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**RENT MANAGEMENT IN PROTON**

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## RENT MANAGEMENT IN PROTON

### 1. Introduction

**K**rueger (1974) and Bhagwati (1979) have written on the efficiency dissipating effects of rent seeking. They assume that market-determined allocation of resources will eliminate rent seeking and thus generate optimal growth. As has been demonstrated by Schumpeter (1934), Khan (1989) and Chang (1994), rents are necessary to stimulate innovative investments that are risky and lumpy. The insight that discount rates have to exceed interest rates to stimulate investment in risky innovative activities has become significant in new growth models (Romer, 1986; Lucas, 1986; Helpman and Krugman, 1989; Grossman and Helpman, 1991).<sup>1</sup> Besides, due to the endemic nature of information asymmetries, quasi rents are bound to occur even in day to day transactions not related to scale economies (Coase, 1937; Williamson, 1979; 1985). Also, powerful interest groups can emerge independently of the state to distort the allocational capacity of markets (Kornai, 1979; Rasiah, 1995: Chapter 2).

For these reasons, Khan (1989), Chang (1994) and Rasiah (1996) have argued that governments creating such rents should ensure that they are temporary and utilised productively. State governance, however, does not necessarily guarantee effective appropriation of rents. Even non-corrupt bureaucrats who possess little knowledge of markets and technology are prone to failure. To minimise government failures, effective coordination through markets becomes essential. As markets are generally underdeveloped in developing economies, contrary to common assumptions, e.g. by Krueger

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<sup>1</sup> Also, public goods command different demand structures and generate externalities with wider societal implications.

Table 3: Proton, Sales and Exports, 1985-95

	Domestic (1) '000	Exports (2) '000	Total (3) '000	% (2)/(3)	% of exports to developed markets#
1985	7.5	0.0	7.5	0.0	0.0
1986	24.1	0.0	24.1	1.0	0.0
1987	24.9	0.4	25.3	1.6	37.7
1988	42.5	0.9	43.4	2.1	73.3
1989	52.7	11.9	64.6	18.4	98.5
1990	72.5	13.1	85.6	15.3	98.5
1991	84.8	15.1	99.9	15.1	98.2
1992	80.4	18.8	99.2	19.0	98.2
1993	94.1	20.3	114.4	17.7	97.1
1994	111.3	15.0	126.3	11.9	91.5
1995*	144.0	21.1	165.1	12.8	88.7

Note: # includes Singapore; \* forecasts

Source: Computed from Proton (1995)

The government's launching of a second automobile firm, Perusahaan Otomobil Kedua (Perodua) suggests some willingness to open the Malaysian market for some competition, albeit from another state-sponsored firm. Also, the Kancil produced by Perodua is smaller and does not compete directly at the same engine capacity and vehicle size level -- with cars manufactured by Proton. Nevertheless, it has probably cut into potential sales by Proton. Proton's share of the domestic market fell slightly from a peak of 74 per cent in 1993 to 73 and 72 per cent in 1994 and 1995 respectively (Proton, 1995 : 6).

As noted earlier, Proton's performance should eventually be judged in terms of the gains generated for the national economy against the welfare loss

