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## **"Deepening Disparities: Political and Economic Effects of FDI on Income Inequality Among Skilled and Unskilled Malaysian Workers"**

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**Renee Ong**  
*Yale University*

### **Introduction**

Though inward foreign direct investment (FDI) has been a key driver in propelling Malaysia's historic economic transformation from a commodity-dependent, agriculture-based economy into the modern, industrialized economy it is today, research on the impact of FDI on income inequality in Malaysia remains limited. Of particular interest within this field of inquiry is a groundbreaking study conducted by researchers Mukaramah-Harun, Siti Hadijah Che Mat, and Zalina-Zainal that concluded the growth of FDI in Malaysia has negatively impacted the distribution of income across different labor groups, contributing to increased income inequality between skilled and unskilled workers.<sup>1</sup> These results are astonishing, given that much of the existing scholarship on Malaysia has found a positive relationship between FDI inflows and the reduction of overall income inequality<sup>2</sup>

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<sup>1</sup> Mukaramah-Harun, Siti Hadijah Che Mat, and Zalina-Zainal, "Does FDI Lead to a Deterioration of Income Distribution?: Evidence from Malaysia," *The Journal of Developing Areas* 49, no. 4 (2015): 341-353, <https://www.jstor.org/stable/24737392>.

<sup>2</sup> Abdul Rahim Ridzuan, Abdul Halim Mohd Noor, and Elsadig Musa Ahmed, "To What Extent are the Social Inequality Impacts of FDI in the Selected ASEAN?," *Applied Econometrics and International Development* 14, no. 1(2014): 189-204, [https://ideas.repec.org/a/ea/aeinde/v14y2014i1\\_14.html](https://ideas.repec.org/a/ea/aeinde/v14y2014i1_14.html).

and a negative relationship between FDI inflows and poverty levels.<sup>3</sup> Makaramah-Harun et al. briefly propose potential drivers behind this finding in the article's introduction and conclusion, including the bias of FDI towards skill-intensive sectors, but do not explore this issue in depth.

This paper aims to build upon the findings of the Makaramah-Harun et al. study and further address why FDI leads to increased income inequality between skilled and unskilled workers in Malaysia. Economically speaking, I argue that the redirection of FDI towards more skilled sectors and the positive correlation between FDI and displacement of unskilled domestic workers have contributed to growing income disparities between these classes of workers. Furthermore, I assert that the Malaysian government's policies to attract export-oriented, high-tech FDI, as well as its pro-Bumiputra (ethnic Malay) national policies that resulted in inequitable FDI gains among skilled and unskilled workers, have also exacerbated this inequality.

Before exploring this issue, one must clearly define what constitutes a "skilled" versus an "unskilled" worker in this context. This paper will employ the definitions established by the Malaysia Standard Classification of Occupation (MASCO) in 2013, as well as the definitions established in Makaramah-Harun et al. MASCO uses the highest level of educational attainment as a determinant for skill level, broadly classifying the nine major occupation groups into three major skill levels. Skilled workers have received tertiary education and include managers, professionals, and technicians/associate professionals. Semi-skilled workers have post-secondary education and include clerical workers, service and sales workers, skilled agricultural workers, craft and related trade workers, and plant and machine operators/assemblers. Low-skilled workers have only a primary level education and include

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<sup>3</sup> Shabbir Ahmad and Noor Al-Huda Abdul Karim, "Foreign Direct Investment: Key to Poverty Reduction in Malaysia," *The IUP Journal of Applied Economics* 8, nos. 5 and 6 (2009): 55-64, [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1485940](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1485940).

“elementary occupations.”<sup>4</sup> Makaramah-Harun et al. employ the MASCO definition for “skilled workers,” while grouping MASCO’s semi- and low-skilled worker classes as “unskilled workers” because of marked differences in skill specificity and other variables compared to their counterparts.<sup>5</sup> Thus, this paper’s working definition of “skilled” and “unskilled” workers in Malaysia will be defined by levels of education, with “skilled” workers having tertiary education or higher, and “unskilled” workers having post-secondary education or lower.

The remainder of this paper is organized as follows. Section 2 introduces the economic factors behind growing skilled-unskilled income inequality. This includes the sectorial redirection of FDI from unskilled to skilled sectors in section 2.1 and how increased FDI flow is correlated with unskilled domestic worker displacement in section 2.2. Section 3 explores the political factors contributing to the issue at hand, discussing the consequences of government policies to promote FDI in section 3.1 and the aftermath of pro-Bumiputra national policies in section 3.2. Finally, section 4 concludes and discusses potential methods to address skilled-unskilled income inequality in Malaysia.

