ASEAN Economic Bulletin Vol. 22, No. 1 (2005), pp. 19–34 ISSN 0217-4472

Trade Policy in Malaysia

Liberalization Process, Structure of Protection, and Reform Agenda

Prema-chandra Athukorala

The purpose of this paper is to examine trade policy-making in Malaysia in the post-independence era with emphasis on factors underlying key policy shifts and to identify key elements of the unfinished reform agenda. The paper provides a historical overview of trade policy-making in Malaysia, paying attention to the underlying political economy, and undertakes a critical evaluation of the current trade and investment policy regime from a comparative regional perspective. It also examines Malaysia's changing policy posture relating to multilateral trade regional and bilateral trade negotiations.

I. Introduction

Malaysia is widely held as a great development success story in the developing world. Notwithstanding the massive economic contraction experienced during the 1997–98 financial crisis, Malaysia's economic performance has been impressive throughout the post-independence period. Sustained high growth (averaging to nearly 6 per cent per annum for the past four decades) has been accompanied by the rising living standards with a relatively equal distribution of income, ameliorating the twin problems of poverty and racial imbalances. This dramatic economic transformation has been underpinned by a long-standing commitment to maintaining a remarkably open trade policy regime. Historically, trade and investment barriers in Malaysia have been low in relation to other countries in the region except for Hong Kong and Singapore. It is widely acknowledged that this policy stance enabled the Malaysian economy to respond successfully to opportunities arising from increasing internationalization of production and world trade expansion. However, this general perception does not imply that all is well with the trade policy regime in Malaysia. As we will argue in this paper, much remain to be done in order to achieve a policy setting needed to place the economy on a sustained rapid growth path.

The purpose of this paper is to examine trade policy-making in Malaysia in the post-independence era with emphasis on factors underlying key policy shifts and to identify key elements of the unfinished reform agenda. The paper begins with a historical overview of trade policy-making in Malaysia, paying attention to the underlying political economy (section II). Section III undertakes a critical evaluation of the current trade and investment policy regime from a comparative regional perspective. Section IV examines Malaysia's changing policy posture relating to multilateral trade negotiations, ASEAN-wide economic integration, and bilateral free trade agreements (FTAs). The final section presents some concluding remarks.

II. Policy Trends

In the 1950s and 1960s, Malaysia's policy thrust was to continue with the colonial open-door policy stance relating to trade and industry, while attempting to redress ethnic and regional economic imbalances through rural development schemes and the provision of social and physical infrastructure (Snodgrass 1980). As in many other developing countries, industrialization through import substitution was a key emphasis of the Malaysian development strategy during this period. However, Malaysian policy-makers, unlike their counterparts in other countries, eschewed "forced" industrialization through direct import restrictions and the establishment of state-owned industrial enterprises (Lim 1992). Moderate tariff protection was by and large the key instrument used in encouraging new investment in manufacturing. The industrialization strategy of the Malaysian government at the time was "largely a promotional effort, geared to the provision of an investment climate favourable to the private enterprise" (Wheelwright 1963, p. 69). The average tariff rate in 1965 was estimated at a mere 13 per cent and very few industries enjoyed nominal tariffs of more than 30 per cent and non-tariff barriers were almost non-existent (Power 1971).

Following the communal riots of 13 May 1969, the Malaysian Government embarked on an affirmative action-based policy package, the New Economic Policy (NEP) (later modified and renamed National Development Policy, or NDP, in 1990) (Leigh 1992, Snodgrass 1980). The overriding objective of the NEP, which came into effect in 1970, was to maintain national unity through the pursuance of two objectives: eradication of poverty among the entire population, and restructuring of the Malaysian society so that the identification of race with economic function and geographical location is reduced. These objectives were to be achieved through a wide range of direct redistribution polices including privileged access to subsidized credits, modern sector employment, and share ownership in private enterprises for the native Malays (*bumiputra*). However, the resource cost of these direct redistribution policies was not a major drag on growth because the government continued to maintain an outward-oriented overall policy stance.

Some elements of the original NEP policy package ran counter to the country's long-standing commitment to attracting foreign direct investment (FDI). These included the requirement to increase the share of *bumiputra* in the corporate sector, to reserve certain percentage of employment in foreign ventures for these people, and a ceiling of 70:30 on Malaysian–foreign equity ownership. The government subsequently took initiatives to ameliorate the adverse impact of these strictures on export-oriented FDI. For instance, as part of the policy package formulated in response to the mid-1980s crisis, 100 per cent foreign ownership was allowed in firms exporting 80 per cent or more of their output.

There was heavy emphasis on the promotion of heavy industries through direct government involvement in the first half of 1980s, as part of the "look East" policy of Dr Mahathir who became Prime Minister in 1981 (Chee 1994). The Heavy Industries Corporation of Malaysia (HICOM), a public sector holding company, was formed in 1980 to go into partnership with foreign companies in setting up industries in areas such as petrochemicals; iron and steel; cement; paper and paper products; machinery and equipment; general engineering; transport equipment; and building materials. The symbol of the selective industrial policy was the Proton (the Malaysian national car) project, a joint venture of HICOM and Mitsubishi Corporation in Japan. By 1987, there were 867 corporate public enterprises in Malaysia, more than a third of which were in manufacturing. Tariffs on a wide range of manufactured goods were substantially increased in the first half of 1980s as part of the heavy industrialization move.

The average nominal tariff rate increased from 22 per cent in the late 1970s to 26 per cent in 1984 (Table 1). Nevertheless, there was no significant reliance of quantitative import restrictions; only 8 per cent of total merchandise imports (on an import-weighted basis) were under such restrictions by the mid-1980s (Menon 2000).

