

INVESTMENT REGIME:**MALAYSIA****1. Overview of the FDI in Malaysia**

The Malaysian investment regime is designed to serve the changing needs and directions of the country's industrial policy, in which the government has always played an active role. Like Thailand, Malaysia went through various phases of import substitution strategy and export promotion strategy as shown in table 1 below. Since 1980, the country has maintained an open policy towards trade and investment. As a result, FDI has played an important role in the capital formation and hence, the development of the economy. As can be seen in table 2, in the early nineties, net FDI inflows contributed to almost a quarter of the country's annual Gross Fixed Capital Formation and equivalent to over 8% of the country's GDP.

Table 1. Stages of Trade Policies in Malaysia, 1957 – Present

Phases	Trade Policies	Emphasis in Manufacturing Production
P h a s e 1	Import-Substitution (IS) Strategy: 1957-70	- Simple consumer goods; - Domestic market-orientation
P h a s e 2	Export-Oriented (EO) Strategy: 1970-80	- Free Trade Zones; - Electronics and textiles for exports; - Export-promotion
P h a s e 3	Second Round of Import-Substitution (IS) Strategy: 1980 - 85	- Domestic market-orientation for selected heavy industries
P h a s e 4	Export-Oriented (EO) Strategy: 1980-present	- Resource-based industries; - Export-promotion; - Manufacturing ++ - Cluster approach: • Internationally-linked • Resource-based • Policy-driven

S o u r c e : T h a m S i e w - Y e a n (2 0 0 3)

Table 2. Trend of Foreign Direct Investment (FDI) in Malaysia, 1991-2002 (RM Million)

Year	Net* FDI in Malaysia	Nominal Gross Domestic Product (GDP)	FDI as a% of GDP	Gross Fixed Capital Formation (GFCF) in current prices	FDI as a% of GFCF
1991	11,118	135,124	8.2	30,599	23.1
1992	13,088	150,682	8.7	53,497	24.5
1993	14,799	172,194	8.6	63,356	23.4
1994	12,017	195,461	6.1	76,357	15.7
1995	14,586	222,473	6.6	107,825	13.5
1996	18,356	253,732	7.2	121,384	15.1
1997	17,790	281,795	6.3	121,494	14.6
1998	10,648	283,243	3.8	75,982	14.0
1999	14,801	300,764	4.9	65,841	22.5
2000	14,393	342,157	4.2	87,729	16.4
2001	2,105	334,589	0.6	83,345	2.5
2002	12,173	361,597	3.4	86,010	14.2

Note: Net: Inflows after taking into account the outflows arising from liquidation of FDI in Malaysia and loan repayments to related companies.

Source: Tham Siew - Yeap (2003)

Since the economic crisis that broke out in 1997, net FDI inflows into Malaysia have dwindled with the general regional economic environment and with the persistent ailing of the Japanese economy, the country's major investor. Lower FDI inflows were experienced also in Indonesia, the Philippines and Singapore. Unlike Thailand, the Malaysian financial sector did not shoulder such large non-performance loans that led to a spade of mergers and acquisitions that drew in FDI flows. The controversial capital control that was implemented in 1998 was targeted at stemming the flow of short-term volatile portfolio investments. There is no evidence that the policy affect the FDI flows since there were no controls on current account transactions, the repatriation of profits, dividends, interest, fees, and other incomes.

The post-crisis drop in FDI has prompted Malaysia to take a major step to liberalize its investment regime. Pursuant to Sixth ASEAN Summit meeting in 1998, where members are urged to take "bold measures" to facilitate speedy recovery from the crisis -- including "short

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term measures to enhance ASEAN Investment Climate", Malaysia offered 100% foreign equity ownership in all manufacturing sectors without any export conditions for all new investment projects or expansion/diversification projects applied by December 31, 2003. This move allows foreign manufacturers to compete in the domestic market. Exceptions were provided for only 7 activities¹ reserved for local small and medium enterprises. In June 2003, the Ministry of Trade and Industry decided to make the liberalization permanent. Thus, bar the seven activities mentioned, the entire Malaysia manufacturing sector is now fully open to foreign investment.