## **1. Economic Factors**

This section will focus on how developments in the stock of FDI and FDI flow have contributed to increased income inequality between skilled and unskilled Malaysian workers. Regarding the former, the diversion of FDI inflows from the manufacturing sector to the service sector has exacerbated this inequality. Greater demand has translated to higher wages for skilled workers and vice versa for their unskilled equivalents. This redirection of FDI inflows has only been accelerated

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<sup>4</sup> “Principal Statistics of Labor Force, Malaysia, Third Quarter 2017,” Department of Statistics, Malaysia, [https://www.dosm.gov.my/v1/uploads/files/1\\_Articles\\_By\\_Themes/Labour\\_Force/Quarterly/Q3%202017/Principal%20Statistics%20of%20Labour%20Force%2C%20Q3%202017-p.pdf](https://www.dosm.gov.my/v1/uploads/files/1_Articles_By_Themes/Labour_Force/Quarterly/Q3%202017/Principal%20Statistics%20of%20Labour%20Force%2C%20Q3%202017-p.pdf).

<sup>5</sup> Makaramah-Harun et al., “Does FDI Lead to a Deterioration of Income Distribution?”

by the Malaysian government's high-tech-oriented FDI policies. However, the role of "hot money" capital controls on the quality of FDI and skilled-unskilled income inequality remains unclear. As for the latter, a positive correlation between FDI inflows and unskilled domestic worker displacement has also led to growing income disparities. The role of Chinese FDI in Malaysia, though difficult to measure, has further amplified the aforementioned correlation.

### **1.1. Malaysia's Changing FDI Stock**

#### *1.1.1. Sectorial Shift of FDI from Manufacturing to the Service Sector*

Nowhere is Malaysia's ongoing development from a lower to a higher-value-add economy more apparent than in the changing sectoral composition of FDI inflows. The country's manufacturing sector, generally dominated by unskilled workers, has seen a marked decline in these inflows, decreasing from an average of 63 percent over the period 1990-1999 to an average of 41 percent in 2018.<sup>6</sup> Inflows in other "unskilled sectors" like construction and agriculture have remained relatively stable at four to five percent over the same periods. Meanwhile, the service sector, which primarily employs skilled workers, has overtaken the manufacturing industry in terms of sectorial FDI inflow, more than tripling from a 15 percent average over 1990-1999 to 49 percent by 2018.<sup>7</sup>

As a result, this sectorial shift has contributed to increased income inequality between skilled and unskilled workers through wage discrepancies. The former benefit from high demand for their skills,

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<sup>6</sup> "Bank Negara Malaysia Annual Report 2009," Bank Negara Malaysia, 2009, 37,

[https://www.bnm.gov.my/documents/20124/830447/ar2009\\_book.pdf](https://www.bnm.gov.my/documents/20124/830447/ar2009_book.pdf); "A Critical Assessment of Direct Investments Abroad (DIA) and the Changing Nature of Foreign Direct Investments," Working Paper, Bank Negara Malaysia, 2018, 6,

<https://www.bnm.gov.my/documents/20124/826852/AR+BA6++A+Critical+Assessment+of+Direct+Investments+Abroad+%28DIA%29+and+FDI.pdf/8c09366b-81e7-f52c-6681-cfb623f05df9?t=1585029956308>.

<sup>7</sup> Ibid.

which only increases the already-present income gap with their unskilled counterparts. Even within the service sector, particularly high-skilled sectors like financial services and shared service operations have disproportionately benefited from this sectorial redirection.<sup>8</sup> On the other hand, the latter often suffer from lower wages as a result of muted demand, job displacement that eliminates their incomes, and low levels of labor mobility (due to lack of education) that prevent them from finding new jobs in other sectors.

The speed of this sectorial trend and its corresponding impact on skilled-unskilled income inequality has only increased thanks to Malaysian government policies related to FDI. Though the scale of individual investments into the service sector was smaller and less capital-intensive than those in manufacturing, the value-add and contribution to the national economy were greater due to the service sector's skill-intensive nature.<sup>9</sup> Thus, the service sector has become incredibly attractive to the Malaysian government as an engine of national growth. Accordingly, the government has promoted FDI into high-technology industries while often failing to address the stagnation and/or deterioration of "traditional," lower-skilled sectors.<sup>10</sup> In essence, skilled-unskilled income inequality has noticeably worsened due to the changing sectoral composition of FDI from the lower-skilled manufacturing sector to the higher-skilled service sector and will likely continue to do so given current trends.

### *1.1.2. The Role (or Lack Thereof) of "Hot Money"*

In analyzing the stock of FDI, it is also important to consider if the quality of FDI has significantly changed and how that would impact

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<sup>8</sup> "Bank Negara Malaysia Annual Report 2009," Bank Negara Malaysia, 36.

<sup>9</sup> Ibid.

