

NEW APPROACHES TO INVESTMENT POLICY IN THE ASEAN 4

Greg Felker with Jomo K. S.

Southeast Asia's economic crisis of 1997-98 prompted major changes in economic policy, including the lifting of barriers to foreign investment in previously sheltered industrial and service sectors. According to conventional analysis, the crisis and ensuing reforms have spelled the demise of government efforts to use strategic industrial policies to promote and guide industrialisation. Having surrendered their discretionary powers to regulate entry into key economic sectors, Southeast Asian governments must now allow international markets to guide their industrial structures toward their natural comparative advantages.

This popular narrative is incomplete and significantly misleading. Liberalisation - voluntary or otherwise - has indeed narrowed the scope for traditional industrial policies, including import protection and investment restrictions to nurture locally controlled infant-industries. Southeast Asian governments have not, however, abandoned efforts to influence sectoral or micro-economic trends in industry. Some of them have matched the dismantling of trade and investment barriers with new measures to encourage investments in more technology- and skill-intensive production. In this regard, post-crisis policy reforms are less revolutionary than they might appear. The "ASEAN 4" - Thailand, Malaysia, the Philippines, and Indonesia - undertook gradual liberalisation during the 1980s and 1990s, and foreign direct investment (FDI) was crucial to their manufactured export growth. Yet, their governments actively promoted and managed FDI inflows, combined export promotion with more traditional infant-industry policies in specific sectors, and attempted to foster production linkages and technology transfer from foreign-dominated export sectors to local supporting industries. The recent crisis has accentuated their search for new forms of industrial policy appropriate to an era of deepening international integration.

This chapter substantiates these arguments by examining a key dimension of industrial policy in the ASEAN 4. Industrial policy refers to all government efforts to influence an economy's sectoral composition or structural characteristics, and includes a variety of instruments, including trade, credit, human resource, and technology policies. While other recent works on Southeast Asia (Jomo *et al* 1997; Lall 1995; Rock 1995) review the spectrum of relevant policies, this chapter focuses on *investment policies* proper, which are measures that regulate or otherwise influence the investment process. Southeast Asian governments have long used equity restrictions, tariff exemptions, and tax incentives to influence the composition of investment flows. As they eased broad regulatory *barriers* in recent years, they increasingly deployed *positive* incentives, infrastructure, and services to encourage desired forms of investment. These changes are more advanced in some of the ASEAN 4 than in others, yet the elements of a new investment policy paradigm are evident throughout the region. They suggest that the scope for positive investment policy in a liberal ownership regime is far greater than commonly assumed.¹

¹ For a general discussion of global investment policy trends, see UNCTAD (1998).

The Changing Context And Content Of Investment Policy In Southeast Asia

Most studies characterise industrial and trade policies in terms of their degree of “openness”, as defined by policy-derived entry barriers, and the extent as well as sector- or firm-specificity of government intervention. Policy regimes fall along a continuum from highly closed and interventionist regimes towards more liberal and incentive-neutral ones. Viewed in these terms, the dominant trend in Southeast Asian investment policies over the past fifteen years has indeed been to relax foreign ownership restrictions and mandatory trade-related investment measures (TRIMs) like local content, foreign-exchange balancing, and technology transfer requirements.

Three broad issues have complicated the regional trend towards open investment regimes, however. First, liberalisation has progressed unevenly across sectors and among the individual countries of the ASEAN 4. As general investment barriers have fallen, the differential incentive effects of remaining restrictions have grown, thus signalling strategic priorities or political sensitivities more clearly. Second, prior to the crisis, liberalisation was usually tied to export promotion, and sometimes to other more specific policy goals such as industrial decentralisation or technological upgrading. Export-oriented industries were accorded liberal foreign ownership rights and exemptions from import duties, for example, while domestic-market production remained more regulated. Thus, ASEAN economies’ integration into global manufacturing networks in the 1980s and 1990s did not signal a commitment to allow markets to determine their industrial specialisations, but rather involved state efforts to respond to opportunities presented by the rapid globalisation of manufacturing.

Third, in several of the ASEAN 4, the major deviation from a neutral incentive regime has derived, not from entry barriers, but from investment *subsidies* like corporate income tax holidays, exemptions, and deductions. Such subsidies are usually viewed as by-products of socially inefficient competition among different jurisdictions to attract investment. Chia (1993: 69) highlights these competitive pressures in arguing that “the significance of the tax incentive now lies more in its absence than presence, as countries without the incentive are perceived to be less friendly towards FDI.” Even if investment incentives are significantly redundant at a regional level, however, they may still result in durable advantages for individual host economies if they attract investments with scale or agglomeration economies, or if positive investment externalities exceed subsidy costs. They may also compensate MNCs for search costs and extra risks involved in transferring advanced production activities to new geographic jurisdictions.²

A distinct but related criticism holds that targeted incentives are simply ineffective in influencing investment patterns (Yeung 1996). Far more important are a country’s economic and policy “basics”: factor endowments and costs, macroeconomic conditions, trade regime, human resources, infrastructure, and the efficiency and reliability of financial and legal systems, as well as investors’ calculations of the security of their property rights, policy stability, and other political risks. While these fundamentals are indisputably crucial, more specific aspects of the “investment environment”, including incentives, have been manifestly important at the margin for investors’ decisions regarding initial location as well as reinvestment for expansion. Most manufacturing investments in Thailand, Malaysia, and the Philippines, including a

² See the discussion in UNCTAD (1998: 97-106).

majority of FDI projects, have received promotional incentives of various kinds. In part, this reflects the fact that “because of distortions in the rest of the economy such as high trade barriers, most investors require some form of incentives if they are going to be able to produce profitably” (OECD 1999: 17). To this extent, broader liberalisation will diminish their importance. Yet, investment incentives have also become important “symbols” that ASEAN governments have used to signal their commitment to welcome and support foreign and local investors, particularly in priority areas (Yeung 1996: 510). Moreover, ASEAN governments have broadened the scope of investment policy beyond fiscal inducements to embrace multi-faceted investment facilitation and service roles. Finally, even though “fundamentals” (e.g. the base of skills and technology) are crucial to industrial success, they are difficult to alter in the short run. Indeed, late-industrialising countries seek FDI precisely because of its potential to augment those endowments, and thus remain interested in influencing the investment process to enhance technology and skill transfers. Investment policies may be ineffective when poorly conceived or implemented, but their potential contribution to local capability building is substantial (UNCTAD 1999). In the case of the ASEAN 4, efforts to enhance the investment environment have often provided the impetus for new initiatives in skill development and technology extension.

Over time, investment policies in the ASEAN 4 have, to varying degrees, embraced new goals, instruments, and institutional frameworks. In terms of new investment policy goals, two themes are now prominent. First, recent investment policies take explicit note of the globalisation of production through multinational corporations’ (MNCs’) international operations. Instead of fostering locally integrated, nationally controlled industry structures, they aim to position the local economy in advantageous roles within MNCs’ own internationally dispersed divisions of labour. Infra-structural and policy support for efficient import and export is of particular importance, but governments have also refined investment incentives to encourage the location of particular corporate functions, such as procurement, management, R&D and design. This shift in orientation from traditional national infant-industry policies towards an embrace of FDI-led integration into regional and global production systems distinguishes the ASEAN-4 from their late-industrialising predecessors, Japan, South Korea and Taiwan. The latter restricted FDI to varying degrees even while avidly acquiring foreign technology through arm’s-length mechanisms like licensing (Maroon 1990; Dahlman and Sananikone 1990; Hobday 1995).

