying for the full cost of labour reproduction (World Bank, 1995: 70).

However, in the rest of this section of the paper, the focus is on assertions 2 and 4 since these are the aspects that are relatively neglected.

3.6 *The Effects on Income Distribution*

IT is hard to see that the effect of the import of foreign workers on income distribution in Malaysia will be anything but harmful. The overwhelming majority of foreign workers are unskilled and as such they are likely to depress the wages of unskilled workers in Malaysia relative to those of the skilled. This is likely to be the case even though there is evidence of some labour market segmentation with foreign workers being paid less for the same job than Malaysian citizens (Pillai, 1992: 18)².

There is evidence in Malaysia of widening differentials between the average wages of skilled and unskilled labour. As the World Bank puts it, "*skilled workers have started to enjoy a wage premium*" (World Bank, 1995: ii; see also Narayanan, 1992: 31). The World Bank report pointed out that

² Of course wage rates are not the only factor of relevance to the employers' decision as to whether or not employ foreign labour. Payroll levies both raise and lower the incentives for employing foreign labour, since employers do not have to pay EPF on foreign labour (World Bank, 1995: para 17), but there are also levies imposed by the government on the employment of foreign labour. Non-payroll labour costs are estimated to be about 20% in manufacturing but about 40% in the plantations.

However, even if the effect is the same, is it an inevitable trend? From the evidence of recent research (see OECD, 1996 and Card, et al., 1996), the answer is 'no'. The research by Card, et al. (1996) suggests that unskilled workers in France have fared very much better than those in the USA. Not only have their wages not declined relative to those of skilled workers (whereas the differential has widened in the USA), but also, the growth of jobs for the unskilled in France has been no slower than in the USA. In other words, the declining relative wage of the US unskilled does not seem to have priced them into a job (relative to France). On the contrary, it is suggested that 'other institutional' factors in France (such as minimum wage legislation and stronger trade unions) may have protected the unskilled workers to some extent. Similarly, in Malaysia, it should be possible for the state, if politically so inclined, to protect the relatively unskilled and reduce the (growing) inequality in incomes. The last section of this paper comes back to these policy issues.

3.7 *The Effects on Investment and on the Restructuring of the Economy*

THUS, it is difficult to identify the effects of the import of UFL on income inequality in Malaysia. However it is even more difficult to trace the effect of UFL on the longer-term restructuring of the economy.

The first basic and very simple proposition is that foreign labour is used in Malaysian production because the employers employing the foreign labour make a greater rate of profit than if they did not employ them. What is the structural effect of this? There are two effects that it is important to distinguish. First, the effect through the capital investment used for capacity expansion in the economy, since it may be that the import of UFL raises the average rate of profit and the incentive to invest. Second, there may be an effect through the capital investment used to 'modernise' the existing capacity. It may be that by shifting the rate of profit in favour of low value-added (per employee) and low skill-intensive investments, the investment pattern will not be consistent with a strategic shift in the Malaysian economy. Neither of these two effects is easy to identify.

To bring about a strategic shift in the economy means that Malaysia has to raise its international competitiveness in the higher value-added activities. This means that higher value-added activities have to be profitable relative to lower value added activities. This is because of a basic proposition in economics namely that Malaysia cannot be internationally competitive in *all* goods and services. All producers in all countries produce according to comparative advantage which is revealed in the form of competitive advantage. These comparative/competitive advantages are a function of the endowments and capabilities (both natural and created) in the country. Some writers (for example, Wood, 1994) assert that financial capital is internationally mobile so that the determining endowments/capabilities are skilled and unskilled labour. So at any one time we have an international pattern of comparative/competitive advantages determined by labour/technology capabilities with the pattern

tending to change over time. The pattern may be slow to change depending on the speed of exit and entry from and to particular industries and because of the variation in learning (and unlearning) curves between industries (Krugman, 1987).

It is likely that the import of UFL will affect relative rates of profit as well as the overall level of profit but the nature of that change will be determined by all the various factors determining profitability which will include the cost of finance, the cost of labour and infrastructure and the incentive structure with the latter being determined to a large extent by the government.

Unfortunately, there seems to be little or no analysis of the rate of profit in different sectors of the economy (Edwards, 1995: 40 gives 1987 figures for the manufacturing sector only) and of the factors determining it. It is clear that in general the rate of profit must have been attractive to generate a high ratio (around 40% over the past five years) of Gross Domestic Capital Formation (GDCF) to GDP with most of it (about two-thirds between 1990 and 1995 - see Ministry of Finance, 1995: Table 2.1) coming from private sources. And of the private investment just over a third came from overseas between 1991 and 1995 inclusive (Ministry of Finance, 1995: 19). This high ratio of (mostly private) investment to GDP must reflect a high and sustained rate of profit, although the factors sustaining that rate of profit are not clear.