<sup>10</sup> M. Yusof Saari, Erik Dietzenbacher, and Bart Los, "Sources of Income Growth and Inequality Across Ethnic Groups in Malaysia, 1970-2000," *World Development* 76 (2015): 312, <https://www.sciencedirect.com/science/article/pii/S0305750X15001746>.

skilled-unskilled income inequality. Consequently, one must address the diminished role of “hot money” through capital controls.

“Hot money” refers to capital that is transferred regularly and quickly between various financial markets as investors aim to maximize profits from short-term interest rates.<sup>11</sup> Though this strategy often benefits investors, host countries are left vulnerable to potential economic destabilization due to hot money’s short-term and speculative nature. Acknowledging these risks, the Mahathir administration clamped down on hot money in 1998 during the peak of the 1997-98 Asian Financial Crisis by imposing foreign exchange controls, blaming hot money speculators for many of Malaysia’s economic woes.<sup>12</sup> The Najib administration later reasserted Malaysia’s strict stance against hot money in 2016 by banning foreign firms invested in domestic markets from trading offshore ringgit derivatives.<sup>13</sup>

Have these capital controls on hot money also impacted FDI, and can one ascertain its impact on skilled-unskilled income inequality? Assuming that these capital controls did have a substantial impact on FDI, it would be plausible that such controls would also have an effect on skilled-unskilled income inequality. Namely, the assumption that only “high-quality” FDI post-capital-controls remained would imply that the sectorial redirection of FDI is even more pronounced than previously thought. Not only would FDI shift towards skilled sectors, but the quality of FDI would have also improved, thus impacting

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<sup>11</sup> Simon Constable, “What is Hot Money?”, *The Wall Street Journal*, February 4, 2018, <https://www.wsj.com/articles/what-is-hot-money-1517799600>.

<sup>12</sup> Alex Frew McMillan, “Malaysia’s troubled fixed currency,” *CNN*, March 28, 2001, <http://edition.cnn.com/2001/BUSINESS/asia/03/28/malaysia.currency/>.

<sup>13</sup> Joseph Sipalan, “Malaysia’s Olive Branch to Foreign Investors Might Not Be Enough,” *Reuters*, August 23, 2019, <https://www.reuters.com/article/malaysia-markets-ringgit/malaysias-olive-branch-to-foreign-investors-might-not-be-enough-idUSL4N25F166>.

skilled-unskilled employment and wage depression to an even greater degree given its non-nominal nature.

However, this assumption that capital controls adversely affected Malaysian FDI flows does not appear to hold. There is a distinct difference between FDI and hot money flows; the former is mainly determined by foreign firms' long-term considerations regarding the cost-benefit analysis of production in another country while the latter is driven by short-term maximization of profit and is more likely to be present in portfolio investments. Capital controls that address hot money do not necessarily have a direct impact on FDI. Indeed, this seems to be the case in Malaysia, as previous assumptions that capital controls hurt FDI inflows were likely based on an inaccurate conflation of "Malaysia's post-crisis experience with that of Thailand and Korea:"

According to official data, during the post-crisis period FDI inflows to Thailand and Korea have indeed increased at a faster rate than those coming to Malaysia. However, this is not a correct comparison... in Thailand and Korea, [hot money] acquisition by foreign companies [...] has been a major component of foreign capital inflows during this period. Malaysia did not resort to promoting acquisition or takeover by foreign companies.<sup>14</sup>

Furthermore, Malaysia utilized different balance of payment accounting methods that separated "true" FDI from hot-money's rapid transfer of existing assets:

According to the FDI classification system adopted by Bank Negara Malaysia in its balance of payments accounts, 'purchase of existing plant and equipment' by foreigners is treated as 'changes of ownership,' not as 'new investment'... Whatever [hot money] takeovers have happened are not reflected in

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<sup>14</sup> Prema-chandra Athukorala, *Crisis and Recovery in Malaysia: The Role of Capital Controls*, Massachusetts: Edward Elgar Publishing Inc., 2001, 106, [https://www.google.com/books/edition/Crisis\\_and\\_Recovery\\_in\\_Malaysia/OH6TxNswArwC?hl=en&gbpv=0](https://www.google.com/books/edition/Crisis_and_Recovery_in_Malaysia/OH6TxNswArwC?hl=en&gbpv=0).

official FDI figures, whereas in Thailand and Korea the value of these deals is captured in FDI data, together with true investment. When allowance is made for these considerations, the decline in FDI flows to Malaysia may be treated as part of the general decline in investment in the country following the onset of the crisis.<sup>15</sup>

Therefore, the impact of FDI flows cannot be strongly linked to the capital controls introduced to curb hot money in Malaysia from the 1998 Asian crisis onwards. Consequently, it is difficult to make a strong argument regarding the link between these capital controls and skilled-unskilled labor inequality.