The second change in the goals of investment policy follows from the earlier discussion. The traditional criteria for evaluating investment performance, such as capital formation, employment generation and foreign exchange earnings, have been joined by a focus on investment projects’ dynamic effects on industrial structure – market access, technology transfer, and human resource development. The accent on positive investment externalities has, in some countries, shifted the target of investment promotion policies from encouraging discrete industries to fostering the growth of dynamic industrial “clusters” of complementary assembly, component production, producer-services, skill-development, and technology support. In addition to attracting new green-field FDI, this goal draws attention to the importance of encouraging established producers to reinvest in deepening their local operations, upgrading skills, forming local linkages, and undertaking a higher profile in their parent companies’ global

operations. This, in turn, suggests the need to provide post-investment services. In pursuing these goals, the ASEAN-4 have followed in the footsteps of their regional neighbour, Singapore, which adopted an FDI-led path to industrialisation early in its history, in large part for strategic reasons. Despite its liberal investment rules, the Singaporean state has actively shaped the investment environment to a remarkable degree of detail by providing an array of subsidies, infrastructure, and complementary public investments (Lall 1996).

As the goals of investment policy shifted in the ASEAN 4 countries, the instruments of investment policy have changed accordingly. Negative restrictions, including foreign equity limits and local content requirements, have been or are currently being phased out in most sectors, though significant exceptions remain. Tax holidays, while controversial in economic welfare terms, have also become less of a differentiating factor among host countries because most governments offer them. In their stead, some ASEAN governments have begun offering a range of services designed to enhance the local investment environment, attract desired forms of investment, and induce positive externalities. These include:

- targeted investment promotion
- one-stop facilitation of administrative approvals for investment;
- provision of specialised physical, customs-related, and technical infrastructure;
- financial and other support for skills and technology development;
- matchmaking between investors and local suppliers; and
- other post-investment services relating to investors' routine operations, such as trouble-shooting administrative problems with other government bureaucracies;
- ensuring that new technology-based start-ups have access to finance and other business support.

Comprehensive investor service packages have become particularly important in some governments' efforts to stimulate the development of information (and communications) technology (IT), particularly since tax incentives are generally less relevant to encouraging new IT start-ups.

These investment policy reforms involve daunting political and administrative challenges. Contrary to popular understanding, they demand that government investment agencies develop *greater* expertise and flexibility -- rather than a sector-neutral and minimally active policy stance. Tailoring the local investment environment to the needs of globally-linked production requires an understanding of the widely varying technological properties of specific industries, the logistical and strategic concerns of multinational businesses, and the rapidly evolving international investment environment. More broadly, changing the mission of investment policy from *regulation* to *promotion* to *service* requires the transformation of deeply embedded organisational cultures within the relevant bureaucracies. This is a primary reason that new investment policies have often involved the creation of special agencies, authorities, or administrative zones.

These new approaches to investment policy confront important challenges and contradictions. Chief among these is what might be termed the "enclave syndrome", in which comparatively sophisticated foreign operations have limited impacts on the host economy in terms of production linkages, skill formation, or technological externalities. Ironically, enclave industrialisation partly reflects the dualistic investment policy regimes

employed by ASEAN governments during the boom years: export-oriented investments were promoted by granting special exemptions from the restrictions that continued to protect domestic-market oriented industries (OECD 1999). At a deeper level, however, the question hinges on local “absorptive capacity”, i.e. the adequacy of local skills and technology levels to benefit from the foreign presence. This poses difficult policy challenges for countries such as the ASEAN 4, which bring few complementary capabilities to the bargaining table. The ASEAN 4 have few medium-sized, technologically advanced sub-contractors able to integrate into MNCs' regional or global supply chains. Similarly, MNCs' efforts to build internally integrated regional divisions of labour may pose a structural constraint on host-countries' efforts to foster local linkages and spill-overs. Even as multinationals have devolved key functions - like marketing, procurement, as well as design and R&D - to their Southeast Asian operations, they have tended to centralise such functions in regional co-ordinating units in Singapore or Hong Kong. These considerations highlight the potential role, as well as potential challenges, for host-country policies to enhance the benefits from FDI.³

The next sections of this chapter review the evolution of investment policy in each of the ASEAN 4, focusing in particular on the tension between national control and international integration. The case studies will also examine the use of incentives to implement industrial strategy goals, including sectoral targeting, technological upgrading, and regional decentralisation. ASEAN governments' responses to the limitations of export-enclave development will also be considered, in particular their efforts to encourage linkages and technology spill-overs under the broad rubric of “industrial clusters”. Finally, each national review will assess the institutional framework for investment policy, and detail efforts to reform those institutions in response to new challenges posed by the changing investment policy paradigm.

Investment Reform in the ASEAN 4

Thailand

Evolution of the Statutory Investment Regime

Investment incentives have played an important general role in stimulating Thailand's industrialisation, and despite a widespread perception that the government was particularly non-interventionist, sector-specific policies were important in a limited number of cases (Rock 1995). During the 1980s, Thailand adopted distinct investment

³ Meanwhile, the evolution of ASEAN investment policies is also influenced by trends at the international level. Existing WTO provisions do not proscribe many investment subsidies and equity restrictions, though they do prohibit most TRIMs along with direct export subsidies. Discussions of a potential multilateral investment policy regime have recently been pursued, first under the auspices of the OECD's Multilateral Agreement on Investment (MAI), and latterly under the WTO's Working Group on the Relationship between Trade and Investment, which is drafting a Multilateral Investment Agreement (MIA). In its restructuring programs in Asia, the IMF has sought to persuade client countries to dismantle or reduce such subsidies. However, as they lose other policy instruments to shape industrialization, it appears doubtful the ASEAN countries will readily surrender their ability to hone their attractions to investors in the name of global or regional efficiency. They have made some efforts to co-ordinate their investment policy regimes at the regional level. The ASEAN Investment Area (AIA) was launched in 1998 to promote a gradual harmonization of investment regimes and encourage greater intra-regional FDI flows across Southeast Asia. Even this effort remains compromised by individual governments' desire to use investment policies to advance their national economies within the regional division of labour.

policies for export manufacturing while continuing to protect its domestic markets. These changes enabled Thailand to attract large FDI inflows and emerge as a leading manufactured goods exporter, but the dualistic policy regime frustrated technological upgrading in export industries as well as the formation of linkages and spill-overs to domestic industry.

Thailand's investment policy regime has long been comparatively liberal towards foreign investment and encouraging of domestic private investment. The Investment Promotion Act of 1977 superseded earlier legislation empowering the Thai Board of Investment (BOI) to grant a range of privileges, including income tax holidays of three to eight years, exemptions from duties on imported machinery and production inputs, and, in some cases, temporary tariff surcharges on competing imports. The Act codified Thailand's long-standing insistence on Thai-majority ownership in domestic-market industries, which meant that most foreign investment took the form of joint ventures.⁴ The Alien Business Law of 1972 excluded foreign investment in "sensitive" industries such as agriculture and media, but this and other restrictions posed few obstacles to most foreign investors, particularly in manufacturing, since BOI-promoted projects were exempted from most of their provisions.⁵ Moreover, without clear criteria for promotion, the Board awarded the status liberally to projects in a wide array of sectors.⁶

If Thailand did not seek to rigorously control foreign investment, however, neither did it attract large inflows or stimulate manufactured exports until the mid-1980s, despite the adoption of an Export Promotion Act in 1972.⁷ Rather, investment promotion policies were clearly geared to support the expansion of domestic business interests. The BOI's joint-venture requirement helped Sino-Thai business groups to diversify from commercial and distribution roles into manufacturing, in partnership with foreign investors, to capture the rents available from the expanding domestic market (Suehiro 1989). Given the loose eligibility criteria for promotional status, established investors in resource-based and low technology industries, like food processing and textiles and garments, could enjoy subsidies for expansion. By the mid-1980s, a number of family-owned Sino-Thai industrial conglomerates had emerged in these fields and begun to penetrate global export markets. Also, during the 1970s and 1980s, the government imposed local content requirements on a growing number of industrial sectors, including agricultural machinery, certain electrical appliances, as well as automobile and motorcycle production. These provisions facilitated the growth of Thai-owned engineering firms, including small and medium-sized parts producers and larger electrical motor, compressor, and foundry operations (Doner 1988). Finally, during the

⁴ During 1960-85, for example, only 5 per cent of all capital in BOI-approved projects was invested in wholly foreign-owned ventures, and this amounted to only 18 per cent of total foreign direct investment. The balance took the form of joint ventures with Thai investors.