2. The FDI Regime

The Malaysian FDI regime is tightly regulated in that all foreign manufacturing activity must be licensed regardless of the nature of the business in which it is engaged. The most interesting feature is that, Malaysia does not have laws governing FDI that lay down the general principles and rules for foreign participation in local businesses as is the case of Thailand and its Foreign Business Act. This has allowed the government maximum policy and regulatory space to screen and control FDI to suit the economic and industrial needs of the particular time.

For example, unlike in Thailand, the foreign equity restrictions in Malaysia are not determined by a law. Malaysia only has "Foreign Equity Guidelines" that can be easily changed by the Government. Until 1998, foreign equity share limits were made conditional on performance and conditions set forth by the industrial policy of the time. For example, in the past, the size of foreign equity share allowed for investment in the manufacturing sector hinges on the share of the products exported in order to support the country's export-oriented industrial policy. FDI projects that export at least 80% of production or production involve advanced technology promoted by the state, no equity conditions are imposed (EIU 2001). However, the restriction was suddenly abolished through the decision of the Ministry of Trade and Industry (MITI) when the country is in dire need of FDI after the economic crisis in 1998 as mentioned earlier.

¹ These activities include metal stamping, metal fabrication, wire harness, printing, paper and plastic packing, plastic injection molded components and steel service centers.

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This sudden policy-shift in opening up the investment regime undoubtedly affects the country's long-standing social policy of redistributing wealth in favor of ethnic Malays and other indigenous people known as the *bumiputras*. This particular goal is provided for by the Federal Constitution and operationalized by the National Development Policy. The goal is to have 30 % of the corporate wealth held by the *bumiputras*. In the area of foreign investment, this translates into the requirement that a portion of the residual of the corporate equity not held by foreign investor is to be reserved for *bumiputras*. Only when the residual equity is not taken up by *bumiputras* can it be allocated to *non-bumiputras*. Similar restrictions apply to employment. Indeed, this policy runs against the principle of non-discrimination advocated by the WTO and most bilateral and regional trade and investment treaties. However, Malaysia managed to ensure that this particular restriction does not hinder potential FDI flow into the "targeted industries" by ensuring that attractive incentive packages and world-class infrastructure and facilities can more than offset its negative impacts. This sudden policy-shift towards opening up the entire manufacturing industries to foreign investors, bar 7 minor ones, in June 1998 showed that, when economic necessity dictates, Malaysia is able to forego this socio-political goal that has been in place for the past three decades.

Besides abandoning the export requirement in 1998, Malaysia has, for a long time, taken steps to minimize other negative incentives, such as nationalization and appropriation, double taxation, joint venture requirements, domestic employment restrictions and restrictions on remittance of profits. Again, as there are no domestic laws that set the general rules or standards on these issues, much has to be achieved through bilateral agreements.

In terms of protection of foreign investment, foreign investors are theoretically guaranteed against expropriation of property without compensation by virtue of Article 13 of the Federal Constitution. In the absence of a comprehensive investment law that can provide a blanket protection against expropriation for all foreign investments, Malaysia has relied extensively on bilateral investment guarantee agreements , or IGAs, to:

- Protect against nationalisation and expropriation
- Ensure prompt and adequate compensation in the event of nationalisation or expropriation
- Provide free transfer of profits, capital and other fees

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- Ensure settlement of investment disputes between private parties and Government under the Convention on the Settlement of Investment Disputes (ICSID) of which Malaysia has been a member since 1966².

It should be noted that, unlike Thailand, Malaysia does not offer post-entry national treatment. This is mainly due to the *bumiputras* policy. Until to date, Malaysia has concluded IGAs with member states of ASEAN and Organization of Islamic Countries (OICs) and 67 other countries³.

While IGAs allow the Malaysian Government to be selective in providing investment protection, it should be noted that the bilateral investment agreements run against the MFN principle of the WTO since each IGA is negotiated individually and independently. However, since BITS have been limited to treatment of investors after entry (such as protection against expropriation and restrictions regarding repatriation of profits), the sovereign right to screen and control entry of FDI is therefore preserved.

