
REGIONAL DISPARITIES, INCOME INEQUALITY, AND POVERTY A Cumulative Causation from Malaysia's Experience

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Changes in economic structure are normally associated with an economy's transformation from an emphasis on agriculture to a more modern, more urbanized, and more industrially diverse manufacturing and services economy. Structural change refers to the relative importance of sectors in the economy such as production and factor use, increases in the rate of accumulation, shifts in the sectoral composition of economic activities (industrialization) focusing initially on the allocation of employment, change in location of economic activities (urbanization) and accompanying demographic transition, decreasing poverty, and inequality in income distribution.

Income inequality and regional disparity happen because of uneven structural change occurring at the same time in different regions. Each region often experiences different patterns of economic and demographic structural changes as well as differences in concentration of population, investment, manufacturing products, labour productivity, and job creation. The levels of regional income have strong linkages with the establishment of the manufacturing sector. Since independence and subsequently after the

implementation of the New Economic Policy (NEP)¹ in 1971, the Malaysian Government has made serious efforts to decentralize manufacturing activities. This is because industrial imbalance has an important relation to the imbalance of household's monthly income, poverty, and unemployment.

Production sources, especially natural resources, capital, and labour, are imperfectly scattered. Many economic activities are concentrated in particular regions, where such regions are an important source of international specialization and trade (Krugman 1999). Uneven regional growth and distribution in the process of structural change are affected by three key factors: firstly, natural resource advantages (imperfect factor mobility), secondly, economies of concentration (imperfect divisibility), and finally, transport and communication (imperfect mobility of goods and services) (Hoover and Giarratani 1999).

Although a study by the World Bank showed that newly industrializing countries, which have rapid export growth and economic growth, have significantly reduced absolute poverty, improved human welfare, and reduced the inequality of income distribution during the thirty years before the onset of the financial crisis in the middle of 1997 (World Bank 1993; Nakao 1997; Ishak 2000), it did not show how this rapid growth creates inequality of economic growth among regions in that particular country. In other words, the general relationship between economic growth and poverty reduction is clear: growth will decrease poverty (World Bank 2001, p. 52). However, rapid growth did not occur in all regions but was restricted to manufacturing-based regions. Thus, regional equality has to be sacrificed to promote maximum national growth by concentrating resources in the most competitive regions (or growth centres), although at the same time governments try to decrease regional and income inequality.

Most of the imported capital (foreign direct investment; FDI) for promoting growth was concentrated in export products. In other words, international factors (FDI and export products) can have strong linkages to regional growth and disparities. At the same time, the location of FDI inflows to a developing country is related to several factors. These include a large domestic market, faster economic growth, higher per capita income, higher level of existing FDI stock, a more liberalized (open) trade regime, higher efficiency wages, and remoteness from the rest of the world (Chunlai 1997*a*, 1997*b*). All of these factors are positively related to FDI inflows, except for remoteness which is negatively related.

Efficiency wages are wages above the market level. Firms that offer higher efficiency wages will attract talented and productive workers to their organizations. In developing and less developed countries, many multinational

companies are able to offer higher efficiency wages to their workers. These firms tend to concentrate in high growth industries and have the benefits of economies of scale. Those industries have the ability to attract FDI and promote economic growth. Remoteness tends to be negatively related to FDI. This is due to the fact that a remote region usually has a low density of economic activities. At the same time, a remote region is far from other cities, towns or ports, and thus incurs higher transportation costs when exporting goods. Low density and higher transportation costs would discourage investors from investing in the region.

In general, most of this comparative advantage was located in developed regions and this led to widening gaps between regions. Hence, without government intervention, income inequality will get worse in the early process of industrialization and will become better when internal and external diseconomies of urbanization (concentration) take place.

REGIONAL DISPARITIES, INCOME INEQUALITY, AND POVERTY

Malaysia comprises two parts: Peninsular Malaysia (also known as West Malaysia) and East Malaysia (situated on the Borneo Island). Being colonized by the British for the period of 172 years has resulted in a dualist economy in Peninsular Malaysia. Transportation investment under the British was highly dependent upon the "growth capacity of the region" (Leinbach 1975). The British strategy was based on the so-called "building upon the best" and this initiated the origins of contemporary regional imbalanced growth in Malaysia (Jomo and Ishak 1986). The economic dualism inherited from colonialism continued after independence in 1957. In some aspects, the dualist economic phenomenon became worse. This dualist phenomenon can be divided into three categories: location (urban-rural); economic activities (modern-traditional); ethnicity (Malay, non-Malay). The groupings of economic activities can also provide a picture of the structure of average incomes of workers. High income is usually referred to as the modern urban sector, medium income is referred to as the modern rural and government sectors, while low income is referred to as the traditional urban and traditional rural sectors. In terms of regional income levels, most of the traditional rural sector was focused in the low-income states. The modern rural sector and traditional urban sector were concentrated in the medium income states, while the modern urban sector was concentrated in the high-income states (Table 5.1).

Generally, before and in the 1970s, the high level of the average income of workers was about one and a half to two times that of the medium level

TABLE 5.1
Distribution of GDP by Origin, 1967 (%)

	<i>Agriculture</i>	<i>Modern Agriculture</i>	<i>Traditional Agriculture</i>	<i>Mining</i>	<i>Manufacturing</i>	<i>Commerce</i>	<i>Service</i>	<i>Others</i>
High income states								
Selangor	11.6	7.6	4.0	6.2	19.9	21.9	19.6	20.8
Penang	15.7	5.4	10.3	—	12.2	22.0	27.6	22.5
Perak	26.2	11.6	14.4	18.2	6.8	16.5	20.7	11.6
Median income states								
Johor	40.7	27.4	13.3	2.0	10.1	14.1	22.8	10.3
Malacca	33.5	26.7	6.8	0.2	6.0	17.8	29.9	12.6
N. Sembilan	35.8	27.6	8.2	1.2	14.3	15.8	20.3	12.6
Pahang	37.1	15.3	21.8	14.2	3.7	15.8	16.4	12.8
Low income states								
Kedah	44.6	19.2	25.4	1.3	4.0	12.5	25.6	12.0
Kelantan	41.1	16.4	24.7	1.9	3.3	11.4	37.0	5.3
Perlis	44.9	4.7	40.2	4.1	3.9	11.4	31.8	3.9
Trengganu	36.7	9.2	27.5	15.0	2.0	12.3	27.5	6.5
Peninsular Malaysia	27.0	14.4	12.6	7.1	11.3	17.5	22.4	14.7

Source: Kok Cheong Lim (1976, p. 83).

of income and about three to four times that of the low level of income (Table 5.2). Besides that, about 60 per cent of workers in Peninsular Malaysia were found in the traditional rural sector and traditional urban sector. Less than one fifth of workers in Peninsular Malaysia were found in the modern urban sector and more than one fifth in the modern rural and government sectors (Government of Malaysia 1971).

In terms of the identification of ethnic groups with their economic activities, the majority of Malays lived in the northern states with many of them working in the traditional rural sector. Most of the non-Malays lived in the southern and western states, where the modern urban sector or the modern rural sector was the important economic activity. In fact, the income of Malays

TABLE 5.2
GDP per Capita, Sectoral Shares of GDP, and Urbanization by State, 1970

	<i>GDP per capita</i>	<i>Sectoral shares of GDP (%)</i>			<i>Urban share of population²</i>
	<i>RM</i>	<i>A</i>	<i>B</i>	<i>C</i>	
Selangor	1,520	14	38	48	45
Penang	939	18	22	60	51
Perak	911	29	35	36	28
Negeri Sembilan	907	37	25	38	21
Pahang	855	42	23	35	19
Johor	835	40	21	39	26
Malacca	761	31	10	59	25
Kedah/Perlis	605	58	12	30	13
Trengganu	536	38	22	40	27
Kelantan	420	43	12	45	15
Peninsular Malaysia	912	29	28	43	29

Notes: 1. Sectors: A = Agriculture, forestry, fishing; B = Mining, manufacturing, construction, utilities; C = Transportation, commerce, government, other services.

2. minimum urban concentration: 10,000 persons.

Source: Salih et al. (1978, p. 89).

was generally lower than non-Malays (Table 5.3). After independence, the situation of regional disparities in Malaysia did not differ much or became worse based on some indicators. Courtenay (1972, p. 142) argued that many kinds of assistance had been given to rural development. However, with the purpose of balancing the growth and particularly maintaining the earning power of the export sector, which is the major support for the economy, the government had to encourage commercial and industrial development. In turn, the rapid growth of the commercial and industrial development brought rising imbalance of GDP per capita between the Malays and the rest as illustrated in Table 5.3. This was due to the fact that the Malays resided mostly in the less-developed states of Terengganu, Kelantan, Perlis, and Kedah while the Chinese and Indians were mostly in the more-developed states. Growth in the developed states occurred not only because of government policies but also because of the pattern of development itself.

The distributions of mean monthly household income between ethnic groups, from 1957 to 1970, showed that the gaps between Malays and non-

TABLE 5.3
State by GDP per Capita and Distribution of Population
by Ethnicity, 1965 (%)

State	GDP per capita (RM)	Population by Ethnicity (%)		
		Malays	Chinese	Indians
Four Northern States				
Terengganu	459	80	13	7
Kelantan	449	92	6	2
Perlis	369	91	6	3
Kedah	536	76	18	6
	518	68	20	12
Three Southern States				
Pahang	762	51	39	10
Johor	985	55	34	11
Melaka	729	50	40	10
	638	50	40	10
Four Western States				
N. Sembilan	1,085	35	47	18
Perak	901	42	40	18
Selangor	891	40	43	17
Penang	1,493	30	47	23
	870	29	57	14
Peninsular Malaysia	850	50	36	14

Source: Lim (1973, p. 139).

Malays were worsening. The Gini coefficient ratio slightly increased from 0.412 in 1957 to 0.502 in 1970. The Chinese-Malay disparity ratio increased from 2.16 to 2.25 in the same period (Table 5.4). Besides that, the distribution of mean monthly household income between urban and rural areas from 1957 to 1970 also showed increases in ratio to mean monthly urban-rural income from 1.84 in 1957 to 2.14 in 1970 (Table 5.5). In terms of the poverty rate in 1970, it was alarming in the rural areas where the majority were Malays.

The levels of regional income have strong linkages with the establishment of the manufacturing sector. Subsequently, the industrial imbalance has an important relation to the imbalance of household monthly income and the regions' GDP levels. Most of the industrial areas were located in the west coast of Peninsular Malaysia.

TABLE 5.4
Distribution of Mean Monthly Household Income and Poverty between
Ethnic Groups, 1957–1970 (RM)

	<i>Mean Monthly Household Income</i>				<i>Poverty</i>
	<i>1957–58</i>	<i>1967–68</i>	<i>1970</i>	<i>(Per cent increase) 57–70</i>	<i>(Per cent) 1970</i>
Malays	139	163	177	27.34	65.0*
Chinese	300	349	399	33.00	26.0
Indians	237	260	310	30.19	39.0
Others					44.8
Total	215	240	267	24.18	
Gini ratio	0.412	0.444	0.502	21.85	
Disparity ratio:					
Chinese/Malays	2.16	2.14	2.25	4.17	
Indians/Malays	1.71	1.60	1.75	2.34	
Chinese/Indians	1.27	1.34	1.29	1.57	

Sources: Snodgrass (1980, pp. 71, 76, 79, and 82); Government of Malaysia (1991*b*, p. 46).