borne by Malaysian consumers. It is clear that protection for the car industry has yet to decline despite huge profits reported by Proton. Why has the government not begun reducing tariffs, especially since the MSE -- based on current technological capability -- has been achieved? Four plausible explanations can be suggested. First, the contract between the government and Mitsubishi could have ensured that the latter would be the prime beneficiary of rents -- only leaving a relatively small share for the former.<sup>3</sup> Second, as the more sophisticated infant industry advocates may argue, to achieve real efficiency gains, the firm requires substantial R&D investments to help accelerate progress towards the technology frontier. Proton was reported to have invested RM82 million in R&D in 1992. However, an engineer from Proton privately conceded that the firm was around 15-20 years behind the technology frontier firms in 1995. Also, Proton has yet to develop independent engine manufacturing capability. It is still dependent on its Mitsubishi partner for the engine and the gear box, and for expertise in several other critical aspects of car manufacture. In fact, Machado (1994) has argued persuasively that Mitsubishi managers' participation has been critical for upgrading and sustaining the high quality standards required in developed markets, suggesting Proton's heavy technological dependence on the Japanese partner. Table 4 shows several technology transfer agreements (TTAs) still tying Proton to foreign technology. Indeed, the car is supposed to embody "Japanese technology, Malaysian style" -- as advertised in England. With reference to Figure 2 again, it can be seen that if investments in R&D generate technical change that improve productive efficiency, then the LRAC would move downwards from  $LRAC_1$  to  $LRAC_2$  so that long run costs at point  $Q_2$ , i.e. the new MSE quantity, will fall to  $C_2$ . In other words, a share of the monopoly rents enjoyed in the domestic market should be invested to help Proton improve its competitiveness and to help it

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<sup>3</sup> Machado (1994) has argued that the deal has seriously restricted Proton's ability to

catch up with and overtake at least some of its international competition. However, the 15-20 year gap behind the technology frontier, does not suggest rapid progress towards the technology frontier.

Also, a significant share of the costs incurred by Proton still goes to its technology suppliers. In Japan and South Korea, pro-active and visionary governance -- by *ex ante vetting*, monitoring technology transfers, *ex post* appraisal and development of institutional capabilities to raise absorptive capacities -- have facilitated extensive technology diffusion (Johnson, 1982; Rasiah, 1995a; Lall, 1996). In Malaysia, the government has lacked technically and economically proficient and politically shrewd technocrats and bureaucrats to maximise gains for local licensees when dealing with foreign licensors and other technology suppliers. Technology transfer agreements (TTAs) in Malaysia have not involved any *ex post* monitoring and appraisal, while the *ex ante* screening is poorly handled (see Rasiah, 1996). Utilisation of parts from foreign transnationals in Malaysia (e.g. Robert Bosch and Nippon denso supply Blaupunkt stereo sets and airconditioners respectively to Proton) and efforts to diversify component sourcing to reduce dependence on Mitsubishi (especially with the rising value of the yen) led to serious government efforts to extend the sources of TTA partners. Indeed, as with most major directives involving Proton, Mahathir himself has been pushing the diversification programme. Officials from the Economic Planning Unit and Proton note that Mahathir has been key to the coordination of Proton's activities. Despite its utility in gaining priority for Proton as well as public and private support in Malaysia and abroad, excessive dependence on a busy Prime Minister has also adversely affected Proton's development.

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raise local productive capacity.

**Table 4: Proton: Technology Transfer Agreements, 1995\***

Country	Joint-Venture	Technical Assistance	Purchase agreement	Total
Japan	16	35	4	55
Germany	3	0	0	3
Taiwan	5	1	0	6
Korea	6	0	0	6
Australia	2	1	0	3
Others	3	3	0	6
Total	35	40	4	79

