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STRIVING
for
INCLUSIVE

DEVELOPMENT

**FROM PANGKOR
TO A MODERN MALAYSIAN STATE**

SULTAN NAZRIN SHAH

By the author of the highly acclaimed *Charting the Economy*, this book is the most comprehensive study yet of Malaysia's impressive economic and social transformation over the past 150 years.

Drawing on primary data sources, archival documents and cutting-edge national and international research, Sultan Nazrin Shah traces in detail Malaysia's fascinating journey, starting from the signing of the seminal Pangkor Treaty in 1874, through British occupation to the present.

The author unearths the true roots of Malaysia's economic and social development—its people, their human capital and well-being, as well as economic structures—including how the British established institutions for the expansion of the lucrative tin and rubber trade, and how they encouraged labour immigration to support their economic ambitions.

The outbreak of World War II and the Japanese occupation forced the British to rethink their strategy for Malaya, which experienced a sequence of turbulent events through to the formation of Malaysia in 1963.

The 1960s saw solid economic growth, but it failed to benefit the bulk of the population, helping to trigger ethnic clashes. One response by the government was the start of redistributive policies and aggressive affirmative action, with the launch of the New Economic Policy in 1971.

Almost 50 years later, sustained rapid economic growth and a modernizing economy have led to fast-rising incomes, the ending of extreme poverty and the emergence of a sizeable middle class, despite setbacks during financial and economic crises.

Striving for Inclusive Development makes it clear that the country still faces huge and complex challenges. Building on its analysis of the past, this landmark book concludes with a forward-looking assessment of these challenges, and sets out Sultan Nazrin Shah's vision for an inclusive and sustainable future.





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SULTAN NAZRIN SHAH



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**For
Azlan and Nazira**

Sejambak melati ayahanda suntingkan,
Buat anakanda pewaris watan,
Sejarah negara ayahanda paparkan,
Moga anakanda jadikan pedoman.

About the Author

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Abbreviations

1MDB	1Malaysia Development Berhad
ASEAN	Association of Southeast Asian Nations
BAFIA	Banking and Financial Institutions Act
CIAM	Central Indian Association of Malaya
CPM	Communist Party of Malaya
CV	Coefficient of variation
EPU	Economic Planning Unit
EU	European Union
FAMA	Federal Agricultural Marketing Authority
FDI	Foreign direct investment
FELCRA	Federal Land Consolidation and Rehabilitation Authority
FELDA	Federal Land Development Authority
GDP	Gross domestic product
GLC	Government-linked company
GLIC	Government-linked investment company
GLEs	Government-linked entities
GNI	Gross national income
GNP	Gross national product
HDI	Human Development Index
HEI	Higher Education Institution
HICOM	Heavy Industries Corporation of Malaysia
HIS	Household income survey
ICT	Information and communications technology
IUUM	International Islamic University Malaysia
ILO	International Labour Organization
IMF	International Monetary Fund
INCEIF	International Centre for Education in Islamic Finance
ISIC	International Standard Industrial Classification
KRI	Khazanah Research Institute
LINUS	Literacy and Numeracy Screening
LNG	Liquefied natural gas
MARA	Majlis Amanah Rakyat
MCA	Malayan Chinese Association
MCP	Malayan Communist Party
MIC	Malayan Indian Congress
MP	Malaysia Plan
MTUC	Malayan Trade Union Council
NAP	National Agricultural Policy