⁵ The Alien Occupation Law of the same year regulated foreign employment in a range of professions, including the law, medicine, architecture, etc. A moratorium on new commercial banking licenses largely closed the financial sector to foreign investment (as well as most new domestic entrants).

⁶ According to one prominent Thai economist, the BOI was "...extremely promiscuous in giving away promotion certificates... The end result was... higgledy-piggledy growth of Thailand's industrial sector with spotty performance in terms of efficiency" (Amar Siamwalla, cited in Doner & Ramsay 1997: 252).

⁷ Exporters were eligible for import-duty exemptions, but they were required to furnish the government with production formulas and detailed documentation of the use of imported inputs for export production. Legislation authorizing the creation of free-trade zones had resulted in only one functioning zone by 1985.

1980s the government orchestrated a large-scale import-substitution program in intermediate industries like chemicals, cement, and fertiliser under its Eastern Seaboard Program (Muscat 1994: 205-216).

With 1983 reorganisation, the BOI published specific criteria for investment promotion for the first time, together with a wide-ranging list of promoted activities. A second reform package in 1987 firmly emphasised *decentralisation* of investment away from Bangkok to outer provinces by establishing three investment zones. New investments in Bangkok would no longer receive tax incentives, while those projects locating in the most remote zone were eligible for maximum benefits: full eight-year tax holidays, exemption from import duty on machinery, and an automatic 75 per cent reduction on import duties for raw materials for five years. The decentralisation thrust was paralleled, however, by new incentives for *export-oriented* manufacturing investments. Such projects received three-year tax holidays and were exempted from equity restrictions, thus enabling multinational corporations to establish wholly owned subsidiaries for their export operations. As FDI flows into Southeast Asia surged in the late 1980s, the government relaxed foreign equity restrictions to allow 100 per cent foreign ownership of projects exporting 80% of output and of those locating in the outer provinces.

These changes were modest by the standards of more export-oriented economies in the region like Singapore and Malaysia, but they marked a significant shift in the relative positions of domestic and foreign enterprise in Thailand's industrialisation. Thai investors continued to enjoy access to the BOI's promotional privileges for both domestic market and export oriented projects, but they protested granting even limited domestic-market access to wholly foreign-owned firms (Lim and Pang 1991: 46-47). By the early 1990s, however, the growth boom had muffled objections to a more liberal regime. Thai businesses were themselves divided on the question of investment and trade liberalisation, and large local companies involved in downstream assembly responded to the new competition by pressing for reductions in tariffs on raw materials and intermediate goods.

In contrast to earlier periods, then, the bulk of new FDI during the period of Thailand's growth boom (1987-97) flowed into the export-manufacturing sector and took the form of wholly foreign-owned subsidiaries. Foreign investment was also encouraged in the infrastructure and transport sectors, particularly several large build-operate-transfer (BOT) mass-transit schemes in the traffic-choked capital. In anticipation of signing the WTO protocol on TRIMs, Thailand reduced the total number of industries with local content requirements from eighteen to four, although the most important local content programs for automotive and motorcycle assembly have been retained until the WTO's year-2000 deadline.

Since its financial collapse triggered the regional economic crisis, Thailand has undertaken substantial efforts to remove remaining restrictions on foreign equity investment. The major focus of attention has been on financial sector restructuring, where the special-purpose Financial Restructuring Authority (FRA) has supervised the disposal of assets taken over from failed banks and finance companies. At the end of 1997, Thailand passed legislation allowing foreign ownership of banking and finance groups, and by 1999 had auctioned four collapsed commercial banks to foreign investors. Other reforms enabled foreigners to own the land under their factories, up to one *rai*

(1,600 sq. m.) of land when investing Bt. 25 million or more. The IMF-backed restructuring program called for other changes to the Alien Business Law, which was replaced by a new Foreign Investment Law on October 21, 1999 after a one-year legislative review. The new law retained the apparatus of a negative-list system and establishes a special approval committee for sensitive sectors, but it mandated greatly simplified approval procedures and opened important sectors such as domestic transport, retail trade, as well as financial and legal services to foreign ownership.

In the industrial sector, the Board of Investment launched several initiatives to encourage greater foreign investment inflow. In September 1997 the BOI waived equity limits for existing joint-venture projects enjoying its promotion, thus permitting foreign partners to increase their stakes without reference to limits on foreign ownership. The change was widened to new investments in November 1998, when the BOI suspended the long-standing requirement for majority-Thai ownership in domestic-market projects.⁸ These conspicuous efforts to relax foreign investment barriers resulted in an influx of new capital in the form of merger & acquisition (M&A) investment. In fact, the BOI established an M&A unit to provide matchmaking services and to co-ordinate necessary approvals. According to a study by Brimble & Sherman (1999), 253 companies applied to the BOI to increase their foreign ownership share between November 1997 and March 1999, of which 135 projects had been implemented worth a total US\$570 million.

The liberalisation of Thailand's investment regime has been a gradual and contested process. The controversies that have occasionally slowed changes did not reflect an unalloyed form of economic nationalism, as foreign investment has long welcomed by both government and most domestic business interests. Rather, the key political issues revolved around the terms for foreign access to the formerly booming domestic consumer market and, more recently, control over insolvent assets. Historically, limits on foreign participation in the service sector and the joint-venture mandate for manufacturing projects nurtured the growth of an influential domestic business class. The government has thus been compelled to negotiate many liberalisation initiatives with the leading business associations like the Federation of Thai Industries (FTI) and the Thai Bankers Association (TBA). The final version of the Foreign Business Law, for example, contains several limiting amendments passed by non-elected Thailand's Senate, which had become dominated in the 1990s by business figures.⁹

Strategic Deployment of Investment Incentives

A second important consequence of Thai business' political influence is that investment subsidies have been applied liberally to a wide range of industries -- ranging from high-tech electronics to mature sectors like agriculture and hotel and tourist projects -- rather than as an instrument for implementing focused strategic industrial policies. In October 1999, the BOI Secretary-General lamented that the political influence of domestic investors had meant the Board could not reject applications for promotional privileges even in industries facing serious over-capacity problems. Attempts to withdraw non-

⁸ Under decentralization incentives, domestic-market projects locating in the remote Zone 3 were already permitted majority-foreign ownership.

⁹ Prior to the 1990s, the appointed Senate included many military officers. Thailand's 1997 Constitution mandated an elected Senate in the year 2000.

strategic sectors from the eligible list provoked allegations that established investors had influenced the Board to exclude new entrants.¹⁰

Within these constraints, however, the BOI has sought, in limited ways, to encourage higher value-added and technology-intensive investments. While failing to focus the list of promoted activities on technology or skills-related criteria, the BOI has granted maximum benefits, regardless of location, to specific high-technology activities like wafer fabrication, precision or automated machinery, and software parks. In 1989 the BOI began offering incentives for the establishment of R&D facilities, and by 1994 had granted incentives to 26 projects worth more than Bt. 1,500 million, and including both local Thai firms and foreign investors. The Board has co-operated in granting promotion to projects affiliated with the National Science and Technology Development Agency (NSTDA), a quasi-government body set up in 1991 to sponsor and conduct applied research in electronics, biotechnology, and materials. The BOI promulgated special promotional privileges for software development in 1997 in conjunction with NSTDA's opening of a software park project; by late 1999, the park's incubator had nineteen start-up tenants. In 1995, the Agency's electronics institute became involved in an ambitious effort by the leading Thai-owned sub-contract assembler of semiconductors, the Alphatec Group, to push Thailand into wafer fabrication, yet the entire project collapsed with the price of memory chips and financial markets in 1996-97.¹¹ The Agency also spearheaded the launching of a ten-year IT strategy in late 1999 that focused on using the government's own electronic systems upgrading to nurture the local IT industry. NSTDA has also developed the country's first science park north of Bangkok near the Asian Institute of Technology, though the financial crisis delayed its opening. The park's prospective tenants included some of the country's leading multinational manufacturers, including design and development centres for auto-makers Toyota and Ford.¹²