## **1.2. Malaysia's FDI Flow**

### *1.2.1. Correlation Between FDI Growth and Displacement of Unskilled Domestic Workers*

Shifting the discussion from the changing stock of FDI to the growing flow of FDI, the existing literature has confirmed the positive relationship between FDI growth and the increasing displacement of unskilled domestic workers with foreign workers in Malaysia. Increases in Malaysian inward FDI have been linked to increasing numbers of foreign workers in Malaysia, but more importantly, "reliance on low-skilled foreign workers [tend] to displace local workers in the low-skilled category."<sup>16</sup> The sheer pace of FDI growth in Malaysia has exacerbated this issue; for instance, FDI net inflows increased from just US\$94 million in 1970 to US\$4.7 billion by 2005.<sup>17</sup> The displacement

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<sup>15</sup> *Ibid.*, 107.

<sup>16</sup> Hamidah Muhd Irpan et al., "Impact of Foreign Direct Investment on the Unemployment Rate in Malaysia," *Journal of Physics: Conference Series* (2016) 710, <https://iopscience.iop.org/article/10.1088/1742-6596/710/1/012028>; "A Critical Assessment," Bank Negara Malaysia, 7.

<sup>17</sup> Kishor Sharma, James Nayagam and Hui Hon Chung, "Determinants of Foreign Direct Investment in Malaysia: New Evidence from Cointegration and Error Correction Model," *Journal of Developing Areas* 46, no. 1 (2012): 73-75, <https://www.jstor.org/stable/23215424>.

of unskilled domestic workers can be attributed to foreign firms' desire to maximize profits by cutting down on labor costs since unskilled foreign workers tend to be "cheaper in terms of wages."<sup>18</sup>

Perhaps unsurprisingly, this job displacement by foreign workers has played a role in increasing skilled-unskilled income inequality among local workers. In line with the findings above, a recent study conducted by Khazanah Research Institute found that foreign workers in Malaysia were predominantly employed in unskilled positions. While the proportion of foreign workers in skilled jobs declined from 2010 to 2016, the share of foreign workers in unskilled occupations almost doubled from 28.2 percent to 42.3 percent over the same period.<sup>19</sup> Unskilled domestic workers are vulnerable to displacement in a way that skilled workers are not; researchers concluded that "on aggregate, [tertiary-educated Malaysians] do not face a high likelihood of being replaced by foreign workers. Malaysians in low-skilled jobs, on the other hand, could stand to lose."<sup>20</sup> Additionally, the rise of unskilled foreign workers has disproportionately hurt domestic unskilled workers' wages. The least-educated and lowest-skilled Malaysian workers were much more likely to experience wage suppression and/or wage stagnation amid rising living costs.<sup>21</sup>

### *1.2.2. The Role (Or Lack Thereof) of Chinese FDI in Malaysia*

In examining this issue, the role of Chinese FDI in Malaysia must be discussed, as its unique nature has implications for skilled-unskilled income inequality. One of the primary criticisms of China's Belt and Road Initiative, an ambitious infrastructure development scheme

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<sup>18</sup> Irpan et al., "Impact of Foreign Direct Investment," 3.

<sup>19</sup> "The State of Households 2018: Different Realities," Khazanah Research Institute, October 2018, 124, [http://www.krinstitute.org/assets/contentMS/img/template/editor/FullReport\\_KRI\\_SOH\\_2018.pdf](http://www.krinstitute.org/assets/contentMS/img/template/editor/FullReport_KRI_SOH_2018.pdf).

<sup>20</sup> *Ibid*, 126.

<sup>21</sup> "A Critical Assessment," Bank Negara Malaysia, 7; Saari, Dietzenbacher, and Los, "Sources of Income."

established in 2013, is an “excessive reliance on Chinese employees for on-the-ground-projects, which deprives participating countries of jobs.”<sup>22</sup> Thus, if Chinese FDI is particularly prominent in Malaysia, the positive correlation between FDI growth and the displacement of unskilled domestic workers, as well as its detrimental impact on skilled-unskilled income inequality, are likely to be even more significant.

It is difficult to determine how much of Malaysia’s FDI originates from China in the first place. According to official statistics, Malaysian FDI chiefly originates from Singapore (21 percent), Japan (13 percent), and international offshore financial centers (12 percent), with only three percent officially attributed to China.<sup>23</sup> On the topic of job displacement, officials report that over 75 percent of foreign workers hail from Indonesia, Nepal, or Bangladesh as of 2015.<sup>24</sup> However, these official statistics may not accurately reveal the extent of Chinese FDI and Chinese workers in Malaysia. Other studies have concluded that FDI from China has increased from just 0.8 percent of Malaysia’s total net FDI inflow in 2008 to 14.4 percent by 2016, primarily due to the Belt and Road Initiative.<sup>25</sup> Coincidentally, Malaysia has also been experiencing a “third wave” of Chinese migration in recent years, with “a fair number” of migrant workers entering into low-skilled sector employment.<sup>26</sup>

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<sup>22</sup> Nyshka Chandran, “China can make its Belt and Road project more successful if it taps into locals, experts say,” CNBC, September 14, 2018, <https://www.cnbc.com/2018/09/14/china-must-do-more-to-tap-locals-in-belt-and-road-initiative-panel.html>.