The question of whether there should be a multilateral rule governing the post-entry treatment of investment has been raised at the Working Group on the Relationship between Trade and Investment (WGRTI)⁴. Many developing countries have made it clear that they are opposed to negotiation on investment in the WTO, at least for the time being, and prefer to continue the analysis and study in the Working Group. On the specific issue concerning BITS, they argue that the existing BITS already provide adequate legal protection to investors, and question whether a WTO agreement on investment would indeed increase investment flows. They have expressed concern that a multilateral agreement would add obligations to developing countries while limiting their ability to align investment inflows with national development objectives. Given the European Union's failure to convince many developing countries to accept the four "Singapore Issues" at the Cancun Meeting in September 2003, the prospect of having a multilateral agreement on investment is at this point, rather bleak. Hence, the global FDI regime is likely to continue to be dominated by BITS in the foreseeable future.

² Details on Malaysia's dispute settlement mechanism can be found at the APEC Secretariat web site at www.apecsec.org.sg

³ Contents of IGAs are provided by the Malaysian Industrial Development Authority (MIDA) at www.mida.gov.my

⁴ Doha Ministerial Meeting 2001: Briefing Note TRADE AND INVESTMENT: Negotiate, or continue to study?

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An empirical study undertaken by Hallward-Driemeier (2003) of the World Bank that examined 20 years of bilateral FDI flows from the OECD to developing countries. It found little evidence that BITs have stimulated additional investment. A similar study by UNCTAD (1998) also found weak correlations between the signing of the BITS and changes in in FDI flows. Other factors, such as macroeconomic stability and the degree of regional integration were found to be significant. Hallward-Driemeier found that BITs do not act as substitutes for broader economic reforms. Rather, they complement them.

Looking back at the case of Malaysia, this may also be the case. After all, Japan, the country's long-standing largest investor, has not concluded an IGA with Malaysia. The country's superior infrastructure, policy coherence in terms of investment, trade and relatively open trade regime and macroeconomic and political stability appear to have played a greater role in attracting FDI.

Besides the IGAs, Malaysia also has bilateral Avoidance of Double Taxation Agreements. As for employment restrictions, one must examine the restriction in a domestic context. For example, Dobson (1998) wrote that while each foreign Bank's subsidiary is limited to hiring two expatriate personnel, this restriction was in fact less stringent than that imposed on domestic banks. Furthermore, the restriction has been somewhat relaxed lately to allow for intracorporate exchanges and short-term assignments after the economic crisis. On 17 June 2003, the Ministry of Industry and Trade (MITI) has established new guidelines on the employment of expatriate personnel that guarantee automatic approval of certain number of expatriate posts and extend the length of maximum employment for both executive and non-executive posts. Again this shows the extreme fluidity of the investment regime in Malaysia.

3. Investment and Industrial Policy

As mentioned earlier, Malaysia's investment policy, and perhaps its trade policy as well, is designed to serve the country's industrial promotion and development policy. This is not surprising considering that the authority involved with investment regulation and promotion is the Malaysian Industrial Development Authority (MIDA), which presides under the Ministry

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of Industry and Trade (MITI)⁵. Therefore, to talk about investment policy, one must refer to the industrial policy.

Malaysia's industrial policy during the seventies and the eighties was focused on promoting exporting industries. As a result, export performance was used as the main conditionality for foreign equity ownership. Basically, the greater the percentage of the products exported, the higher the foreign equity share. For example, if the project exports more than 80% of the products, 100% foreign ownership is allowed. Consequently, foreign firms in Malaysia have been confined to export industries. Only in 1998 were such restrictions lifted in order to revive the sluggish FDI inflows.

Before the mid eighties, incentives were based on the investment project. But then after, incentives were provided according to the product and activity-based in order to steer investment towards the 12-targeted industries that were specified in the First Malaysian Industrial Plan (1986-1995). Since then, investment incentives have become much more selective and have changed over time depending on the priority sectors specified in subsequent industrial plans, which focused increasingly on high technology industries, research and development, development of human resources, development of industrial linkages and manufacture of machinery and equipment (see table 3).