In the wake of the crisis, the BOI refocused its attention on assisting the restructuring and upgrading of Thailand's existing industries. In conjunction with special Ministry of Industry funds for capital equipment acquisition in the textiles, footwear, food processing and other industries, the Board granted special duty exemptions on imports of capital equipment "using higher technology". The Board has also broadened its efforts to encourage established foreign investors to deepen their investments in Thailand. In 1995, it established a non-profit Investor Club Association to serve as an organisational interface for providing post-investment services to promoted companies, which has since enrolled 800 BOI-promoted companies. The Association's 60 staff operate an electronic raw materials tracking system, linked to the Customs Department through electronic-data interchange, that manages the documentation necessary to avail

¹⁰ *The Nation*, October 21, 1999.

¹¹ In 1999, NSTDA and the Ministries of Science and Industry mounted a new push to attract foreign investment in wafer-fabrication with government equity support. The BOI initially opposed the project on the grounds that Thailand lacked sufficient capacity to make it a success (*Bangkok Post* 25 March 2000), but eventually agreed to provide maximum eight-year tax holiday incentives to wafer fabrication projects regardless of investment zone.

¹² The NSTDA negotiated directly with Ford and advocated on its behalf in winning additional incentives for its proposed investment from the BOI (*The Nation*, 21 April 2000).

of import-duty drawbacks. In 1997 the BOI also co-ordinated the establishment of a one-stop office with the Immigration Department to process applications for work permits.¹³

In 1996, the Board also announced non-tax incentives for the establishment of regional headquarters operations, i.e. multinational corporate offices established to provide managerial and technical support to affiliates throughout Southeast Asia. Investors in these activities are automatically accorded five expatriate work permits and allowed to import capital equipment duty-free. The criteria were liberally defined to include consulting, exporting, wholesaling, and equipment maintenance, and by 1999, the BOI had approved some 102 trade and investment support offices, with cumulative investment of more than Bt3.2 billion. The incentive was extended in August 1999 to international procurement offices, which co-ordinate sourcing of components and other production inputs from local and regional suppliers.

It is difficult to assess the differential impact of these measures, but a growing number of multinational companies have in recent years selected Thailand as their regional production and export base. Notable among them are Japanese electronics producers Fujitsu and Minebea, U.S. disk-drive maker Read-Rite, German engineering firm Siemens, and auto-makers Toyota, Isuzu, Honda, Mitsubishi, Mazda/Ford, and General Motors. In the case of Thailand's auto sector, the Ministry of Industry used accelerated relaxation of local-content policies as a bargaining chip to lure a US\$1.5 billion investment by GM in 1995. Similarly, when the recent crisis crippled domestic auto sales, the government bargained with foreign auto assemblers to lower import duties on parts, assembly kits, and built-up vehicles in exchange for commitments to refocus their production plans on export markets.

The BOI's rather indiscriminate promotional policy received greater scrutiny after the crisis struck. As part of its short-term response to the collapse in investment, the Board relaxed export and regional decentralisation criteria for investment promotion, offering optimal terms for all new projects through the end of 1999. In late 1998, it extended its import-duty exemption privileges to non-promoted firms operating in priority industries. These efforts considerably reduced the element of discretion and selectivity in Thailand's already lax investment policy regime. Yet, the IMF preferred to increase the incentive neutrality of Thailand's business environment by curtailing investment incentives altogether in favour of broad-front reductions in tariffs and foreign investment barriers. In fact, the Fund recommended disbanding the Board altogether, or at least removing its powers to award tax holidays.¹⁴

Instead, the Thai government decided to revamp the agency once again, and a Cabinet-level committee drew up a new set of guidelines in mid-1999. The proposed reforms would universalise national treatment, doing away with virtually all foreign equity restrictions, in line with provisions of the IMF adjustment program, and would also focus the criteria for investment promotion more tightly in two ways. The prior policy of investment location decentralisation, suspended during the crisis, was to be revived with more generous tax and import-duty exemption privileges for projects located in outlying provinces. Second, companies applying for promotion would be screened according to their investments in R&D, technology improvement, and human

¹³ The BOI claims the center can facilitate approval of work permits within three hours.

¹⁴ A World Bank study estimated that the Board's tax holidays had far exceeded the long-term revenue benefits, a conclusion disputed by the Board. *Business Day* (Bangkok) March 20, 1998.

resource development and would also be required to obtain ISO9000 quality-system certification for most industries. Rather than sectoral targeting, therefore, the proposed guidelines would link incentives to the goal of improving investment quality as measured by positive externalities-producing investments in technology and skills. It is not yet clear how these criteria will be measured and whether they will be implemented rigorously; similar decisions in the past produced little discernible change to the allocation of incentives. If implemented strictly, the new guidelines would narrow domestic Thai industries' access to investment privileges. More certain is that the BOI will continue to strengthen its investor service functions will continue.

The Enclave Dilemma, Linkage Promotion, And Technology Diffusion

Thailand's manufactured export boom was driven in part by Thai investors in resource-based and labour-intensive industries like food-processing and textiles, but a new wave of wholly foreign-owned multinational subsidiaries in the electronic and automotive sectors has led industrial expansion since the late 1980s. A key argument for the liberalisation of FDI rules was the need to encourage technology transfer. This term is typically used, often implicitly, in two very distinct ways. In the first sense, technology is transferred when foreign subsidiaries introduce improved technologies in their own operations. It is often presumed that this will lead to a second form of technology transfer -- the diffusion of technology to local enterprises through a number of mechanisms. The most important of these are the training of local staff and knowledge-diffusion through sub-contracting or other backward production linkages to local components suppliers, assembly sub-contractors, and providers of specialised tooling or engineering support. As research in advanced industrial countries has shown, such networks can create dynamic *industrial clusters* by allowing inter-firm co-operation in upgrading skills, technologies, and quality standards (Porter 1990; Storper 1997).

Through its local-content programs in auto-motives and agricultural machinery in the 1970s and 1980s, Thailand had developed a relatively large base of supporting industries in metalworking, tool & die, plastic products, printed circuit-board assembly, and electrical components.¹⁵ Yet, these firms still operated as protected domestic-market industries, displaying relatively low levels of productivity and quality. Before the introduction of a VAT in 1992, Thailand's business sales tax created a cascading tax burden on inter-firm transactions. Finally, potential suppliers to multinational exporters were forced to pay considerable tariffs on their own imports. These *indirect exporters* were technically eligible for import duty drawbacks, but often found it difficult, in practice, to provide the necessary detailed documentary proof of the incorporation of imported components and raw materials into export products. Therefore, when new foreign investors set up export operations during the boom years, they formed relatively

¹⁵ A 1995 study by the Japanese International Co-operation Agency (JICA) identified 402 electrical and electronics parts suppliers, of which 97 were primary suppliers to major assemblers, 30 (31%) wholly Thai-owned, 47 (48%) joint-ventures, and 20 (21%) wholly foreign-owned. The study found 374 auto-parts suppliers; of 134 primary suppliers, 72 (or 54%) were wholly Thai-owned and 58 (43%) were joint ventures.

few local production linkages. Instead, they sourced inputs with imports or from foreign suppliers who had also migrated to Thailand.¹⁶

In response to this concern, the Thai Board of Investment launched a BOI Unit on Industrial Linkage Development (BUILD) in 1992. The BUILD program attempted to play a matchmaking role between large assemblers and small & medium industrial (SMI) suppliers by providing procurement guides to new and existing promoted investors. Little progress was made during the program's initial few years; the BOI lacked sufficient staff numbers and expertise to provide important technical or financial assistance to prospective suppliers, while most large foreign and local companies displayed little interest. In 1997, the BOI revamped and enlarged its linkage-promotion effort by initiating a "buyers-meet-vendors" program, in which the Board vetted and escorted potential suppliers on factory visits to large assemblers. A companion program involved procurement fairs in which large companies displayed the type of parts they would be willing to consider sub-contracting locally. By 1999, the BOI had arranged visits to 18 large-companies involving a total of 491 potential suppliers, and claimed that 58 contracts worth nearly Bt1 billion had resulted from the meetings, though the importance of the Board's intervention is unclear.

