Malaysia and the Resource Curse

From 1970 to 1990, Malaysia developed at an incredible rate. In twenty years, the country shifted from a primarily agriculture economy, to a manufacturing economy (Randhawa 2011, Razali 1999). Today, Malaysia is one of the richest countries in South East Asia and is quickly approaching developed nation status (Randhawa 2011, Razali 1999). Much of this growth was fueled by the government controlling oil production and state centered industrialization (Randhawa 2011). Despite ample literature demonstrating a connection between natural resource rents and ineffective governments, Malaysia's government has successfully used the nation's resources to assist economic development by fueling manufacturing. Malaysia's effective government developed out of necessity. Shortly after gaining independence, the country was on the brink of civil war (Rinehart 2015). The state promised to alleviate ethnic tensions by developing the country and improving citizen's living standards (Rinehart 2015). The National Economic Policy (NEP) helped promote economic and social equality among citizens; however, the policy would have been ineffective without the funding provided by natural resources.

This paper is divided into three primary parts. It opens by providing some of the literature surrounding the resource curse. Next, it demonstrates that Malaysia has successfully beaten the resource curse. Finally, this study shows that Malaysia's ethnic divisions and effective government policies helped the nation avoid and overcome the resource curse.

The Resource Curse

Although the theory is debated, a large collection of literature demonstrates a relationship between resource dependence and poor economic performance (Ross 1999; 2001, Guliyev 2013, Ploeg 2011). Resource wealth likely hinders a country's development for several reasons. Many natural resources experience severe price fluctuations; as a result, states struggle to develop long term financial plans (Guliyev 2013, Ploeg 2011, Ross 2001). When prices are high, governments may increase spending on welfare programs or other public goods (Ploeg 2011, Ross 1999; 2001). However, when prices fall and revenues drop, they will be unable to meet their prior commitments (Ploeg 2011, Ross 2001). States will also have an easier time securing loans when resource prices are high (Ross 1999; 2001). Nevertheless, if prices fall and lenders call in their loans, states will be unable to make their payments (Ross 1999; 2001). Thus, resource dependent states often struggle to develop long term financial plans resulting in economic development and persistent growth.

The "Dutch Disease" refers to another common problem associated with resource wealth. Discovering natural resources leads to an increase in demand for the nation's exports, which drives up the country's exchange rate (Ross 1999, Ploeg 2011). Although importers benefit from the high exchange rate, exporters suffer because their goods become more expensive on the global market. Agriculture products, the primary export for many undeveloped countries, are significantly affected by high exchange rates. High exchange rates also make it more difficult for domestic producers to sell locally because foreign goods are relatively cheaper; this creates a "crowding out effect" (Guliyev 2013, Ploeg 2011). However, natural resources constant demand and limited supply means that resource exporters are not adversely affected by high exchange rates. As a result, countries' economies increasingly rely on natural resources and their economies are unlikely to diversify (Guliyev 2013, Ploeg 2011, Ross 1999).

After first discovering natural resources, most states lack the infrastructure to extract them. Thus, foreign or state owned companies are generally used for extraction. Foreign ownership of extraction results in most funds flowing to the foreign country rather than remaining domestic

(Ploeg 2011). To avoid sending resource profits to other countries, states often take control of resource extraction. Although this process helps keeps funds within the country, it creates several policy problems for the home state.

State owned resources eliminate the governments need to tax its citizens because resources provide the majority of state revenues (Guliyev 2013, Ploeg 2011, Ross 1999; 2001). Ross (2001; 1999) developed the phrase ‘the rentier effect’ to explain the relationship between resource wealth, taxation, and government accountability. Taxation creates accountability; therefore, eliminating taxation decreases government accountability. Democratization relies heavily on citizens holding their governments accountable. Without accountability, states are unlikely to develop democracy. The process of taxing citizens also helps the government create and develop bureaucracy. Without taxation, governments often struggle to build up bureaucratic institutions.

Resource wealth also reduces a state’s chance of developing democracy through the ‘spending effect’ (Ross 2001). States with ample resource revenues can provide citizens with enough public goods to prevent an uprising, but not enough public goods to allow the state to modernize. This prevents the necessary social changes needed for democratization from taking place (Inglehart 1997).

