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INSTITUTIONS AND INDUSTRIAL DEVELOPMENT IN SABAH

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Abstract: *Industrialisation has been and continues to be lynchpin to modernise a state economy. Here, configuration of industrial policy is central in expanding and diversifying the downstream activities. Coherent industrial policy implementation depends upon the role of institutions that shape and facilitate elite policy makers in configuring and defining policy priority. It is important to note that institutions for every state differs significantly, this is due to the historical specificity, political events, norms that formed institutions. The institutional settings can condition policy actor defines interest and priority differently. In the case of Sabah, although the state is rich in resources, the implementation of industrial policy seems to be little success. The existing state's economic structure does not support the expansion of downstream industry. The state continues to focus on resource extraction activities instead of moving up the value chain in the industrial sectors. This structural deficiency can be attributed to ineffective institutions which hinder coherent industrial policy implementation. Given the limited industrial development and policy-implementation gap, the state has fallen behind in many aspects of economic development.*

Keywords: *Political economy, industrial development, economic development, institutions*

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Introduction

The key questions in political economy of development are the causes of differences in economic growth and economic development. While most economic scholars have long recognized that growth and development are associated with human capital, physical capital, saving and investment, resources, and technology. However, the capacity to configure and coordinate the above factors for growth and development lies in the role of institutions. A focus of institutions has been and continued to be central to examine differences of development outcome whether cross-countries or even across states in a federation like Malaysia (Suffian, 2019).

Institutions lead to economic development. Industrialization is the key to structural change because it involves production transformation, accumulation of technological capabilities, creating capital-intensive activities and modernizing economy (Rasiah, 2020; Chang, 1999; Jomo & Wee, 2014). Here, Industrial policy refers to the government strategic role in stimulating specific economic activities in productive sector that crucial to promote structural change. Configuration of such policy largely depends upon the role of institutions which are influenced by historical specificity, political demand, and norms, this will have impact on industrial policy.

This paper examines Sabah's industrial development and the institutional constraints in implementing coherent industrial policy. Sabah is a resource-rich state in Malaysia. Given it abundance of resource, Sabah ranked 5th as top contributor of gross domestic product (GDP) to Malaysia. This state has achieved commendable economic development, however, attempts to pursue structural change through industrialization seems limited. The institutions embedded with political consideration and private interests somehow has constrained the state to implement effective industrial policy. This makes the state fall behind in many aspects of economic development despite rich with resources. This paper is structured as follows. The next section presents the theoretical framework to describe the role of institutions and industrial policy. The subsequent section discusses the political economy of Sabah and the third section provides an analysis of economic development of the state. The fourth section examines how the role of institutions affects industrial policy implementation, and the final sections concludes the arguments in this paper.

Institutions and industrial policy

The role of institutions is a fundamental cause of economic growth and development or its decline (Whitely, 2003; North, 1990; Scott, 2008; Rodrik, 2000; Chang & Andreoni, 2019; Kar et al., 2019; Suffian, 2021). However, there is scant attention on the role of institutions to take centre stage in analysing in economic growth and development. In the context of Malaysia, there has been limited analysis on political economy, individual state development and what limits the state development progress. Therefore, this paper will utilise institutional theory to assess Sabah's industrial development and its constraining factors.

Institutions are widely known as "rules of the game" in a society (North, 1990: 3). The role of institutions shape, facilitate, constrain, and guide interaction between economic actors to determine developmental outcome or its decline (North, 1991). The term 'humanly devised constraint' and argues that the devised constraints determine how things can be done or cannot be done in certain institutions. Understanding the constraints provides incentive for economic actors how to play the "rules of the game" to attain actors' preferences in the policymaking institutions.

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Institutions are not homogenous, and all country's institutions differ significantly (Whitely, 2003). Institutions are nationally bounded because it constructed by specific formal rules (e.g. law, constitutions and policy) and informal rules (e.g. norms, values and conventions). Both give idiosyncratic phenomenon how institutions are formed because the set-ups have its root from historical specificity, political and economic demand, power relations and culture. Therefore, institutions affect the interactions between economic actors to establish collective decision and configuration of economic interests in economic policy domain.