The Board also used its main promotional incentives to develop supporting industries in order to deepen the export structure. In 1993, investments in several activities, including forging and casting operations and the production of mould & die or jigs & fixtures, became eligible for full tax holidays regardless of their location (i.e. even if located in the Bangkok area). The same exemption was broadened in 1994 to include other supporting industries and manufacturing services, such as precision machining, engineering plastics, and several types of tool-making, and widened again in subsequent years. Promotion of supporting-industry investment, however, was not targeted to encourage indigenous enterprises to form linkages with foreign export firms. Rather, it explicitly sought to encourage Japanese and other East Asian SMIs to follow their assembly customers to Thailand. To the extent that industry clusters would emerge, therefore, they were not guaranteed to result in technology transfer to indigenous industry.

The problem of developing Thai supplier industries has become particularly acute in the wake of the economic crisis, which devastated SMIs dependent on contracts with large auto and electronics assemblers. Perhaps half of Thailand's 1,200 auto parts suppliers had gone bankrupt by early 1999 (Brimble & Sherman, 1999: 21). Some of the leading parts producers were forced to ask their Japanese joint venture partners to increase their equity stake under BOI's special rules. Many such deals included special buy-back options should the Thai partner recover financially within a specified time period. However, even Thailand's giant Siam Cement Group, a leading player in the BOI-co-ordinated efforts to localise components production in the automotive and

¹⁶ Local content data is relatively scarce, particularly for the 1990s, but Ramstetter & Tambunlertchai (1991: 98-9) showed that the import-intensity of foreign-owned exporting firms grew over the period from 1974 to 1986, e.g. electrical machinery (73 per cent to 85 per cent), apparel (73 per cent to 76 per cent), and textiles (58 per cent to 66 per cent). Other case studies report that foreign export firms have found it difficult to find acceptable local suppliers (FIAS 1991; Dahlman & Brimble 1990: 24).

electrical appliance sectors during the 1980s, declared its intention to hand over its auto-parts subsidiaries to its Japanese partner, Toyota.¹⁷

While the BOI has been active within its sphere of authority, Thailand's overall efforts to foster industrial clusters have been hampered by an inadequate infrastructure for providing financial, skill, and technical support for SMIs. Many small suppliers lack access to commercial bank lending, and they have been largely frozen out of formal credit markets since the onset of the crisis. A Small & Medium Industry Finance Corporation was set up in the early 1990s to provide subsidised loans for technical upgrading by supporting industries, but has been widely criticised for an overly bureaucratic operating style and poor financial performance. Other dedicated financial programs for supplier industries have foundered due either to bureaucratic obstacles or the unwillingness of private banks to assist in implementing government credit-subsidy schemes. Industrial and technical extension services have likewise been meagre, though a few exceptions exist, including the Industry Ministry's Metal Working Industries Development Institute (MIDI), which has provided quality-control and automation technology training to the tool & die industry. The National Science & Technology Development Agency forged research and technology extension linkages with a number of indigenous industries, though the scope of its outreach to industry remains limited.¹⁸ In late 1999, the government opened a new SME (small and medium enterprise) Financial Advisory Centre with branches in nine provincial universities to consult smaller firms in drafting restructuring plans and accessing government support programs.

Efforts to address the low level of workforce skills have likewise lagged behind the demands of industry, though the skill development infrastructure has recently expanded. The Thai-Japan Technological Promotion Institute, set up in 1973 by Japanese and Thai business associations, offers a range of courses in quality control subjects, and in 1997, opened a separate training institute to train workers in automation skills. In 1998 a new joint industry-government skills training institute was opened in partnership with the German government. In 1998, the Ministry of Industry began to spin off several of its internal offices and industrial extension operations into sector-specific extra-bureaucratic institutes charged with co-ordinating technical assistance programs, including training assistance, equipment upgrading, and ISO9000 quality certification. The institutes, ranging from electronics to auto-motives, textiles, food, and agro-industry, are organised as public-private corporations, to be jointly run with their counterpart industry associations. While it is too early to assess their prospects, their corporatisation, independence from civil service, and close links with relevant private sector associations (several institute directors were appointed from the private sector) bodes well for an enhanced technical extension effort. An overall evaluation thus reveals the system of technology-extension and skills-development institutions in Thailand has been poorly funded and unresponsive to the needs of industry. Yet the crisis has given new impetus to efforts to strengthen technical and financial support for small and medium-sized manufacturers.

¹⁷ In the end, the Siam Cement Group retained a small minority stake at Toyota's request.

¹⁸ From 1992 to 1996, the NSTDA performed some 417 consultancy projects, and gave matching grants worth a mere Bt. 1.13 million to 10 companies for technology acquisition projects. From 1988 to 1997, the Agency approved 31 loans worth Bt. 26.65 million and 10 grants worth Bt. 4.10 million to support private sector research projects.

The Institutional Framework For Investment Policy

The key actor in Thailand's investment regime is the Board of Investment. Whereas its counterpart agencies in most countries are primarily implementers with little policy role, the BOI's status as a semi-autonomous agency under the Prime Minister's Department gives it a high degree of influence over a broad range of investment issues. For many years, the BOI was empowered to grant not only tax incentives and import-duty exemptions, but also special tariff protection, bans on new entrants into particular sectors, and approvals for expatriate employment. The BOI has also co-ordinated local content programs in several sectors, and in recent years, has taken the lead in seeking new ways of promoting linkage formation and providing investment facilitation and post-investment services.

The BOI's wide powers do not signify exclusive authority, however. Its incentive programs overlapped and often conflicted with the functions of the Ministries of Industry, Finance, Commerce, and others. The Board of Investment proper, which oversees the BOI agency, is an inter-ministerial committee chaired by the Prime Minister, but most policy co-ordination is worked out through lower-level inter-agency committees involving the BOI and its counterparts in other ministries. The relationship with the Ministry of Industry (MOI) is particularly important, as the MOI has juridical authority over all industrial policies. The MOI has bureaus charged with supervising the growth of particular sectors, as well as several offices with policy and licensing functions. For example, a special MOI policy committee manages local content and tariff policies for the key automotive sector. Frequent government changes and cabinet reshuffles have hindered the MOI and other line ministries from following through on perennial proposals to invigorate industry-support programs.

The BOI's autonomous powers have made it the target of criticism from turf-conscious bureaucracies as well as economists critical of its incentive program as unfocused, redundant, or even distorting. As military-appointed technocrats reoriented Thailand's development strategy during the 1980s towards an export focus, the Board spearheaded moves to liberalise entry conditions for new FDI inflows. Partly as a result, the civilian Chatichai government in 1989 and 1990 considered disbanding the board, and in 1992, several of the Board's discretionary powers over tariffs were removed, including the power to grant duty exemptions for imports of capital equipment. Moreover, the BOI's duty-exemption incentives have become less potent as Thailand's trade regime has lowered tariffs on a range of intermediate inputs in the 1990s. Given that most inputs and capital equipment imports still face residual tariffs, however, the Board's ability to grant total duty exemptions and assist with processing the required paperwork remains valuable to most industries.¹⁹

The erosion of its tariff powers and criticism of its tax incentives have prompted the Board to emphasise its role in providing a range of non-pecuniary investor services, as described above. In 1992, the Board reorganised its internal structure and established seven sector-specific investment promotion divisions, though it still lacks sufficient personnel and technical capacity to evaluate the technical or skill content of projects, tie

¹⁹ In its 1999 reform, for example, the BOI proposed restoring the duty exemption for machinery imports. Investors have complained that the standard tariff rates of up to 5 per cent still hinder investments to upgrade their capital stock.

incentives closely to strategic criteria, and monitor the productivity performance of promoted industries. The Board came under renewed criticism in the wake of the economic collapse in 1997, but the Thai business community came to the agency's defence, arguing that it remained the most credible and accessible interlocutor for much of the private sector. Despite the promulgation of new foreclosure and bankruptcy laws, the BOI has been a critical player in facilitating the flow of merger & acquisition investment in the industrial sector, and its new guidelines suggest an intention to leverage its information resources to remain a key player in future investment deal-making.