TABLE 5.5
Distribution of Mean Monthly Household Income between
Urban and Rural Areas, 1957–1970 (RM)

	<i>Mean Monthly Household Income</i>				<i>Poverty</i>
	<i>1957–58</i>	<i>1967–68</i>	<i>1970</i>	<i>Per cent increase 57–70</i>	<i>Per cent 1970</i>
Urban	319	360	432	35.42	21.3
Rural	173	185	202	16.76	58.7
Peninsular Malaysia					49.3
Ratio of means	1.84	1.95	2.14	16.30	

Sources: Snodgrass (1980, pp. 71, 76, 79, and 82); Government of Malaysia (1991*b*, p. 46).

Although empirical studies on growth and regional disparities have shown (Williamson 1965 and Mera 1975) that there exists a close inverse connection (inverted U-shaped relationship) between unbalanced regional development and the stage of development (time), it may be different in Malaysia's case. Experience in trends of growth and income inequality showed that Malaysia, as well as Korea and Indonesia, departed from the general trend of inverted U-shaped relationship between economic growth and income inequality (Ishak 2000). This is because poverty alleviation in the process of structural change was the ultimate goal of the national development policy.

In Malaysia's case, eradicating poverty and economic restructuring were the main objectives of Malaysia's redistributive policies, namely the NEP that has been exercised since 1971. This was because economic development during the 1950s and 1960s concentrated mainly on accelerating the maximum growth strategy of the economy through investment in infrastructure to promote maximum development of export commodities and import substitution industries. Although this strategy did serve to strengthen the economy considerably, it resulted in the unbalanced diffusion of economic activities and contributed to a marked economic activities differential between ethnic and geographical location. It did not deal adequately with the problem of social (ethnic) and economic imbalances faced by Malaysian society (Government of Malaysia 1991*a*). This was inherited from the colonial period, which caused economics of dualism in Malaysia. This economic dualism was based on economic activity as well as ethnic and geographic linkages. Most of the Malays, who lived in low-income states, were involved in the traditional agriculture sector and were less productive, while non-Malays (most of them migrated to Malaya in the early 1900s) lived in high-income states (colonial concentration states), and were involved in the non-agriculture sector or modern agriculture sector with high productivity. Dualistic economic development that exists in almost all states in Malaysia was due to foreign domination and exposure to colonization during most of the past century. Most of the indigenous Malay population which remained in the agriculture sector, mainly in rural areas or in the less-developed regions in the east coast of Peninsular Malaysia, was largely bypassed by the new development (Reynolds 1982).

NEP objectives were to be achieved through rapid growth with equal distribution. It aimed to strike an optimum balance between the goals of economic growth, to ultimately eliminate the social and economic inequalities and imbalances in the country, and promote and strengthen national integration by reducing the wide disparities in economic development between states and between the urban and rural areas in the country. Manufacturing was seen as the engine of growth to spearhead the restructuring

of economic activity and society (Rajah and Ishak 2001). The goals of the regional development policy in Malaysia can be defined as decreasing the socio-economic gap between regions and increasing the quality of life in the less-developed states/areas, goals which parallel the national development goal of “growth with equal distribution”.

Among the four regional development strategies, the industrial dispersal strategy was seen as the most important tool to overcome the problem of unequal development between regions in Peninsular Malaysia (as the engine of growth to spearhead the restructuring of economic activity and society). The strategy was introduced after 1956 under the First Malaya Plan (1956–1960). This strategy was accompanied by the rural strategy on urbanization and creation of new growth centres to enhance industrial development and urbanization, scatter new development and growth, especially to the less-developed states, increase economic opportunities as well as monthly income, decrease poverty and unemployment in the less-developed areas by diversifying the economic base of the less-developed states, and generate higher economic growth. This included the establishment of industrial areas as growth centres, which were located near major towns. Furthermore, under Investment Incentive Acts, a number of instruments have been used to achieve this strategy, which included tax holidays, investment allowances, and the provision of industrial estates and free trade zones in a particular development location to make it more attractive to private investors. This strategy was also used as a tool to decrease out-migration from rural areas (and less-developed states) to the established congested areas (more-developed states). Regional development plans were integrated into the national plan in the Outline Perspective Plan and every five-year development plan (Table 5.6).

Since 1971, under the NEP aimed at eradicating poverty and restructuring society, the Malaysian Government has tried to promote a balance in economic activities in order to overcome marked economic differences between geographical locations. Development planning has changed from “building upon the best” (under British colonial times) to “accelerating maximum growth” (1950s and 1960s), and finally to “growth with equal distribution” (1971 until now).

The NEP was the essence of Malaysia’s First Outline Perspective Plan (1971–1990) which included four five-year plans; i.e., Second Malaysia Plan (1971–1975) up to Fifth Malaysia Plan (1986–1990). The Second Outline Perspective Plan (1991–2000), which was implemented within the framework of the New Development Policy (NDP), consisted of two five-year plans; i.e., the Sixth and Seventh Malaysia Plans. Currently, Malaysia is undergoing its Third Outline Perspective Plan (2001–2010), which is implemented within

TABLE 5.6
National Planning, 1950–2010

<i>Long-term Development Plan/ National Policy</i>	<i>Years</i>	<i>Five year Development Plan</i>
	1950–1955 1956–1960 1961–1965 1966–1970	Draft Development Plan, Malaya First Malaya Plan Second Malaya Plan First Malaysia Plan
First Outline Perspective Plan New Economic Policy (1971–1990)	1971–1976 1977–1980 1981–1985 1986–1990	Second Malaysia Plan Third Malaysia Plan Fourth Malaysia Plan Fifth Malaysia Plan
Second Outline Perspective Plan National Development Policy (1991–2000)	1991–1995 1996–2000	Sixth Malaysia Plan Seventh Malaysia Plan
Third Outline Perspective Plan National Vision Policy (2001–2010)	2001–2005 2006–2010	Eighth Malaysia Plan Ninth Malaysia Plan

Sources: Asan (2004; 2006).

the National Vision Policy (NVP), and consists of the Eighth and Ninth Malaysia Plans.

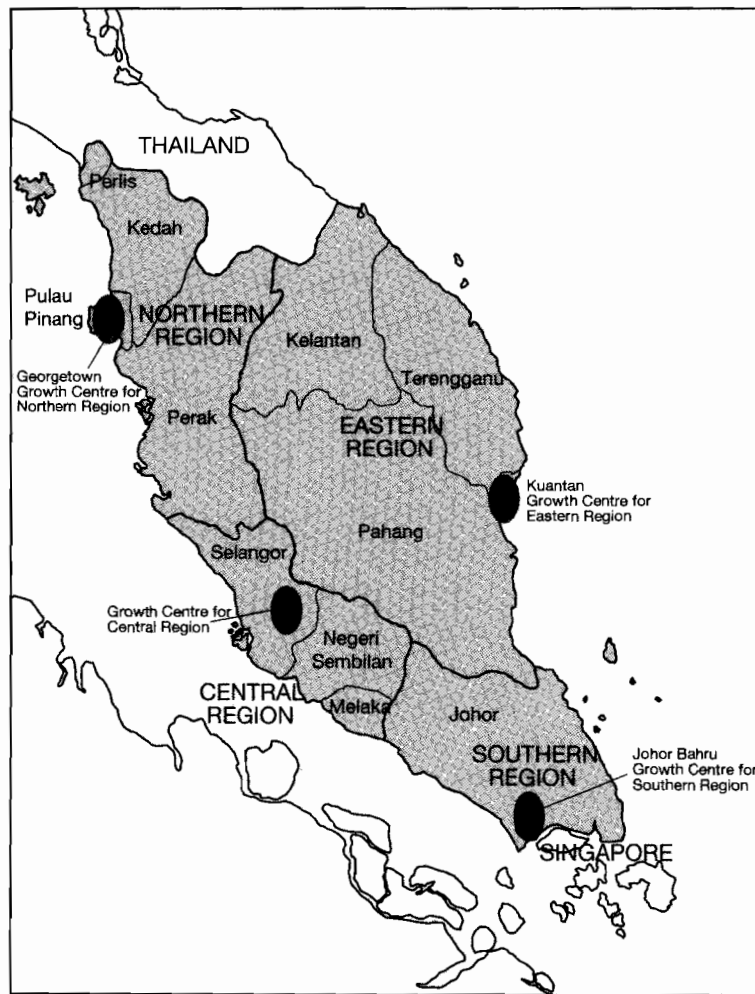
Even though the NEP ended in 1990 the country's development objective of achieving "growth with equal distribution" is still being given priority in the NDP and NVP due to the fact that the objective has not yet being achieved, as echoed by the then Prime Minister Abdullah Badawi when delivering the Ninth Malaysia Plan, "the wealth and income gaps still exist especially among ethnic groups, and between urban and rural areas".

REGIONAL DEVELOPMENT IN THE MALAYSIAN CONTEXT

Since 1981 the states in Malaysia have been aggregated into six regions (Government of Malaysia 1981). Each region consists of a contiguous landmass, which is in a more or less uniform stage of development and may encompass an entire state or a group of states. In general, these regions

share similarities in resources and in terms of economic activities and have been dominated by a single metropolitan area (growth centre). Peninsular Malaysia consists of four regions while East Malaysia consists of two regions (Figure 5.1).

FIGURE 5.1
Location of Regions in Peninsular Malaysia



Source: Asan (2006).

Regions in Peninsular Malaysia (West Malaysia):

1. *Northern region*: consists of four states — Perlis, Kedah, Penang, and Perak, with Georgetown as the growth centre.
2. *Central region*: consists of four states — Selangor, Federal Territory of Kuala Lumpur, Negeri Sembilan, and Melaka, with Kuala Lumpur as the growth centre.
3. *Eastern region*: consists of three states — Kelantan, Terengganu, and Pahang, with Kuantan as the growth centre.
4. *Southern region*: consists of one state, Johor, with Johor Bahru as the growth centre.

Regions in East Malaysia:

1. *Sabah region*: consists of Sabah (including Federal Territory of Labuan), with Kota Kinabalu as the growth centre.
2. *Sarawak region*: consists of Sarawak, with Kuching as the growth centre.