There is a broad consensus among scholars that institutions have implications on economic development. In general, economic development is a process which is linked to industrial development along with economy-wide accumulation of capabilities and structural change (Andreoni & Chang, 2017). Industrialization is the key for structural change because it involves production transformation, accumulation of technological capabilities, creating capital-intensive activities and modernizing economy (Rasiah, 1996; Chang, 1999; Jomo, 1993). Industrial development has wide sectoral interlinkages that have the capacity to pull the rest of the economy in all sectors (Kaldor, 1967; Myrdal, 1957). With regard to late industrializing country, the process of industrialization does not occur spontaneously through market forces (Amsden, 2001). It requires strategic intervention such as reallocation of resources, subsidies, infrastructure development and mitigating trade-off to spur structural change. In this sense, industrial policy is crucial in industrializing the state.

Industrial policy refers to the government's strategic role to stimulate specific economic activities in productive sector to promote structural change (Chang, 1994; Whitfield & Buur, 2014). Such policies targeted at specific sector, which qualify for incentives and other policy arrangements to prioritize the sector's interest. This includes adjustment of macroeconomic policy, allocation of resources, configuring new economic rules and learning rents (Whitefield & Buur, 2014). The policy is devised to form comparative advantage of certain sectors to be competitive in the market.

Configuration of industrial policy is influenced by the role of institutions (Suffian, 2019). The institutions can affect how actors conceive development preferences, define and defend interest. The role of institutions is also to structure the organization of elite actors in bargaining, negotiating, resolving conflict and transfer of resources (Suffian, 2020; Hollingworth, 2000). The process structured by the institutional context can influence decision-making, economic rules and interpretation of preferences. At times, choices of economic interests will also have strong political consideration rather than economic rationale.

The primary actors of industrial policymaking institutions are political elites, bureaucrats, selected enterprises and business organizations (Hollingworth, 2000; Whitely, 2003). Deliberations between these actors are crucial in devising strategies for industrializing the state. The process of deliberation is usually done to decide which sectional interest should be prioritized for industrial development and receive preferential access to resources. However, the deliberation process is subject to distribution of power structured by the institutions. The balance of power between the political institutions and society can impact the configuration of economic preference in the policymaking institutions. In the context of uneven power relations in which the non-state actors' power is weak, this raised the political institutions power in deciding the state's resources. Since industrial policy is a political process, political elites have more bargaining power to define preferences for development.

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Industrial policy also features conjoin effort between the state and 'selected' private enterprises. These enterprises are backed by the state resources that serve as 'big push' so that they can grow in the marketplace (Athukorala, 2014). Resource accessibility rely on the political elites' economic preferences without industrial based. Those enterprises who have close connection with political elite will have the advantage to access state resources. Conventionally, industrial policy facilitates private enterprises based on its merits (Jomo, 2007; Amsden, 2001). It is expected that the local enterprises will be able to strengthen their indigenous technology and learning capability.

It will easily be susceptible to collusion when existing institutions facilitate a patron-client network (Suffian, 2018). Once collusion occurs, the 'selected' local enterprises and political elite tend to seek mutual benefits by having access to state resources (McNamara, 2012). The elites provide access to rent, while the enterprises are likely to be providing political-based support and funding (Tan, 2010). Replacing this unproductive producer is difficult as the patronage system has been embedded in the institutional setting. The industrial policy ideal practice is to enhance resource accessibility to the private enterprise. It is also to facilitate the selected private enterprise to grow competitively. The government has to offer other productive producers if the local enterprise fails to perform, especially in manufacturing, export, and technological upskilling (Jomo, 1993). However, patronage embedded in the institutions constraining the replacement of unproductive producers. This leads to institutional constraints in coordinating and implementing coherent industrial policy.

Patronage embedded in the institutions can also breed rent seeking behavior to secure economic rent (Suffian, 2019). Those who obtain economic rent for example subsidies, licenses and quota will have 'excess profits'. The problem with rent-seeking is that an elite political actor creates rent for selected enterprises with political considerations instead of economic rationale. This leads to political captured state resources are used to serve a narrow political interest and the selected few groups who are connected to the political elite. Furthermore, once captured by unproductive groups who have considerable political influence and personal connections, they can organize resistance (Alavi, 1982). Unproductive groups can threaten any policy changes that undermine their interest (Estache & Foucart, 2013). Once this rent is captured and facilitated by patronage, it is difficult for the economy to diversify. Although diversification will improve economic growth, such agenda in the economic policymaking institutions can be conveniently hijacked by political elites.

