

# THE PHASES OF INDUSTRIAL DEVELOPMENT IN SABAH

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**Abstract:** *This paper is a preliminary assessment of the industrial development in Sabah. It is widely known industrial development is the primary key to modernise an economy and structural change. Transition of structural change requires the state to configure coherent industrial policy to ensure industrial development can take place. Throughout the history of Sabah industrial development, the state has continuously attempted to industrialise the state but transition to pursue structural change is limited. This limitation is due to the inefficacy of planning and implementation of industrial policy which is influenced by political dynamic of the state and federal-state relations. This paper examines phases of industrial development and political dynamics of the state. Policy priority defines by elite policymaker and asymmetrical power relations between federal and state government can likely hinder a desired trajectory of industrial policy outcome.*

**Keywords:** *political economy, industrial development, industrial policy, Sabah*

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## Introduction

Poor but rich, this paradox of development fits the description of Sabah economic development. The paradox occurs due to limited structural change. There are broad consensus among political economist and economist scholars that the limitation is due to the state continues to emphasis resource-based activities that gives rise the 'resource curse'. Extractive economic activities are given priority and there is lack of diversification in the industrial sectors. It is widely acknowledged that industrial development has the key to pull the rest of the economy (Kaldor, 1967; Myrdal, 1957; Chang, 1999). Proponents of industrial policy scholars argue that economic structural change depends on a coherent industrial policy to provide 'big push' for transformation. Industrial policy involves forming comparative advantage, transforming production process and human capital development, investment in technological capabilities, creating capital intensive industry to modernise the state. The role of the state is crucial stimulating specific economic activities into a productive sector.

This paper examines Sabah's industrial development performance. Sabah endows with abundance of resources such as petroleum, timber, fishery, agriculture produce, palm oil etc. The primary sector is one of the main contributors to the economy that comprising agriculture, plantation, forestry, and petroleum. Given its resource abundance, Sabah contributes significantly to the country's gross domestic product (GDP), and the state is ranked the fifth highest contributor to the Malaysia GDP. Ever since Sabah became part of the federation of

Malaysia, the state economy has developed steadily. However, attempts to pursue structural change through industrialisation appear to be limited. This limitation is due to domestic political dynamic that somehow influence the implementation of industrial policy. How the political elite define and defend policy interest can constraints a coherent industrial policy implementation. A centralised function of the federal government can potentially encumber the state government to carry out policy. At times restrictive function of the state industrial policy may push the state government to continue focusing unheralded sectors.

The rest of this paper is structured as follows: the next section presents the phases of Sabah's industrial development; the section after that discuss the constraining factor in pursuit of industrial development in Sabah; and the final section concludes the arguments of this paper.

### **Industrial Development in Sabah**

Sabah is a rich resource state in Malaysia. Ever since the formation of Malaysia, this state has achieved commendable economic development, improvement in trade, expansion of economic activities and physical infrastructure, better road connectivity, an increase in income per capita, and poverty reduction. Initially, Sabah's economic structure was mainly agriculture-based such as timber, rubber, cocoa, and copra. All these were activities inherited through colonial legacy (Sabah,1963). In the late 1960s, oil palm became a key industrial crop and has remained so until today. In the mid-1970s, the oil and gas sector rose to become the main resource-based sector and has continued to dominate the state economic activities.

For the past decades, the industrial sector has contributed only single-digit to the state's GDP, on average 8.8 percent between 2010 – 2020. This indicates that there is limited diversification in the manufacturing sector. Sabah industrial sectors mainly focus on low-mid value-added activities such as food processing, wood and furniture, petroleum and chemical, and textiles. There are no new industrial sectors were introduced for the past 10 years to expand manufacturing activities. Though the effort to broaden industrial activities is in place budget allocation to boost the sector but it remains small as compared to the agriculture sector. On average, the state budget allocation between 2010 – 2015 for the industrial sector is RM136,640 million and increased slightly between 2016 – 2022 which is RM143,124 million. In contrast to the agriculture sector which received on average RM 287,074 million between 2010 – 2015 and increased closed to double between the year 2016 – 2022 that accounted for RM506,812 million.