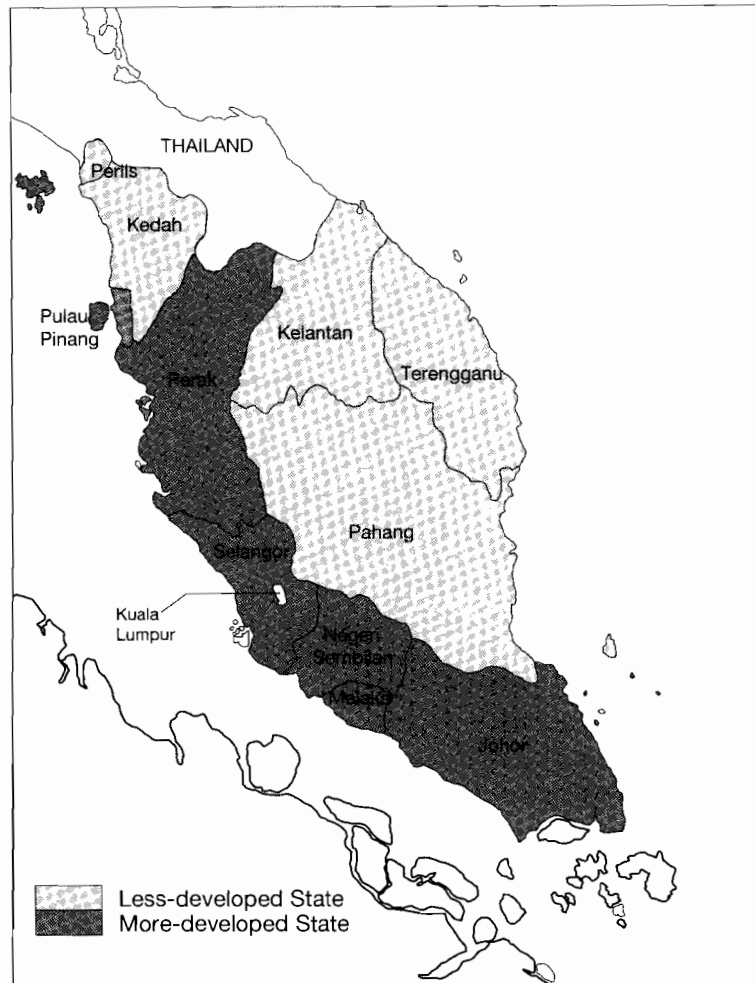
Starting in 2001 the composite development index has been used and the states in Malaysia have been divided into two categories based on the level of development (Government of Malaysia 2001*b*, p. 116). The composite development index comprises ten indicators: GDP per capita, unemployment rate, urbanization rate, registration of cars and motorcycles per 1,000 of population, poverty rate, population provided with piped water, population provided with electricity, infant mortality rate, and number of doctors per 10,000 of population. Based on these indicators, states in Malaysia have been divided as follows (Figure 5.2):

1. *More developed states*: Johor, Melaka, Negeri Sembilan, Perak, Penang, Selangor, and Federal Territory of Kuala Lumpur.
2. *Less developed states*: Kedah, Kelantan, Pahang, Perlis, Sabah, Sarawak, and Terengganu.

URBANIZATION, INCOME REDISTRIBUTION, AND POVERTY REDUCTION

The manufacturing industry (secondary sector) is often thought of as the engine of economic growth for a country. However, this sector is often concentrated in the urban areas which leads to a large migration of people from the rural areas to the major cities such as Kuala Lumpur, Petaling

FIGURE 5.2
Location of States by Levels of Development in Peninsular Malaysia



Source: Asan (2006).

Jaya, Penang, and Johor Bahru. In Malaysia the urbanization rate is based not only on the rural-to-urban migration but also on the natural increase in population in that particular area. The urbanization rate² in Peninsular Malaysia increased rapidly from 27 per cent in 1970 to 62 per cent in 2000, and it was more concentrated in the developed states. Although the

Primacy Index (PI)³ fell from 0.38 in 1991 to 0.29, which showed that the concentration of population in the primary city was decreasing, three major towns in the less-developed states (Kota Bharu, Kelantan; Kuala Terengganu, Terengganu; and Kuantan, Pahang) were taken over by metropolitan towns in Selangor (Subang Jaya, Ampang Jaya, and Shah Alam, Table 5.7). Kuala Lumpur remained the primary city with a population size of approximately three times that of the second-largest urban centre, Ipoh, in 1991 to two times that of the second-largest urban centre, Johor Bahru, in 2000. In 2000, metropolitan towns located in less-developed states in Peninsular Malaysia were Kuantan, Kuala Terengganu, and Kota Bharu, which were four to five times smaller than Kuala Lumpur.

TABLE 5.7
The Primacy Index for Major Metropolitan Towns, Malaysia, 1991 and 2000

	1991			2000		
	<i>Metropolitan Towns</i>	<i>Population (thousands)</i>	<i>Ratio KL to the others</i>	<i>Metropolitan Towns</i>	<i>Population (thousands)</i>	<i>Ratio KL to the others</i>
1	Kuala Lumpur	1,145.3	1.0	Kuala Lumpur	1,305.7	1.0
2	Ipoh	468.8	2.4	Johor Bahru	642.9	2.0
3	Johor Bahru	441.7	2.6	Klang	626.6	2.1
4	Klang	368.4	3.1	Ipoh	536.8	2.4
5	Petaling Jaya	351.0	3.3	Subang Jaya	437.1	3.0
6	Kuching	277.9	4.1	Petaling Jaya	432.6	3.0
7	Kota Bharu	234.6	4.9	Kuching	422.2	3.1
8	Kuala Terengganu	228.1	5.0	Ampang Jaya	357.9	3.6
9	Georgetown	219.6	5.2	Shah Alam	314.4	4.2
10	Kuantan	202.4	5.7	Kota Kinabalu	306.9	4.3
11	Seremban	193.2	5.9	Seremban	290.7	4.5
	Primacy Index		0.38			0.29

Source: Siti (2007, p. 23).

However, in terms of distribution of the urbanization ratio in Peninsular Malaysia from 1970 to 2000, it responded well to the government policy. The ratio of the urbanization rate of Kuala Lumpur to the other areas decreased (Table 5.8). For example, the ratio of the urbanization rate of Kuala Lumpur to Kedah has decreased from 8 in 1970 to only 3 in 1995. In general, in the year 2000, the ratio of the urbanization rate of Kuala Lumpur to other more-developed states was around 1 to 2, while for the less-developed states, it was around 2 to 3. In 1980, the ratio of the urbanization rate of Kuala Lumpur to other more-developed states was around 2 to 3, while for the less-developed states, it was around 2 to 11. The urbanization rate in the more-developed states ranged from 25 per cent to 100 per cent in 1970, and increased to 55 per cent to 100 per cent in 2000. The urbanization rate in the less-developed states ranged from 0 per cent to 27 per cent in 1970, and increased to 34 per cent to 50 per cent in 2000. It showed that the distribution of the urbanization rate in Peninsular Malaysia has become more equal.

The ethnic composition of the urban population changed with increased involvement of Malays in the industrial and commercial sectors of the economy in line with the NEP (Table 5.9). In 1970 only about 14.8 per cent of Malays lived in urban areas. However, by 2000 this proportion rose to 50.6 per cent.

TABLE 5.8
Urbanization Rate by State, 1970–2000

		<i>Urbanization rate</i>					
		<i>70</i>	<i>80</i>	<i>85</i>	<i>90</i>	<i>95</i>	<i>00</i>
More-developed states	Selangor	45.0	34.2	34.5	55.3	80.8	88.3
	Penang	50.7	44.7	49.3	60.4	77.0	79.5
	Perak	27.5	32.2	32.3	33.6	56.2	59.5
	Johor	26.3	35.2	35.3	43.7	54.4	63.9
	Melaka	25.1	23.4	23.3	23.3	49.5	67.3
	Negeri Sembilan	21.5	32.6	32.6	42.1	47.3	55.0
	Kuala Lumpur	100	100	100	100	100	100
Less-developed states	Terengganu	27.0	42.8	42.8	51.1	46.6	49.4
	Kedah	12.7	13.9	14.4	16.0	35.1	38.7
	Kelantan	15.1	27.7	27.7	32.1	33.5	33.5
	Pahang	19.0	26.2	26.2	24.6	35.0	42.1
	Perlis ¹	—	8.7	8.8	11.2	29.6	33.8

Note: 1. Perlis, urbanization rate 1970 = 0

Source: Asan (2004).

TABLE 5.9
Distribution of Population by Ethnic Groups, 1999 and 2000

1991	<i>Total</i>		<i>Urban</i>	
	<i>Number (thousands)</i>	<i>Per cent</i>	<i>Number (thousands)</i>	<i>Per cent</i>
Bumiputra	10,646.4	60.6	4,410.2	39.7
Chinese	4,945.0	28.1	3,817.5	76.0
Indian	1,394.0	7.9	897.2	63.8

2000	Number (thousands)	Per cent	Number (thousands)	Per cent
Bumiputra	14,248.2	65.1	7,258.7	50.6
Chinese	5,691.9	26.0	4,848.1	85.9
Indian	1,680.1	7.7	1,356.1	80.0

Sources: Government of Malaysia (2005, p. 23).

In terms of the rate of growth of the urban population, the highest was Malays/bumiputra followed by Chinese and Indians. However, the Chinese still accounted for more than three quarters of the urban population.

Although generally the urbanization rate has increased in less-developed states (due to the increase of new economic activities), high out-migration still occurs from the less-developed states to the more-developed states. These migrants consist of both low- and high-skilled workers and constitute Malays/bumiputra and non-Malays/bumiputra. This phenomenon occurs mainly because of the large disparity of wages between the less-developed and more-developed states. For example in 1984 the average monthly household income in Kuala Lumpur was 3 times higher than that in Kelantan (Table 5.10). Although in 2007 the ratio of Kuala Lumpur incomes to those in the less-developed states has decreased, it was still at least 2 times higher than those in the less-developed states. The ratio in the less-developed states ranged from 2 to 3 in 2007.

Undeniably, the combined effects of the deliberate poverty eradication policies and the rapid growth of the economy led to a decline in the incidence of poverty in all states in Peninsular Malaysia. Incidence of poverty in Malaysia has decreased from 52.4 per cent in 1970 to only 3.6 per cent in 2007 (Table 5.11). In other words, incidence of poverty has decreased 93 per cent since the implementation of the NEP, which was attained through rapid socio-economic development with significant participation of the poor.

TABLE 5.10
Mean Monthly Household Income by State, 1984 and 2007

	<i>State</i>	<i>1984</i>	<i>Ratio</i>	<i>2007</i>	<i>Ratio</i>
Less-developed states	Kelantan	500	3.1	2,143	2.5
	Kedah	552	2.8	2,408	2.2
	Terengganu	604	2.5	2,463	2.2
	Perlis	553	2.8	2,541	2.1
	Pahang	767	2.0	2,995	1.8
More-developed states	Perak	706	2.2	2,543	2.1
	Melaka	831	1.8	3,421	1.6
	Negeri Sembilan	831	1.8	3,336	1.6
	Johor	851	1.8	3,457	1.5
	Penang	946	1.6	4,004	1.3
	Selangor	1,271	1.2	5,580	1.0
	Kuala Lumpur	1,535	1.0	5,322	1.0

Note: A ratio of mean monthly household income of Kuala Lumpur to other states.

Sources: Hashim Shireen-Mardziah (1998, p. 73); Economic Planning Unit (2007).

TABLE 5.11
Poverty Rate (%), Malaysia, 1970–2007

	<i>1970</i>	<i>1985</i>	<i>1990</i>	<i>1995</i>	<i>1997</i>	<i>1999</i>	<i>2002</i>	<i>2004</i>	<i>2007</i>
Total	52.4	20.7	16.5	8.9	6.1	7.5	5.1	5.7	3.6
Urban	22.3	8.5	7.1	3.7	2.1	3.4	2	2.5	1.9
Rural	60	27.3	21.1	15.3	10.9	12.4	11.4	11.9	7.1

Sources: Chamhuri (2010); Economic Planning Unit (2007).

The overall poverty rate in Malaysia has decreased from 52.4 per cent in 1970 to 16.5 per cent in 1990, and reduced further to 6.1 per cent in 1997. The 1999 economic slowdown saw the rate increased to 7.5 per cent but later decreased to 5.7 (Government of Malaysia 2001). In 2004 the poverty rate was at 5.7 per cent due to the application of a new methodology in redefining Malaysia's poverty income line (Government of Malaysia 2006). The number of poor households also dropped from approximately 1 million in 1970 to 311,300 in 2004 (Chamhuri 2010).