Institutional arrangements of industrial policy also evolve around the bureaucracy. The state's institution is deemed crucial in the configuration of coherent policy (Evans, 1995; Wade, 2018; Johnson, 1990). Autonomous bureaucracy that is insulated by private interest is central for economic technocrats to independently develop economic rules, implement and design policy, and allocation of resources. In this context, autonomous translates to the ability for the bureaucracy to work and cooperate with productive industrial groups without being interfered by private political interest. The reason to insulate the bureaucracy is to let the technocrats who have the knowledge in a particular sector to devise strategic plans. However, once the bureaucracy is captured by political interest, it loses its autonomy to formulate and implement policy (Tan, 2009). Once this occurs, the bureaucrats will do what is necessary to retain political elites and the selected enterprises' interest. As such, tweaking policy terms become the norm in serving the ruling elites and the selected enterprises. As a result, Meritocratic assessment of economic development such as diversification can be hindered if the private interests of the political elites and selected enterprises are undermined.

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Institutional arrangements of industrial policy are crucial to push industrialization and to nurture dynamic local enterprises. Economic diversification heavily relies on the coherent industrial policy arrangement, coordination and implementation. Industrial policy is seen as an ‘enabler’ to divert resources for productive groups in the society to form comparative advantage, while simultaneously expanding the manufacturing sector and moving up the value chain.

A Brief Political Economy Of Sabah

Sabah is one of the thirteen states in Malaysia. Between 1967 and 2020, the state has had its fair share of political woes and power struggles which resulted in some dramatic change of government. From the Alliance Government, USNO, Berjaya, Parti Bersatu Sabah (PBS), Barisan Nasional, Warisan and to Gabungan Rakyat Sabah (GRS). All these political parties that formed the government had a vision to transform Sabah into economic hub of Malaysia. The first two governments attempted to change the state’s economic structure by moving away from traditional resource extraction like timber and cash crop practiced by former British colony (Hoyle, 1980). In this effort, various economic plans were set to modernize the state such as human capital development, infrastructure, urbanization etc. Sabah Foundation is one of the instrumental organizations established to promote education. Other government boards such as Land Development Board and Sabah Padi Board were also initiated to spur economic development in the state. However, local politics and increasing tension in relationship between the federal and state government has somehow preoccupied political leaders. After the formation of Malaysia in 1963 till late 1970s, many states right issues remain unresolved. Political leaders were preoccupied with the negotiations and bargaining with the federal government that brought about tension between the federal-state relations (Ross-Larson, 1976). During Berjaya era, the government has somehow taken a friendly approach with the federal government. Vigorous policy orientated was implemented towards rapid development in agriculture sector (Thoburn 1977). This period saw rapid expansion and diversification of cash crop cultivation. Various state-own-enterprise are created to help expand the domestic economy. Oil and gas sector also started to expand. During Berjaya period, the government signed the most controversial petroleum agreement which resulted in the state receiving five percent of oil royalty (Lim, 2008). With the vast expansion of agricultural-based activities, the Berjaya government managed to make Sabah the third-richest state in the country.

Under the PBS era, the government continued to expand the state economy. PBS is one of the party’s components in the Barisan Nasional (BN) coalition. On the outset, they receive federal support in terms of development funds. However, the federal-state relations remain in unease. Argument on state’s rights, political autonomy and fiscal decentralization continues putting strain on central and state government. Eventually, various development funds are unreasonably halted or delayed soon after PBS pulls out from BN. This is common in a centralized federation setting. Most of the development funds and other trade activities are under the purview of the central government. Hence, being opposition state, Sabah development plans at the federal level somehow is given less priority.