Table 3 List of Major Investment Incentives (Manufacturing Sector)

Tax Incentives	Tax Concessions
Pioneer Status	Exemption of income (for high technology companies and companies in an approved Industrial Linkage Scheme) for five years, thereafter a 30% corporate tax, an added incentive for Sabah, Sarawak, Labuan and designated Eastern Corridor of Peninsula Malaysia, a 15% corporate tax.
Investment Tax Allowance	An allowance of 60% (80% for Sabah, Sarawak, Labuan and designated Eastern Corridor of Peninsula Malaysia) of qualifying capital expenditure incurred during the first five years. The allowance can be utilized to offset against the 70% (85% for Sabah, Sarawak, Labuan and designated Eastern

⁵ This is markedly different from the case of Thailand where the authority concerned with foreign investment -- i.e., the Department of Business Promotion -- resides within the Ministry of Industry, and the main investment promotion authority, the Board of Investment, is attached to the Office of the Prime Minister. Only the Industrial Estate Authority of Thailand comes under the Ministry of Industry. Given a coalition government where each Minister belongs to a different political party or different faction within the same party, coordination between Ministries have not been smooth.

Tax Incentives	Tax Concessions
	<p>Corridor of Peninsula Malaysia and 100% for high technology companies) of the statutory income in the year of assessment. Any unutilized allowance can be carried forward to the following year until the amount has been used up.</p> <p>Different incentives given to companies specializing in R&D activities, an allowance of 100% for R&D, Contract R&D and Technical/Vocational Training Companies (50% for in house R&D companies) in respect of qualifying capital expenditure incurred during the first ten years. The allowance can be utilized to offset against the 70% of the statutory income in the year of assessment. Any unutilized allowance can be carried forward to the following year until the amount has been used up.</p>
Reinvestment Allowance (RA)	<p>An allowance of 60% of capital expenditure incurred by the companies. The allowance can be utilized to offset against the 70% (100% for Sabah, Sarawak, Labuan and designated Eastern Corridor of Peninsula Malaysia and companies which can improve significantly in productivity) for of the statutory income in the year of assessment. RA is given for a period of 5 years beginning from the year of first reinvestment is made.</p> <p>Upon expiry of RA, companies producing promoted products/engaging in promoted activities are eligible for Accelerated Capital Allowance on capital expenditure where 40% of initial rate and 20% of annual rate will enable capital write off within 3 years.</p>
Incentives for Industrial Adjustment	Incentive given to manufacturing sector for reorganization, reconstruction or amalgamation within the same sector, enhancing industrial self sufficiency, improving industrial technology, increasing productivity and enhancing efficient use of manpower and resources.
Incentives to strengthen the Industrial Linkages Scheme <ul style="list-style-type: none"> • Incentives for Large Companies • Incentives for Vendor 	<ul style="list-style-type: none"> • Tax deductions for expenditure incurred for training of employees, product development. • Pioneer status or an ITA status for five years with 100% exemption on the statutory income
Incentives for Export	Double deduction for promotion of exports, double deduction on freight charges, double deduction of export credit insurance premiums. Tax exemption on the value of increased exports, industrial building allowance and export credit refinancing scheme
Incentives for Promoting Malaysian Brand Names	<ul style="list-style-type: none"> • Double deduction for expenditure local advertisement. • Professional fees paid to companies promoting Malaysian Brand names.
Training Incentive <ul style="list-style-type: none"> • Pre Employment Training • Double Deductions for expenses Incurred for Approval Training • Human Resources Development Fund 	<ul style="list-style-type: none"> • Single deduction on training expenses incurred prior to the commencement of business. • Double deductions on expenses incurred of employees trained at an approved training institutions

Tax Incentives	Tax Concessions
Infrastructure Allowance	Companies which are engaged in the manufacturing or commercial sector in East Malaysia and the Eastern Corridor whereby expenses incur on qualifying capital infrastructure are given an infrastructure allowance of 100%. The allowance can be utilized to offset against the 85% of the statutory income in the year of assessment. Any unutilized allowance can be carried forward to the following year until the amount has been used up.
Incentives for Research & Development Contract R&D Company	<ul style="list-style-type: none"> • Eligible for Pioneer Status with full income tax exemption at statutory level for five years, or an Investment Tax Allowance (ITA) for 100% on qualifying capital expenditure within 10 years. The ITA can be used to offset against the 70% of the statutory income in the year of assessment. • Eligible to apply for ITA 100% on qualifying capital expenditure incurred within 10 years. The ITA can be utilized to offset the 70% of the statutory income in the year of assessment. • Eligible to apply for ITA of 50% on qualifying capital expenditure within 10 years.