Sabah has sought to industrialise and modernise the state by expanding industrial development. Given the centralised feature of the Malaysian federation, the industrial policy and master plan are formulated at the federal level. The country's development planning is under the purview of the federal government. This includes the financing of development activities in the National Finance Council (Hutchinson, 2014; Loh, 2010). The Sabah state industrial policy is usually an extension of the federal policy (McMorrow and Talip, 2001). Although the industrial policy is centralised, the state has policy space to produce its own industrial plan, particularly to develop strategic sectors that the state has a locational advantage in. The State Development Department or Economic Planning Units of the Chief Minister's Office, Ministry of Industrial Development, formulate Sabah's industrial policy. In this regard, the Chief Minister's Office holds considerable power over policy priority and decisions, particularly in matters related to the industrialisation of the state.

## Phases of Industrial Development

### Phase I (mid 1960s – 1985)

In the mid-1960s, Sabah's industrial development was limited to simple processing activities, such as shoe or slipper-making, plastic, basic wood, and food processing. In the 1970s, the government started to introduce import substitution industrialisation (ISI) as part of strategy to expand industrial development. The overall ISI strategy emphasised the promotion of industrial development via the private sectors and addressed the weak industrial-based economy. Prior to this, most of the activities promoted by the state characterised low value-added activities. However, the Sabah ISI strategy to expand its manufacturing sector had limited success due to various infrastructure problems and lack of skilled labour. Underdeveloped infrastructure and logistical problems became a hindrance for Sabah in its ISI expansion. Abdullah (2003) points out that the price, quantity, and variety from ISI were no match to those in Peninsular Malaysia's. However, despite the limitation of ISI in Sabah, the state government continued to emphasise the resource-based industrialisation approach in efforts to build linkages between the agricultural, mining and quarry sectors with manufacturing activities.

The Berjaya state government focused on building linkages between extractive and manufacturing activities to expand industrial development. The government designed investments climate for resource-based industry, agro-based for food processing, labour intensive industry with a condition 'learning by doing' to enhance export-oriented industry. They also adopted a friendly approach with the federal government to obtain substantial support. According to Hoyle (1980), the Industrial Coordination Committee was set up in 1976 to oversee and regulate the pace and pattern of industrial development in Sabah. This gave the government the edge to set the tone for industrialising the state by utilising state resources.

In mid of 1970s, resource-based industrialisation came about through the agro-based processing of commodities such as palm oil, cocoa, coconut, and rubber. In fisheries, the focus was prawn processing for food manufacturing. Food processing started to grow in this period, as this was heavily emphasised by the state government (Second Malaysia Plan 1971–1975). The timber sector saw the rise of the integrated wood-based industry such as plywood, lumber core and construction plywood. Meanwhile, in the mineral sector, copper processing was the primary focus. The timber industry was the most important export income earner for Sabah during the early period of industrialisation (Lim, 2008). The initial stage of industrialisation coincided with the grand Malaysian policy is known as the New Economic Policy (NEP). The NEP sought to maintain national unity through economic distribution programmes to attain its twin-pronged objectives: to eradicate poverty and restructure the society to eliminate the identification of race according to economic functions.

To that extent, the government policy in favour of state intervention in public resources allocation into public sector ownership and control of business enterprises (Rasiah and Shari, 2001). The state established a considerable number of public enterprises (sometimes in collaboration with the private sector) as part of accumulating *Bumiputra* industrial groups. Under the banner of 'national interest' to help the *Bumiputra* lead industrial development in Sabah (Hoyle, 1980), state-owned enterprises became the primary vehicle to increase participation of the *Bumiputra* community in industrial activities. The Sabah Economic Development Corporation (SEDCO) was established to plan and accelerate activities in the manufacturing sector in Sabah simultaneously to accommodate the 'restructuring agenda' for the *Bumiputra* in Sabah. This was a critical juncture for the formation of state-owned

enterprises, where the overarching agenda was to assist the *Bumiputra* to grow in industrial activities that focused on resource-based industrialisation. Thus, racial considerations became embedded in policies when planning industrial development.