PBS was dislodged by BN in 1994 when several members of PBS defected. After BN has set foot in Sabah, the party held the longest serving government that lasted for almost two decades. There were many economic development agendas did not really benefit the state. Firstly, the system did not allow leaders to make a vigorous and long-term plan. After the end of the rotational system, the political scenario is quite stable, along with close relationship between

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federal and state government. Rapid economic development plans were devised such as development of economic corridors, expansion of oil and gas industry, tourism, timber, palm oil plantation, cocoa, agriculture, and food related industry. Growth rate has been positive during the UMNO-led BN government, but ironically the overall development has led to uneven distribution of wealth. The report from the World Bank in 2010 stated that Sabah is one of the poorest states in Malaysia.

The year 2018 was one of the historical moments for Malaysia. Pakatan Harapan (PH) victory against UMNO-led BN in the general election has also brought about changes in Sabah politics. Again, defection dislodged BN and enabled Parti Warisan Sabah, a local-based party, to form the state government. Parti Warisan Sabah aspired to bring about changes to the economic development in Sabah. The government acknowledged that the economic problem in Sabah is due to lack of diversification, limited downstream industry, excessive patronage or cronyism in government procurement and the perennial issue state autonomy. The newly elected government envisioned to transform Sabah into resources-based industrialization and to further strengthen agriculture sectors along with downstream industries. Though resource-based industrialization policy remains unknown, the government introduced Sabah Agriculture Blueprint as the new guiding principle to develop the agriculture and food industry. In 2019, GDP growth rate recorded 0.5 percent, one of the lowest in the decade (Department of Statistic, 2020). Warisan government is blamed for bad management, but during that year Malaysia had a short diplomatic row with India. In addition, the European Union's sanction on Malaysian palm oil because of alleged bad practices in the production process. Since Sabah is one of the main contributors of palm oil in the country, export contraction affects the state overall exports and balance of trade.

Though Warisan government set to be different from the previous government, most of the development approach remains the same. There is no significant structural change in the state. As echoed by Gomez (2018) 'business as usual' and patronage system remains unchanged because most of the government linkage companies (GLCs) are run by political appointees rather than technocrats. During the Covid-19 outbreak, various economic plans were put on hold. The lockdown has exacerbated the state economy, particularly the tourism industry, which is one of the main contributors to the service sector in GDP. Hence. This has put the Sabah economy in recession. It is estimated that GDP growth rate will contract to negative 15 percent. The Warisan government lasted for two years, after the Chief Minister called for a snap election due to defections of state assemblymen. The party lost in the state election and was replaced by Gabungan Rakyat Sabah (GRS).

Sabah Economic Development

Ever since the formation of Malaysia, this state has achieved commendable economic development, improvement in physical infrastructure, better road connectivity, increase in income per capita, and poverty reduction. Trade performance has also improved significantly. In 1962, Sabah's trade was recorded around RM462 million. After five decades, the trade value was reported as worth approximately RM81 billion in 2011 (Rafiq, 2015) and it continues to grow. In 2019, the state recorded RM84 billion totals of trade. A similar trend can be seen in GDP, whereby the state recorded only RM 1 billion in 1971 (World Bank, n.d.). The GDP increased 80 times more, which accounted for RM84 billion in 2019. The economic indicator shows the state has improved its economic activities through some diversification in various sectors. Furthermore, the abundance of resources in Sabah has also made this state one of the biggest producers of petroleum, rubber and cocoa in Malaysia and palm oil in the world.

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In the recent year, the service sector has become an important contributor to the GDP. Prior to the pandemic outbreak, Sabah tourist arrival recorded 4.1 million and between 2014 – 2019 the average of tourist arrivals for Sabah is between 6 and 7 percent. Department of statistic Malaysia (2019) shows that accommodation sector has contributed 980 million for the year 2019. As such, this has made Sabah to receive the highest tax revenue from tourism, which accounted for 25.32 million. Mining and quarrying are the second essential sectors for Sabah. The Main activities are oil and gas and other mineral extractions. On average, this sector has contributed 22.57 percent to Sabah's GDP. Additionally, agriculture constitutes the third most influential sector in Sabah and contributes 22 percent. Both manufacturing and construction recorded single digit for the past decades. Sabah is among the top of the country's GDP. Overall, Sabah contributed 6 percent share of the country's GDP between the period of 2014 – 2019. Most of these contributions depend on resources extractions activities. Sabah's GDP growth rate has shown upward trends for the period of 2013 – 2017. At its peaks, the state recorded 8.2 percent growth rate in 2017. This was the first time the state recorded closed to double-digit growth rate and for that particular year, Sabah's GDP growth rate was higher than the national figure of 5.9 percent. Such high growth rate was driven by strong global commodity demand along with high inflow of tourist arrivals. In 2018 and 2019, there were lower external demands that affected investment and export-oriented activities and products (Department of Statistic, 2019). During these years, the change of government in 2018 has contracted domestic and foreign direct investment. While the beginning of Covid-19 outbreaks during fourth quarter, many economic activities are impacted.