Note: \* as of September

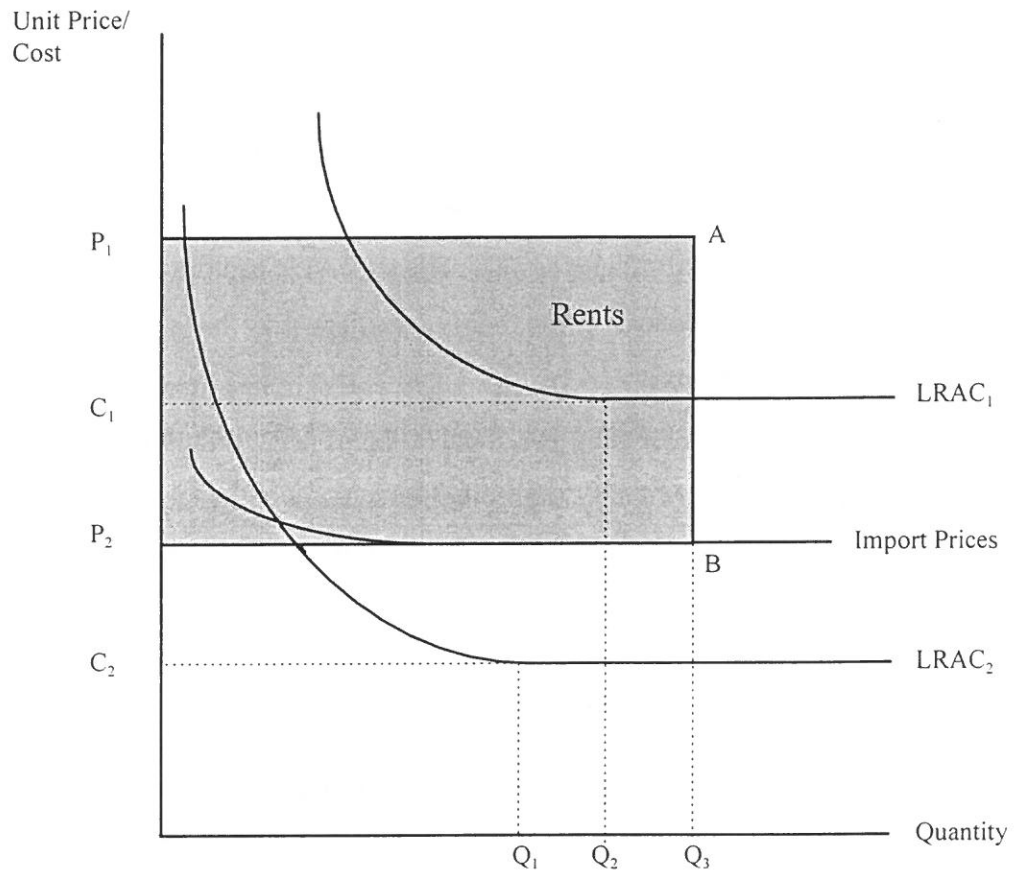
Source: Proton (1995: 9)

The vendor development programme (VDP) launched through Proton works through an umbrella framework where captive rents from Proton sales are shared with the mainly *Bumiputera* vendors and their partners. Since most of the *Bumiputera* vendors are recent start-ups with limited business and manufacturing experience, Proton has had to pay high prices to these suppliers (see also Rasiah, 1996b). Proton has to source parts and components from high cost government designated producers in the hope that, in the long run, they will improve efficiency and reduce prices below those of imports, thereby enhancing Proton's competitiveness. Part of the monopoly rents enjoyed by Proton in Figure 2 actually goes towards the development of domestic suppliers. If such extension of the domestic value added chain helps lower input prices so that they become cheaper than imports, then it will help push down LRAC from LRAC<sub>1</sub> to LRAC<sub>2</sub>. However, Proton's production officials say that, while they have succeeded in increasing local content in a short time to 80 per cent, the other consequences have been mixed. Most suppliers have actually raised costs to

Proton as they have not managed to significantly improve efficiency. The main benefits generated so far have been improvements in delivery time and some cost reduction for certain components. Also, the suppliers have themselves been importing considerably, meaning that much of the 80 per cent local context has actually been imported. In addition, interviews suggest that a significant share of the rents accruing to suppliers have been appropriated by Japanese suppliers attracted to Malaysia by Mitsubishi -- who, despite sharing equity with *Bumiputera* partners, have retained control over the key technologies used besides securing the lion's share of the rents thus obtained (see also, Machado, 1994).