### **Phase II (1985 – 1995)**

Between 1980 and 1985, it has become the booming period to Sabah economy (Lim, 2008). The expansion of a resource-based industry backed by state-owned enterprises led to diversification of downstream industries. The industrial enterprises established at the time were sugar refineries, flour mills, food processing plants, integrated wood-based industries, coconut oil and palm oil refineries, battery assemblies, and simple motor vehicle assemblies. During the mid-1980s, signs of the economic transition into industrial activities were seen, and diversification started to grow gradually, but most manufacturing activities involved low value-added activities. This is common in any transitional economy in a developing country. Structural change remained limited. Although the state attempted to pursue industrial development, domestic and foreign investments tended to gear towards extractives activities. The petroleum industry was supposed to be the linchpin of Sabah's expansion in the manufacturing sector. However, after the state signed one of the most controversial agreements in the history with the federal government, which gave birth to the Petroleum Development Act 1974, considerable authority was given to Petronas (a national oil company) to regulate the exploration concession system and production activities related to oil and gas. Hence, the state was left with a limited purview over its own oil and gas sector.

Then, the federal government introduced the first Industrial Master Plan (IMP), the IMP I (1986–1995), along with a heavy industrialisation program. It is aimed to lay the foundation for manufacturing industries, particularly non-resource-based industries, for industrial development. Technological acquisition and upgrading to enhance production, processing and value addition become the central agenda. This policy was a turning point for industrial development in Malaysia, especially with the formation of the Heavy Industries Corporation of Malaysia Berhad (HICOM). It was one of the strategies to expand the industrial-based economy through the promotion of intermediate and capital goods (Jomo, 1993; Suffian, 2021). This brought new development to most states under the Locational Incentive Scheme, and the federal government provided tax relief for private enterprise ventures that utilised the locational advantages of the state to embark on industrialisation projects. The industrial projects established in Sabah under the heavy industrialisation policy of the Fifth Malaysian Plan 1986 - 1990 were a methanol plant and a hot briquette iron plant (Ministry of International Trade and Industry, 1986). Although heavy industrial projects were introduced in the state, the overall contribution to manufacturing remained meagre, and the manufacturing sector only grew to 4.6 per cent in 1987 from 4 per cent in 1980 (Ministry of Industrial Development, 1996).

Recognising the significant role of industrial development, the Sabah government under Parti Bersatu Sabah (PBS) introduced the Sabah Action Blueprint 1987. This blueprint can be deemed an industrial policy for the state and provided a framework for industrialising the state. The blueprint acknowledged that the Sabah economy depended heavily on resources from extractive activities and planned to initiate structural change (Ministry of Industrial Development, 1987). The overarching objective of the Sabah Action Blueprint was to transform the state economy into a more diversified one and to expand value-added activities. The strategies emphasised linking agro-based sectors with manufacturing and high value-added activities. Resource-based industrialisation remained the primary focus, and the focus during this period was on technological upgrading, private sector initiatives and infrastructure

development. During the period of 1985–1995, Sabah was under opposition rule and was considered an opposition state. Hence, there was limited support for industrial development as well as a lack of federal support in many aspects, especially infrastructure development and financial assistance (Wee, 1995). During this period, the industrial development in Sabah was focused on wood products and timber processing. There was no significant change in industrialisation projects due to a limited fiscal capacity and the fact that the federal government did not prioritise the Sabah state government's industrialisation projects (Loh, 2010; Agus, 2001). Eventually, the state government turned to the agriculture sector, particularly on the timber industry, and attempt to revitalise and promote village industries using simple technology and traditional skills.

The transition into an industrial-based economy remains uncertain in Sabah. There has not been any significant transition from a dependence on resource extractive activities to wider industrial-based activities. Industrial development was slow with a very narrow-based industry characterised by low value-added activities. Kaur (1998) demonstrated that the economic structure and the pattern of growth that were established earlier remained unchanged for Sabah while the economic structure in Peninsular Malaysia experienced a massive transformation, especially in the manufacturing sector. The limited expansion of the manufacturing industry in Sabah meant that it had to rely heavily on the import of consumer products from Peninsular Malaysia.