Lack of Industrial Policy

Sabah has been considerably left behind in socio-economic development, particularly in industrial development. The state unable to escape from the 'resource curse' although known as resource-rich state. There is very limited initiative to develop strategic economic sectors based on value-added activities or expansion from the current economic activities to promote economic growth. Modernizing an economy requires the state to engage in industrial activities from low value added to high value-added activities. The key to move up the value chain is through the development of the manufacturing sector. By this, it means that the economy must invest on downstream industries which are manufacturing-based. Manufacturing is the key to increase productivity, diversify economy, employment, income, and value-added activities.

Sabah remains a resource-based economy and service-oriented activities. This does not mean that such economy is not important for growth. Nevertheless, the extent to which such sector can push economic growth is limited. For instance, although Sabah GDP has grown significantly due to resources-based activity and tourism, unemployment rates remain high. This is because primary extraction activities do not help the economy to diversify. Furthermore, primary extraction activities do not require skilled workers. Over the past seven years, the tourism sector has increased significantly from RM5.5b to RM8.342b in 2012 to 2019. Service sector like tourism is crucial in generating income for the state. In terms of tax revenue, tourism sector has contributed 25 million to the state in 2019. However, such sector does not have expansive push factor to grow the economy. The spillover effect is limited because it does not promote downstream industry and manufacturing extensively. This is the reason for unemployment rate remain high in Sabah (Suffian, 2018).

Resource-based activity and service sectors are important. However, the sectors need to create and nurture the growth of value-added sectors. Production activity needs to move up the value chain. For instance, in the petroleum industry, Sabah can focus on refinery or even R&D

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activities. This is also applicable to palm oil activities. As it happens, the palm oil activities in the state are dominated by non-Sabahan based companies and revenue from these companies does not go into the state government. Therefore, the State government needs to identify value-added sectors to improve state productivity. Value added manufacturing sectors have a huge potential to improve growth, employment opportunity and move up to middle-end or higher end of the manufacturing activities. By enhancing the manufacturing sectors, raw materials can be utilized by the state instead of exporting them to the Peninsular or China.

Industrial policy in Sabah to expand downstream industries has existed since the Berjaya government and the subsequent governments (PBS, BN and Warisan). Institutional arrangements to devise action plans and programs has been an ongoing process. The State Economic Planning Unit, Ministry of Industrial Trade, Department of Industrial Development and Research and Institute of Development studies are created to oversee the industrial development of the state. Various studies and policies have been designed such as Sabah Economic Action Plan, Sabah Industrial Master Plan, Sabah Industrial Action Plan, Sabah Structure Plan, Sabah Long Term Strategic Action Plan to identify strategic sector to improve productivity through manufacturing. This also includes moving up the value chain and the upskilling process. The state also forms Sabah Development Corridor that emphasizes on utilizing the state's resources for industrial development and expansion of downstream industries.

Although the state is committed to pursuing industrial development, the role of institutions can hinder the efforts of elite policy actors. One important factor for structural change is for the elite policy actors to transfer resources to newly identified sector that can facilitate industrialization. This includes facilitating productive business group in the manufacturing sector. However, transferring those resources is subject to the commitment of political elites, bureaucrats, and business groups. In Sabah, the political elites play a dominant role in policy arrangements. While the bureaucracy is supposed to be autonomous in formulating economic policy. The political elite has a strong influence that has the capacity to assert their interests and making the bureaucrats subservient to their demands (Orlando, 2021). At times, the bureaucrats will tweak policy or rules to meet the interest of their political master. Some local enterprises even share interlocking interest with the political elites. Gomez (2018) analyzed the dense network between political elite and business enterprises maintaining political base support and financing. In this regard, institutional arrangement for implementing industrial policy revolves around political elite interest. To transfer state resources to a new industry, the political elite tends to calculate risk and benefits from developing the new industry. Although the manufacturing sector has a wide spin-off effect, political elites may hesitate from using state resources to develop this sector if their own interest in local enterprises are compromised.