The economic crisis during 1985–87, which originated in a combination of budget deficits caused by the heavy industrialization move and adverse trends in prices of Malaysia's major export products (Corden 1996), put an end to the state-led heavy industrialization push. The crisis management policy package placed greater emphasis on the role of the private sector and strengthening the conditions for export-oriented industrialization through greater participation of FDI. The structural adjustment reform package introduced in response to the crisis involved a gradual process of privatization and restructuring of state-owned enterprises. By the early 1990s state-ownership in manufacturing was limited only to some politically sensitive ventures in automobile manufacturing (the Proton project), petrochemical, iron and steel, and cement industries. The Promotion of Investment Act of 1986 introduced fresh and more generous incentives for private investors, and some of the ethnic requirements on company ownership of the NEP were relaxed.

Reforms in the later 1980s also involved significant tariff reductions and removal of quantitative import restrictions. Some of the tariff increases introduced in the first half of the 1980s were reversed and further tariff cuts were introduced as part of market-oriented reforms in the late 1980s. The average effective rate of manufacturing protection, which increased from about 25 per cent in the early 1960s to 70 per cent in the early 1980s, declined continuously thereafter, coming down to below 30 per cent by the late 1980s (Alavi 1996, Tables 3.2, 3.3, and 7.2). However, a number of "politically sensitive" industries continued to benefit from high tariffs.

In the early 1990s, Prime Minister Mahathir came up with a policy blueprint (the Vision 2020 Statement) for transforming Malaysia to a developed country status by the year 2020. Most of these proposals — in particular those relating to the provision of infrastructure, maintaining macroeconomic stability, human capital development and commitment to a more equitable distribution of fruits of economic growth — simply reconfirmed the long-standing commitment

TABLE 1
Trend in Average Nominal Tariff Rate, 1965–2002
(Unweighted, percent)

1965	13	1993	14.3
1970	18	1994	13
1978	22	1995	12.3
1984	26	1996	8.7
1986	15.4	1997	9.1
1987	13.6	1998	7.1
1988	13	1999	8.1
1989	17	2000	9.1
1991	16.9	2001	9.2
1992	12.2	2002	10.1

SOURCE: Power (1971): data for 1965; Ariff (1991): 1970 and 1984; Lee (1986): 1978; Hoekman, Mattoo, and English (2002): 1986–89; and calculations by the author based on tariff schedules available from the APEC Secretariat online database.

of the Malaysian Government to good governance. The new policy also introduced a plethora of new incentives geared to industrial upgrading and strengthening domestic linkages of the manufacturing sectors, which opened up new opportunities for policy-maker desecration. However, the long-standing commitment to private sector oriented growth in the context of an open trade and investment regime continued to remain the basic tenet of Malaysia's national development strategy.

Malaysia's policy response to the recent (1997–98) financial crisis involved some notable departure from persistent trade liberalization over the previous decade (Athukorala 2003). The 1998 Budget speech announced increase in import duties on automobiles, vans, and motorcycles from 30–200 per cent to 40–300 per cent for CBU (completely built-up) and 4–42 per cent to 30–80 per cent for CKD (completely knocked down) and for construction equipment from 0–35 per cent to 5–50 per cent. In addition, a number of heavy and construction equipment, hot and cold rolled flat products of iron or non-alloy steel, ephedrine and its salts, chemical products, certain electrical household goods were brought under non-automatic import licensing. The declared purpose of these measures was to bring down the current account deficit, but cushioning local producers (including the national car producer, Proton) against domestic demand contraction was obviously a key motivating factor.

There was, however, no retreat from the country's long-standing commitment to promoting FDI. The capital outflow controls introduced as part of the crisis management policy package were confined to short-term capital only (Athukorala 2003). Profit remittances and repatriation of capital related to FDI in the country continued to remain free of control. Moreover, some new measures were introduced to further encourage FDI participation in the economy. These included allowing 100 per cent foreign ownership of new investment in domestic manufacturing; increasing the foreign ownership share in the telecommunication projects from 30 per cent to 69 per cent (under the condition that the ownership share is brought down to 49 per cent after five years), increasing the foreign ownership share in stock broking companies and insurance sector from a previous uniform level of 30 per cent to 49 per cent and 51 per cent respectively; and permitting real estate investment by foreigner in new or less than 50 per cent completed projects subject to a minimum investment limit of RM250,000.

III. Current Trade Policy Framework

Tariffs have continued to be the main border measure affecting Malaysia's import trade throughout the post-independence period. By the mid-1990s, only a 4.5 per cent of all tariff lines had non ad valorem tariffs, and this declined further to 0.7 per cent by 2002 because of the further rationalization of the tariff structure following the signing of the WTO Agreement in 1995. There are no tariff quotas or variable import levies (Table 2).

Malaysia has bound only 65 per cent of its tariff lines as part of its WTO commitments. Moreover, the bound rates are much higher than the applied MFN rates (WTO 2002).[1] Both these features of the tariff structure have provided the government with scope to raise applied tariffs (as was done in 1998), imparting a degree of uncertainty to applied tariffs. The tariff increases introduced in 1998 (see above) have resulted in a mild, yet notable, reversal in the declining trend in the average nominal tariff rate maimed from the mid-1980s (see Table 4). However, it is important to note that the average level of nominal tariff protection is lower than that indicated by the simple average applied MFN average owing to various tariff concessions, often for capital and intermediate inputs, as well as preferential rates, particularly those favouring ASEAN countries under AFTA. The ratio of actual import duty collected to total value of merchandise imports (the implicit nominal duty rate) in fact declined from 3 per cent in 1997 to 1.2 per cent in 2003.[2]

The degree of dispersion tariff rates measured by the coefficient of variation increased from 91 per cent in 1988 to 170 per cent in 1997 and then to 210 per cent in 2002, reflecting the increase in the number of tariff lines with rates