Source : Malaysia, 2003 (Economic Report 2002/2003)

3. Assessment of the Impact

According to Tham Siew-Yean (2003), FDI has played a significant role in the development of the Malaysian industry and the attainment of its socio-political goals. Since the opening up of the investment regime in 1985, the contribution of foreign establishments to total value-added of the manufacturing sector increased from 33.4 to 44.2 per cent during 1986 to 1999 and their employment share increased from 30.3 to 38.1 per cent during the same period of time. Due to the rapid expansion in the manufacturing sector, Malaysia ceased to be labor surplus country and began to face a labor shortage in the early nineties. The excess demand on labor have pushed up wages considerably.

In terms of R&D and technology diffusion, in the year 2000, foreign establishments contributed to 64% of the total private R&D expenditure, which was roughly equivalent to the spending on the part of the government. Malaysia's total R&D expenditure is equivalent to 0.5% of its GDP in the year 2000. There is no quantitative assessment of the extent of technology transfer from MNCs. However, several studies indicate that technology diffusion has taken place through informal channels rather than formal written contracts. The impact on industrial linkages are also sketchy. Studies conducted in the late seventies and early eighties showed little backward linkages established in the various industries. Studies in the nineties showed the opposite. It is believed that competitive pressures in the global market

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have forced TNCs to develop a more flexible production and automation that allow more proximate sourcing in order to cut costs. But even then, very few small and medium local firms are involved in these linkages mainly because of technological and human capacity constraints.

Malaysia's investment policy has to a certain extent, achieved the socio-political goals of transferring wealth to Malays. Ownership of share capital (at par value) of limited companies held by Bumiputras increased from 2.4 per cent in 1970 when the policy was first implemented, to 19.1 per cent in 1999. Since the share is still well below the target level of 30 per cent, it is likely that the current restrictions on ownership will be maintained, although their coverage may become more limited in the face of increasingly investment liberalization.

Finally, in terms of environmental impact, Malaysia has attempted to raise the environmental standard by amending the Environmental Quality Act (1974) by requiring that licenses are required for pollution of the air, noise, soil, inland waters and the disposal of oil and wastes. All industrial projects are required to conduct an Environmental Impact Assessment (EIA) and the Department of Environment holds broad powers to undertake Environmental Audit. Despite the regulatory upgrade, according to Rajenthiran, Arumugam (2002), "*environmental management is partly saddled by weak institutions, relatively weak enforcement, a lack of industrial players' participation, potential conflicts between the federal and state governments, and politicization*".

4. Conclusion

The prominent feature of the Malaysian FDI regime is that it is tightly screened and controlled so as to ensure that the FDI inflows serve domestic economic and social goals. This case-by-case screening of investment projects has been made possible by the absence of a general investment law that allows maximum discretion on the part of the administration. In order to be able to effectively screen FDI. The general regime is relatively closed in terms of both pre-entry and post-entry treatment of foreign investment. However, generous exemptions and plenty of fiscal incentives ensure that the general restrictions do not hinder FDI flows into the promoted areas.

In general, Malaysia has been relatively successful in attracting FDI despite its relatively closed FDI policy as a result mainly of its *bumiputra* policy and the absence of a law that offers some minimum investors' protection. The main contributing factors are the country's

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extremely flexible investment regime that is adaptable to the specific needs of the industry or the economy at a particular time. The abandoning of the *bumiputra* policy after 3 decades in the post-crisis period would confirm this. Selective, but comprehensive and carefully-crafted fiscal incentive packages served to attract FDI despite what appears to be a relatively stringent regime also served to attract FDI. Malaysia currently has 16 incentive schemes designed specifically for various industries⁶ as well as activities⁷ that it would like to promote.

Although, like Thailand, Malaysia also offers an array of fiscal incentives such as tax credits and duties exemptions, there is no doubt that the country's political and macroeconomic stability, coherent industrial policy, relatively liberal trade regime, skilled human resource and superior infrastructure provide the necessary "enabling environment" for FDIs.

⁶ These are the manufacturing industry, the tourism industry, agriculture, services, shipping and transport, manufacturing-related services, multi-media supercorridor and knowledge-based industries.

⁷ These are environmental management, research and development, training, operational headquarters, regional distribution centers, international procurement centers, representative offices and regional offices.

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