In addition to taxation problems, state owned resources also provide leaders with tremendous power. In both authoritarian and democratic states, leaders are generally short sighted and focused on maintaining control. Staying in power requires leaders to please their constituencies. In democratic states, this constituency is often large, so the optimal way to maintain power is through public policies that benefit the majority of citizens, who are generally more interested in their current situations than future dilemmas. In response, democratic leaders generally avoid investing in long term plans that will reap future rewards. Authoritarian leaders are also short sighted; however, they rely on small constituencies to maintain control. It is generally more efficient for authoritarian leaders to direct benefits explicitly to their cronies rather than through public works, which increases the prevalence and likelihood of corruption (Ross 1999; 2001, Ploeg 2011, Gyimah – Boadi and Prempeh 2012). Similar to democratic leaders, authoritarian leaders' spending habits center around short term rather than long term investments. An increase in funds from oil revenues exacerbates the situation in both authoritarian and democratic states; as a result, growth from investment is unlikely (Ross 1999; 2001, Ploeg 2011).

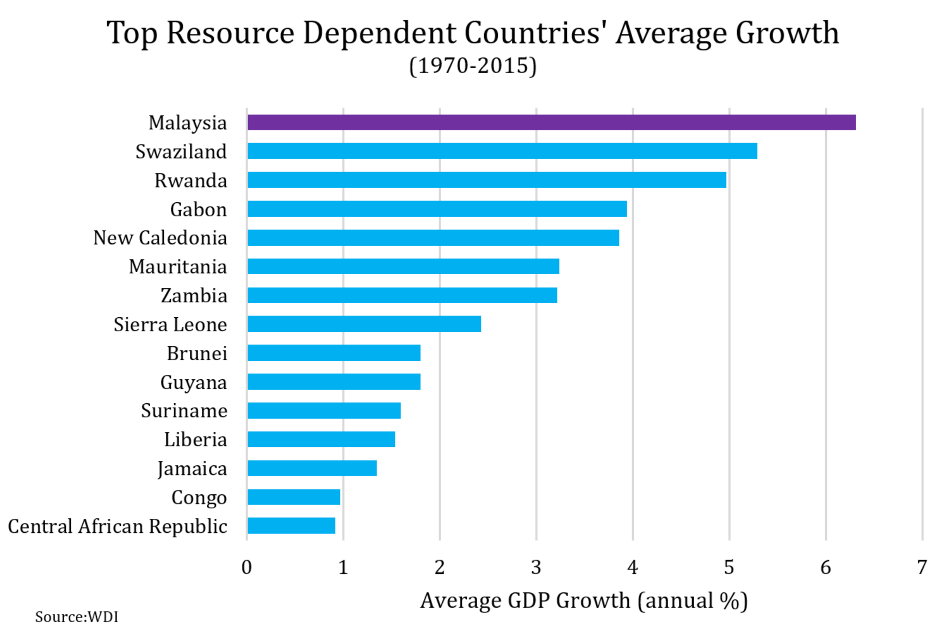
Resource revenues provide authoritarian leaders with a constant source of revenue not dependent on the economy. Not only does this money allow leaders to easily pay supporters, but it also relinquishes them from the responsibility of growing the economy. In non-resource dependent states, authoritarian leaders rely on the economy and taxes to provide enough funds to pay their cronies. When the economy does not provide these funds, leaders have little incentive to help it grow and the economy will likely be neglected (Ploeg 2011, Ross 1999; 2001).

High resource wealth is also positively correlated with conflict levels. Natural resources help fuel civil wars by providing insurgencies with revenues (Weinstein 2007). Fighting may also center around the resource itself as different groups battle for control. Unlike other commodities, natural resources are point source, meaning they cannot be moved (Weinstein 2007). This increases the likelihood that conflicts will revolve around the resource.

Malaysia Today

Malaysia's current situation clearly demonstrates that the country has successfully beaten the resource curse. Resource wealth generally harms states by stifling growth, creating ineffective governments, and increasing conflict. Although Malaysia still struggles with these issues, they are less prevalent today than they were prior to the country's dependence on natural resources.