TABLE 2
Tariff Structure of Malaysia (MFN Tariff), 1988, 1993, 1997, and 2002

	1988	*1993*	*1997*	*2002*
Number of tariff lines (at 10 digit HS level)	12,183	11,875	10,372	10,368
Bound tariff lines[a] (%)	0.8	0.8	63.7	63.5
Duty-free tariff lines[a] (%)	10.3	13.4	58.6	58.3
Specific and mixed tariffs[a] (%)	22.2	12.0	4.5	0.7
Tariffs with no ad valorem equivalent[a] (%)	7.4	5.9	4.5	0.7
Simple average applied rate (%)	17.5	15.2	8.1	9.5
Agriculture (HS 01-24)	7.7	7.3	4.8	3.5
Industrial products (HS 25-93)	14.8	14.7	8.5	10.1
Tariff range (%)	0–208	0–140	0–200	0–300
Import weighted average (%)	15.5	11.9	9.9	
Domestic tariff peaks[b] (%)	0.8	2.2	15.8	9.8
International tariff peaks[c] (%)	51.3	49.1	25.9	23.8
Coefficient of variation (%)	91	86	170	212
Simple average tariff by stage of processing (%)				
Raw materials	14.6	14.3	1.0	0.9
Agricultural products	16.9	16.5	0.6	0.5
Mining products	3.6	3.8	1.0	1.0
Manufactured products	5.9	5.8	3.2	3.0
Semi-processed products	18.3	15.3	7.0	7.8
Fully processed products	18.1	15.4	11.9	14.2

NOTES: a. As a percentage of total tariff lines.
b. Domestic tariff peaks are defined as those exceeding three times the overall simple average MFN rate.
c. International tariff peaks are defined as those exceeding 15 per cent.
SOURCE: WTO (2002), Tables III.1 and III.2.

less than 10 per cent and higher than 20 per cent (Table 2). By contrast, domestic tariff peaks (tariff lines with rates exceeding three times the simple average tariff rate as a percentage of total tariff lines) have declined. Tariff peaks apply, *inter alia*, to automobiles, beverages, textiles, and clothing. The increases in nominal tariff rates in recent years have largely been confined to products in final goods. Nearly 60 per cent of total tariff lines continued to remain duty-free. These tariff lines relate mostly to inputs to domestic industry (that is, products in the first stage of processing and the semi-processed products). A large number of dutiable imported inputs also benefit from various tariff concessions.

Heavy protection of automobile industry remains a major anomaly in Malaysia's structure of industrial protection. The domestic automobile market is protected through both tariff and non-tariff measures. At Chapter (2-digit) level of the Harmonized System (HS) of tariff, the average nominal tariff on automobile is 30.2 per cent while all the other tariff rates are around or below 20 per cent.[3] It is important to note that the average masks much higher protection given to various vehicle types produced domestically. Following the latest increases in October 1997, currently automobile tariff range from 42 per cent to 80 per cent on CKD cars, and from 140 per cent to 300 per cent on CBU cars. Most automobile parts and components, except tractor parts (duty-free) are subject to 25–30 per cent tariffs. Motor vehicles, chassis fitted with engine for automobiles and motor vehicles, chassis not fitted with engine and parts thereof, bodies for ambulances, and road tractors for semi-trailers are subject to discretionary import licensing. In addition, a number of internal taxes, such as sales tax at 10 per cent, exercise tax at various rates, and road taxes based on engine capacity are imposed on all vehicles. The national cars, Proton and Perodua, receive 50 per cent reduction in exercise tax. All assemblers and manufacturers including the two national car companies must source certain percentage of parts and components locally (WTO 2002, p. 77).

Table 3 compares Malaysia's tariff structure in 2002 (the latest year for which comparable data are available) with that of the major trading nations in the region. Despite recent tariff increases, Malaysia's average tariff rate is relatively low (both in terms of the simple average and import-weighted average) by the regional standards.[4] However, the degree of dispersion of tariff in Malaysia (measured by the coefficient of variation, or CV) is relatively high because of high tariff peaks relating to a few product lines, such as motor vehicles in particular.

III.1 Effective Protection for Import-Competing Production

As noted in the previous section, the tariff structure in Malaysia is "cascading", that is, tariffs are generally higher on final goods than on production inputs (intermediate and capital goods). An important implication of this cascading tariff structure is that the nominal tariff rates do not provide an accurate picture of the resource allocation effects of the overall tariff system. Under a cascading tariff structure, the resource allocation effects of the tariff structure on a given product sector depend not only on the tariff rate applicable to that sector but also on tariffs on all other sectors which provide production inputs (intermediate and capital goods) to the sector, both directly and indirectly. In this section, we attempt to examine the overall incentives provided for domestic traded goods production by the tariff structure by combining the tariffs on each sector and tariffs on its input-supplying sectors in the context of input-output linkages within the economy. The analytical tool used for this purpose is the effective rate of protection (ERP). The ERP measures the proportionate increase in per unit value added of a given industry/sector due to the complete system of tariffs. More specifically, it takes into account the protection on output and the cost-raising effects of protection on inputs.

In the context of an economy like Malaysia (and most developing countries) where export-promotion policies are pursued alongside import-substitution polices, it is important to estimate ERP for import-competing and export-oriented activities separately. However, because of the unavailability of data on export subsidies, import duty rebate and other duty concessions afforded export producers, this paper focuses only on ERP for import-competing production. Our estimates are based on the tariff schedule as at late 2002 (obtained from the APEC website) and intermediate import coefficient derived from the Input-Output Table for 1991 (Department of Statistics, Malaysia 2002). The nominal rates (NRP) used in estimation are simply the official applied tariff rates (*ex ante* rates) summed up at the input-output sector level using import value weights. It is important to note that our estimates understate the impact of the trade policy regime on import-competing production because they do not capture various non-tariff elements in the incentive structure.

According to our estimates, the average ERP for all tradable sectors is 9.6 per cent (Table 4). This implies that the combined domestic value added in traded goods production under the current structure of import tariff is 9.6 per cent higher than what is achievable under free trade. This figure, which is remarkably low by the developing country standards, however, hides considerable high effective protection enjoyed by some sectors and industries.