NDP	National Development Policy
NEAC	National Economic Advisory Council
NECC	National Economic Consultative Committee
NEP	New Economic Policy
NIE	Newly industrialized economy
NKEA	National key economic areas
NVP	National Vision Policy
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
OPP	Outline Perspective Plan
PADU	Education Performance and Delivery Unit
PEMANDU	Performance Management and Delivery Unit
PES	Post-enumeration survey
Petronas	Petroleum Nasional Berhad
PISA	Programme for International Student Assessment
PMFTU	Pan Malayan Federation of Trade Unions
PMGLU	Pan Malayan General Labour Union
PNB	Permodalan Nasional Berhad
PPP	Purchasing-power parity
PWT	Penn World Tables
R&D	Research and development
RIDA	Rural Industrial Development Authority
RISDA	Rubber Industry Smallholders Development Authority
SABK	Sekolah Agama Bantuan Kerajaan (Government-aided Religious School)
SDG	Sustainable Development Goal
SITC	Standard International Trade Classification
SME	Small and medium-sized enterprise
SMKA	Sekolah Menengah Kebangsaan Agama (National Islamic Secondary School)
SNA	System of National Accounts
STEM	Science, technology, engineering, and mathematics
TFP	Total factor productivity
TFR	Total fertility rate
TIMSS	Trends in International Mathematics and Science Study
TPA	Tin Producers Association
TRIPS	Trade-Related Intellectual Property System
TVET	Technical and Vocational Education and Training
UiTM	Universiti Teknologi MARA (MARA University of Technology)
UK	United Kingdom
UMNO	United Malays National Organisation
UNDP	United Nations Development Programme
US	United States

Preface

In my book *Charting the Economy*, published in 2017, I presented a new set of estimates for Malaya's gross domestic product (GDP) in the first four decades of the 20th century. This was a period during which Malaya was under British colonial administration. I also made some comparisons of the dynamics of colonial economic growth with that of post-independence Malaysia. The GDP estimates in that book arose from the research that I undertook during my doctoral studies at Harvard, and which I have continued since through my 'Economic History of Malaya' project—see www.ehm.my.

This publication, *Striving for Inclusive Development: From Pangkor to a Modern Malaysian State*, presents the results of my continuing research. It is based on comprehensive analysis of primary economic and social data, extensive study of archival documents, and an in-depth review of the extant colonial and contemporary economic literature. The analysis reveals the impressive progress Malaysia has made, while also illuminating the challenges that remain. Faced with the possibility of the country falling into the 'middle-income trap', a new approach is now needed to realize the goal of transforming Malaysia into a more prosperous, resilient and cohesive nation.

I continue to be intellectually indebted to many people and institutions for generously sharing ideas, insights, and information, without which this book would not have come to fruition. Although they are too numerous to mention individually, it gives me great pleasure to acknowledge all those who have supported and enthusiastically encouraged my research.

I would like to recognize the continuing support of Azirah Hashim, Executive Director of the Asia–Europe Institute of the University of Malaya for hosting the Economic History of Malaya project. My appreciation also goes to the Department of Statistics–Malaysia, especially for the outstanding support given by Chief Statistician Mohd Uzir Mahidin and his staff, as well as the Ministry of Education–Malaysia, and the staff of the National Archives of Malaysia, Singapore, and the United Kingdom.

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It also gives me great pleasure to acknowledge the continued leadership vision provided by Richard Leete, manager of the Economic History of Malaya project. The project has received valuable technical inputs from David Demery, Frank Harrigan, and C. Peter Timmer. I have also received helpful support from several research assistants who have worked with the project, including Chan Kar Ee, Cheng Fan Soon, Noor Ismawati Mohd Jaafar, Angela Lee, Vincent C. S. Lim, Sharon Ng, Sonia Persson, and Rabbi Royan.

In any single book covering some 150 years of the country's economic history, there are bound to be omissions, as well as some important topics that deserve to have been covered in greater detail. I hope that the findings presented here will help inspire further research to fill such gaps. I also hope that the lessons learned from our history will encourage us to strive for greater inclusivity of national institutions, and fairer economic and social policies that will improve the welfare and well-being of all Malaysians.

Sultan Nazrin Shah
Istana Iskandariah

Introduction

This book, which traces the evolution of what is now Malaysia from a far-flung colonial trading outpost at the time of the Pangkor Engagement in 1874 to a modern, diversified economy, is divided into five parts, in 10 chapters, which chronicle the events and the transformations—as well as the people—that marked this journey.

Part 1, *Forming a Nation and a Mosaic Population*, comprises two introductory chapters that focus on how Malaysia and its institutions were formed, and how its population grew.