Generally poverty is defined as the inability of households to obtain the necessities of life or basic needs measured in terms of income or

consumption. In Malaysia, poverty is measured using poverty line income (PLI) which reflects the minimum level of income or consumption on those basic goods such as food, clothing, housing, and basic services such as education, medical care, transport, recreation, and cultural services. A household is considered poor if its income or consumption is below the official PLI. Table 5.12 shows the basic consumption components for Peninsular Malaysia, Sabah, and Sarawak. The PLI is different for each of these regions. The major components in the PLI are food, rent, fuel and power, transport, and communications.

In 2005 the PLI was revised to incorporate PLIs for food and non-food items. The PLI is defined differently for each household depending on the size of the household, demographic composition, and location (state and stratum). A household is considered poor if it is unable to fulfil the basic requirements of its members, i.e., if its income is less than its PLI. Absolute poverty exists when the household's income is less than PLI for food, which is a new measurement used currently, and its value is usually higher than the old measurement that used half of PLI (Government of Malaysia 2006).

TABLE 5.12
Components of PLI (%), 1997–2002

Consumption Components	Peninsular Malaysia		Sabah		Sarawak	
	1997	2002	1997	2002	1997	2002
1. Food	62.1	65.5	60.0	53.8	57.8	61.2
2. Clothing and Footwear	7.7	5.6	6.0	4.7	6.6	5.1
3. Others	25.5	24.1	39.2	36.8	30.8	28.9
a. Rent, Fuel and Power	13.2	12.7	23.1	20.7	8.9	7.9
b. Furniture and Household Equipment	2.3	2.0	2.9	2.6	3.1	2.8
c. Medical Care and Health Expenditure	1.2	1.3	1.1	1.1	6.1	6.0
d. Transport and Communications	6.8	6.3	9.0	9.2	8.9	8.7
e. Education, Recreation, and Cultural Services	2.1	1.9	3.2	3.1	3.9	3.6
4. Safety Margins (5%)	4.8	4.8	4.8	4.8	4.8	4.8
Total	100.0		100.0		100.0	

Source: Chamhuri (2010).

Prior to the NEP much of the focus of development policies and programmes was centred on growth. Under the NEP the strategy of poverty eradication called for a pattern of development which provided opportunities for the poor to participate effectively in the growth process and share the benefits of development. Major poverty eradication strategies were through land development and in situ agriculture programmes, apart from the absorption of the rapidly growing rural labour force into higher income jobs in the industrial and services sectors.

The improvements made in respect to poverty eradication in Peninsular Malaysia are shown in Table 5.13. Despite the substantial progress made, poverty remained a problem in the less-developed states, especially in Kedah, Perlis (in the Northern region), Terengganu, and Kelantan (in the Eastern region).⁴ In these states the poverty rates were still relatively high, ranging from 7.2 to 3.1 per cent in 2007. In less-developed states, besides the high incidence of poverty that existed at the beginning of the NEP, the agricultural sector remained important in these states. In most developing countries, including Malaysia, the poverty rate was high in the agricultural sector, especially among the small holders (Williams 1991; Malaysia 2001c).

Although the poverty rate was high in the agricultural sector, it was different in the state of Pahang. The opening of new land for resettlement was one of the programmes that contributed to the reduction of poverty. About

TABLE 5.13
Incidences of Poverty by State

	<i>State</i>	<i>1970</i>	<i>1990</i>	<i>2007</i>
More-developed states	Kuala Lumpur	45.0	3.8	1.5
	Johor	29.2	10.1	1.5
	Selangor	43.7	7.8	0.7
	Penang	44.9	8.9	1.4
	Melaka	44.8	12.4	1.8
	N. Sembilan	48.6	9.5	1.3
	Perak		19.3	3.4
Less-developed states	Pahang	43.2	10.3	1.7
	Perlis	64.5 ¹	17.2	7.0
	Kedah		30.0	3.1
	Terengganu	68.9	31.2	6.5
	Kelantan	76.1	29.9	7.2

Note: 1. Kedah including Perlis for the 1970 data.

Sources: Asan (2004); Economic Planning Unit (2007).

30 per cent of the rural households in this state were involved in the Federal Land Development Authority (FELDA) schemes. Income improvements among settlers in land development schemes were more substantial. The average monthly income of settlers on FELDA schemes ranged from RM490 to RM810 in 1979 compared with incomes of only about RM80 to RM120 from their previous occupations (Government of Malaysia 1981).

The encouragement by the government towards dispersal of industries in the less-developed states in which the majority of the population was the Malay ethnic group enabled the poor rural and urban households to gain employment in manufacturing activities, thereby raising their levels of income. In 1980 only about 17.1 per cent of the total investment approved in manufacturing projects was planned to be located in the relatively less-developed states where the incidence of poverty was high. By 1997 the proportion increased to 44.7 per cent of total investment approved in manufacturing projects.

Mean monthly gross household income by the Malay ethnic group increased tremendously from only RM172 in 1970 to RM3,156 in 2007 (Table 5.14). The percentage annual growth rate of the mean monthly gross household income of the Malay ethnic group was highest compared to other ethnic groups during the period. However, the Chinese mean income was still above the national average. As the mean monthly gross household income increased, the poverty rate for the Malay ethnic group decreased from 64.8 per cent in 1970 to 3.3 per cent in 2007 (Table 5.15). However, poverty among Malays was still relatively high compared with other ethnic groups in the rural and urban areas.

The poverty rate tends to have a positive relationship with the percentage of the Malay ethnic population, number of persons employed in the primary

TABLE 5.14
Mean Monthly Gross Household Income by Ethnic Group
(in Current Prices, RM)

	1970	1990	2007
Malays	172	940	3,156
Chinese	394	1,631	4,853
Indians	304	1,209	3,799
MALAYSIA	264	1,167	3,620
Urban	428	1,617	4,295
Rural	200	951	2,239

Sources: Asan (2004); Economic Planning Unit (2007).

TABLE 5.15
Poverty by Ethnic Group

	1970	1990	2007		
	<i>Total</i>	<i>Total</i>	<i>Total</i>	<i>Urban</i>	<i>Rural</i>
Malay	64.8	20.8	5.3	3.0	8.2
Chinese	26.0	5.7	0.6	0.5	1.1
Indians	39.2	8.0	2.6	2.4	3.9
Total	49.3	15.0	3.6	1.9	7.1

Sources: Chamhuri and Surtahman (1999, p. 374); Economic Planning Unit (2007).

sector, and percentage of labour force with no primary level of education. In terms of the agricultural sector itself, the poverty rate tends to have a positive relationship with hectares of paddy and rubber plantation areas but not with hectares of oil palm. This was also another reason why the poverty rate in Pahang was less compared to other less-developed states. Usually all FELDA schemes in Pahang were planted with oil palm. Besides that, the poverty rate also tends to have a positive relationship with distance from Kuala Lumpur and distance from regional growth centres (Asan 2004).

The higher education level and experienced labour force are another two factors that make investors more interested in the developed regions than less-developed areas (Meerman 1979). Moreover, there is an inverse relationship between the education level and the poverty rate. This means that when the education level is increasing, the poverty rate will decrease (Mohd Yusuf 1990). Also, an educated and experienced worker will migrate to the developed regions and the inexperienced ones will remain in the less-developed states (Pryor 1979).

INCENTIVES AND MANUFACTURING DISPERSAL

In order to promote industrial activities in the less-developed states (or districts), the government introduced the concept of a “development area” under the Investment Incentive Act, 1968. Industries that were located in these areas would be granted additional incentives.⁵ The “development areas” covered the entire states of Perlis, Terengganu, Melaka, Sabah, Sarawak, and the relatively less-developed districts of Kedah (excluding Kuala Muda district), Pahang (excluding Kuantan district), and southeast of Johor (Figure 5.3). It also included two industrial estates: Kemunting Industrial Estate (in the state of Perak) and Senawang Industrial Estate (in the state of Negeri Sembilan),

TABLE 5.16
Correlation between Poverty and Some Demographic,
Economic, and Location Variables

	<i>Positive Correlation</i>	<i>Negative Correlation</i>
Percentage of Malay population	0.33*	
Percentage of Chinese population		-0.28*
Percentage of Indian population		-0.30
Percentage of Other population		-0.43*
Number of persons employed in primary sector	0.31*	
Number of persons employed in secondary sector		-0.46*
Number of persons employed in tertiary sector		-0.42*
Percentage Labour Force by Level of Education, No formal education	0.86**	
Percentage Labour Force by Level of Education, Primary	0.47**	
Percentage Labour Force by Level of Education, Secondary		-0.68**
Percentage Labour Force by Level of Education, Tertiary		-0.53**
Job vacancies		-0.33**
Agriculture – paddy (hectare)	0.36**	
Agriculture – palm oil (hectare)		-0.40**
Agriculture – rubber (hectare)	0.24**	
Distance from Kuala Lumpur	0.40**	
Distance from regional growth centres	0.46**	

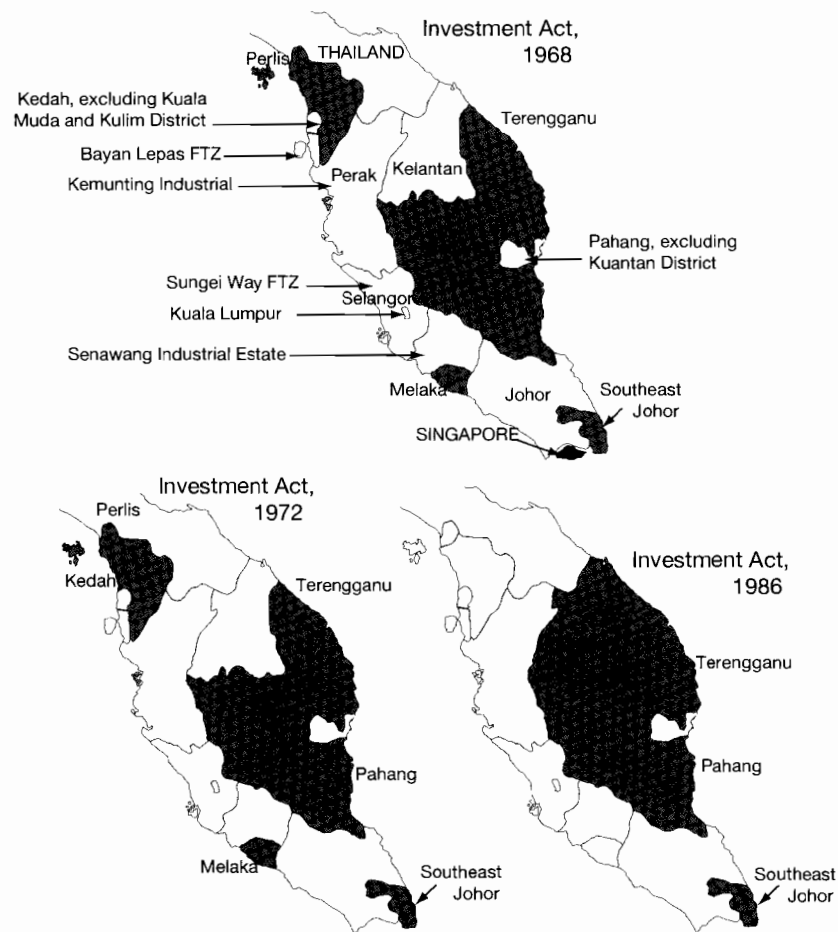
Notes: **Correlation is significant at the 0.01 level (2-tailed); *Correlation is significant at the 0.05 level (2-tailed).

Sources: Asan (2004; 2006).

and two Free Trade Zone (FTZ) industrial areas: Bayan Lepas FTZ (in the state of Penang) and Sungai Way FTZ (in the state of Selangor). These two industrial areas were the pioneer industrial areas and were isolated from the concentrated industrial areas in the state of Selangor and Penang, while the FTZs were the pioneer FTZs in Malaysia.