As we have seen, labour productivity has risen quite sharply in recent years, even when it is adjusted for the revised employment figures. But so has capital input so that total factor productivity (TFP) growth is claimed to have been low. For the period between 1987 and 1993, the World Bank gives an average figure of 0.9% pa (World Bank, 1995: para 3). This is very much lower than the average of 2.5 percent per annum given in the Seventh Malaysia Plan for the 1991-95 period but we have already seen that this TFP growth estimate is almost certainly overstated because of the understatement of employment of foreign labour.

Nevertheless, what matters more than TFP growth for the rate of profit of investors is the change in unit labour costs. According to World Bank (1995: 6), unit labour costs seem to have been more or less constant for the manufacturing sector between 1986 and 1991 and yet this is hard to reconcile with a comparison of wage increases and labour productivity over the same period. For example, between 1987 and 1991, the real wage rate of unskilled manufacturing workers rose by 4.9 percent or about 1 percent a year while that of semi-skilled rose by 9.7 percent or about 2 percent per year (World Bank, 1995: 10). Such rises were slower than the rise in labour productivity over the same period. Furthermore, the Seventh Malaysia Plan talks about a declining trend in unit labour costs in Malaysia over the period between 1991 and 1995 (EPU, 1996: 116).

So declining unit labour costs may have sustained or even raised the rate of profit. What role has the tax and tariff incentive structure played?

This is not at all clear. It seems that the government has not significantly changed the incentive structure through tax and tariff protection over the 1990-1995 period, at least for the manufacturing sector, although no study of the effective rate of protection (ERP) has been done over the past five years or so (MITI, 1994, 36). The average of import duty revenue to imports has declined from 10 percent in 1980 to 5 percent in 1990 and 1995 but of course this average is not a good indication of the level of effective protection. Data on changes in corporate taxation were not looked at in this study since these taxes are unlikely to be an important incentive since they affect the net rate of profit and do not determine whether a profit is made in the first place.

Thus, the international competitiveness of the Malaysian economy in general and of the manufacturing sector in particular does not seem to have been changed much through state protection (that is through tax and tariff incentives) in the past decade. Nor has it been significantly affected by Malaysia pricing itself into the international market through changes in the real effective exchange rate. As Table 7 shows, the ringgit was sharply devalued (in real terms and with respect to trading partners) between 1960 and 1970 and again between 1985 and 1988, but since 1988 there has been little change in the real effective exchange rate. Thus, Malaysia's competitiveness in the first half of the 1990s has not been achieved through a significant devaluation of the ringgit.

As stated, no detailed analysis or decomposition of the rate of profit in Malaysia seems to be available. However it seems that changes in unit labour costs have been important and it is likely that labour markets (including the import of UFL) have played a significant role in maintaining a high rate of profit in Malaysia. In this sense the import of UFL may have been a stimulus to investment in the economy.

On the other hand, the import of UFL is likely to have had a harmful affect in terms of the direction of investment. The import of UFL has probably shifted the investment incentive away from higher value-added, more skill-intensive activities towards low value-added, low skill-intensive activities. Thus, it is the relative rates of profit which are also important but much more research than has been possible for this paper is needed to estimate the effects of foreign labour on the pattern of investment in the Malaysian economy. However, the picture becomes very complicated when indirect effects of the import of UFL are considered such as those which work through the exchange rate and through the prices of non-traded goods.

3.8 *The Exchange Rate Effect*

IT may be that UFL, if used intensively in the production of goods with a high net export or import substitution component, will raise the exchange rate above what it would otherwise be, and to that extent will discourage the

production of new, high value-added goods for export. Thus, the availability of relatively low-wage, unskilled labour may act like a Dutch disease effect⁶ insofar as the unskilled foreign labour is in high net export-earning industries.

One example of this is palm oil which is a commodity with a very high net export content. The availability of cheap foreign labour for harvesting the palm fruit is likely to keep the production of palm oil above what it would otherwise be, at least in the short run. This will have a knock-on effect raising the exchange rate above what it would otherwise be.

Year	1965=100	1985=100	1990=100
1960	125		219
1965	100		175
1970	81		142
1975	76		133
1980	82		143
1985	85	100	149
1986		84	125
1987		80	119
1988		72	107
1989		71	105
1990			100
1991			97
1992			103
1993			103
1994			100
1995(June)			99

Sources: Edwards 1995, Table 4;
International Financial Statistics, August 1990
and December 1995 (IMF, Washington)

Note: A rise in the index represents a real appreciation in the ringgit relative to Malaysia's trading partners. A fall denotes a devaluation

⁶ The Dutch disease effect refers to the way in which the export of newly-discovered natural gas from the Netherlands in the 1960s was said to 'crowd out' (through a real appreciation of the exchange rate) the manufacturing sector. The argument is that this may be a not-easily-reversible process if there are dynamic economies of scale (through a learning curve) in the manufacturing sector (Krugman, 1987: 49,50).