Malaysia

Evolution of The Statutory Investment Regime

Malaysia was the most active among the ASEAN 4 in reshaping its investment regime to capitalise on the regional boom in manufacturing FDI during the 1980s and 1990s, though it has resisted pressures to liberalise other sectors in the wake of the crisis. Malaysia launched its industrialisation program with the 1958 Pioneer Industries Ordinance, which granted tax holidays and import duty exemptions to import-substituting investments in a wide range of consumer and resource-based manufacturing goods. Unlike Thailand, however, foreign corporations captured the majority of benefits from the investment incentives in the manufacturing sector, as foreign-majority joint ventures were widely tolerated. When domestic consumer markets became saturated in the late 1960s, the government refocused its incentive regimes on export-oriented manufacturing with the Promotion of Investments Act of 1986. The Federal (later Malaysian) Industrial Development Authority (MIDA) implemented new promotional measures including ten-year Pioneer Status tax holidays and import-duty exemptions for exporting firms.

For a variety of reasons, Malaysia was far more successful than the other ASEAN 4 in attracting foreign manufacturers seeking a base for low-cost assembly and re-export of electronics products. Besides the country's proximity to Singapore, a key factor was the creation of ten Free Trade Zones (FTZs) by Malaysia's state governments. The FTZs offered multinationals an environment perfectly suited to internationally linked export processing, with controlled labour, subsidised infrastructure, expedited customs administration, and freedom from import duties and export taxes.²⁰ From 1972 to 1979, total manufactured exports grew from RM723 million (about US\$300 million) to RM4,860 million, while the share of FTZ firms in total manufacturing exports increased from a mere 1 per cent to 75 per cent (Rasiah 1993: 137). With the government's priorities fixed on employment generation, MIDA focused on investment promotion and made little or no attempt to screen foreign investment proposals, target incentives on particular sectors (electronics dominated FTZ production and general exports), or impose performance requirements for technology transfer or local content.²¹

The domestic investment policy regime became highly regulated during the 1970s. As part of its New Economic Policy, the government promulgated a comprehensive industrial licensing system under the Industrial Co-ordination Act (ICA) of 1975. The ICA's primary purpose was to serve as an instrument for regulating the

²⁰ In 1975, the Licensed Manufacturing Warehouse (LMW) program extended similar treatment to individual factories set up outside the zones.

²¹ The automotive sector was subject to a separate local-content program managed by an inter-agency committee housed in the Ministry of Trade and Industry.

expansion of ethnic-Chinese business and to foster inter-ethnic redistribution of corporate wealth by guiding new investment opportunities to the indigenous *Bumiputera* (primarily ethnic Malay) communities.²² The Act also established a similar rule of thumb for employing workers from indigenous groups. In the early 1980s, a new government under Prime Minister Mahathir Mohamad launched a second round of import substitution in intermediate and heavy industries. The program took the form of new joint venture projects between state-owned enterprises and foreign (mostly Japanese and Korean) partners in auto-motives, motorcycle assembly, steel, cement, fertiliser, petrochemical and other industries. For the first time, government bureaucrat-managers engaged in detailed negotiations over the technical content of investment projects with their foreign technology suppliers. The heavy industries drive resulted in several costly failures, as when the Perwaja steel plant's prototype technology failed to operate successfully (Chee 1994). A mid-decade recession caused the program to be restructured drastically, but the auto sector project in particular was sustained (and later expanded) by government subsidies and import protection. The heavy industries push was soon followed by the promulgation of a ten-year Industrial Master Plan (IMP) for 1986-95, which laid out a program of detailed sectoral intervention inspired by Korea's industrial policy model. The IMP recommended more stringent screening of foreign investment, including an expanded negative list of sectors prohibited for foreign ownership, mandatory export requirements on all new FDI, and detailed targets for both technology transfer and local content.

Established multinational exporters operating in the FTZs were largely unaffected by the changes in domestic investment policy during the 1970s and 1980s. For the most part, they were exempt from the new equity-sharing guidelines, and found little difficulty in complying with government directives to employ a large percentage of *Bumiputera* workers, who were mostly young unskilled female school-leavers. Mahathir's more interventionist approach in the early 1980s combined with global recession to slow FDI inflows. A mid-decade recession caused the government to shelve the IMP's proposals for more rigorous FDI screening and instead move to overhaul its investment regime to attract greater FDI inflows. A new ruling permitted foreign investors to set up wholly-owned subsidiaries in all projects exporting at least 80 per cent and majority foreign-ownership in projects exporting at least half of their output. In 1986, these and other changes were codified in a new Promotion of Investments Act. The Act offered a new round of Pioneer Status tax holidays, and widened the scope of investment tax allowances for expansion projects for existing investors. Indirect exporters, including suppliers selling to firms in the FTZs, were exempted from the Industrial Co-ordination Act's equity-sharing guidelines and granted access to export tax incentives. The broad impact of these changes was to generalise many of the liberal rules obtaining in the FTZs to the wider investment regime, and to forcefully commit Malaysia to an FDI-led industrialisation strategy.

The decisive embrace of foreign investment met with tremendous success over the ensuing decade. FDI flooded into Malaysia from Japan and East Asia, along with U.S. and European electronic and chemical firms and Singaporean-based manufacturers.

²² Firms above a minimum equity threshold were required to share equity, usually 30 per cent, with *Bumiputera* partners. The 30 per cent rule was not explicitly mentioned in the ICA itself. Rather, it was the overall target for *Bumiputera* ownership of listed corporate wealth by 1990.

In response to this influx, the government moved during the 1990s to revise the investment regime in order to place greater emphasis on investment quality as measured by technology content and value added. Mahathir's 1991 Vision 2020 manifesto spoke of the need to deepen and upgrade the industrial structure. In 1996, the Ministry of International Trade & Industry (MITI) issued a Second Industrial Master Plan (IMP2), which emphasised the goal of transforming assembly-dominated export industries into more locally integrated industrial clusters. The plan promised to stimulate backward integration by encouraging investments in component production, design and R&D, as well as forward integration into trading, marketing, and local brand development. These ambitious industrial policy goals did not, however, signal a general tightening of the investment regime, although the government did intervene to promote indigenous infant industries in a few sectors. Rather than exclude undesirable investment or impose performance requirements on foreign investors, the government primarily sought to influence investment quality through an array of positive incentives, as described below.

As the economic crisis swept Southeast Asia in 1997 and 1998, the Malaysian government took additional steps to liberalise conditions for manufacturing FDI. The National Economic Recovery Plan issued in mid-1998 lifted all restrictions on foreign equity in new manufacturing projects, regardless of export orientation, for a period of two years (though the relaxation was unlikely to be reversed after that time). As in Thailand, pre-existing joint ventures serving the domestic market were permitted to increase their foreign shareholdings, while wholly foreign-owned firms, previously required to export 80 per cent of output, were now permitted to sell up to half their output locally. By April 1999, some 49 joint-venture companies had increased their foreign ownership ratio with capital injections totalling RM3.45 billion.²³ The government granted blanket exemptions from import duties to all machinery and equipment imports, as well as to all inputs used in export production. Beyond all these adjustments to the rules, the recovery plan explicitly declared a "hands off" attitude towards existing foreign investors' compliance with the terms of their investment licenses. The auto-motives sector continued to be the most salient exception to Malaysia's generally open regime for manufacturing investments. In late 1999, the government announced that it would postpone implementing its commitments under the ASEAN Free Trade Agreement (AFTA) to tariff reductions on auto-parts, kits and built-up units.