<sup>23</sup> “A Critical Assessment,” Bank Negara Malaysia, 6.

<sup>24</sup> “The State of Households 2018,” Khazanah Research Institute, 120.

<sup>25</sup> Tham Siew Yean, “Chinese Investment in Malaysia: Five Years into the BRI,” *ISEAS Perspectives* no.11, February 27, 2018, 2, [https://www.iseas.edu.sg/images/pdf/ISEAS\\_Perspective\\_2018\\_11@50.pdf](https://www.iseas.edu.sg/images/pdf/ISEAS_Perspective_2018_11@50.pdf).

<sup>26</sup> Tashny Sukumaran and Coco Liu, “Why are Chinese moving to Malaysia by the thousands?”, South China Morning Post, March 25, 2017, <https://www.scmp.com/week-asia/geopolitics/article/2080869/why-are-chinese-moving-malaysia-thousands>.

It is challenging to make definitive conclusions regarding China's role in the growing flow of FDI and how that relates to skilled-unskilled income inequality in Malaysia without knowing the extent of Chinese FDI. However, the role of Chinese FDI in Malaysia—and its consequences for inequality—will almost certainly grow as China's Belt and Road Initiative continues to expand in breadth and depth.

## **2. Political Factors**

This section will focus on how the Malaysian government's policies to attract FDI, and its pro-Bumiputra redistribution and educational policies have increased skilled-unskilled income inequality in Malaysia. The government's export- and high-tech-oriented FDI policies have led to the displacement of and wage suppression for unskilled domestic workers while benefiting skilled ones, contributing to increased disparities in income. Similarly, pro-Bumiputra asset redistribution and university policies, coupled with the general backlash to the pro-Bumiputra nature of these policies, have resulted in growing skilled-unskilled income inequality within the Bumiputra class itself (by enriching the most skilled Bumiputra) and within the population as a whole (by creating a "brain drain" of skilled workers), respectively.

### **2.1. Consequences of Malaysian Government Policies to Attract FDI**

In recent times, the labor income for unskilled workers has markedly reduced due to increased dependence on imported inputs and skill-biased technological change, both driven by export-oriented, tech-sector-biased policies.<sup>27</sup> The impact of increased reliance on imported inputs and the effect of skill-biased technological change were not isolated from one another in the Saari, Dietzenbacher, and Los, study. Still, their combined effect was astonishing: the labor income coefficient of unskilled labor reduced on average by 85 percent from 1970 to 2000, while the coefficient for skilled labor increased by 18

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<sup>27</sup> Saari, Dietzenbacher, and Los, "Sources of Income," 324.

percent.<sup>28</sup> Even more remarkable is that the combined effect of these two factors on labor income was negative for all unskilled workers regardless of urban or rural residency and ethnicity, while the impact on skilled workers was “always positive.”<sup>29</sup>

### *2.1.1. Export-Oriented FDI Policies and the Displacement of Domestic Unskilled Workers*

The Incentive Investment Act of 1968 and the Free Trade Zone Act of 1971 are highly emblematic of the Malaysian government’s aggressive pursuit to attract export-oriented foreign investment. The former aimed to specifically promote export-oriented FDI by offering “exemptions from company tax and duty on imported inputs, investment tax credits, and accelerated depreciation allowance on investment.”<sup>30</sup> The Incentive Investment Act was amended just two years after its creation to be even more ambitious in promoting export-oriented industries to foreign investors, abolishing the payroll tax, and introducing tax exemptions for increased employment.<sup>31</sup> Not to be outdone, the Free Trade Zone Act established ten free trade zones in Malaysia that enjoyed “subsidized infrastructure, fast consideration of custom formalities, duty free access to imported inputs and capital goods, and removal of export taxes.”<sup>32</sup>

These policies have contributed to a dramatic growth in Malaysia’s exports from USD\$1.7 billion in 1970 to USD\$247 billion by 2018.<sup>33</sup> However, the “positive influence of export growth could not offset the negative influences of changes in labor and capital input compensation

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<sup>28</sup> *Ibid.*, 321.