Chapter 1 outlines the historical evolution of the separate geographical entities of the Malay peninsula over the past 150 years, their changing governance, and how they eventually came together to form Malaysia. It describes the institutions that the British progressively established during their lengthy rule, primarily if not exclusively in order to consolidate their economic and strategic interests. These included political and administrative structures, a legal and security system, and economic policies intended to facilitate investment, trade, and fiscal stability. However, World War II shattered the illusion of British protection of the Malay states, and of Sabah and Sarawak. The post-war proposal to create a Malayan Union with centralized government control and common citizenship aroused widespread opposition among the Malays and led to an upsurge in nationalism. In Britain, too, after the war, there was growing acceptance of the need for a new focus on Malaya's 'development', and for a managed transition to independence.

Chapter 2 begins with an overview of the history of Malayan population census-taking, and of how colonial administrators introduced an ethnicity-based classification that served to separate different communities. It assesses how colonial immigration policy responded to meeting the labour-force needs of the peninsula's growing extractive economy, and the huge impact that migration had on population growth and ethnic composition. Migrants settled in and around tin-mining areas, estate plantations, and the steadily growing towns located in the west coast states. The northern and east coast states attracted far fewer migrants and remained populated predominantly by peninsula-born Malays. At independence in 1957, occupational segregation and segmented settlement patterns were a legacy of colonial immigration policy: they had become institutionalized, and ethnicity had become closely identified with a person's economic function. After 1957, immigration was at first curtailed, but since the 1980s a much more liberal policy has been adopted, with new waves of Asian foreign labour entering Malaysia to meet

shortages of lower-skilled workers. Yet in the other direction, there have been persistent outflows of the more highly skilled Malaysians, weakening the country's human capital base.

Part 2, *Enhancing Human Well-being*, traces the development of the country's segmented education and health systems, and the steps taken by colonial and Malaysian governments to build human capital and advance well-being.

Chapter 3 reviews the nature of Malaya's highly segmented education system, where few children—almost all of them from privileged families—had opportunities beyond the basic primary level. During late colonialism, and especially after independence, the fundamentals of the education system began to change, with progressively expanded opportunities that eventually provided much greater access to all levels of education. A more integrated school system gradually emerged to help support nation building and to meet the country's changing human resource needs. Yet six decades after independence—and despite hugely positive trends in education indicators—the *quality* (rather than the *quantity*) of education has not reached the originally expected standards, an issue experienced by many developing countries. The education system is not responding well enough to the needs of the labour market, nor is it ensuring a successful transition for all from school to decent work.

Chapter 4 examines how Malaya's health policy evolved to support colonial economic development. As infectious diseases took a heavy toll on migrant workers and threatened to decimate the labour force, improved sanitation and health services became imperative. But most measures were implemented in urban areas, and so had little impact on the bulk of the rural population. Only after World War II, with heavy investment in expanding the health infrastructure, improving nutrition, controlling infectious diseases, and adopting disease-prevention and health-promotion measures, was there real progress in health care for the rural population. Health outcomes improved spectacularly, with dramatic gains in life expectancy at birth, consolidating the conditions for a fertility transition and subsequently a demographic dividend which would go on to support economic growth.

Part 3, *Expanding and Diversifying the Economy*, presents the book's core economic analysis. It starts with a discussion of the establishment of institutions, and the expansion of the trade in tin and rubber in the colonial period, and proceeds to an evaluation of economic performance since independence.

Chapter 5 begins in the late 19th century, when most of the world's tin was mined in the Federated Malay States. The first two decades of the 20th century

then saw Malaya become the world's leading producer of rubber, as demand soared, largely as a result of the advent of the mass production of automobiles in the United States. Malaya's economy was ravaged, however, by the Great Depression of the 1930s, when rubber and tin prices collapsed. In the absence of social safety nets, many people suffered great hardship during these years. By the early 1950s, the colonial administration had more or less rebuilt the pre-World War II commodity-exporting economy, following the destruction of economic activities during the Japanese occupation. From independence through to 1969, much of the colonial legacy remained. However, while the economy sustained solid growth during these years, the rewards were not evenly felt, with the rural population, and Malays in particular, remaining distanced from the modern sector and enjoying little benefit.

Dissecting the factors underlying post-independence economic growth, Chapter 6 focuses on the increase in productivity, and considers the effects that structural change and the demographic transition have had on Malaysia's economy. Although economic growth compared favourably with that in most other developing countries in the 1950s, the reasons why Malaysia has not performed as well as the Republic of Korea, Singapore, and Taiwan are explored, with deficits in human capital identified as a key part of the answer. This chapter also considers the extent to which Malaysia's development is sustainable, by looking at development through the lens of the accumulation of 'genuine wealth'—the country's portfolio of natural, human, and manufactured capital.