### **Phase III (1995 – 2005)**

In the 1994 state election, the PBS government lost in the election by defections, hence, this enabled Barisan Nasional (BN) gained control of the state. In 1995, the Sabah state government under BN introduced its first Sabah Industrial Master Plan (SIMP), and this plan provided guiding principles to industrialisation. Like the previous plans, the state wanted to move away from resource extraction activities, and the SIMP was more rigorous in accelerating the rate of industrial growth. The objective was to aggressively revitalise industrialisation and industrial development to generate a high level of economic growth, improve the standard of living and move up the production value chain. The plan identified key growth areas for industrialising the state and attempted to widen the manufacturing sectors not just in resource-based industries but also in non-resource-based industries, such as the electrical and electronics, machinery, mould and die, and food processing industries.

A special task force was set up to plan and coordinate industrial projects with the private sector. Deliberation between the state and private enterprises enabled a joint effort to be made to spur industrialisation in the state. This was an important feature in the industrial policy. The state–private collaboration was to reduce asymmetrical market information, allocate sufficient resources and adjust the policy to help the targeted industry to grow (Rodrik et. al., 2004). Institutional arrangements between the state and the private sector provided incentives to the private sector to participate in industrial activities (Suffian, 2021). The SIMP had similar characteristics with the IMP II (1995 – 2006), to increase productivity, broaden manufacturing activities and build competitiveness using domestic technology. The SIMP set the ambitious target of a 35 percent contribution from the manufacturing sector to the Sabah state GDP in 2020.

Manufacturing started to expand, and there was gradual diversification in downstream industries. The first Kota Kinabalu Industrial Park (KKIP) was set up. The KKIP serves as an integrated industrial park and catalyst to pursue industrialisation in the state. The Sabah

manufacturing sector recorded double-digit contribution to the GDP in 1995, accounting for 14 percent of the GDP, compared to 8.9 percent in 1990. It reached a peak of 15 per cent in 1996, prior to the Asian Financial Crisis (AFC). More than 9,000 jobs were created during the expansion period (Abdullah, 2003; Ministry of Industrial Development, 1996). Post AFC, domestic and foreign direct investments declined significantly (Athukorala, 2011). Not only Sabah but the entire nation suffered a contraction in the manufacturing sector due to declining exports. In 2000, the state government introduced the Sabah Industrial Action Plan (SIAP) (2000–2005) to revitalise the industrialisation development. The plan was to carry out ‘implementable action plans’ (Ministry of Industrial Development, 2000) that focused on two industrialisation projects, namely, resource-based industrialisation and non-resource-based industrialisation. The primary objective was to seek feasible industrial development to revive the state economy. To this end, several fundamental problems had yet to be addressed in terms of the high cost of business due to a lack of infrastructure, poor logistics and connectivity, and the unstable supply of utilities (Malaysia Productivity Corporation, 2016; Rafiq and Mansur, 2020). The minimum threshold of infrastructure to support industrial development was inadequate. Subsequent state and private sector pro-growth arrangements were insufficient. For example, a site in KKIP costs around RM10 per square foot compared to a site in Pasir Gudang (in Peninsular Malaysia), where it costs around RM4.50 per square foot. There was a lack of assertive priority setting for the industrialisation project by state policy actors in state economic policymaking institutions. Agriculture, mining, and tourism tended to dominate the economic policy agenda. All these factors eventually hampered industrial development.

#### **Phase IV (2006 – 2018)**

Under the IMP II, the federal government introduced regional economic corridors. The IMP II acknowledged the importance of industrial catch-up, technological upscaling, and improvements in innovative activities to create economic corridors that can utilise regional advantages, such as resources, infrastructure, logistics and port facilities (Suffian, 2021; Athukorala and Narayan, 2017). The overarching purpose of economic corridors is to utilise locational advantage, reduce transaction cost, expand shared inputs, increase productivity, and promote public–private partnerships (Athukorala and Narayan, 2017). With the new industrial cluster-based approach, the Sabah government introduced the Sabah Development Corridor Blueprint 2006–2025, under the purview of the Sabah Economic Development Investment and Authority (SEDIA). The purpose of SDC was to move up the industrial activities value chain in the downstream industries. Initiatives focused on creating new industries, upskilling human resources, and advancing technology and research and development (Sabah Development Corridor, 2006). Under the SDC, value-added downstream industries focused on palm oil, wood processing, biotechnology, and oil and gas. The SDC gave rise to the Kimanis Power Plant, Sabah Oil and Gas Terminal (SOGT), and the Sabah Ammonia-Urea Plant (SAMUR) (Mulok et al., 2015).