<sup>29</sup> *Ibid.*

<sup>30</sup> Sharma, Nayagam, and Chung, “Determinants of Foreign Direct Investment in Malaysia,” 72.

<sup>31</sup> *Ibid.*, 72-73.

<sup>32</sup> *Ibid.*, 72.

<sup>33</sup> “Exports of Goods and Services (Current \$US)- Malaysia,” *World Bank Data*, <https://data.worldbank.org/indicator/NE.EXP.GNFS.CD?locations=MY>.

for labor incomes.”<sup>34</sup> The Malaysian government’s policies to attract export-oriented FDI have had the unintended consequence of increasing Malaysia’s reliance on imported inputs while shutting out domestic companies. Export activities in Malaysia were “mostly driven” by foreign multinational firms lured by the government’s generous export-oriented FDI policies; unfortunately, such activities rely heavily upon imported inputs with “no or few backward linkages to domestically-owned industries, in particular small and medium size enterprises.”<sup>35</sup>

This increased reliance on imported inputs has specifically hurt unskilled domestic workers and consequently played a role in skilled-unskilled income inequality. The ratio of exports to imports decreased from 1.28 in 1987 to 1.10 in 2000, while import requirements per unit of export output for almost all sectors in Malaysia have increased by an average of 65 percent.<sup>36</sup> In other words, unskilled domestic workers (of which the majority are employed in the manufacturing industry) have been increasingly excluded from the benefits of FDI-driven export growth, as their labor is being substituted for by foreign inputs. Export-oriented FDI policies contributed to the aforementioned 85 percent reduction in unskilled workers’ labor income coefficient, compared to the 18 percent increase for skilled workers. However, its impact was not detailed in the study.

### *2.1.2. High-Tech FDI Policies and Bias Towards Skilled Workers*

The Malaysian government also implemented FDI policies designed to attract foreign investment into high-technology industries in line with their objective to move the Malaysian economy up the value-add spectrum:

These reforms included the amendment to the Free Trade Zone Act (in 1990) which was originally enacted in 1971, and the review of investment incentives to encourage higher value

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<sup>34</sup> Saari, Dietzenbacher, and Los, “Sources of Income,” 321.

<sup>35</sup> *Ibid.*, 318.

<sup>36</sup> *Ibid.*, 321.

added and capital-intensive industries (in 1991). In addition to these, export conditions and equity policy guidelines were relaxed in 1996 and 1998, respectively.<sup>37</sup>

However, the government failed to fully address the asymmetry these policies created between skilled and unskilled sectors. While “modern” sectors thrived, “traditional” sectors that employed unskilled labor, like manufacturing and agriculture, faced stagnation and/or deterioration. Indeed, the “differences in productivity, income, and ultimately wealth of those engaged in [the modern and traditional sectors] increased.”<sup>38</sup>

This skill-biased technological change, driven by national policies to attract FDI, continues to favor skilled workers. Studies conducted using Malaysian manufacturing data claim “technological change is biased toward the use of skilled workers such as professionals, technicians and managers.”<sup>39</sup> This is unsurprising, considering existing research that has identified skill-biased technological change as the main driver for income inequality (including evidence from India and the United States).<sup>40</sup> Malaysia’s policies to attract high-tech FDI have indeed advanced the technological sophistication of its economy. Still, they have also amplified the impact of skill-biased technological change, boosting demand (and thus wages) for skilled workers and vice versa for the unskilled. Skill-biased technological change has contributed to the 85 percent reduction in the labor income coefficient of unskilled workers and the 18 percent increase for skilled workers from 1970 to 2000.<sup>41</sup>

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<sup>37</sup> Sharma, Nayagam, and Chung, “Determinants of Foreign Direct Investment in Malaysia,” 73.

<sup>38</sup> Saari, Dietzenbacher, and Los, “Sources of Income,” 312.

<sup>39</sup> *Ibid.*, 321.

<sup>40</sup> Yoko Kijima, “Why did wage inequality increase? Evidence from Urban India, 1983–99,” *Journal of Development Economics* 81, no. 1 (2006): 97–117,

<https://www.sciencedirect.com/science/article/abs/pii/S0304387805001380>.

<sup>41</sup> Saari, Dietzenbacher, and Los, “Sources of Income,” 321.

## **2.2. Consequences of Pro-Bumiputra National Policies**

In line with the government's FDI policies, pro-Bumiputra policies also resulted in a widened income gap among Malaysian workers. In force from 1971 to 1990, the National Economic Policy had two key objectives: "poverty eradication regardless of race" and "restructuring society to eliminate the identification of race with economic function."<sup>42</sup> Though it was designed to reduce socioeconomic-driven resentment between Malaysia's three main ethnic groups (Chinese, Indian, and native Malay), NEP policies were highly pro-Bumiputra in practice. Unfortunately, many pro-Bumiputra policies contributed to skilled-unskilled labor inequality, both within the Bumiputra class itself and within the local population.