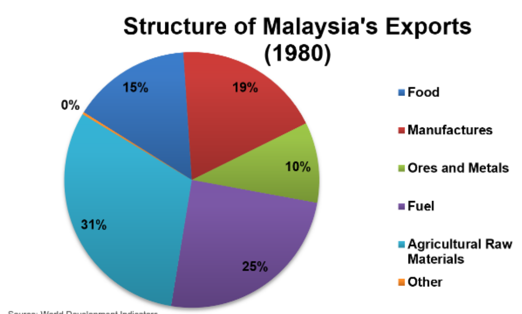
From 1970 to 1990, the country had an average growth rate of 8.5% as the state switched from an agriculture based economy to a manufacturing one (Randhawa 2011). Although growth has slowed slightly in the past ten years, it remains high, with an average rate of 4.9% (WDI). Malaysia has also grown significantly faster than other resource dependent states. According the World Development Indicators, in 2015, the average growth rate among the top 75 most resource dependent states was 2.7%, while Malaysia grew 4.9%. Malaysia's superior performance is also demonstrated by examining the average growth rate from 1970 to 2015 of the fifteen (one standard deviation from the mean) most resource dependent countries in 1970. The average growth of the top resource dependent countries was 2.9%, while Malaysia grew at an average rate of 6.3% (WDI).

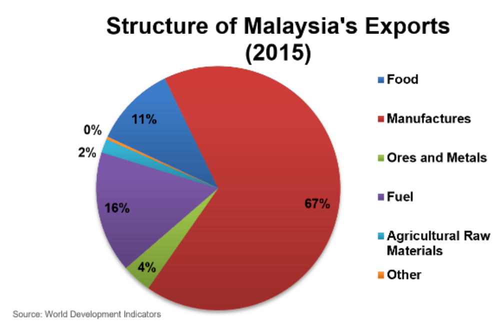


Economic diversification has played a major role in the country's persistently high growth rate. Unlike many resource dependent states, Malaysia has successfully diversified its economy.

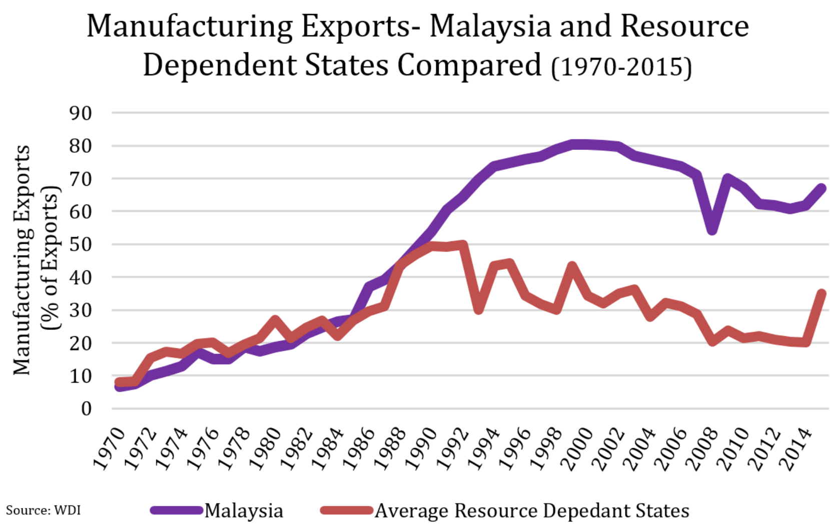
In 1970, when the state first gained control of oil extraction, almost 17% of the country's GDP came from resource rents (WDI). At its peak in 1985, 31% of Malaysia's GDP relied on natural resources; by 2015, that number dropped to less than 5% (WDI).

Despite diversifying its economy, natural resources remain a major source of income for the country. Fuels, specifically petroleum, constitute about 16% of Malaysia's merchandise exports (WDI). Ores and minerals comprise about 4% of exports, making nearly 20% of the country's merchandise exports resource reliant (WDI). However, these numbers have changed drastically since 1980, when ores and minerals were about 10% of exports and fuel was nearly 25% of exports (WDI). The shift in exports away from natural resources has been spurred by government policies specifically directed at developing the manufacturing sector (Razali 1999, Rinehart 2015). In 1970, only 7% of exports were in manufacturing; by 1980, about 20% of exports were from the manufacturing sector (WDI). Today, almost 67% of exports are manufactured goods (WDI).





Malaysia's manufacturing sector has also outperformed other resource reliant states. Examining the average manufacturing exports from 1970 to 2015 of fifteen countries with the highest resource rents in 1970, reveals that Malaysia has been more successful at developing its manufacturing sector than the typical resource reliant state. From 1970 to 1990, Malaysia's manufacturing market grew at a rate similar to other resource dependent countries; however, after 1990, Malaysia industrialized at a much faster rate. By 2000, about 80% of Malaysia's exports were manufactured goods, while only 45% of exports for the average resource dependent state were manufactured goods (WDI). By demonstrating persistently high growth and economic diversification Malaysia overcome part of the resource curse.