Since the advent of the crisis, Malaysia's liberal policies towards manufacturing FDI have been overshadowed by the controversy surrounding its imposition of selective capital controls. So far, it has also refused to follow its neighbours in removing barriers to foreign investment in the financial sector, where a 30 per cent limit remains the rule. The government observes that wholly foreign-owned banks licensed in earlier decades account for more than one-third of commercial bank assets. Unlike Thailand, Malaysia has resisted selling off most of the vast assets that have been nationalised under its aggressive financial restructuring program, though some large foreign merger and acquisitions projects have been approved, as in the cement and telecommunications industry. In 1999, the government launched a plan to consolidate the banking industry through forced mergers in lieu of foreign acquisitions, but suggested that the ultimate goal of restructuring was to prepare the sector for liberalisation.

²³ Figures quoted in *The Star*, April 6, 1999.

The Strategic Deployment of Investment Incentives

While according foreign investors a leading role in industrialisation, the Malaysian government has sought to use discretionary investment incentives to shape the composition and quality of investment inflows. Since 1986, the primary goals have been to lure investments in higher-technology activities and to encourage the deepening of the industrial structure from assembly activities to more integrated industrial clusters. In the mid-1980s, tax deductions were offered for firms' approved expenditures on training as well as research and development (R&D). These had relatively little impact since many large companies already enjoyed tax relief, while difficult application and post-expenditure reimbursement procedures have deterred many small companies. In 1990, tax incentives were extended to MNCs that set up regional Operational Headquarters (OHQs) to provide management services, logistics, and co-ordination for subsidiaries in Malaysia and the broader region.

More changes were initiated in 1991 after a broad review of MIDA's investment policy regime. These reforms moved the incentive regime a step towards neutrality by phasing out tax incentives for exports and reducing the scope of the core tax incentive, Pioneer Status tax holidays. Henceforth, "ordinary" Pioneer Status would exempt only 60 per cent of corporate profits (instead of the previous full exemption), and would normally be granted for only three to six years (instead of ten). This change created "room" for the government to use full tax exemptions to induce investments in specific higher-technology sectors. MIDA announced that it would screen applications for pioneer status more rigorously using four broad criteria: value added of 30 to 50 per cent, local content levels of 20 to 50 per cent, depth of technology (as measured by the proportion of managerial and technical staff), and linkage effects (largely a qualitative assessment of how the project complements Malaysia's industrial structure).

In 1995, MIDA's parent ministry, MITI, elaborated the shift in investment policy by announcing new criteria for general investment promotion along with special incentive programs for "high-technology" and "strategic" investment projects. A baseline criterion for pioneer status was established based on capital investment per employee (CIPE). Proposals involving less than RM55,000 (at that time, US\$21,568) CIPE would henceforth be turned down unless they met other criteria: value-added of 30 per cent or more; 15 per cent of workforce in managerial, technical, or supervisory (MTS) positions; location in outlying states; or activities deemed strategically beneficial to Malaysia's industrial progress. Separate incentive programs were launched for high-technology projects, defined as those committed to incurring R&D expenditures equal to 1 per cent of sales within three years of start-up, and having 7 per cent of the workforce comprised of employees holding post-secondary certificates or diplomas in technical subjects. Accompanying these general criteria was a list of specific activities to be promoted under the high technology designation, including: computers and computer peripherals, LCDs (liquid crystal displays), medical equipment, biotechnology, automation equipment, advanced materials, opto-electronics, software, alternative energy, and aerospace. High-technology projects would receive a ten-year tax holiday on 100 per cent of corporate income, and would be allowed greater freedom to employ expatriate researchers or scientists as well as to hold unrestricted foreign exchange accounts in local banks. Finally, a catchall category of "strategic" investment projects

allowed the government to grant full ten-year tax holidays to individual projects at its discretion.

In the crucial semiconductor industry, the government long sought to lure foreign investments into wafer fabrication without much success. More recently, it has followed Singapore's lead in making direct investments in joint-venture wafer fabrication plants. The government's Malaysian Institute of Microelectronic Systems (MIMOS) has opened a pilot facility to develop circuit designs, though its commercial impact has yet to be demonstrated. The Sarawak state development corporation has backed a joint-venture wafer fabrication investment, while the Ministry of Finance's strategic investment arm, Khazanah Holdings, has also taken a stake in a planned wafer fabrication plant in the Kulim Technology Park in Kedah.

Recognising that an acute shortage of skilled labour was a basic constraint on technological upgrading, the government also reformed incentives related to human capital formation. In 1993, the government replaced an existing tax incentive for corporate training expenses with the Human Resources Development Fund (HRDF), an industry sector-wide payroll levy and training subsidy scheme. Firms employing more than fifty workers²⁴ were required to contribute one per cent of their payrolls to the Fund, and could apply for reimbursement of a percentage of expenses on approved training programs or submit their in-house annual training plans for approval. In 1996, approved reimbursements rose to US\$63 million and the number of trainees grew to 518,710.²⁵

Besides revamping its investment incentives, the government created a series of direct funding mechanisms for high-technology industries during the 1990s. In 1993, the Ministry of Finance established Khazanah Holdings as a special-purpose vehicle to invest in strategic and high technology projects, which by 1999 numbered 33, and ranged from the government's "national car" companies to high-technology start-ups and investment partnerships with foreign venture-capital companies. The Malaysia Technology Development Corporation (MTDC) was set up as a public corporation under MITI the same year. Initially charged with financing the commercialisation of public sector R&D, the MTDC soon evolved into a conglomeration of technology-related programs. Chief among these was MTDC's effort to stimulate the growth of Malaysia's venture-capital industry. By 1999 the group managed six separate venture capital funds itself, and controlled 26 companies in advanced materials, biotechnology, electronics, fine chemicals, IT and multimedia. For the Seventh Malaysia Plan (1996-2000), several other new technology funding mechanisms were announced, including venture funds linked to the Multimedia Super Corridor and Technology Park; a matching grant scheme for joint public-private R&D under the Science Ministry; and two RM100 million matching-grant funds administered by the MTDC for technology acquisition and commercialisation. However, uptake of these funds has been modest, and the administering agencies are still

²⁴ The HRDF's coverage was extended in 1995 to companies with more than ten employees but with a minimum investment capital.

²⁵ *Utusan Melayu*, August 25, 1997. A World Bank (1997: 61) study concluded, "HRDF has had a significant role in increasing training among medium and large firms... but not small firms... Among purely domestic firms, HRDF has only been effective in increasing the training of large firms with over 250 employees."

groping for a way to utilise them effectively.²⁶

Specialised Infrastructure for Technological Upgrading

The new incentives for industrial upgrading were further linked to the federal government's provision of new infrastructure for higher-technology investment. Seeking to emulate successful policy thrusts in Taiwan, Korea, and Singapore, Malaysia's Ministry of Science, Technology and the Environment established a Technology Park in 1988. The unit operated in temporary premises before moving in 1994 to permanent facilities, which included a National Testing Centre, laboratories for advanced materials and flexible manufacturing, and a design and automation technology training centre. By 1997, 40 companies had occupied the park, many of them information technology or software companies. Another such park was set up in Malacca in 1993 to house government-backed ventures in advanced composite materials and aerospace components.