Industrial policy is a 'big push' for the government to spur industrial activities. The key vehicles to spur industrialization is the GLCs. The overarching intention of setting up GLCs is to venture into new industry to create competitive advantage and ultimately send a signal to private sector to invest in the industry. The GLCs can be deemed as state entrepreneurs that given them special access to state resources. In this regard, the enterprises can have substantial capital to start up industries. In Sabah, there are more than 249 GLCs and more than hundreds of subsidiaries. Most of the GLCs are politically appointed individual with lucrative perks. Most of these GLCs are in the service industry (tourism, finance, telecommunication), resources based and real estate sector. Limited GLCs involvement simply shows that the government has little interest in developing manufacturing sector, but rather prefer to venture into easy profit sector.

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GLCs roles in industrializing the state is crucial. Easy access to economic rents due to close ties with the state suggests that they have better position to start up downstream activities. The state can transfer resources to GLCs to facilitate the manufacturing sector. GLCs can provide backward and forward linkages for other SMEs that are involved in the sector. However, the problems with GLCs are that when political appointee assume the leadership, it is difficult for the enterprise to operate based on economic rationale (Gomez & Jomo, 1997). Political appointee could not detach themselves from political interest and genuine development interest. Hence, political consideration tends to interfere with business planning. This gives a fertile breeding ground for rent-seeker to obtain preferential access to state resources. To that extent, GLCs are likely to venture into businesses that are quick and profitable. This is partly done to accumulate resources for political funding. Thus, GLCs have little interest in venturing into downstream activities because manufacturing sectors have a longer gestation period before becoming stable or mature. This is unlike resources-based industry or service sectors that have quicker turnover.

Although the government is committed to industrializing the state, institutional arrangement that revolves around political interest can potentially ‘hijack’ structural change to promote industrial development. Once political consideration precedes economic rationale, the existing institutions will become tools for political elite to extract resources. Acemoglu and Robinson (2012) pointed that ‘extractive institutions’ are considered as the permit granted to the elites to rule over and exploit others. The political elite will devise ways to extract resources in the easiest way. Political elites also exert power over the state bureaucracy to gain advantages in economic policy.

Therefore, implementing industrial policy becomes limited. Expansion of downstream industry will be constrained because less resources are being transferred to facilitate a particular sector. Similarly, at the state bureaucracy, the bureaucrats tend to tweak terms of policy to meet the interest of the political elites. This could end up re-focusing on resource-based activities and service sector. The GLCs and other private enterprises that are closely linked to the ruling elite and benefited from the economic rents are unlikely to venture into the manufacturing sector because they are already ‘comfortable’ with the current status quo. This is not easy to change because this business entity has close relations with political elites and is also part of a political based support. All in all, despite the presence of industrial policy, the role of institutions has constrained the industrial development of the state.

Conclusion

Industrializing the state is crucial. However, to promote economic growth relives to the role of institutions had on structuring the interactions of the principle elite actors such as the political elite, state bureaucracy and domestic enterprises. Ideally, institutional arrangement of political elites and economy actors can construct ‘rules of the game’ to promote industrial development. Additionally, elite policymakers can transfer resources to enable an identified industrial sector to grow. This can gradually strengthen industrial based and pursue economic structural change. Simultaneously, industrial policy can facilitate local enterprises to focus on non-resource based activities and build their competitive edge by moving up the value chain.

Comprehensively, it can be argued that the institutional arrangements that revolves around elite policy actors have hindered industrial development. Although industrial policy has been planned and formulated, policymakers have only shown feeble attempts to implement the said policy. The role of institutions that constrains the efforts of elite policy actors restricted policy

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implementation and stalled industrialization projects. This has significantly inhibited downstream activity in the state. Thus, the state continues to be a 'captive market' as it continues to focus on low-end production activities. There will be limited positive spin-off effects to the total welfare of the economy with this setback set against Sabah economy. Ultimately, the political considerations infused in the role of institutions will eventually 'hijack' the state's industrial development.

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