### *2.2.1 Pro-Bumiputra Asset Redistribution Policies*

The NEP's pro-Bumiputra asset redistribution policies had the unintended consequence of contributing to skilled-unskilled income inequality (particularly within the Bumiputra ethnic group itself) by predominantly enriching skilled Bumiputra. Though the state initially focused on transferring economic wealth under the NEP through trusts created for Bumiputras, the spotlight shifted to enriching individual Bumiputra instead:

In the late 1970s and early 1980s, around 70% of corporate assets designated for Malays were held in trust agencies, with the remainder 30% held by Bumiputra individuals. However, from the 1980s onwards, much more emphasis was given to personal wealth acquisition by Malays. By 1990, Bumiputra

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<sup>42</sup> K.S. Jomo, "The New Economic Policy and Interethnic Relations in Malaysia," United Nations Research Institute for Social Development, September 1, 2004, <https://www.unrisd.org/unrisd/website/document.nsf/%28httpPublications%29/A20E9AD6E5BA919780256B6D0057896B>.

individuals owned 73% of Malay corporate assets, which rose to 91.2% in 2002, with the remainder held in Bumiputra trusts.<sup>43</sup>

This shift towards building Bumiputra wealth created a small group of wealthy Bumiputra elites whose wealth accumulation depended on strong political and business connections rather than merit. Indeed, retroactive studies have found that “the move towards privatisation of state assets under Mahathir’s leadership did more to transfer large sums of national wealth into the hands of a small number of well-connected Malays than to drastically improve productivity and efficiency.”<sup>44</sup> One such example of this egregious problem was with Amanah Saham Nasional (ASN), which was meant to transfer assets held in Bumiputra trusts to the ethnic group itself. However, more than two million Bumiputra owned shares in ASN, 1.3 percent of these Bumiputra individuals owned 75 percent of ASN’s total shares.<sup>45</sup>

As FDI and Malaysia’s economic power both grew over the two decades the NEP was in place, these individuals at the top of the “skilled” spectrum accumulated increasingly massive amounts of wealth to the detriment of not just other ethnic groups but also of other Bumiputras that this policy was designed to benefit as a collective.<sup>46</sup> In other words, the NEP’s asset redistribution policies had a significant negative impact on skilled-unskilled income inequality because those who benefited from the nation’s prosperity were disproportionately already members of “skilled” occupation groups, such as managers and professionals. The newfound wealth of this elite group of skilled Bumiputra was not accompanied by a corresponding increase in unskilled workers’ incomes from asset redistribution, further increasing this inequality. This pro-Bumiputra redistribution policy has exacerbated the impact of

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<sup>43</sup> John Lee, “Malaysian Dilemma: the Enduring Cancer of Affirmative Action,” The Center for Independent Studies, February 23, 2011, 10, <https://www.cis.org.au/publications/foreign-policy-analysis/malaysian-dilemma-the-enduring-cancer-of-affirmative-action/>

<sup>44</sup> *Ibid.*

<sup>45</sup> *Ibid.*, 11.

<sup>46</sup> *Ibid.*

FDI on skilled-unskilled inequality; increased FDI has driven national economic growth, which means more assets to redistribute and therefore, more significant disparities between the have and have-nots.

### *2.2.2. Pro-Bumiputra University Policies*

In the same vein, the NEP's pro-Bumiputra university policies also intensified skilled-unskilled income inequality by enriching the most skilled Bumiputras. Before the NEP, Bumiputras were heavily underrepresented in Malaysian universities, a shortcoming that was most severe in more lucrative STEM fields.<sup>47</sup> The NEP thus set up a university quota system that ensured Bumiputra majorities among students, faculty, and staff, as well as a scholarship system that awarded 80 percent of its scholarships to Bumiputra students who only needed to fulfill the "minimum requirements for admission."<sup>48</sup> The NEP also directed public funds to establish programs to support both Bumiputra students studying overseas and institutions that exclusively admitted Bumiputras for post-secondary vocational training.<sup>49</sup>

Though Bumiputras' educational and economic status relative to other ethnic groups improved under the NEP's university policies, these same policies disproportionately benefited the wealthiest Bumiputra student who could already afford university education and training programs in the first place.<sup>50</sup> Recalling that this paper's working definition of "skilled" workers encompasses those who have received tertiary education, the NEP's policies primarily benefited the most skilled Bumiputra. Unskilled Bumiputra workers did not reap the benefits of the NEP's university policies, trapping many in lower-

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<sup>47</sup> Suet-ling Pong, "Ethnicity and Schooling in Malaysia: the Role of Policy," Committee for International Cooperation National Research in Demography (CICRED), International Seminar on Educational Strategies, Families, and Population Dynamics, November 1999, 5, [http://www.cicred.org/Eng/Seminars/Details/Seminars/education/ACTES/Com\\_Pong.PDF](http://www.cicred.org/Eng/Seminars/Details/Seminars/education/ACTES/Com_Pong.PDF).