The average ERP for the three sectors of production — agriculture (1.4 per cent), mining (–0.1 per cent), and manufacturing (16.3 per cent)

TABLE 3
Summary of the Tariff Structure in Selected Asian Countries

Tariff rates	China 2001		Indonesia 2001		Malaysia 2002		Philippines 2001		Thailand 2004		Vietnam 2003	
	No. of lines	%	No. of lines	%	No. of lines	%	No. of lines	%	No. of lines	%	No. of lines	%
0–5	440	8.6	2,969	58.1	2,625	60.3	2,760	53.99	2,474	47.4	4,999	46.8
6–10	1,353	26.5	749	14.7	465	6.9	1,441	28.19	622	11.9	1,055	9.9
10–15	1,003	19.7	782	15.3	361	5	380	7.43	641	12.3	176	1.6
15–20	754	14.8	496	9.7	283	14.2	448	8.76	519	9.9	856	8
20–25	617	12.1	74	1.4	702	6.6	3	0.06	29	0.6	121	1.1
25–30	315	6.2	6	0.1	299	5.5	15	0.29	643	12.3	1,164	10.9
30–40	502	9.8	7	0.1	327	0.5	13	0.25	240	4.6	985	9.2
40–50	50	1	8	0.2	23	0.2	35	0.68	15	0.3	1,001	9.4
50–60	7	0.1	2	0	15	0.2	17	0.33	30	0.6	25	0.2
60–80	29	0.6	2	0	7	0.2	0	0	11	0.2	3	0
80–100	15	0.3	1	0	0	0.1	0	0	0	0	292	2.7
> 100	13	0.3	14	0.3	2	0.5	0	0	0	0	12	0.1
Total Lines[a]	5,098	100	5,110	100	5,709	100	5,112	100	5,224	100	10,689	100
Tariff bands	57		52		48		38		57		16	
Range tariff	1–122		0–170		0–300		0–60		0–80		0–150	
Average Tariff	17.48		8.43		10.2		7.6		11.99		18.53	
CV	71.3		127.8		197.0		93.9		101.3		120.78	

NOTES: a. At the 6-digit level of the Harmonized System (HS) of tariff.
CV Coefficient of variation.
SOURCE: Compiled from country tariff schedules available from the APEC Secretariat online database.

TABLE 4
Malaysia: Composition of Tradable Production, and Effective Rate of Protection for Import Competing Production and Its Components*

IO code		*Value added (%)*	Σa_{ij}	$\Sigma a_{ij}t$	*NRP*	*ERP*
	Agriculture	39.3	14.5	0.32	1.6	1.46
1	Agriculture products other	7.0	18.8	0.30	0.9	0.79
2	Rubber primary products	5.4	8.1	0.19	0.0	–0.21
3	Oil palm primary products	9.0	7.8	0.19	0.0	–0.20
4	Coconut	0.3	5.0	0.09	11.8	12.37
5	Tea	0.1	11.3	0.33	4.1	4.21
6	Livestock breeding, etc.	2.2	66.6	0.12	0.3	0.52
7	Forestry & logging	12.1	8.8	0.48	4.4	4.25
8	Fishing	3.2	21.3	0.46	0.0	–0.58
	Mining	1.8	28.7	0.90	0.9	–0.11
10	Metal ore mining	0.6	35.3	0.94	0.2	–1.16
11	Stone, clay & sand quarrying	1.2	26.4	0.91	1.2	0.41
	Manufacturing	58.9	37.7	2.36	13.0	16.33
12	Meat & meat product	0.2	87.9	0.36	0.4	0.19
13	Dairy production	0.4	49.4	1.95	1.8	–0.32
14	Preserved fruit & vegetables	0.2	54.7	2.59	3.3	1.59
15	Preserved seafood	0.2	80.4	0.63	3.1	12.74
16	Oils and fats	2.4	84.3	1.92	2.8	5.78
17	Grain mills products	0.2	57.8	0.89	0.0	–2.10
18	Bakery products	0.5	55.3	1.81	13.0	24.98
19	Confectionery	0.1	68.6	2.15	15.0	40.87
21	Other foods	0.7	35.5	1.06	3.5	3.77
22	Animal feeds	0.2	32.0	0.67	0.0	–0.99
23	Wine and spirits	0.1	19.0	1.49	29.5	34.56
24	Beef, soft drinks	0.8	40.1	2.92	17.0	23.43
25	Tobacco	0.6	38.8	1.79	5.0	5.25
26	Yarns and cloth	1.4	30.1	2.37	14.5	17.32
27	Knitted fabrics	0.4	29.8	2.20	11.9	13.88
28	Other textiles	0.2	38.9	2.99	16.4	21.93
29	Wearing appear	2.0	26.9	2.14	18.7	22.70
30	Leather industries	0.1	28.0	1.99	1.5	–0.75
31	Footwear	0.0	31.4	3.06	19.9	24.60
32	Sawmills products	2.7	73.7	3.04	5.6	9.59
33	Other Wood products	0.1	55.2	2.48	17.0	32.44
34	Furniture & fixture	0.6	51.8	3.30	19.7	34.14
35	Paper & board industries	1.3	32.2	1.38	6.7	7.79
36	Printed products	1.6	26.0	0.55	0.9	0.43
37	Industrial chemicals	3.7	33.1	0.68	1.7	1.55
38	Paints & lacquers	0.3	30.4	1.00	7.7	9.70