After the implementation of the NEP, the government introduced the “Location Incentive Scheme” (under Investment Incentive Act, 1972). More incentives were given to the local and foreign investors to

FIGURE 5.3
Investment Incentives Location Act 1968, 1972, and 1986



Source: Asan (2006).

locate their activities in the less-developed states (or districts),⁶ mainly to redistribute the industrial activities from more concentrated areas in the more developed states. Compared with the development area under the Investment Incentive Act, 1968, the Location Incentive Act, 1972 only covered the entire states of Perlis, Terengganu, Melaka, Sabah, Sarawak, and the relatively less-developed districts of Kedah (excluding Kuala Muda

district), Pahang (excluding Kuantan district), and southeast of Johor. It did not include Kemunting Industrial Estate, Senawang Industrial Estate, Bayan Lepas FTZ, or Sungei Way FTZ because it referred only to the less-developed states (or districts).

Further incentives were given under the Promotion of Investments Act 1986, which was introduced as a replacement for the Investment Incentive Act, 1972. Although industrial development focused more on the West-Coast Corridor, additional incentives were given to the industries located in the East-Coast Corridor of Peninsular Malaysia. It covered Kelantan, Terengganu, Pahang, and the district of Mersing in the southeast of Johor. Compared with the Location Incentive Scheme, additional incentives under the Promotion of Investments Act 1986 did not cover the states of Melaka, Kedah, or Perlis (located on the west coast of Peninsular Malaysia) because the additional incentives were only given to the industries located in the East-Coast Corridor of Peninsular Malaysia, mainly to give it more of a comparative advantage.⁷

The Investment Incentive Act was replaced for two reasons. Firstly, to make investment in Malaysia more attractive and to have a competitive advantage over other countries in the ASEAN region. This is because other countries also have their investment incentives and Malaysia must compete to attract FDI, especially from multinational companies. Secondly, regarding the additional incentives given to the selective states or districts, the number of states that received the incentive was decreased from six states under Investment Act 1972 to only three states under Investment Act 1986. Kedah, Perlis, and Melaka — that were given additional incentives under Investment Act 1972 — no longer received additional incentives under Investment Act 1986. Manufacturing activities in these states increased rapidly and focus had to be given only to the states located in the East-Coast Corridor (Kelantan, Terengganu, and Pahang) where the manufacturing activities were relatively less. Other than incentives under the Investment Incentive Act, the State Economic Development Council (SEDC) also provided some incentives to promote investors, especially FDI, to set up factories in those particular states since 1971.

Besides the huge incentives in manufacturing industries, especially in the less-developed states, the government also took further steps to promote manufacturing industries by developing industrial estates. The strategy seeks to encourage new manufacturing industries to move to the less-developed parts of the country, especially in the east coast states, from the congested areas in Selangor (Klang Valley) and other major urban centres on the west coast. Numbers of existing industrial estates increased rapidly in the states of

Kedah, Perak, Terengganu, Selangor, and Johor. In the less-developed states, the number of existing industrial estates increased rapidly from none in 1970 to 105 in 2002, while in more-developed states the number increased from 8 in 1970 to 188 in 2002 (Table 5.17). Although the number of existing industrial estates in the less-developed states increased, the size of the industrial estates was rather small. This is because most of the industries located in the less-developed states were small and medium industries (SMI) and labour intensive. In 1990 only 3 per cent of industrial estates in less-developed states were larger than 200 hectares, while 11 per cent of industrial estates in the more-developed states were greater than 200 hectares.

Although the manufacturing sector in Peninsular Malaysia as a whole experienced rapid average annual output growth rate, its distribution was

TABLE 5.17
Number of Existing Industrial Estates, 1970, 1990, and 2002

	1970	1990	2002	
			Number	Expansion 1990–2002
– Perlis*	0	2	7	5
– Kedah*	0	15	28	13
– Penang	3	9	18	9
– Perak	1	19	34	15
Northern Region	4	45	87	42
– Pahang*	0	11	34	23
– Kelantan*	0	6	15	9
– Terengganu*	0	12	21	9
Eastern Region	0	29	70	41
– Selangor	2	25	37	12
– N. Sembilan	1	8	18	10
– Melaka	0	7	27	20
– K. Lumpur	0	4	19	15
Central Region	3	44	101	57
Johor/Southern Region	1	20	31	11
<i>Less Developed States*</i>	0	46	105	59
<i>More Developed States</i>	8	92	188	96
Peninsular Malaysia	8	138	289	151

Sources: Asan (2004; 2006).

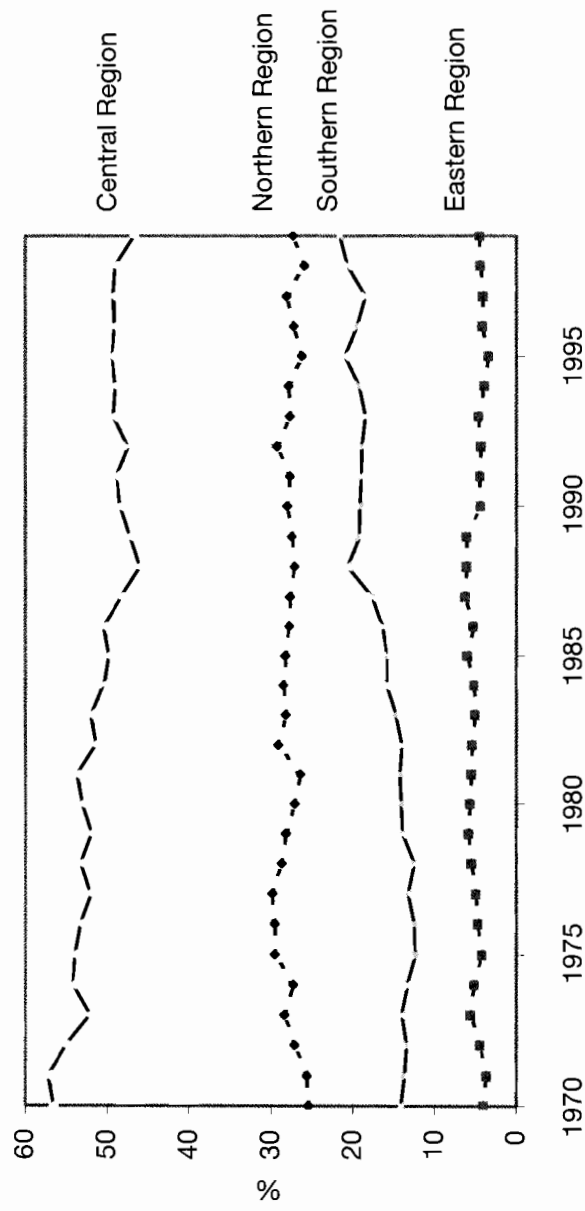
still more towards developed states. In fact, although the federal and state governments have made serious efforts to increase manufacturing activities in less-developed states by introducing several incentives, the distribution of manufacturing activities in Peninsular Malaysia had not changed much by the end of the NEP (1970–90). Figures 5.4 and 5.5 show the percentage contribution of output and labour by region for the period 1970 until 1999. These trends show that decreasing output and labour contributed by the central region were not overtaken by the northern and eastern regions but by the southern region. It contradicted the government policy to increase output and labour contributed by the northern and eastern regions.

Although the government redistribution policy has increased manufacturing output and labour in the northern region, a greater percentage increase came from the state of Penang but not from the states of Kedah or Perlis (less-developed states). In the eastern region (all states in the eastern region were categorized as less-developed states) the output contribution was relatively small, at only 0.3 per cent, while labour contribution did not increase but decreased about 1.4 per cent. Government policy was also intended to decrease output and labour contributed by the central and southern regions. However, the policy only succeeded in the central region. In the southern region, output and labour contribution continued to increase.

States that recorded a huge decrease in their output and labour contributions to the Malaysian total were Selangor and Perak, while states that recorded a big increase in output and labour contributions to the Malaysian total were Penang (7.4 per cent) and Johor (5.1 per cent). This situation showed that several incentives under the federal and state governments were not successful in their goal to increase manufacturing activities in the less-developed states. Penang and Johor were not placed under any Development Area, Location Incentive Scheme, the East-Coast Corridor, or any other incentives under SEDC, but the manufacturing output and labour contributions increased and were still relatively high. Although the district of Mersing (in southeast Johor) was placed under the Development Area status, the Location Incentive Scheme, and is currently under the East-Coast Corridor, Mersing industrial area contributed less than 2 per cent of the total manufacturing output and labour.⁸

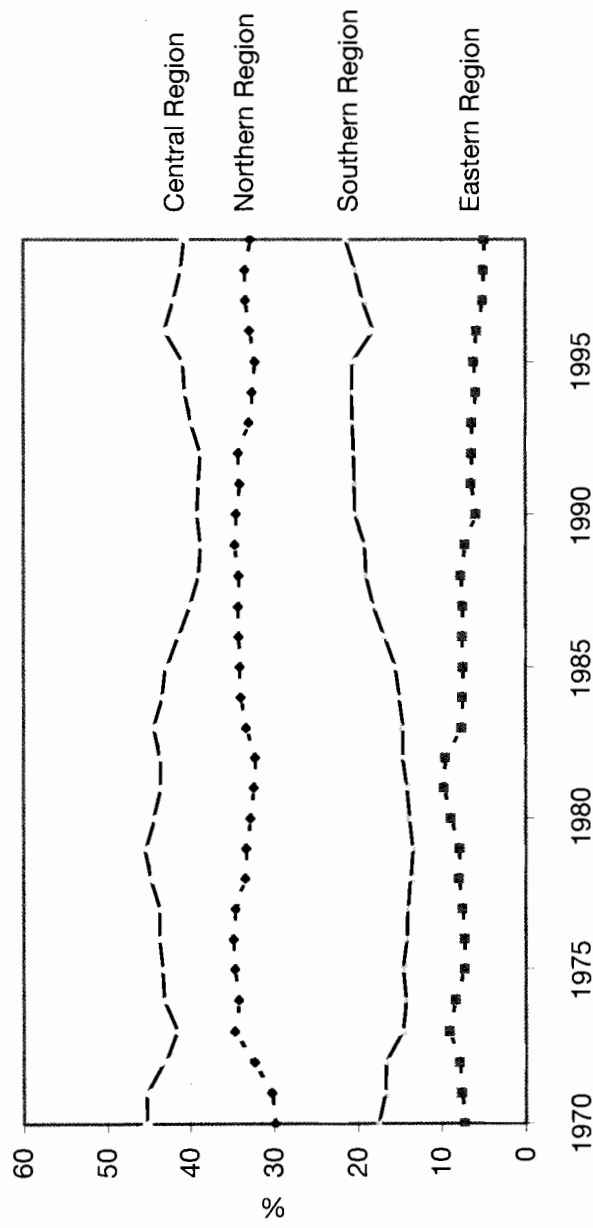
An investment incentive plays an important role in increasing manufacturing activities in Malaysia. Investment incentives in Malaysia started with the Investment Incentive Act, 1968 which was replaced by the Investment Incentive Act, 1972. Further incentives were given under the promotion of Investments Incentive Act, 1986,⁹ which was introduced as a replacement to the Investment Incentive Act, 1972. The most apparent effects from the

FIGURE 5.4
Percentage Contribution of Output



Sources: Asan (2004) and Hasnah and Asan (2008).