<sup>48</sup> Ibid.

<sup>49</sup> Ibid.

<sup>50</sup> Lee, "Malaysian Dilemma," 12.

paying jobs due to their lack of education and increasing skilled-unskilled income inequality.

The impact of educational attainment on income has only grown, as FDI is biased towards higher-skilled sectors and skilled workers are in ever-greater demand. Therefore, FDI's negative impact on skilled-unskilled income inequality has likely increased due to pro-Bumiputra NEP policies.

### *2.2.3. General Backlash to Pro-Bumiputra Policies*

Decades of pro-Bumiputra policies have fostered resentment among other ethnic groups. The New Development Policy (NDP) and the Second OPP later replaced the NEP in 1990, which were replaced by the National Vision Policy (NVP) and the Third OPP in 2000. In terms of pro-Bumiputra affirmative action objectives, these policies were changed little.<sup>51</sup> Signifying their discontent, “the number of skilled non-Malays [meaning non-Bumiputra] leaving the country is one indication of resentful non-Malays voting with their feet, a problem that has become a significant brain drain for the population”; one percent of the total population, not including students studying abroad, left Malaysia just between March 2008 and August 2009.<sup>52</sup> Though “the government refuses to give an ethnic breakdown of these citizens” that have left Malaysia, “anecdotal observations reveal that the vast majority of these itinerant Malaysians are of Chinese or Indian ethnicity.”<sup>53</sup>

This skilled non-Bumiputra brain drain has magnified FDI's impact on skilled-unskilled income inequality. Again, recall that FDI is biased towards higher-skilled sectors, leading to greater demand for skilled workers. With a lower supply of skilled workers in the country due to pro-Bumiputra policy resentment, coupled with a higher demand for

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<sup>51</sup> R. Thillainathan and Kee-Cheok Cheong, “Malaysia’s New Economic Policy, Growth and Distribution: Revisiting the Debate,” *Malaysian Journal of Economic Studies* 53, no. 1 (2016): 51-68, <https://mjes.um.edu.my/index.php/MJES/article/view/2779>.

<sup>52</sup> Lee, “Malaysian Dilemma,” 9.

<sup>53</sup> *Ibid.*

skilled workers as a whole, skilled worker incomes have noticeably risen, in contrast to unskilled workers' wage stagnation.

### **3. Conclusion and Recommendations**

This paper has explored the potential economic and political factors behind the relationship between FDI and increased income inequality between skilled and unskilled workers in Malaysia. FDI has a direct economic impact on such inequality through the changing sectoral composition of FDI and the correlation between increased FDI flow with unskilled domestic worker displacement. This impact has been exacerbated by political factors, including the consequences of policies to attract FDI and national policies favoring ethnic Malays.

In tackling this complex issue, the Malaysian government should focus on making gains from FDI more equitable across all skill levels.

Firstly, changing the sectoral composition of FDI or addressing skill-biased technological change would be difficult, considering Malaysia's ambitions to further redirect its economy towards higher-value-add skilled sectors further. With this in mind, the state would do well to aid unskilled workers in achieving greater labor mobility through educational and training programs. The administration should also consider improving both the quality and accessibility of educational and training programs for unskilled workers, with lower entry barriers and incentives to ensure their enrollment and continued participation in the programs.

The Malaysian government should also implement policies that guarantee the domestic economy and unskilled domestic workers enjoy growing FDI. In particular, the government should design and enforce policies that incentivize foreign firms to employ unskilled domestic workers over unskilled foreign workers, as well as policies that encourage foreign firms to use domestic inputs rather than imported ones. Through educational/training programs and policies aiming to direct FDI's benefits towards the domestic economy, unskilled workers would become less vulnerable to job displacement and depressed wages.

Simultaneously, increased labor mobility would allow them to adapt as Malaysia's economy continues to develop.

Lastly, the Malaysian government should reduce pro-Bumiputra policies that exacerbate skilled-unskilled income inequality. Indeed, the government has made progress on this last recommendation; former Prime Minister Najib Razak's New Economic Model, implemented in 2010, already began to scale back the NEP's ethnicity-based affirmative action policies.<sup>54</sup>

Though addressing skilled-unskilled income inequality in Malaysia will be difficult due to the issue's multifaceted nature, the government must continue to fight for those who are most vulnerable to its ambitious future economic development goals.

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<sup>54</sup> Lee, "Malaysian Dilemma," 1.

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