TABLE 4 *(Continued)*

IO code		Value added (%)	Σa_{ij}	$\Sigma a_{ij}t$	NRP	ERP
39	Drug & medicines	0.2	37.9	1.05	0.0	–1.69
40	Soap and cleaning preparations	0.5	27.8	1.25	9.4	11.31
41	Other chemical products	0.3	39.5	1.35	3.8	4.11
42	Petrol & coal industries	0.6	128.6	1.77	4.5	–9.61
43	Processed rubber	0.5	10.9	0.35	15.9	17.46
44	Rubber products	2.5	39.3	4.25	32.7	46.90
45	Plastic products	1.3	38.2	1.32	17.6	26.38
46	China & glass industries	0.8	32.0	1.68	15.2	19.90
47	Clay products	0.7	33.0	1.01	16.3	22.80
48	Cement, lime & plaster	1.2	42.6	1.41	5.5	7.15
49	Other non-metal products	0.8	50.3	1.87	9.7	15.75
50	Iron & steel	1.9	42.1	1.65	5.5	6.59
51	Non-ferrous metals	0.3	45.0	1.93	11.9	18.04
52	Metals furniture & fixtures	0.2	42.2	2.10	17.8	27.22
53	Structural metal industries	0.8	43.2	3.96	19.7	27.68
54	Other metal products	1.8	41.5	2.52	11.9	15.97
55	Industries machinery	0.3	28.9	1.20	2.9	2.39
56	Household machinery	1.8	32.1	0.92	1.2	0.44
57	Radio, TV & com. equipment	12.4	25.0	1.33	7.9	8.82
58	Electric appliance	0.3	39.7	1.11	4.3	5.29
59	Other electrical machinery	0.3	27.9	1.08	1.0	–0.12
60	Ship & boats	0.7	19.2	0.73	2.4	2.08
61	Motor vehicles	5.8	29.7	7.32	47.5	57.16
62	Cycles & motorcycles	0.6	47.8	9.19	24.3	28.93
63	Other transport equipments	0.9	12.3	1.81	0.7	–1.27
64	Instruments & clocks	0.2	32.4	1.05	0.8	–0.32
65	Other products	0.3	27.9	1.12	4.0	3.97
	All tradable sectors	100	22.7	1.4	7.7	9.6

NOTES: *Tradable production excluding crude petroleum and natural gas (I-O Sector 9).
NRP Nominal rate of protection (trade weighted nominal tariff rate).
ERP Effective rate of protection estimated using the fomula,

$$ERP_j = \frac{t_j - \Sigma a_{ij} t_i}{t_j}$$

where
a_{ij} = share of input i in cost of j at free trade prices;
t_j = nominal tariff rate of protection (NRP) on product j; and
t_i = nominal rate of protection on product i.

ERP for a given product depends upon tariffs on outputs and inputs and on the free trade input share. Overall protection to value added depends upon the interplay between output and input tariffs (t_j and t_i) and the share of imported inputs in production costs (a_{ij}). In other words, the overall tariff structure has both a tax and a subsidy element; whereas tariffs on the final good operate as a subsidy, tariffs on intermediate inputs operate as a tax.
SOURCE: Author's computations based on tariff schedule for 2002 (APEC website) and Input Output Tables 1991 (Department of Statistics, Malaysia, 2002).

— points to a clear incentive bias in favour of manufacturing over the other two sectors. The estimates also reveal a high degree of variability in ERP across industries. Within manufacturing, ERP associated with export-oriented industries (for example, household machinery; industrial machinery; radio, TV and computer equipment; and other electronics) is much smaller compared with domestic market-oriented sectors (for example, motor vehicles; cycles and motorcycles; metal products; rubber goods; plastic products; and furniture). Thus, the protection structure has a built-in dualistic pattern.

The implications of the cascading nature of the tariff structure for the incentive structure for domestic manufacturing is vividly demonstrated by the ERP estimates for individual I-O industries. Since the nominal protection rates (NRP) on final goods are generally higher than those on intermediate goods, the net effect of the nominal tariff structure has been to yield ERPs that exceed the nominal tariff rate in most industries. The rank correlation coefficient between NRP and ERP across the 65 sectors is rather weak (a mere 0.2). This relationship points to the importance of intermediate tariffs in determining the net protective effect of the tariff structure.

III.2 Export Taxes and Subsidies

Some primary products, notable forest products, crude oil, and selected palm oil products are subject to export duties. In 2000 these duties contributed to about 2 per cent tax revenues. A few agricultural products are also subject to prohibitions, restraints, and licensing requirements. There are no export duties on manufactured products. On the contrary, assistance is provided to manufactured exports through import tariff concessions, tax exceptions, export credit, export insurance and export credit guarantees, export promotion, and marketing assistance. In addition, Malaysia maintains two types of facilities for export processing with minimum customs formalities: licensed manufacturing warehouses and free trade zones. Malaysia is committed to phasing out these export subsidies in the manufacturing sector over eight years, to bring them in conformity with the WTO Agreement.

Despite Malaysia's remarkable export success over the past two decades, still export subsidies are an important item in the export incentive package. To what extent have these subsidies been important in explaining the "export success"? Has it been based primarily on sound economic fundamentals, while subsidies simply taking the form of unnecessary, costly transfers from the government to the export sectors? Answering these and related questions is important in assessing the implications of promised dismantling of export subsidies for Malaysia's future growth prospects.

III.3 Non-tariff Barriers (NTBs)

There are no import quotas in Malaysia and the existing import prohibitions are limited only to those implemented for national security reasons. The average NTB-coverage of import trade is relatively low by the regional standards (Table 5). However, some agricultural and industrial products have continued to remain under import licensing. As noted, following the onset of the recent financial crisis the licensing list was widened to cover a number of heavy and construction equipment, iron and steel products, industrial chemicals and certain electrical household goods. Consequently, the number of tariff lines subject to non-automatic import licensing requirements increased from 17 per cent in 1996 to 27.3 per cent in 1997 (WTO 2002, p. 39). There are no estimates of the actual import restraining effect of these controls. However, there is circumstantial evidence that the degree of restrictiveness involved in the licensing process has increased following the onset of the crisis. A close look at the commodity coverage of licensing suggests that a significant number of these products directly compete with domestic production by public sector enterprises. It could well be that licensing is used in a more restrictive manner in these areas to protect government monopolies at the expense of the private sector.