FIGURE 5.5
Percentage Contribution of Output



Sources: Asan (2004) and Hasnah and Asan (2008).

government industrial incentives are in terms of the Investment Incentive Act, 1986. Before the 1986 act, about 37 to 47 per cent of approved projects were the result of investment incentives given by the government (Table 5.18). This amount increased rapidly after the 1986 act. For instance, in 1990, the amount increased to about 58 per cent. However, it decreased in 1997 due to the economic downturn. Most of the industries that received this incentive were the export-oriented industries located in the more-developed states, especially in Selangor, Penang, and Johor. Location incentives were less effective; projects approved under this incentive were small compared to other incentives — they account for less than 3 per cent of the approved manufacturing projects with incentives.

The unbalanced distribution of industrial concentration between states was the other main factor that created unbalanced growth between states in Peninsular Malaysia. There are two groups of industries distributed in the regions. The first group encompasses modern technology industries, especially for exported products, which can be seen in the well-developed regions, and the second is the small industries for domestic goods in the less-developed

TABLE 5.18
Approval of Manufacturing under Investment Incentive Acts of 1972 and 1986

<i>Investment Incentive Act</i>	<i>Investment Incentive Act, 1972</i>			<i>Investment Incentive Act, 1986</i>		
	1976	1980	1985	1990	1997	2000
With incentive:	202 (47.5) ¹	184 (40.0)	229 (36.6)	524 (57.8)	213 (28.1)	205 (25.5)
– Pioneer status	105	104	78	440	154	153
– Investment Tax Allowance	76	73	143	84	59	52
– Location incentive ²	7	2	8	—	—	—
Without incentive	223	276	396	382	546	600
Total	425	460	625	906	759	805

Notes: 1. Figures in parentheses show the percentage.

2. Number of manufacturing approved with location incentive was not recorded separately because it was incorporated under Pioneer status and Investment Tax Allowance deduction (Act, 1986).

Sources: Asan (2004; 2006).

regions. Inequality in this industry distribution will create a problem as it affects the population as well as the income of the regions.

Industrialization in Malaysia gradually shifted from an import-substitution industry in the 1960s to an export-oriented one in the 1970s, and later to heavy industry since the early 1980s. Exports of commodities as a main source of growth, for both the economy and the agricultural sector, were no longer important. Agricultural exports declined in share from 52.1 per cent in 1970 to only 35.8 per cent in 1980, mainly due to the slow growth in the production of rubber and the emergence of crude oil and manufactured goods as important export commodities. After 1980 (the start of the Fourth Malaysia Plan) the manufacturing sector was projected to grow at a rapid rate of 10.9 per cent per annum (Government of Malaysia 1981).

The final aim of the industrialization strategy since 1970 was to meet the NEP objectives of growth and equal distribution. This is because manufacturing was seen as the engine of growth to spearhead the restructuring of economic activity and society, besides absorbing the surplus labour from the agriculture sector (Rajah and Ishak 2001). Emphasis was given to the creation of employment, development of all scales of industries, and participation of Malays in the manufacturing sector, especially in the less-developed states. The structural change from a labour-intensive manufacturing industry to a capital intensive (heavy) manufacturing industry and optimization of the use of resource-based industries have somehow increased the relative role of manufacturing activities in the less-developed states.

Growth in the manufacturing sector since the 1980s was a result of the diversification of manufacturing towards capital-intensive industry, especially export goods, as well as maximizing the comparative advantage of Malaysia's resource endowment. Specific tax incentives were also provided to encourage the growth of export-oriented industries. In addition a substantial proportion of manufactured exports came from the FTZs.¹⁰

FTZs are specially designated for export-oriented industries. Currently, there are sixteen FTZs in Malaysia. Eleven of the FTZs are located in the more-developed states. The infrastructure network, which provides easy access to the services industry, was the main reason why most of the FTZs were located in the more-developed states. The FTZs were developed near to the well-established industrial estates and infrastructure network mainly to generate backward and forward linkages to other industries as well as to make it more attractive to FDI.

In general, the electronic (and machinery) industry, as Malaysia's main source of manufacturing exports, was concentrated in more-developed states in 1985 and more so in 1995. In less-developed states, this industry became

important only in the state of Kedah. Selangor, Penang, and Johor recorded a high share of total national manufacturing output in three important industries. Of the five less-developed states, Kedah, Perlis, and Terengganu have changed their economic structure rapidly, while Pahang and Kelantan did not change much. Electronic industries have become more important in Kedah, while heavy industry expanded in Terengganu and Perlis. Although Kelantan and Pahang received extra investment incentives (under Investment Incentive Act, 1986 — East-Coast Corridor) the industrialization process was slow and more concentrated on resource-based (wood and rubber) and food manufacturing industries. These industries have less potential for employment and are more focused on domestic products rather than being export-oriented.

Although the concentration of these industries is on the rise in the less-developed states, the concentration of capital, labour, value added and output remained more dominant in the developed states. As a result, value added per worker, output per worker, and average monthly wage per worker were higher in the developed states compared to the less-developed states (Figure 5.6 and Table 5.19).

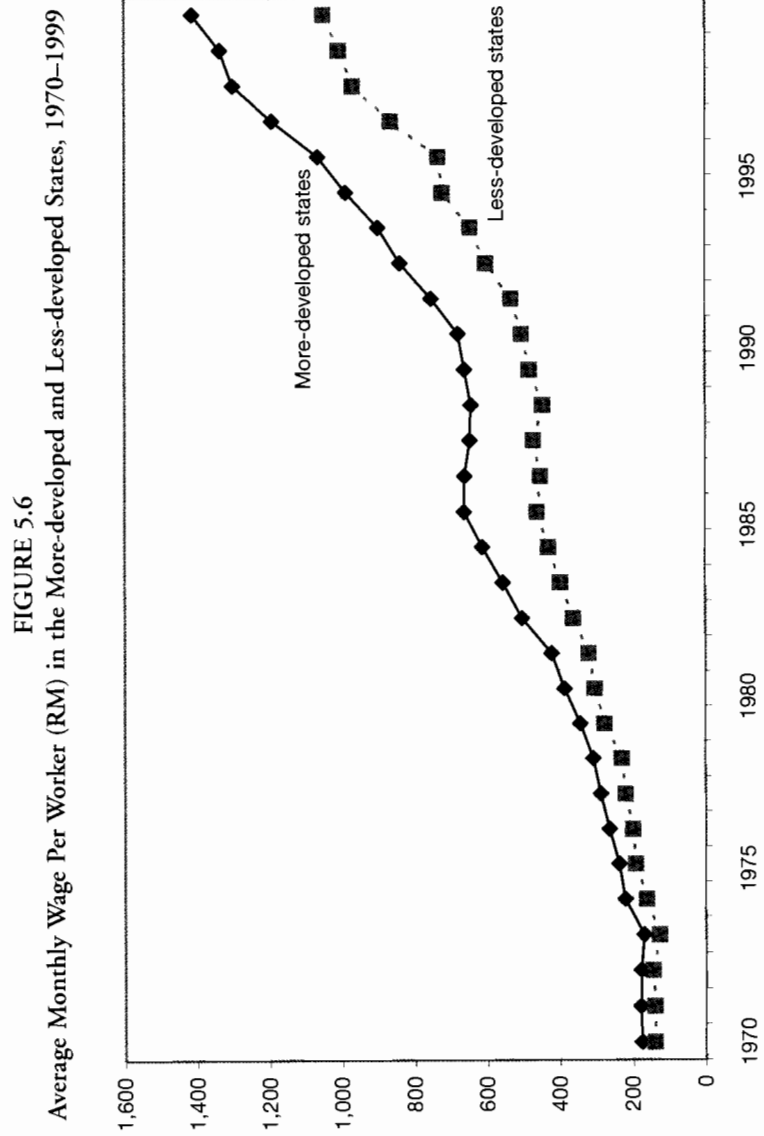
REGIONAL CONVERGENCE

Since independence, and especially after 1970, it was hoped that the manufacturing sector would increase economic opportunities through diversification of economic activities in the less-developed states as well as

TABLE 5.19
Value Added, Output, and Capital Per Worker (RM)

<i>Region</i>	<i>Year</i>	<i>Value added per worker</i>	<i>Output per worker</i>	<i>Total Manufacturing Output ('000)</i>
More-Developed States	1970	7,881	25,814	3,617,357
	1980	9,584	67,420	27,964,096
	1990	29,232	118,427	79,615,778
	1999	65,942	279,246	303,631,335
Less-Developed States	1970	4,414	17,803	316,681
	1980	5,747	44,254	2,812,780
	1990	20,218	73,901	7,637,396
	1999	48,512	193,592	25,627,524

Sources: Asan (2004; 2006).



Source: Asan (2004; 2006).

convergence of manufacturing activities (mainly output) in the more-developed states. However, until 1999, capital, labour, and output continued to be concentrated in the more-developed states. In 1999 total manufacturing output in the more-developed states was about twelve times greater than that of the less-developed states (increased from about RM3 billion in 1970 to about RM303 billion in 1999). In addition, two important indicators towards convergence — value added and output per worker — were also dominated by the more-developed states, mainly explained by the differences in investment rate, labour force growth rate, and technological progress (Asan 2006).

Although the manufacturing sector in Peninsular Malaysia as a whole has experienced rapid average annual output growth rate, its distribution remained unchanged. This phenomenon can be shown in terms of β convergence or α convergence. β convergence will occur when the less-developed states (low-income region) grow faster than the more-developed states (high-income region; the slope coefficient from regression of the growth of manufacturing output on the logarithm of its level). However, the trends of growth of manufacturing output in more-developed states and the less-developed states were parallel (both coefficients were about 0.15). In other words, there is no tendency towards convergence between the more-developed states and the less-developed states (Figure 5.7).

Meanwhile, α convergence will take place when the gap between the more-developed states and the less-developed states declines (standard deviation of the distribution of the manufacturing output across regions declines). The α convergence was in line with the β convergence. The distribution of manufacturing output across regions continued to increase (Figure 5.8). α convergence increased rapidly, especially after the implementation of the Investment Incentive Act, 1986. As was discussed in the previous part, this situation can be explained by the cessation of the location incentive scheme under Investment Incentive Act, 1972 and the location of the FTZ which focused more on export manufacturing goods, most of which were located in the more-developed states. Although under the Investment Incentive Act, 1986, FDI and domestic investment increased rapidly, they were higher in the more-developed states than in the less-developed states.

Lesser convergence between the more-developed states and the less-developed states was not only because of less FDI and domestic investment (and less growth of manufacturing output) in the less-developed states, but also because of socio-economic and demographic indicators that were dominated more by the more-developed states. This was in line with the convergence hypothesis (with more rapid convergence in countries with higher schooling levels); more schooling (as measured by male secondary attainment); higher

life expectancy, a proxy for better health and human capital in general; terms of trade improvement and resulting high FDI flows, posited to generate added employment and income; a lower government share (investment), which is posited to release resources for more productive private investment; and a lower total fertility rate, which attenuates capital-shallowing and adverse saving-rate impacts of high youth dependency (Kelley and Schmidt 1998, p. 23).