Malaysia's government has also avoided high levels of corruption and maintained sound economic policies, despite the nations resource wealth. In 2016, Malaysia ranked 55th on Transparency International's Corruption Index, with a score of 49 out of 100. According to Transparency international, the country ranked 5th among resource dependent countries. The world governance Indicators placed Malaysia in the 66th percentile of all countries. Despite this, Malaysia still suffers from some corruption, as demonstrated by the unexplainable $700 million in the Prime Ministers personal bank account (Corruption Index).

However, corruption has not interfered with the country's success. According the World Governance Indicators, in 2015, Malaysia scored above the 70th percentile on three of their six indicators- government effectiveness, regulatory quality, and rule of law. These high scores are unsurprising based on the government's successful implementation of economic and social policies. Although controversial, these policies, such as the New Economic Policy (NEP), are generally directed toward improving the country's education and healthcare system (Welsh 2007, Rinehart 2015, Razali 1999). The results have been significant, demonstrating the government's ability to implement effective public policies.

Percentile Rank of Institutional Quality in Malaysia (2015)

Voice and Accountability	36
Government Effectiveness	77
Regulatory Quality	75
Rule of Law	72
Control of Corruption	66
Political Stability and Absence of Violence/Terrorism	54

Source: World Governance Indicators

Although NEP was designed to promote growth throughout the country, it was specifically aimed at improving the rights and opportunities of ethnic Malays (Welsh 2007, Rinehart 2015, Razali 1999). Although inequality between groups has shrunk, ethnic tension remains. Islam's role in the country's government has been a recent source of controversy (Welsh 2007, Pepinsky 2009). Most Malaysian Muslims are also ethnic Malays, resulting in a continuation of the traditional ethnic battles (Welsh 2007).

After independence, Malaysia adopted a democratically elected parliamentary system; however, Malaysia is often referred to as an electoral authoritarianism. The Barisan Nasional Party (BN), the coalition formed by the United Malays National Organization (UMNO), has ruled the country without interruption since the first election in 1969 (Pepinsky 2009, Rinehart 2015, Welsh 2007). The United States and the global community often criticize the BN for restricting opposition speech (Rinehart 2015). Malaysia scored in the 36 percentile on the Worldwide Governance Indicator's rule of law indicator in 2015. The conviction and imprisonment of opposition leader

Anwar Ibrahim is a prime example of the governments restrictions on free speech. From 1993 to 1998, Anwar was a prominent member of the UMNO and was often considered second in command to the Prime Minister; however, shortly after splitting with the coalition in 1998, he was arrested and accused of sodomy (Rinehart 2015). After a series of overturns, Anwar was finally sentenced to five years in prison by the highest appellate court in Malaysia, eliminating his possibility of holding an important opposition senate seat (Rinehart 2015).

In a dramatic upset, 2008 marked the first election where the BN failed to gain a super majority of seats, making it the first time in the country's history where the ruling party was unable to change the state's constitution at will (Pepinsky 2009, Case 2010). Case (2010) and Pepinsky (2009) have deemed this a significant blow to the country's authoritarian system and state that it provides hope that Malaysia and other electoral authoritarianisms will transition towards democracy. The loss of the BN's super majority demonstrates that electoral authoritarianisms are not trapped; they can still become democracies. In 2013, the BN again failed to gain a super majority, or even a majority, of the popular vote (Welsh 2013). However, the group still garnered a majority of seats, because of this, many are declaring electoral fraud (Welsh 2013).

For decades, Malaysia has clearly been an electoral authoritarianism, but recent elections have challenged this classification. In transitioning towards democracy, Malaysia is in the process of defying the resource curse, which claims that resource dependent countries are unlikely to develop democracy.

In opposition to the resource curse, Malaysia has successfully grown and diversified its economy. The state has shifted from an agriculture society dependent on natural resources to a manufacturing economy. Despite some corruption, Malaysia generally has less corruption than other resource dependent states. In addition, the government has successfully implemented several economic and social policies, such as the NEP. Democracy is also on the rise in Malaysia, with the UMNO failing to win a super majority of seats for the first time since the country's independence. Taken together, these accomplishments demonstrate that Malaysia has beaten the resource curse.