On the other hand, in the longer run, the availability of cheap foreign labour may have a number of effects which impede the industry's survival insofar as they are an obstacle to the introduction of mechanisation and therefore higher productivity. About a third of the cost of palm oil (from the factory mill) consists of harvesting costs. These consist of the cost of cutting the fruit bunches and of transporting them to the factory. According to economists in the Palm Oil Research Institute of Malaysia (PORIM) and in the Ministry of Primary Industries, there is considerable potential for the mechanisation of fruit collection (using what are called 'mechanical monkeys' or 'grabs') and for fruit transport (using what are called 'mechanical buffalo') but the efficient use of such mechanisation requires more research and in some cases the redesign of planting on the 'inside' of terraces. The availability of relatively cheap foreign labour is likely to be a deterrent to this research and redesign.

Thus, in the short run, the availability of low-wage UFL may help to maintain a high rate of profit in the growing of palm oil but, in the long run, by discouraging mechanisation, may impede the upgrading of the palm oil industry. When the indirect effect of palm oil production through the exchange rate is added, the picture becomes even more complicated⁷.

Furthermore, it should be noted that if UFL is available to other labour-intensive manufacturing industries (eg. electronics and textiles), it will not necessarily have the same indirect effect through the exchange rate insofar as these industries have a lower net export content.

3.9 *The Effect on Non-traded Goods as Inputs*

THESE is an important second indirect effect of the availability of relatively low-wage UFL. This works through the prices of internationally non-traded goods which are, ultimately, inputs into internationally traded goods.

A real exchange rate devaluation change has its effect through raising the (home currency) prices of internationally traded goods relative to those of non-traded goods⁸. To put this another way, the relative prices of non-traded goods (for example, haircuts) fall with devaluation.

⁷ Similar complications are evident in the rubber-growing industry. For a discussion of these, see the Ph D thesis of Nayagam, 1990 and also Nayagam, 1992

⁸ Conversely, if exports are higher than they would otherwise be due to the 'support' of foreign labour to the oil palm industry, then the ratio of traded to non-traded goods prices falls.

However, the same effect may happen through a path other than that of a change in the exchange rate. Thus by UFL being employed in non-traded goods industries, the cost and (relative) price of non-traded goods may be below what they would otherwise be. If so the effect may be to act as the equivalent of a change in the exchange rate.

Unfortunately, this effect is even more difficult to trace in empirical terms than the investment diversion or the direct exchange rate effects. For a start, there are many different non-traded goods and services in which foreign workers are employed. Secondly, there must be some considerable doubt as to whether the availability of low wage labour actually reduces the prices of all or even most non-traded goods. The following paragraphs consider three categories of non-traded goods (construction, retail and wholesale trade services and domestic services), if only to highlight the problems rather than to provide comprehensive answers.

Firstly, as we have seen, one major sector in which foreign labour is employed is the *construction* industry. Unfortunately, this includes a diverse collection of 'goods' including the construction of housing and offices, transport infrastructure (roads, rail services and ports) and 'environmental' infrastructure (gas, electricity, water, drainage and sewage). To trace the effects of UFL through each of these is difficult but at this stage, one general point can be made, namely that there is no assurance that the low-wage foreign labour will be reflected in lower *prices* of these non-traded goods, even if their production costs are lowered. Indeed, given the imperfections in the production of these goods in Malaysia there may be little or no effect on the prices of non-traded goods. Instead the lower costs may simply be reflected in exceptionally high profit rates accruing to those lucky enough to get planning permissions and licenses given that the market for many of the goods and services produced by the construction industry are highly 'regulated' though not necessarily in favour of national capital (Gomez, 1994; Jomo, 1994). However, it is interesting to note that Narayanan has claimed that improvements in construction techniques may **not** be held back by the availability of cheap foreign labour. He argues that new techniques are stimulated by the contractors having to meet tight delivery deadlines (1992: 14).

By contrast, in the *retail and wholesale trade services*, it may well be true that the availability of foreign labour keeps down both the *cost* and *price* of the services. On the other hand, the availability of UFL is likely to deter the pace of reorganisation in the industry in the longer term by making self-service facilities (eg. petrol pumps and food supermarkets) relatively less profitable and/or more risky. Thus, in the longer run, the costs and prices may be higher than otherwise.