This industrial corridor basically revisited the initial industrialisation strategy that was resource-based industrialisation with the intention of moving up the value chain in the downstream industries. While industrial clusters have their merits for increasing productivity, expanding downstream industries, and ultimately improving industrial development, the fact remains that infrastructure gaps and inadequate skilled human resources have not really helped the industrialisation plan. Furthermore, substantial investment had been targeted at the resource-based industry because this sector was more lucrative and easier than downstream industries. Policymakers from political elites also tended to give this sector priority due to economic rent, as securing certain concessions will provide windfall profits to those powerholders. This

included activities from the construction industry that local small- and medium-sized enterprises (SMEs), especially subcontractors, could participate in with less high-technological requirements. According to Mulok et al. (2015), the total cumulative investment from 2008 to 2015 was RM147.28 billion after the SDC was introduced, but less than 10 per cent of this investment was channelled to downstream industries. Although there were inflows of investment in downstream industries, most of these were from low value-added activities. The manufacturing sector has never seen double-digit growth, even though this was stressed under the SDC. The sector recorded 8.9 per cent growth in 2008 and 7.8 per cent in 2017. The oil and gas industry that was supposed to spur economic activities for downstream industries retained low value-added activities, while most of the related value-added activities were based in Sarawak instead. The widely acclaimed SOGT became just a storage and processing terminal for liquid gas and nitrogen (LNG) that would later be transported to Petronas' LNG Complex at Bintulu in Sarawak for downstream activities (Hydrocarbon, 2008). Most of the local Sabahan SMEs serviced businesses under the oil and gas sector but were not involved in capital-intensive activities.

#### **Phase V (2018 – 2020)**

In 2018, after the Pakatan Harapan political coalition ousted the BN government, the Warisan government in Sabah wanted to transform the state into an industrial hub. The Warisan government acknowledged that a lack of industrialisation strategies and poor infrastructure did not help downstream industries to move up the value chain. This had discouraged domestic and foreign investments in manufacturing and caused high unemployment in the state (WIFE, 2020). The government set another ambitious target where the manufacturing sector will contribute 35 per cent to the state GDP in 2030. This was another ambitious plan, but there was no concrete industrial master plan—except for the Sabah Agriculture Blueprint and Sabah Timber Industrial Master Plan—to reinvigorate resource-based industrialisation. The state government banned log exports to ensure that there was an adequate supply of wood for downstream industries, especially for the furniture-making business. However, the short-lived Warisan government was unable to carry out its industrialisation plan due to the pandemic-induced economic crisis along with the political crisis, which led to a change of government in the 2020 Sabah state elections.

After the state general election in 2020, the newly elected government rolled out another grand policy, which was Sabah Maju Jaya (SMJ). The SMJ focused on creating new industries and expanding downstream industries as a new source of economic growth. This time, the plan stressed the importance of digitalisation and technological upgrading along with an emphasis on the skilled worker. The SMJ was designed against the backdrop of a pandemic-induced crisis, which had compelled the government to navigate its way around new sources of economic growth, including incorporating digitalisation and technological advancements into the manufacturing sector. The existing plan does not really depart from the previous SIMP, as the state has retained the resource industrialisation strategy since this is the locational advantage of Sabah.

#### **The Encumbered Industrial Development in Sabah**

Despite the introduction of various industrial plans over the past few decades, the transition into industrial-based activities is still unsuccessful, and there has been no significant industrial deepening. To a large extent, the state still depends on extractive activities but has shifted its focus to the service sector (especially the tourism sector) as a source of economic growth. The

limited structural change has been blamed on incoherent industrial policy planning and implementation.