Furthermore, the government has no rigorous mechanisms to monitor and improve performance to adjust tariffs downwards to reflect new levels of efficiency achieved by Proton and its suppliers. Given the monopolistic privileges it has enjoyed, it is unlikely that Proton will initiate such progressive tariff reductions. Interviews support the view that the bureaucracy has little relevant technical competence, let alone inclination to assess and improve Proton's performance and to adjust optimal tariff levels to sustain growth, improve efficiency and enhance welfare. Yet, performance auditing can easily be done. Profits and internal rates of returns can easily be computed for different tariff scenarios taking account of both outputs and inputs. Further assumptions can be made based on informed estimates of likely domestic demand at different tariff levels. It is unlikely that Proton can compete with foreign cars without significant tariff protection for quite some time to come. In September 1995, customers in the United States, Australia and Malaysia paid RM45,000, RM50,000 and RM115,000 respectively for a Toyota Camry. If the Toyota Camry, or a cheaper model, such as the Toyota Corolla or Nissan Sentra were available at US tariff rates, it is difficult to imagine significant numbers of Malaysian consumers still wanting to buy the Proton. Rigorous performance

evaluation can be used to force Proton to improve efficiency, and to facilitate a gradual reduction in tariffs.



**Figure 2: Rents and Technical Improvements**

High rents have enabled Proton's suppliers to enjoy lucrative returns without being internationally competitive. Due to the lack of information, one can only conjecture about the significance of the problem. If it can be established (e.g. by using simulations of performance when tariffs are removed) that Proton is neither likely to be internationally competitive nor capable of generating efficiency gains, it could then be argued that the venture itself has

only enriched Proton and others linked with it, including the vendors. There is some evidence of politically favoured firms having access to Proton's rents (Jomo, 1985; Khor, 1987), but this in itself does not doom the firm in the long run. High rents benefit the politically connected and have made a big success in the eyes of the electorate (e.g. because of the high profits and share prices).

Finally, as Machado (1994) has succinctly documented, it is likely that a substantial share of the rents has been appropriated by Mitsubishi through a very biased TTA with its Malaysian partners. The excessive capture of Proton's rents by Mitsubishi and Japanese components suppliers may have limited Proton's capacity to re-invest productively. As noted earlier, poor governance and little emphasis on the development of local support institutions and productive capacities has allowed Mitsubishi and the Japanese suppliers to retain control of the key technologies involved (Rasiah, 1997b). Hence, all four possible explanations of why the government has not been reducing tariffs appear plausible.

Within the framework to encourage training established by the Human Resources Development Council, Proton contributes one per cent of its payroll to its Fund, and has reclaimed close to 90 per cent of this for approved training schemes from the time of the application of the relevant act in 1993. Interviews, however, suggest that a significant share of the expenses incurred have been spent on non-technical motivational courses. Individuals still visit Mitsubishi Japan for training, but only to acquire assembly know how for new models, e.g. a batch of trainees returned at the end of 1995 with new know-how for assembly of the Perdana model. In 1996, the firm opened a training centre on its premises, introducing modular training programmes. It is too early to assess its success, though all ten workers interviewed claimed substantial learning acquired through participation in such programmes.



Also, the utilisation of state-of-the-art process techniques has been limited. A private organisation was engaged in 1995 to introduce just-in-time practices in the production plant but problems led to the cancellation of the consultancy. Production managers reported continuing such efforts, but without any clear targets. The production cycle time in 1995 was 85 seconds, down from 125 seconds in 1985, suggesting that the pace of improvement has been rather slow and comparing quite unfavourably with the 60 seconds average cycle time achieved by German car assemblers (Roth, 1995). If the high quality standards of German firms are also taken into account, Proton's comparable cycle time may actually exceed 100 seconds. Quality control circles (QCCs) have been introduced since 1985, but process improvements achieved through such small informal groups have been fairly modest. Minor improvements in pellet-unloading and jig-handling have been some of the improvements attributed to direct workers. The organisation of QCCs and their links with innovative learning through access to state-of-the-art processes, and mechanical and auto documents have not been very up-to-date. The relatively slow development of process technologies may be an important reason why delivery times to domestic consumers is still very much delayed -- from one to three months.