How Malaysia Beat the Resource Curse

Malaysia's ethnic tensions forced the nation to effectively use its natural resources to implement policies designed to reduce inequality. Unlike most nations that ignored ethnic hostilities after gaining independence, Malaysia's government chose to directly confront the issues. The government recognized that a civil war would diminish the leaders power and hurt their status. Their policies, specifically the NEP, were successful primarily because they were funded by natural resource revenues. Therefore, Malaysia's ethnic problems helped the nation avoid and overcome the resource curse.

After decades of colonial rule, Malaysia negotiated its independence from Britain in 1957 and became a commonwealth state (Rinehart 2015). The new nation soon adopted a parliamentary government and held its first election in 1967. The UMNO, representing ethnic Malays, won the election (Welsh 2007; 2013, Pepinsky 2009, Rinehart 2015). In 1969, riots broke out between ethnic Malays, the Chinese, and the Indians (Rinehart 2015). While consisting of a minority of the population, the Chinese held a majority of the wealth, infuriating the majority Malay group.

To ease the riots, prevent civil war, and maintain control, the government recognized the need to please their constituency, ethnic Malays. Had they ignored the crisis, the country likely would have erupted into civil war and the state's leaders would have lost power (Razali 1999). Thus, NEP was devised with the central purpose of shrinking inequality between ethnic Malays and the Chinese (Razali 1999). Primarily an affirmative action program, NEP granted the Malay population greater access to education, employment, and government benefits (Razali 1999). The Malay language also replaced English as the primary language in schools (Razali 1999). NEP had some success, but it was limited. While several Malays rose to the middle class, most remained impoverished. However, the success of some Malays provided the community with hope and a sense of economic security.

NEP aided the country's growth by improving education and healthcare. The healthcare system was improved by increasing government spending on hospitals and clinics in rural areas (Razali 1999). The government attempted to address inequality among rural and urban dwellers by increasing the quantity and quality of schools in rural areas. In addition to increasing funding for rural schools, Children without access to adequate schools were placed in urban districts with superior schools (Razali 1999). In 1970, about 46% of primary school age children were not attending school, by 1998, only 4% of school age children were not attending school (WDI). Throughout the 1950s, 60s, and 70s, the government focused on improving primary education. However, as the economy grew and the education system improved, the focus switched to secondary education. In 2001, a higher percent of government funding went toward higher education than primary or secondary education (WDI). Today, every child in Malaysia is guaranteed eleven years of education (Razali 1999).

Although these policies appear humanitarian, they were primarily driven by political necessity. The winning coalition, the BN, relied on rural Malays to reelect them into office. Therefore, politicians implemented these policies to improve the lives of ethnic Malays, thereby ensuring their reelection. This also prevented the state from reverting to authoritarianism. Leaders understood they would remain in control as long as they continued to please their constituents, ethnic Malays. In addition, improving the lives of rural Malays decreased the likelihood of civil war, which would decrease the leaders power.

However, NEP had some unintended consequences. One of NEP's provisions was to eliminate discussion on "sensitive" issues (Rinehart 2015, Welsh 2007). The government stated that reducing free speech was designed to improve ethnic relations. As discussion areas diminished, religion became the prominent arena for political opposition and community bonding (Welsh 2007). As a result, religion grew in importance. The majority of ethnic Malays are Muslim, so as religion became more popular, Islam took a more prominent role in politics. The BN began promoting the Islamization of Malaysian society as a means to improve the lives of Malays (Pepinsky 2009). Thus, even as wealth inequality between Malays and non-Malays decreased, ethnic tensions remain, but today they are generally aligned with religious preferences.

The NEP depended on natural resources for funding; without these funds, the program likely would have failed. For most of the twentieth century, oil extraction and refinement was performed by the Royal Dutch Shell Company. With foreigners owning oil production, Malaysia received few profits. In 1974, Malaysia's government created Petronas and took control of the process (Rinehart 2015). Petronas' creation corresponded perfectly with the implementation of NEP. Oil funds were directed almost exclusively toward NEP projects, such as improving schools and hospitals, increasing the number of government employees, and improving the welfare system (Welsh 2007, Razali 1999, Randhawa 2011). The country's need for additional money to successfully implement NEP prevented the government from misusing oil revenue.