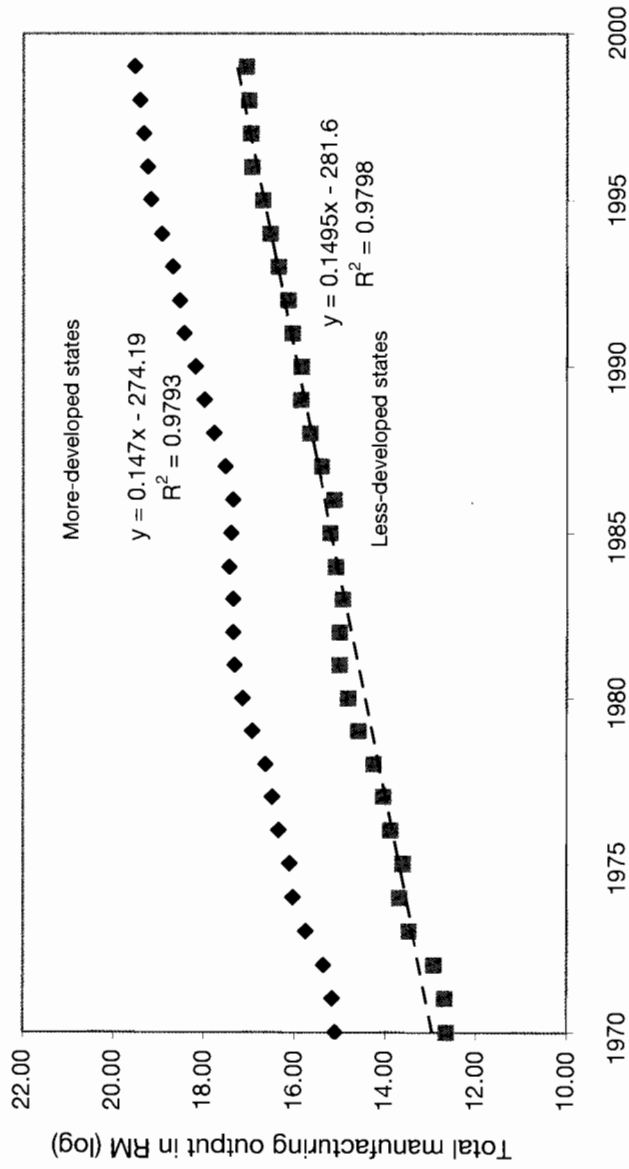
Manufacturing activities in the more-developed states concentrated more on export-oriented (mainly electronic and machinery industries) products, while manufacturing activities in the less-developed states were more concentrated on resource-based (wood and rubber) products and food industries, which were more for the domestic market. Convergence is stronger among countries that have strong trading relationships (Ben-David 1996). However, trading of manufacturing products within the more-developed and the less-developed states was relatively low.

Other factors that could have resulted in convergence between the more-developed states and the less-developed states in Peninsular Malaysia did not arise due to the diffusion of technological change that was more dominant in the more-developed states. Besides the higher secondary education levels which facilitated the absorption of new technologies in the more-developed states, capital-intensive industries were also concentrated in the more-developed states. Technology transfers (mainly by FDI), large firm size, and human resource development (HRD; education and training), as well as accumulation of knowledge through research and development (R&D)¹¹ drove faster productivity growth in the more-developed states (Asan 2006).

Low R&D and HRD not only caused low total factor productivity (TFP) but also less output elasticity of labour and capital in the less-developed states (Table 5.19). Labour and output in the less-developed states were less efficient compared with the more-developed states. However, government intervention by increasing the capital flow in government subsidiary companies in the less-developed states showed a good response. In the period 1994–1995, the output elasticity of labour in the less-developed states was greater than that of the more-developed states. In other words, more capital flowed to the less-developed states in the process of convergence across regions.

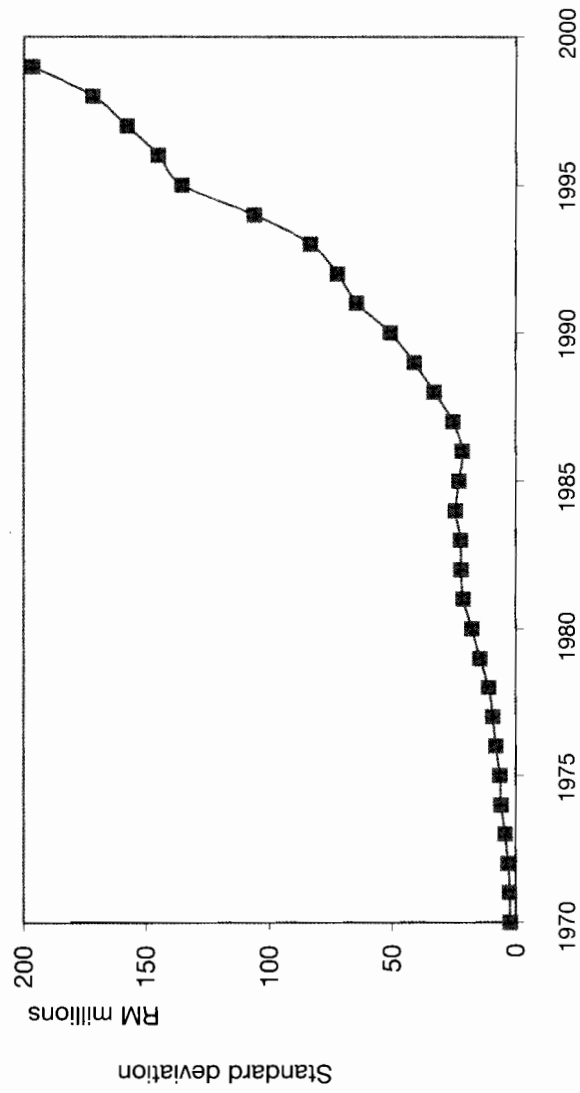
Overall, the manufacturing sector in Peninsular Malaysia showed no tendency towards convergence between the more-developed states and the less-developed states. The growth trend of manufacturing output across regions (β convergence) remained unchanged, while the distribution of the manufacturing output across regions (α convergence) increased continuously. The convergence process in Peninsular Malaysia was limited because of several factors, such as disadvantages in the demographic indicators; less trading

FIGURE 5.7
The β Convergence



Source: Asan (2004; 2006).

FIGURE 5.8
The α Convergence



Source: Asan (2004; 2006).

TABLE 5.20
Capital and Labour Efficiency, 1990–91 and 1994–95

	<i>Output elasticity of labour</i>		<i>Output elasticity of capital</i>	
	<i>MDS</i>	<i>LDS</i>	<i>MDS</i>	<i>LDS</i>
1990–91	1.606	1.082	0.972	0.657
1994–95	1.702	1.287	1.019	1.119

Notes: Output elasticity of labour = $\frac{\partial Y/\partial L}{L/Y}$

Output elasticity of capital = $\frac{\partial Y/\partial C}{C/Y}$

∂ = change in Y, L or C in that particular year

Y = output in RM

L = number of labour

C = number of capital

Sources: Asan (2004; 2006).

between states; slower diffusion of technological change; less HRD, R&D, and low productivity growth (TFP); as well as less efficiency of labour and capital in the less-developed states.

CONCLUSION

Since 1956, under the First Malaya Plan, and especially after 1970, the manufacturing sector was seen as the main tool to spearhead the restructuring of economic activities across regions. This is because industrial imbalance has an important relationship to the imbalance of household monthly income, poverty, and unemployment. An industrial dispersal strategy was incorporated in the five-year Malaysia plans. In order to promote industrial activities in the less-developed states, the government introduced the concept of “development areas” under the Investment Incentives Act, 1968; “location incentive schemes” under the Investment Incentive Act, 1972; and “East-Coast Corridor” under Investment Incentive Act, 1986. Industries located in particular areas received benefits through tax holidays and investment allowances that were attractive to private investors. It was hoped that these incentives would increase manufacturing activities in the less-developed states which recorded less monthly income, high poverty and unemployment as well as out-migration.

However, the location incentives were less effective; projects approved under these incentives were small compared to other incentives — they only accounted for less than 3 per cent of the approved manufacturing projects

with incentives. Most industries were still located in the more-developed states mainly due to established manufacturing activities in those areas with easy access to infrastructure, service industries, and large labour and consumer markets. Although the cost of land (industrial areas, especially developed by the private sector) in the more-developed states was relatively high, the investors were still willing to locate their firms in the more-developed states after taking into consideration the deduction of production costs from the location incentives if the firms were to be located in the less-developed states. The relative advantage of positioning the firms in the more-developed states was greater than that of the location incentive.

One disadvantage in the redistribution of manufacturing activities in Peninsular Malaysia was due to the FTZ industries strategy. Investors in the FTZs were mainly foreign direct investors, export-oriented, and capital-intensive industries. Since 1970 the FTZs were located in the more-developed states mainly due to the infrastructure network, which provided easy access to service industries. The FTZs were developed near to the well-established industrial estates and infrastructure network mainly to generate backward and forward linkages to other industries and to make them more attractive to FDI. Because the FTZs were more oriented to export products, it was more convenient to locate them near ports. However, the major ports in Peninsular Malaysia were located in the more-developed states; Port Klang in the state of Selangor and Pasir Gudang Port in the state of Johor (beside the Port of Singapore).

Even though the number of existing industrial estates in the less-developed states has increased, the area they cover is small, and they were all developed by the government. The industries located in the less-developed states are small and medium industries that are labour intensive. They are largely resource-based (wood and rubber) and food manufacturing industries focused on domestic products rather than export-oriented, while the more-developed states concentrate more on electronics (and machineries). These industries are capital-intensive and export-oriented (mainly dominated by FDI in the FTZs).

Labour intensive industries showed more dispersal across regions (such as food, beverages, and tobacco, wood products, rubber industries, and non-metallic minerals), while high-technology industries (such as textiles and clothing, paper, printing, and metal products) remained concentrated in the more-developed states. This scenario has a close linkage with the background of the labour market in that particular state. Although the FDI was more dispersed compared with domestic investment, the numbers in the less-developed states were still low and were more on labour-intensive manufacturing activities, mainly because the cost of hired labour was relatively cheap.

Even though total manufacturing output in Peninsular Malaysia experienced rapid annual growth, its distribution remained unchanged. In other words, there is no tendency towards convergence between the more-developed states and the less-developed states. It seems that there was an economic and demographic “disadvantage cycle” which occurred in the less-developed states. This cycle is shown in Figure 5.9.

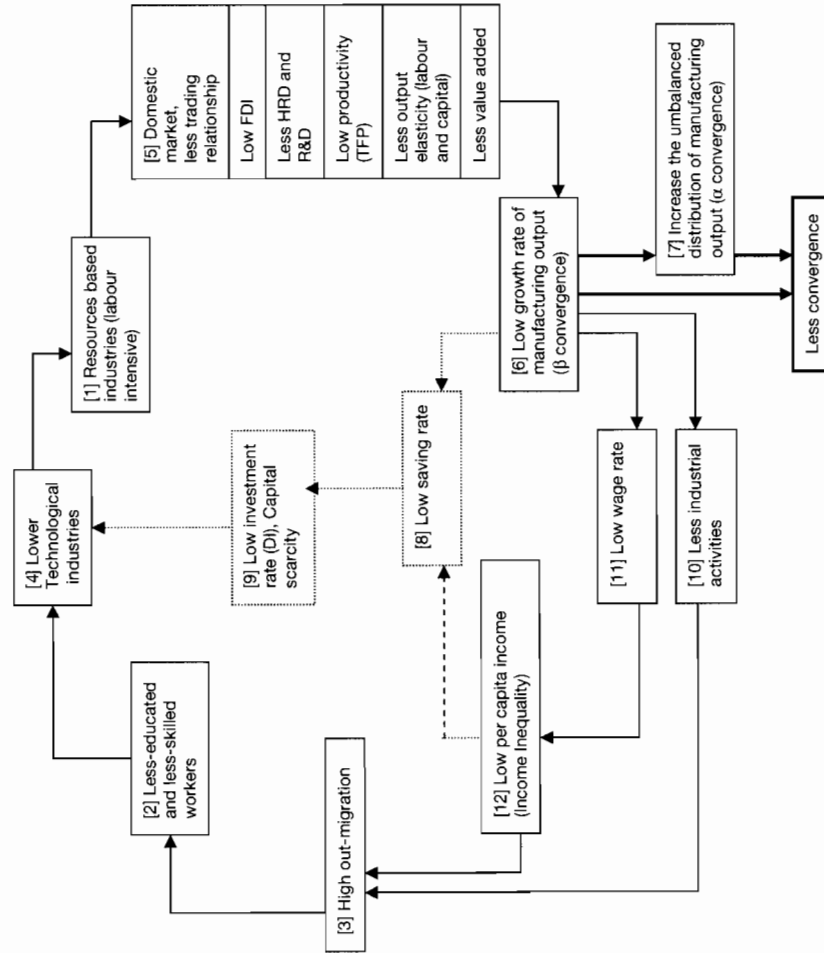
Most of the manufacturing activities in the less-developed states were resource-based and labour intensive industries [1]. These activities have a close linkage with the background of the labour supply in that particular state [2]. This is because educated and experienced workers have migrated to the developed states [3], which created a lower technological industrial environment in the less-developed states [4].