Thirdly, UFL used in *domestic service* may be said to add to the labour force in two ways - firstly as an addition in themselves but secondly by encouraging an increase in the participation of Malaysian women in the labour force. However two points need to be made. Firstly, some of the labour that it recorded as coming in as

4.2 *The Policy Implications*

THE fact that Malaysia is not alone in experiencing widening differentials between skilled and unskilled labour should not be grounds for complacency. The latest *Employment Outlook* of the OECD has pointed to the socially harmful effects of the growing inequalities in many of the OECD countries (OECD, 1996). There is no reason to suppose that these effects are any the less harmful in Malaysia. Furthermore market forces are unlikely to quickly correct these differentials and the government needs to take effective action. Not only do forces in the labour market work slowly, but the government itself has created the problem by allowing UFL to enter the economy in such large numbers.

Thus on income distribution grounds alone there is a case for much greater control on the import of foreign labour¹¹. There are those who say that, with increasing globalisation and with increasing links between regions of Malaysia and regions in Indonesia and Thailand, effective controls on labour immigration are not possible. However, if the government has the political will, certain measures (such as punitive fines on employers of 'illegals') would be successful. Stronger controls should be imposed alongside a planned labour policy which should put an end to the stop-go policy on immigration of the immediate past (Pillai, 1995: 234; World Bank, 1995).

On the grounds both of income distribution and of economic restructuring, the role of UFL in the Malaysian economy should be reduced and then phased out over a five to ten year period. This means that the growth rate of the economy should be slowed down so as to be consistent with an 'indigenous labour sustainable rate of growth' (ILSROG) of GDP. This is estimated to be about 6 percent to 7 percent annually by contrast with the 8 - 9 percent annually actual growth rate of the past five years. As pointed out in Section 3, if a rate of about 9 percent per annum continues,

"(a second) factor which slowed down the adjustment process in Singapore was a substantial reliance on foreign labour, especially large numbers of unskilled or low-skilled foreign workers for factory work, construction, and even domestic services" (Cheah Hock Beng 1995: 21)

¹¹. The imposition of stringent controls on the immigration of UFL might not be sufficient by itself to bring about a greater equality in income distribution. Other measures are likely to be necessary and desirable (for example the introduction of minimum wage legislation and redistributive taxes). Such measures are likely to not only bring about a more equal income distribution but in doing so are likely to provide the basis for faster economic growth by 'deepening' the domestic market (Jomo, 1994: 98).

the number of foreign workers in the economy is likely to rise by up to 200,000 every year.

Thus, a slower rate of growth is desirable in the short run. In addition to sucking in less foreign labour and to reversing the otherwise ever-larger wage differential between skilled and unskilled labour, a slower rate of growth would have a number of advantages:

Firstly, it would give the effects of the HRDC-sponsored supply of skilled labour longer to work. The World Bank report argues that the supply elasticity of skilled workers is low in Malaysia (World Bank, 1995: 18). In this case, a slower rate of economic growth would give a longer time for the supply of skilled labour to respond to the initiatives of the HRDC.

Secondly, it would enable the government to be more selective about the type of industries into which, and the terms on which, foreign direct investment could be encouraged.

Thirdly, it might reduce the ever-tighter infrastructural bottlenecks and reduce the rising environmental costs of Malaysia's development.

Thus, a slower rate of growth in GDP in the short run may be compensated by a faster, long run rate of growth of a restructured economy. In addition, a decrease in the import of UFL could be offset to some extent if the government took a number of steps to increase the growth in the domestic (Malaysian-citizen) labour force, namely;

(i) by increasing the *female participation rate* (the number of females economically active as a percentage of the total number in the working age population of 15 to 64 years). This participation rate is low in Malaysia (47% in 1990) compared to that in Thailand (76% in 1990) and has increased only slowly over the past two decades (in 1970 it was only about one percent lower than the 1990 rate) (World Bank, 1995: 12). One explanation for this may lie in the low pay for Malaysian women relative to Malaysian men. Thus there is a low gender wage ratio in Malaysia (1:2, female to male, 1990) relative to those in Thailand (1:1.1), Philippines (1:1.33) and Japan (1:1.7) (World Bank, 1995: 44). The World Bank suggests that part of the explanation for this low ratio could lie in the high non-wage benefits that women receive as employees (and the costs of which the employers have to pay) (World Bank, 1995: 44). Nevertheless it seems likely that low wages for Malaysian women are part of the explanation for the low female participation rate. Other factors accounting for the low participation rate are probably structural (few creches) and cultural;

(ii) by raising the *retirement age* which, in public sector employment is currently 55 years;

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