Also, despite considerable cooperation from Chinese in marketing and servicing, there has been a serious lack of coordination between such operations and manufacturing. The lack of effective coordination between the two has often left many sales outlets short of cars to meet domestic demand. Proton's production officials seem unable to explain the delivery delay of 1-3 months. In some cases, customers have only obtained the Perdana model after 6 months. The rents associated with the Proton cars and the long waiting time have given rise to a lucrative black market. Also, six repair shop managers, reported that

their complain of some frequent defects (e.g. involving automatic windows and central locking) have gone unheeded. A broad-based committee -- involving representatives from all the firms and institutions -- directly and indirectly involved in Proton's value added chain could ensure more effective coordination to minimise market and government failures.

There is much more to be achieved -- in terms of product and process technologies -- for Proton to be classified a success. Given the challenges posed by recent liberalisation globally, a thorough review of Proton's performance is urgently required. The World Trade Organisation (WTO), formed in 1995, has set a period of 5 to 8 years for lowering tariffs to 0-5 per cent, though, it is unclear how this will be implemented. The ASEAN Free Trade Area (AFTA) has set a similar time frame for the reduction of tariffs in Southeast Asia; AFTA's deadline for 'normal track' product trade liberalisation is also the year 2003 (ASEAN, 1995). The looser but larger forum, the Asia Pacific Economic Cooperation (APEC) Forum has set a longer time frame for full trade liberalisation -- 2010 for developed economies and 2020 for developing economies (Soesastro, 1994) -- giving Proton more breathing room. Whatever the impact of such trade liberalisation drives, Proton's operations -- particularly its performance under circumstances of gradual reduction in protection -- require more rigorous scrutiny so that the Malaysian economy eventually gains real benefits from the project. Unless such rigorous assessments and appropriate policy reforms are undertaken, the venture will continue to be an uncompetitive rent-generating means to benefit a few at the expense of Malaysian consumers and tax payers.

#### 4. Conclusion

It can be seen that Proton has had three main objectives besides developing national automotive manufacturing capacity; first, to expand *Bumiputera* involvement in automotive manufacturing, second, to promote industrial linkages, and third, to push the industry towards the technology frontier. The project has required the creation of rents to achieve financial viability for Proton and the generally inexperienced *Bumiputera* parts suppliers. While its launch initially involved little private-public sector coordination, largely due to poor inter-ethnic business cooperation in the early and mid-1980s, the persistence of this problem reflects poor governance. Ethnic Chinese sales and support networks have mushroomed all over the country as Proton car sales and services have become very lucrative. Such ethnic Chinese involvement, however, has not extended into manufacturing.

Proton has enjoyed substantial protection over its decade of existence, apparently even after achieving minimum scale efficiency. The need for R&D investments to catch up technologically and to shift more of the car value added chain to Malaysia, the lack of effective government measures to review and improve performance, the influence of the politically connected, and the restrictive TTA conditions imposed by Mitsubishi which has led to a significant share of the rents being transferred abroad all appear to explain the persistence of high monopolistic rents. While the first factor may be considered desirable, the remaining three are unproductive. For Proton to become economically viable, the terms of the TTA should shift substantially to favour the local partners. The government should not only improve its bargaining capacity, but also expand local absorptive capacities. Hence, although production has

expanded relatively strongly, a relatively high share of the profits generated by Proton have continued to remain in the hands of its foreign technology suppliers.

The real test for Proton will come when protection is reduced, though, greater liberalisation may pose a serious threat to its very existence. Even if liberalisation threats evaporate, it is important for the government to ensure that Proton is indeed moving towards the technology frontier and greater international competitiveness, and that domestic costs eventually decline below import prices. Otherwise, the Malaysian economy will continue to lose economic resources with little long term gain, while domestic consumers continue to bear the burden of Proton's profits.

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