The resource-based and the labour intensive industries were owned mainly by the domestic investors and their products were also for the domestic market (FDI activities were more capital intensive and focused on export-oriented products) [5]. The lower technological industrial environment, small firm size, less HRD and R&D, less output elasticity of labour and capital, and less value added slowed the TFP growth. It is undeniable that all these factors have caused a low growth rate of manufacturing output (β convergence) in the less-developed states [6] and increased the unbalanced distribution of manufacturing output (α convergence) across regions [7].

On the investors' side, a low growth rate of manufacturing output means less marginal profit as well as lower savings [8]. In this scenario, less-developed states also faced the problem of capital scarcity and they chose to invest in manufacturing that used less capital as well as less technological components as the best solution [9]. Besides that, less marginal profit (because of the low growth rate of manufacturing output) was the important factor in why there were less industrial activities in the less-developed states [10], while on the labour side, less marginal profit (because of the low growth rate of manufacturing output) has a strong linkage with the low wage rate [11], low monthly per capita income, and low saving rate in the less-developed states [12]. Less industrial activities as well as monthly per capita income (because of the low wage rate) then caused high out-migration to the developed regions [3]. Only those with less education and experience will remain in the less-developed states, and finally the cycle will start again.

In conclusion, based on the disadvantage cycle, it was difficult for the government to increase manufacturing activities in the less-developed states, especially the capital-intensive industries. Most of the industries were labour-intensive, which recorded low productivity and output growth rate

FIGURE 5.9
“Disadvantage Cycle” in the Less-developed States



Source: Asan (2004, 2006), Hasnah and Asan (2008).

which then slowed the process of convergence in the less-developed states. Three strategies have been implemented to overcome the above problems. The strategies were to increase the quality of life, including education and infrastructure; giving extra incentives for the capital-oriented industries; and to increase government investment in the subsidiary companies in the less-developed states. However, due to the disadvantage cycle (Figure 5.9), the convergence process in the less-developed states remains unchanged.

Increasing education and infrastructure in this scenario in which the industrial activities in the less-developed states remain unchanged (less number of industries and low wage rates) make the out-migration continue to increase. Further incentives (under the Investment Incentive Act) for the capital-oriented industries to be located in the less-developed states were also unsuccessful mainly because the workers were less-educated and experienced. Finally, even though the government has invested in the subsidiary companies (capital-intensive industries) in the less-developed states, those industries were more capital driven with less contribution to the TFP. It did not help much in the process of convergence because of the low growth rate of the manufacturing output.

CLOSING REMARKS

Regional disparities, income inequality, and poverty are interrelated issues mostly discussed in development economics. They are important issues that stem from a lack of economic growth and thus are dealt with by governments all over the world through various development policies.

To an extent, the development policies of the Malaysian Government have been able to address these issues successfully. Poverty has decreased sharply, standards of living among Malaysians and within each ethnic group have improved, and unemployment decreased in all regions. However, most industries, especially those capital intensive and export-oriented ones, are still located in the more-developed states mainly due to established manufacturing activities in those areas with easy access to infrastructure, services industries, and large labour and consumer markets. The advantages of positioning firms in the more-developed states is greater than any advantages of setting up firms in the less-developed states.

In order for policymakers to make better development policies to bridge the gap between the more-developed and the less-developed states, we believe that a better understanding of the disadvantage cycle that is occurring in the less-developed states is necessary. Previous development policies were shown to be inadequate to bridge this gap. A better understanding of the constraints

in the disadvantage cycle might help policymakers to come up with a more holistic development policy that could narrow this gap.

Notes

1. The NEP was developed based on the recommendations by the Department of National Unity (DNU), Economic Planning Unit (EPU), the Treasury, Malaysia's Central Bank, Department of Statistics, and the Federal Industrial Development Authority (FIDA) in the period 1969–1970. Please refer to “*The Birth of a New Development Strategy*”, in Faalan et al. (2003, pp. 25–73; 250–423).
2. In the 1991 Census, urban areas were defined as gazetted areas with their adjoining built-up areas, which had a combined population of 10,000 or more. Built-up areas were defined as areas contiguous to a gazetted area and having at least 60 per cent of their population (aged 10 years or more) engaged in non-agricultural activities and at least 30 per cent of their housing units having modern toilet facilities. In the 1970 and 1980 censuses, the urban definition was only restricted to the gazetted areas with a population of 10,000 and more (Government of Malaysia 1995, pp. xvii and 29).
3. Primacy Index (PI) refers to the rank size rule and measures the concentration of population in the primate city in relation to the rest of the cities. Increase in PI means increase in concentration of population in the largest city. $PI = C_i / \sum C_k$; where C_i is the population of the largest city and C_k is the population of the k city, $k = 2, 3, \dots, n$. Metropolitan towns refers to urban areas with a minimum population size of 75,000 persons. In 2000, there were 40 metropolitan towns in Malaysia, but only 13 were located in the less-developed states (Siti 2007).
4. Poverty in Malaysia is primarily a rural phenomenon. Within each ethnic group, rural residents are more likely to be poor. Rural Malays and rural Indians are the two most poverty-prone subgroups; in both rural and urban subsets, Chinese are the least poverty-prone (Kusnic and DaVanzo 1982, p. 25).
5. The incentives provided for industries to locate in a development area are linked to some of the incentives provided under the Investment Incentives Act, 1968. For pioneer industries locating in a development area, an additional year of tax relief is granted irrespective of the size of the capital investment. Also, should an electronic firm which enjoyed the special incentive from the electronic industry be located in a development area, it becomes eligible for an additional year of tax relief. For a company that had been granted the investment tax credit (ITC), an additional credit of 5 per cent of the approved capital expenditure would be granted if the company is to be located in a development area (Lee 1978, pp. 456–58).
6. In addition to the “development area” in the Investment Incentive Act, 1968, any industry located in the gazetted location incentive scheme becomes eligible for five years of tax relief compared with three years tax relief if the industry is located in the development area. Areas covered under the Location Incentive

Act overlapped with locations under the development area in the Investment Incentive Act, 1968.

7. It was hoped that these additional incentives would decrease the cost of production. States on the east coast of Peninsular Malaysia recorded less comparative advantage in terms of concentration of population (consumer), labour force (high out-migration, especially those who are experienced and educated), and social infrastructure.
8. In 1996 (July), from 4,403.47 total hectares of industrial land developed under Johor State Economic Development Corporation (SEDG), only 16.59 hectares (0.38 per cent) were located at Mersing Industrial Estate (Mersing I). While, in 1998 (January), of 4,443.78 total hectares of industrial land developed under SEDG, only 1,500 hectares (0.33 per cent) were located at Mersing Industrial Estate (Mersing II).
9. For example, under Investment Incentive Act, 1986, a company granted Pioneer Status will enjoy partial exemption from the payment of income tax. It will only have to pay tax of 30 per cent on its statutory income. The period of tax exemption is five years; however, as an added incentive, companies located in the designated Eastern Corridor of Peninsular Malaysia will only have to pay tax of 15 per cent on their statutory income during the tax exemption period of five years. A company granted Investment Tax Allowance will be given an allowance of 60 per cent on the qualifying capital expenditure incurred within five years from the date on which the first qualifying capital expenditure is incurred. The allowance can be utilized to offset against 70 per cent of the statutory income in the year of assessment. Any unutilized allowance can be carried forward to subsequent years until the whole amount has been used up. The balance, i.e., 30 per cent of the statutory income, will be taxed at the prevailing company tax rate. As an added incentive, companies located in the designated Eastern Corridor of Peninsular Malaysia will be granted an allowance of 80 per cent on the qualifying capital expenditure incurred. The allowance can be utilized to offset against 85 per cent of the statutory income in the year of assessment (MIDA 2009).
10. The term FTZ was used under the Investment Acts 1968, 1972, and 1986. However, those acts have been revised and restructured under a new act, Free Zones (FZ) Act 1990. Free Zones consists of Free Trade Zones (the current meaning of FTZ is different from the previous FTZs mentioned in the Investment Acts 1968, 1972, and 1986), Free Industrial Zone (FIZ is similar to the previous FTZ in the Investment Acts 1968, 1972, and 1986), and Free Commercial Zone (FCZ). A Free Zone is an area declared by the Minister of Finance under the provision of Section 3(1) of the Free Zones Act 1990. It is mainly designed to promote entrepôt trade and specially established for manufacturing companies that produce or assemble products mainly for export. A Free Zone comprise a free commercial zone for commercial activities which include trading (except retail trading), breaking bulk, grading, repacking,

relabelling and transit, and a free industrial zone for manufacturing activities. The activities and industries therein are subject to minimal customs formalities and it is deemed as a place outside the Principal Custom Area except in respect of Prohibition of Imports and Exports under Section 31 of the Customs Act 1967. To date there are 13 FCZs located at the North, South, and West Port of Port Klang, Port Klang Free Zone, Pulau Indah MILS Logistic Hub, Butterworth, Bayan Lepas, KLIA, Rantau Panjang, Pengkalan Kubor, Stulang Laut, Johor Port, and Port of Tanjung Pelepas. Other than minimal customs formalities, FIZs enable the export-oriented companies to enjoy duty-free import of raw materials, component parts, machinery and equipment required directly in the manufacturing process, as well as minimal formalities in exporting their finished products. To date there are 16 FIZs located at Pasir Gudang, Tanjung Pelepas, Batu Berendam I, Batu Berendam II, Tanjung Kling, Telok Panglima Garang, Pulau Indah (PKFZ), SungaiWay I, SungaiWay II, Ulu Kelang, Jelapang II, Kinta, Bayan Lepas I, II, III, Bayan Lepas IV, Seberang Perai, and Sama Jaya. Companies can be located within FIZs when their entire production or not less than 80 per cent of their products are meant for export and their raw materials/components are mainly imported. Nevertheless, the government encourages FIZ companies to use local raw materials/components (MIDA 2009).

11. In 1989, the country's R&D expenditure was 0.8 per cent of GDP. Of this total, 20 per cent was contributed by the private sector, which was made up mostly of foreign entities (FDI) (Government of Malaysia 1991*b*, p. 211).

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