Defining policy priority and preference is crucial to come out with coherent industrial implementation. The political elites play a strategic role in this arrangement. The interpretation of interests and priorities by political elites has had a significant impact on the direction of the industrial policy. Industrial development in Sabah is constrained by the priority set by these political elites. Industrial deepening depends on an expansion of downstream industries, chiefly on the development of the manufacturing sector, with value-added activities. However, such a sector is not really a priority or concern in policymaking processes. Most of the state resources are focused on developing the agriculture, construction, and tourism sectors. There is less effort to develop industrial activities because it requires hard work. This includes coming up with competitive products and requires highly paid workers and substantial investments in research and development. Since a long gestation period is required for growth, SMEs may take some time to be competitive in the manufacturing sector. The long gestation period for return on investment does not really incentivise elite policymakers to seriously venture into industrial deepening. The political elites prefer the 'low-hanging fruits' sector, which can make them quick money. The agriculture and construction sectors are deemed 'easy' projects because they do not really involve high-technology capacities, and economic rents can be easily distributed to politically linked individuals.

The uneven power relations between the federal and state governments have somehow skewed the priority of the state agenda for industrial development. Most decisions regarding investments for foreign and domestic industries lie in the hands of the federal government, especially the Ministry of Industrial Trade and Industry (MITI). For example, the recent widely publicised deal with South Korea Nexilies, a copper foil manufacturer worth RM2.3 billion, is a federal government initiative. Peninsular Malaysia usually has the upper hand when it comes to receiving investments from industrial projects with more value-added activities, while Sabah is more likely to receive investments for resource-based or low value-added manufacturing activities. The reason Sabah is missing out in the priority list is due to its inadequate infrastructure to support industrial development. Infrastructure problems, such as inadequate power supplies, poor internet connectivity, water supplies, road connectivity and port facilities, have been perennial problems that have impeded industrial development.

The federal government has overall responsibility to promote industrial development through domestic and foreign investment. There is less priority to develop the industrial sector in Sabah. The federal government tends to focus on industrial development such as Selangor, Penang, and Johor because such states already have more diversified industrial activities. Such inequitable treatment was due to 'taking for granted' the need for Sabah economic development, as recently raised by many Sabahan politicians, especially in development funds. East Malaysia states only received RM9.8 billion while Peninsular Malaysia received RM67.8 billion in the recent budget. This does not commensurate with the resource contribution by Sabah state to the national coffer. Furthermore, there is also a minimal representation of Sabahan in the federal policymaking which includes top officials in the federal ministries. There is also a lack of understanding of the need for the Sabah economic development at the federal agencies. Unsympathetic towards Sabah's needs, most policymakers do not pay serious attention to the stumbling block for industrialising the state hence this does not put pressure on federal policymakers to push for industrial development agenda. In the context of uneven power

relations between the federal and state government, the federal government can easily shift considerable attention to Peninsular Malaysia industrial sector development.

However, although uneven power relations can be problematic in prioritising the state's industrial sector, the problem can also be attributed to the state's policymaking institutions. As a state, Sabah needs to assert its interest in industrialising the state beyond its resource-based industries. There is not enough pressure asserted by the political elites to push the state's industrial development agenda up the priority list at the federal government level. There is no constant pressure by the political elites to push strategic sectors (e.g., the oil and gas, mineral, food production, wood processing and rubber industries) that the state intends to focus on for moving up the value chain. Furthermore, infrastructure projects that are supposed to facilitate the growth of industrial development are likely to be 'politically captured', and politically linked individuals are likely to obtain project approvals instead of the most competent supplier. Therefore, the planning and implementation of infrastructure projects tend to have sub-optimal or fail-to-deliver outcomes.

### Conclusion

Although various policies have been introduced by the Sabah government to industrialise the state, industrialisation projects were not able to expand the state's downstream industries or move up the industrial activities value chain. Industrial policy implementation has been derailed, and intentions to modernise the state through industrialisation and industrial deepening have not occurred in this resource-rich state. Interpretation of interest by political elites have encumbered an effective planning of policy which resulted an incoherent implementation. The idea of 'low hanging fruit', yield quicker result such as resource based industry overwhelm policymaking institutions. Therefore, expansion of manufacturing that requires vast investment and long gestion period becomes less important. This skewed the priority to industrialise the state. The asymmetrical power relations between the federal and state relations can derail the state intention to pursuit industrial development. Federal policy not prioritising the state industrialising the state can impede the state industrial policy. The centralise administrative function and fiscal autonomy lie in the federal government does not provide much policy space for state to push policy agenda. Rather the federal government would prioritise other states that already established a comparative advantage. Then most resources will be channelled to more advance state. Therefore, less attention are given to Sabah, the rich but poor state.

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