In 1998 and 1999, Malaysia revised its anti-dumping and countervailing legislation with a

TABLE 5
Coverage Ratio of Non-tariff Barriers in Import Trade[a]
(Unweighted, percent)

	1984–87	1988–90	1991–93	1997–2000
China	10.6	23.2	11.3	5.7
Indonesia	94.7	9.4	2.7	3.1
Korea, Rep.	8.8	4.0	2.6	1.5
Malaysia	3.7	2.8	2.1	2.3
Philippines	44.9	—	—	1.8
Thailand	12.4	8.5	5.5	2.1

NOTES: — Not available.
a. Calculated as percentage of import value of HS6 tariff lines affected by NTBs in total imports. NTBs include quantitative restrictions in the form of all types of licences and import authorization, quotas, import prohibitions, advanced import deposits, foreign exchange restrictions, fixed customs valuations, and state trading monopolies.
SOURCE: Hoekman, Mattoo, and English (2002, Table A-4 and WTO, *Trade Policy Review* (various country reports).

view to bringing it into conformity with the WTO agreement on Subsidies and Countervailing Measures. However, unlike many other WTO member countries, Malaysia has not relied heavily on contingent measures for controlling imports; during 1997–2001 Malaysia initiated only five anti-dumping investigations (of which three were provisional measures).[5] Nor has it resorted to other trade remedies, such as safeguarding legislation. At first look, this is indeed a positive development, but it could well be that there is no need to rely on anti-dumping or other contingency measures as discretionary licensing act as a more effective (hidden) tool of protection in the hand of the Malaysian authorities (Panagariya 2003, p. 280).

III.4 Non-border Measures Affecting Foreign Trade

Non-border measures, notably production subsides, are used to support domestic (non-plantation) agriculture. The total government outlay on these support measures amounted to RM995 million in 1998 (the latest year for which data are available). The rice sector stands out as the single most assisted agricultural activity. The government assists rice producers with a comprehensive fertilizer subsidy, a guaranteed minimum price and a price subsidy scheme. Poverty reduction and food security are often cited as the main rationale behind such policy. Under the guaranteed minimum price scheme, BERNAS (a privatized enterprise involved in state trading) undertakes to buy paddy from farmers at not less than the guaranteed minimum prices. Under the paddy price subsidy scheme, the government makes fixed payments to farmers for the paddy sold by them to any commercial rice mills. Total expenditure in 1998 on the three schemes amounted to RM547 million (US$150 million) or nearly 55 per cent of total production subsidies.

The wholly state-owned company PETRONAS (established under the Petroleum Development Act 1974) continues to be the main vehicle for the appropriation of resource rents from oil and gas; it has exclusive rights of ownership, exploration and production, and is responsible for planning, investment, and regulation of all activities relating to exploration of petroleum products. Foreign investment or participation in the upstream industry (processing and refining of petroleum and the manufacture of petrochemical products) is accepted in the form of production-sharing contracts (PSC); by the end of 2000, PETRONAS had signed more than sixty PSCs with foreign companies. Foreign equity participation up to

100 per cent is permitted in the mining sector depending on the level of investments, technology and risk involved in the project, the availability of Malaysian expertise in the exploration and mining, and the level of domestic value added.

As part of commitments of the WTO agreement on Trade Related Investment Measures (TRIMs), Malaysia abolished all local content requirements measures on 31 December 2000, except those in the motor vehicle sector. Malaysia requested an extension of the transition period until 2005 for eliminating local content requirements in the automobile sector as a condition for establishing a new industry. In compliance with the Agreement on Trade Related Intellectual Property Rights (TRIPs), Malaysia has enacted two new legislation — the Layout Design of Integrated Circuits Act 2000 and the Geographical Indications Act 2000 — and has amended the Patents Act 1983, Trade Marks Act 1976, the Copyright Act 1987, and the Industrial Designs Act 1996 (WTO 2002, p. 19).

The services sector, which accounts for over half of GDP, is not as open to trade as agriculture and manufacturing. Foreign commercial presence is by and large confined to joint ventures in which combined foreign ownership cannot normally exceed 30 per cent, although there has been modest relaxation of foreign ownership restrictions in telecommunications. Moreover, there are tight restrictions on the involvement of non-citizens in professional services and the recognition of overseas professional qualification. The Malaysian government has already signed the Information Technology Agreement and the Fourth and Fifth Protocols of the General Agreement on Trade in Services (GATS) concerning basic telecommunication services and financial services respectively. Nevertheless, the progress with implementing the proposed reforms is much slower than anticipated. There is no national treatment commitment on banking and insurance and no bindings securities.

Malaysia is not a party to the WTO Agreement on Government Procurement (GPA), though it does participate in the WTO working group on Transparency in Government Procurement. Government procurement procedures in Malaysia, notably preferential margins, tend to favour locally owned businesses, particularly where relatively small amounts are involved. Foreign suppliers are usually excluded for contracts of large amounts unless the supplies or services are not available locally; foreign contractors are allowed to participate only if there is no local expertise.

IV. Malaysia, WTO, and FTAs

Malaysia became a signatory to the GATT in 1957, but as most other developing country members, it was not particularly active in global trade policy debate during the ensuing three decades. There was, however, a notable turnaround in Malaysia's international trade diplomacy following the launching of the Uruguay Round trade negotiations in mid-1980s. It joined hand with the other four main ASEAN economies (Singapore, Indonesia, Thailand, and the Philippines) to form a strong common front in Uruguay Round market access negotiations, particularly relating to manufacturing trade. This new-found enthusiasm was underpinned by the growing importance of export-oriented manufacturing in Malaysian growth dynamism. As a member of the Cairns Group, Malaysia also supported the case put forward by the major agricultural exporting countries (led by Australia) for redressing long-standing disarray in world agricultural trade.

The onset of the recent financial crisis and the subsequent economic collapse seem to have ushered in a notable change in Malaysia's position on global trade liberalization under the WTO. The notable pro-activism that prevailed during the Uruguay Round negotiations and the three years following the setting up of the WTO in 1995 has begun to give way to anti-globalization rhetoric (or "Third Worldism"). Malaysia has begun to "bowl alone" in the WTO in a defensive manner, departing from the pro-liberalization common front it maintained with the other ASEAN countries in the Uruguay Round (Sally 2004). The Malaysian authorities have not "officially" backtracked from their call for further liberalization of manufacturing trade and processed tropical agricultural products (in particular palm oil), but unfortunately this agenda has been compromised by the new-found allegiance to Third Worldism.