Chapter 7 continues the story of economic development since 1970. The 1970s saw the emergence of an interventionist state, and the start of redistributive policies and aggressive affirmative action intended to sever the colonial association of ethnicity with economic function. The two decades of the New Economic Policy (1971–1990) saw rapid growth and modernization of the economy, and significant social rebalancing in economic terms. Growth accelerated in the first part of the 1990s, appearing to vindicate the policy redirection that followed the commodity crisis of the mid-1980s; but there were signs of overheating and growing economic imbalances in these years, which contributed to vulnerabilities in the economy, and eventually led to severe corrections during the Asian financial crisis. Nonetheless, at the dawn of the new millennium, real incomes were far higher than they had been in 1990, and solid economic growth continued through to 2008, when Malaysia's economy again stalled as the global financial crisis and Great Recession hit. At the start of the current decade, the economy was again growing, even if concerns were being voiced about slowing economic momentum, institutional weaknesses, and the risks of becoming caught in the 'middle-income trap'.

Part 4, *Achieving Growth with Equity*, turns to the processes by which the transition from a predominantly agricultural economy to a modern one led to a huge reduction in poverty, and to more equitable income distribution.

Chapter 8 analyzes, at the commodity and state level, the role of agriculture in the country's structural transformation and in the enormous reduction in absolute poverty. After 1970, structural transformation accelerated in nearly all states, and rural Malays found higher-paid jobs in urban areas. The productivity of farmers who remained behind rose nearly as fast as that of workers in urban areas, so that the gap between rural and urban labour productivity started to narrow. Fast-rising incomes in rural and urban areas led to a rapid decrease in poverty. By our present decade, absolute poverty has been virtually eliminated, essentially driven by economic growth and the diversification of agriculture.

Chapter 9 begins with an analysis of consumption inequality in colonial Malaya, where Europeans—and a tiny minority of other communities who were living a high-status European lifestyle—were vastly better off than the masses. Indeed, differentials in private consumption expenditure *widened* during the first four decades of the 20th century. 'Growth with equity' became the primary policy objective after independence, starting with the New Economic Policy, as the government played a more interventionist role in managing economic policy, blending it with affirmative social objectives. Standards of living improved sharply from the 1970s onwards, and real average household income more than doubled between 1995 and 2016. A sizeable middle class, which includes members of all communities, has emerged. The country has also made some progress towards a more equitable distribution of income among ethnic groups. Even so, while the income share of the bottom 20 per cent of individuals has improved in recent years, it remains unacceptably low.

Part 5, *Creating an Inclusive and Sustainable Future*, concludes this book-length inquiry with a forward-looking assessment of some of the central challenges facing Malaysia today. It underlines the fact that the country has made impressive development progress since the end of colonial rule, and that all communities have played an important role. But the time is now ripe for Malaysians to evaluate their circumstances afresh and make key choices about future directions.

'Sultan Nazrin Shah's economic history of Malaysia is an intellectual feast of the highest order. This is the definitive study of Malaysia's long quest for inclusive economic development. With remarkable historical knowledge, technical precision, and comprehensive and judicious exploration of the data, Sultan Nazrin Shah tells the fascinating story of a country that emerged from the imbalances and inequalities of the colonial era to face head-on the challenges of forging a modern, multi-ethnic, and inclusive society.

Malaysia has made remarkable strides, as the book cogently describes, but also faces complex challenges in the years ahead. *Striving for Inclusive Development* is an invaluable guide for understanding Malaysia's past and charting its future.'

Jeffrey D. Sachs

University Professor at Columbia University

'This is an exceptional and timely book, important for the future of Malaysia. By grounding his analysis on the most thorough study of Malaysia's past growth that has ever been undertaken, Sultan Nazrin Shah is able to explore the nation's future opportunities with a rare combination of technical mastery and practical realism. A successful society depends upon maintaining a critical mass of informed citizens: this lucid book is a model contribution to this process.'

Professor Sir Paul Collier, University of Oxford

(author of *The Future of Capitalism*)

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