In addition to creating NEP, Malaysia's government also attempted to promote growth by altering its international economic policy. Throughout the 1950s and 60s, Malaysia relied on import substituent but the economy stagnated (Randhawa 2011). In the late 1960s, Malaysia switched to an export based economy, with tin and rubber as its main exports (Randhawa 2011). After the country gained control of oil production, the economy quickly grew.

However, unlike most resource dependent states, Malaysia's government made concentrated efforts to diversify the economy. Malaysia Inc., created in 1985, was designed to encourage cooperation between the public and private sector (Razali 1999). The 1983 Liberalization and Privatization Policy expanded this effort by moving some government operations into the private sector, which helped expand the private sector, increase efficacy, and decrease the size and scope of government (Razali 1999). Throughout the eighties and nineties, the manufacturing sector grew, reaching its peak in 2000 (WDI).

Yet, it was not until after the Southeast Asian financial crisis and mounting public pressure that the government began to focus on improving the service economy (Randhawa 2011). Malaysia has had minimal success in growing this segment of its economy. Several scholars have claimed the state is stuck in the 'middle income trap', meaning the country is struggling to move from a developing nation into a developed nation (Rinehart 2015, Randhawa 2011).

Despite this, Malaysia has successfully diversified its economy and grown its private sector through effective government policies. This was primarily driven by the need to improve the lives of its citizens to prevent ethnic conflict. Similar to the increase in public services, the government's decision to help the economy move away from oil was driven by the need to decrease inequality. The government hoped that growing the private sector would increase jobs outside the city, where most ethnic Malays reside.

The Southeast Asian financial crisis also forced the government to decrease spending on public goods. To avoid decreasing public benefits, the government privatized many government services, such as such as education, health care, communication, and transportation (Razali 1999).

However, as the economy grew and became less reliant on oil, government corruption increased. The privatization of many public services led to a decrease in government spending; although this benefits the public during economic crises, it creates a revenue surplus during periods of prosperity, leading to an increase in corruption.

Ethnic tensions have also helped the country avoid adopting a closed autocracy. For most of the country's history, UMNO was guaranteed an election victory. Citizens generally voted along ethnic lines and the UMNO represented the majority ethnic group- Malays (Welsh 2007, Pepinsky 2009, Rinehart 2015). As long as they were able to please ethnic Malays, UMNO did not have to fear losing an election. However, since 2000, the groups position has become precarious. Increased transparency has revealed higher corruption rates, turning many voters to the opposition group (Pepinsky 2009). Many organizations claim UMNO conducted election fraud to secure a majority of parliamentary seats after the 2013 election (Welsh 2007). Therefore, the group may be becoming more authoritarian as their prospects of reelection diminish. However, UMNO no longer has a super majority of seats, meaning they lost the power to alter the state's constitution. This may help the state turn away from authoritarianism and adopt a more democratic system.

Conclusion

Most resource dependent countries struggle from the resource curse. As resource demands cause the state's exports to increase, the country's exchange rate increases. As a result, other products are less competitive on the global market and foreign goods are cheaper than domestic products. State owned resources eliminate the governments need to tax its citizens; therefore, decreasing accountability and the state's chance of developing democracy. Leaders also tend to be short sighted, leading to investment in short term rather than long term projects. Because most resource wealthy states are authoritarianisms, resource revenues are often used to pay the leaders cronies, which increases corruption. As a result, resource dependent states generally struggle to develop and experience little growth.

However, Malaysia's ethnic tensions have helped the state beat the resource curse. After independence, the country was on the brink of civil war. To prevent war breaking out and to maintain control, the government enacted several policies attempting to decease wealth inequality between Malays and non-Malays. These policies were funded by resource revenues. Rather than investing in short term projects, Malaysia's government chose to tackle inequality through improving education and healthcare. This helped the country experience future growth. Had the government taken the same route as most resource reliant states, the country would have likely erupted into civil war and fallen into the resource trap.

Malaysia has experienced tremendous success. Although the country is still struggling to adopt developed nation status, Malaysia has grown significantly in the past 40 years. Unlike in 1970, most of Malaysia's exports today are manufactured goods, demonstrating the country's success in diversifying its economy. Malaysia's population attending primary school is also much higher today than 30 years ago, indicating a rising living standard among most of the country's residents. Malaysia has successfully beaten the resource curse.

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