In the lead-up to the Seattle Ministerial Meeting in 1999, instead of supporting launching of a new round of WTO negotiations ("Millennium Round") alongside Singapore and Thailand, Malaysia joined the developing country defensive position of the Group of 15 (G15) and the like-minded group (LMG) led by India, Pakistan, and Egypt. The G15/LMG position, which received unequivocal support from Malaysia, was that core developing country concerns relating to the implementing Uruguay Round commitments ("the implementation agenda") should be dealt with before proceeding with a new round, and the new round should be narrowly focused on market access issues relating to agricultural trade, trade in manufactured good, and services trade. These countries were against including new items on the reform agenda, in particular the four "Singapore Issues" — investment rules, competition policy, trade facilitation, and transparency in government procurements. They were also more defensive in the GATS negotiations.

Malaysia continued to adhere to this defensive supposition at the Cancun Ministerial. Since then it has begun to display some flexibility on Singapore issues and renewed commitment to the Doha Round under the leadership of Datuk Seri Abdullah Ahmad Badawi. However, future direction of Malaysian international trade diplomacy is still shrouded in uncertainty and ambiguity.

Malaysia is a founding member of the Association of the Southeast Asian nations (ASEAN) and the ASEAN Free Trade Agreement (AFTA). As part of its AFTA commitments, Malaysia agreed to provide tariff preferences to the AFTA member countries on 8,764 tariff lines under the Common Effective Preferential Tariff (CEPT). Starting in 1993, Malaysia has progressively placed 96 per cent of the agreed tariff lines under CEPT. Two-thirds of these tariff lines are duty-free. Malaysia has obtained AFTA approval for not including automobile products (218 tariff lines) into the CEPT scheme until 2005 in view of the difficulties faced by the domestic automobile industry. Tariff preferences granted under the CEPT scheme are subject to the fulfilment of rules of origin criteria, which have been set at minimum 40 per cent local or regional value-added.

In addition to the tariff preferences granted under the CEPT scheme, Malaysia provides the other five original member countries of ASEAN[6] with tariff preferences under ASEAN Preferential Trading Agreement (APTA) signed in 1997. APTA covers all products that are not included in the CEPT scheme and the preferential rates are 50 per cent to 100 per cent lower than the respective MFN rates. Between 1997 and 2003, when APTA was folded into AFTA, the simple average of APTA tariff decreased from 4.7 per cent to 3.9 per cent, as against an increase in the average MFN rate from rose from 8.1 per cent to 9.2 per cent.

The widening gap between the average MFN tariffs and the significant tariff preferences granted under the CEPT and APTA schemes, coupled with the widening gap between APTA and MFN rates, have set the stage for potential diversion of Malaysia's trade from non-AFTA trading partners to AFTA countries. No systematic study of such trade diversion has yet been undertaken. The share of imports from AFTA countries in total imports of Malaysia increased from 18 per cent to over 23 per cent between 1996 and 1999, but this increase cannot be ascribed to trade diversion alone.[7] Various other factors, including the significant depreciation of ASEAN currencies against non-ASEAN currencies in the wake of the Asian financial crisis and the growing important intra-regional cross-border trade in components within vertically integrated manufacturing production (in particular electronics and motor vehicle industries) many have contributed to the increase in intra-regional trade.

Until recently Malaysia was rather sceptical about the new-found global fondness for entering into regional/bilateral free trade agreements (FTAs). When Singapore announced in 1999 that it was negotiating an FTA with Japan in that year, Malaysian authorities warned that such a move would endanger not only the ASEAN's plans for further strengthening of regional economic relations and forming a prospective East Asian Economic Grouping (EAEG) involving China, Japan, and South Korea, but also ongoing process of multilateral trade liberalization under the WTO. It also expressed concerns that entering into bilateral deals by individual ASEAN countries would provide a "back-door" entry into ASEAN for third parties. However, over the past two years or so, the Malaysian Government appears to have chosen to join the FTA bandwagon. The key concern underpinning this policy shift appears to be that Malaysian exports would become less competitive because of the preferential treatments enjoyed by other competitors through FTA. Malaysia is currently in the process of negotiating FTAs with Japan (under the label of a Comprehensive Economic Partnership Agreement), and with India and Australia. It has also already signed a Trade and Investment Framework Agreement (often a prelude to FTA negotiations) with the United States, and is considering a number of FTAs with other major trading partners. Malaysia has also begun to show greater enthusiasm in forming ASEAN-wide FTAs with India, Japan, New Zealand, and Australia (Sen 2004; Arnold 2005).

V. Concluding Remarks

Malaysia certainly stands out among developing countries for its long-standing commitment to maintaining a relatively open trade and investment policy regime. Malaysia's record is particularly remarkable in that it entirely reflects unilateral and voluntary policy choices, not a result of influence by a major trading partner (as in the case of Taiwan, for example), conditionality imposed donor agencies, or multilateral negotiations under the auspices of the GATT/WTO. However, there are notable anomalies in the structure of protection that encourage channelling of resources into unproductive enterprises and projects. In particular, the protection structure is characterized by a dualistic pattern in which a export-oriented production takes place under virtual free trade regime side by side with a predominantly domestic market-oriented production assisted by tariff protection. The other lacuna of the trade policy regime include high degree of dispersion of tariff rates because of high tariff peaks relating to a few product lines, and increased reliance on non-automatic import licensing to regulate imports of a significant number of products which directly compete with domestic production by public sector enterprises. The rate of effective protection varies significantly across sectors/industries implying ample room for policy discretion, rather than pure economic considerations, in influencing resource allocation in the economy.

A systematic analysis of the magnitude and implications of export and production subsidies and various non-border measures impacting on foreign trade is not possible because of data limitation (without undertaking a major research effort). But with the benefit of hindsight and based on the general experience of other countries, one can argue that much remain to be done to redress growth retarding impact of policy failures in these areas. It is unfortunate if the new-found interests in "Third Worldism" and in FTA continue to distract the attention of Malaysian leadership from these much-needed reforms.

Despite the impressive achievements so far, Malaysia has a long way to go in bridging its development gap with the East Asian NIEs, let alone the major industrial powers in the OECD league. It has so far been in the first phase of the East Asian model of export-led industrialization characterized by manufacturing labour-intensive goods by combining low-cost labour with imported intermediate inputs and capital goods. As low-wage labour has been exhausted and wages begun to rise, future growth depend crucially on the ability to cross over to the second phase of this model (as did Taiwan and Korea in the second half of the 1970s) involving heavy reliance on capital and technology-intensive manufacturing.

The major challenge currently facing the Malaysian economy in gaining economic maturity is to move towards a more uniform incentive structure with a view to redressing the structural dualism in domestic manufacturing and upgrading of the workforce to create the resource base to enter world trade in high-tech and human capital-intensive product areas. Government policy initiatives in the form of restricting migrant worker inflows and implicitly discouraging labour-intensive production through greater selectivity in investment approvals will achieve this outcome only if the skill content of the domestic labour force can be upgraded at a rapid rate. These forced resource reallocation policies carried out independently of the economy's capacity to meet the demand for skilled labour can turn out to be counter-productive. This is so as the multinational enterprise affiliates which dominate export-oriented manufacturing have the alternative options of either upgrading their production depending on the availability of skilled labour or shifting operations to other low-cost sources in response to labour scarcity.

NOTES

1. In 2002, the simple averages bound, unbound, and applied tariff rates were 19 per cent, 35 per cent, and 9.2 per cent respectively. There, tariff averages, in particular the one relating to bound tariff, are remarkably low by the developing country standards. All agricultural tariff lanes were bound, but on average at much higher levels compared to manufacturing tariffs.
2. Figures reported in this paper, unless otherwise stated, come from the Ministry of Finance, *Economic Report* (various issues).
3. Tariff rates reported in this paper are from Malaysia's latest (2003) tariff schedule available in the APEC Secretariat online database.
4. Over the past two years, average tariffs in Indonesia and the Philippines have come down slightly below the Malaysian level, and the average tariff of China had approached the Malaysian level by 2004.
5. Total number of anti-dumping cases notified by the member countries to the WTO in 1999 amounted to 360, up from 150 in 1998.
6. Indonesia, the Philippines, Singapore, Thailand, and Brunei.
7. In fact, there is anecdotal evidence that CEPT concessions are hardly used by traders because of administrative complexities and various other reasons (Zainal Abidin 2002).

REFERENCES

Alavi, Rokiah. *Industrialisation in Malaysia: Import Substitution and Infant Industry Performance*. London: Routledge, 1996.

Ariff, Mohamed. *The Malaysian Economy: Pacific Connections*. Kuala Lumpur: Oxford University Press, 1991.

Arnold, W. "Asia Embraces Free Trade Deals". *International Herald Tribune*, 12 March 2005.

Athukorala, Prema-chandra. *Crisis and Recovery in Malaysia*, 2nd ed. Cheltenham: Edward Edgar, 2003.

Chee Peng Lim. "Heavy Industrialisation: A Second Round of Import Substitution". In *Japan and Malaysian Development in the Shadow of the Rising Sun*, edited by K. S. Jomo, pp. 244–62. London: Routledge, 1994.

Corden, W. Max. *Pragmatic Orthodoxy: Macroeconomic Policies in Seven East Asian Economies*. San Francisco: International Center for Economic Growth, 1996.

Department of Statistics, Malaysia. *Input-Output Table 1991*, Kuala Lumpur: Department of Statistics, 2002.

Hoekman, Bernard, Aaditya Mattoo, and Philip English. *Development Trade and the WTO*. Washington, D.C.: World Bank, 2002.

Lee, K.H. "Malaysia: The Structure and Causes of Manufacturing Sector Protection". In *The Political Economy of Manufacturing Protection: Experiences of ASEAN and Australia*, edited by Christopher Findlay and Ross Garnaut. Sydney: Allen and Unwin, 1986.

Leigh, Michael. "Politics, Bureaucracy, and Business in Malaysia: Realigning the Eternal Triangle". In *The Dynamics of Economic Policy Reforms in South-east Asia and the South-west Pacific*, edited by Andrew J. MacIntyre and Kanishka Jayasuriya, pp. 115–37. Singapore: Oxford University Press, 1992.

Lim, David. "The Dynamics of Economic Policy-making: A Study of Malaysian Trade Policies and Performance". In *The Dynamics of Economic Policy Reforms in South-east Asia and the South-west Pacific*, edited by Andrew J. MacIntyre and Kanishka Jayasuriya, pp. 94–114. Singapore: Oxford University Press, 1992.

Menon, Jayant, "How Open is Malaysia? An Analysis of Trade, Capital and Labour Flows". *World Economy* 25, no. 2 (2000): 235–56.

Panagariya, Arvind. "Trade Liberalization in Asia". In *Going Alone: The Case for Relaxed Reciprocity in Freeing Trade*, edited by Jagdish Bhagwati, pp. 119–301. Cambridge, Mass: MIT Press, 2003.

Power, John H. "Structure of Protection in West Malaysia". In *The Structure of Protection in Developing Countries*, edited by Bela Balassa. Baltimore, MD: Johns Hopkins University Press, 1971.

Sally, Razeen. *Southeast Asia in the WTO*. Southeast Asia Background Series No. 5. Singapore: Institute of Southeast Asian Studies, 2004.

Sen, Rahul. *Free Trade Agreements in Southeast Asia*. Southeast Asia Background Series No. 1. Singapore: Institute of Southeast Asian Studies, 2004.

Snodgrass, Donald. *Inequality and Economic Development in Malaysia*. Kuala Lumpur: Oxford University Press, 1980.

Wheelwright, E. L. "Industrialisation in Malaysia". In *The Political Economy of Independent Malaya*, edited by T. H. Silcock and E. K. Fisk. Canberra: Eastern University Press, 1963.

WTO (World Trade Organization). *Trade Policy Review: Malaysia 2001*. Geneva: WTO, 2002.

Zainal Abidin, Mahani. "ASEAN Integration: At Risk of Going in Different Directions". *World Economy* 25, no. 9 (2002): 1263–317.

Prema-chandra Athukorala is a Professor at the Division of Economics, Research School of Pacific and Research Asian Studies, The Australian National University.