MITI soon followed suit, and in 1995, opened the Kulim High-Technology Park in partnership with the Kedah state government. The Kulim Park was primarily reserved for MNCs qualifying for MIDA's new high-technology incentives, including planned wafer fabrication plants, and also sought to absorb spill-over investments from nearby Penang. The Kulim park was designed to offer an integrated environment for R&D and technology-intensive production, with supporting facilities such as an IT centre, integrated manufacturing lab, CAD/CAM centre, skills training centre, incubation facility; on-site presence of the chief public technology institutes and universities; special infrastructure (toxic waste disposal, fibre optics, redundant power supplies); and dedicated lots for small firms in ancillary or supporting industries. Meanwhile, individual state governments in Penang, Malacca, Johor, and Sarawak followed the federal government's lead and created specially equipped parks for high-technology industry.

Responding to multinational corporation's complaints, the government acted to build a network of industrial skills institutions responsive to the changing needs of high-technology investors. In 1989, the Penang State government helped to found a very successful MNC-supported Penang Skills Development Centre. Using this as a model, the federal government encouraged other states with industrial concentrations, including Selangor, Kedah, and Johor, to set up similar industry-managed training centres. The federal government matched these initiatives by negotiating with the German, French, and Japanese governments to set up specialised training institutes, as Singapore had done a decade earlier.²⁷

Malaysia's high-technology policy ambitions crested in 1996, when Mahathir unveiled his costly blueprint for a Silicon Valley-style information technology zone on a

²⁶ The MTDC has disbursed its funds somewhat more vigorously; by June, 1999 it had approved RM34.6 million (US\$9.5 mil.) to 23 companies for technology acquisition and RM16 million to 21 companies for the commercialization of public and private R&D. The effectiveness of these funds' use in terms of sales generated or any other measure is not known.

²⁷ The German-Malaysian Institute opened near Kuala Lumpur in 1992 with a capacity to train 450 students in industrial electronics and automated manufacturing. Its French counterpart accommodated 600 trainees in electro-mechanical systems. In 1995, the government signed an agreement with the Japanese government and Keidanren, Japan's leading business federation, to set up the Japan-Malaysia Technical Institute in Penang to provide advanced training in electronics and automated manufacturing technologies.

vast green-field site south of Kuala Lumpur. The Multi-Media Super Corridor (MSC) arrived as the apotheosis of Malaysia's efforts to refocus its investment regime to promote MNC-led high technology industrialisation. The MSC offered a raft of generous incentives, including tax holidays and subsidised high-technology infrastructure, to attract investments in new-product development and R&D from leading global IT, multimedia, and other software companies. Mahathir convened an international advisory panel of CEOs of the world's leading software multinationals to guide the development of the MSC. Charter corporate members of the MSC have participated in the governance of the zone, helping to design a special legal framework suited to the needs of technology-based enterprises. A government-owned Multimedia Development Corporation (MDC) has administered the corridor's development and screened applicants according to detailed criteria centred on R&D and new-product innovation. The MDC wields independent power to approve investments and grant incentives, including an RM200 million matching-grant scheme and RM120 million venture capital fund for new technology start-ups. By the end of 1999, the MDC had approved 300 "MSC-status" companies, of which 177 (59%) were Malaysian-majority owned and the remainder from Europe, the U.S., Japan, Singapore and a few from other countries.

The actual impact of targeted incentives and infrastructure on the content of foreign and local investment activities is, of course, difficult to assess. Throughout the 1990s, however, a growing number of electronics MNCs announced their intention to locate regional production headquarters in Malaysia, introduce advanced product lines, and begin undertaking design and R&D activities. The prototype for this trend was the massive complex of 18 Matsushita assembly, components, tooling, and R&D subsidiaries supporting the production of air-conditioners and colour televisions for regional and global export markets.²⁸ Penang, in particular, saw the emergence of a cluster of supporting industries surrounding the integrated circuit assembly industry and newly-arrived disk drive assembly operations. The government's 1994 National Survey of Research and Development reported that 29 wholly-owned and 29 foreign-majority MNCs engaged in formal R&D in that year. In fact, their spending (US\$30 million and US\$16 million respectively) accounted for almost two-thirds of all manufacturing sector R&D.²⁹ The OHQ scheme met with modest, but respectable results. Twenty-seven MNCs employing 326 expatriates had acquired the designation by May 1997. By mid-1999, incentives had been awarded to 45 OHQs and 39 international procurement offices (IPCs). Between 1994 and early 1998, MIDA granted "high technology" status and incentives to 22 projects worth RM2 billion (approximately US\$800 million before the 1997-8 crisis) in capital investment, and 21 "strategic" projects (15 wholly foreign, one majority foreign, two majority Malaysian, and three wholly Malaysian) worth almost RM14 billion from 1992 to early 1998. The government's promotional policies undoubtedly reinforced the MNCs' own strategic decision making to undertake greater intra-firm technology transfer as part of their elaboration of regional production systems. Nevertheless, it appears that the Malaysian government -- by broadly linking incentives

²⁸ By 1995, Matsushita's Malaysian operations accounted for 25 per cent of its parent group's overseas production, and a similar proportion of its global (including Japan) production of air conditioners and televisions.

²⁹ Figures from MASTIC (1996) *1994 National Survey of Research and Development*, Table 5.5. Excludes petroleum products and refining.

and infrastructure to skills and technological upgrading -- was able to exploit changes in MNCs' international production strategies to advance Malaysia's position in an evolving regional division of labour.

The Enclave Dilemma, Linkage Promotion And Technology Diffusion

Malaysia's heavy dependence on export-processing FDI has long raised concerns about the extent to which multinational companies have, in fact, diffused technology to local personnel and industrial firms. In the early phases of Malaysia's export-led manufacturing growth, foreign export processing in the Free Trade Zones generated negligible linkages or spill-overs to the local economy.³⁰ The FDI boom of the late 1980s and early 1990s considerably expanded the multinational production base in Malaysia, yet the overall growth of local value-added and production linkages was painfully slow. The import ratios for non-resource based manufacturing fell slightly from 55 per cent in 1986 to 47 per cent in 1992, indicating a slight increase in local content. Progress was greatest in the auto sector, where the government intervened directly to localise production, but trends in other sectors were ambiguous, and import dependence in the key electronics sector remained stable at around 70-75 per cent. The 1986 reforms extended incentives and foreign ownership exemptions to indirect exports, i.e. sales from suppliers to export assemblers. As a result, much of the subsequent growth in local content came from the relocation of Japanese and East Asian supplier firms to serve their major assembly customers' Malaysian operations. Guyton's (1996) detailed study of 40 Japanese consumer electronics firms revealed that 30 firms sourced at least half of their components (by value) from other Japanese firms (including 11 which sourced exclusively from Japanese suppliers), while only one firm sourced more than 40 per cent of its inputs from Malaysian-owned suppliers.

In seeking to remedy the problem of low linkages and technology spill-overs, however, the government avoided strict local content or sub-contracting mandates, for fear of damaging Malaysia's reputation as an investment host. A symbolic 30 per cent local content policy was set in 1990 for the electronics sector, but was loosely monitored and rarely, if ever, enforced. MITI also announced a Domestic Investment Initiative in 1993 in response to criticisms that its new, more stringent criteria for investment incentives were biased toward foreigners. The program slightly expanded access to pioneer status incentives for small & medium sized industries (SMIs), but amounted to little more than a repackaging of existing facilities.

Instead, the government has tried to foster local content and linkages through two means: targeted infant-industry policies and a comprehensive linkage development program. The "national car" company, Proton, was launched in 1983 as one of Mahathir's earliest high-tech visions. Besides undertaking backward integration from assembly into component production, one of Proton's chief missions was to give birth to a local auto-parts industry with significant *Bumiputera* participation. In 1988, the government began subsidising the direct costs of Proton's vendor-assistance program, which claimed a supplier base of 162 firms in 1993. A similar project was launched in late 1996 to create a fully integrated electrical appliance industry under local control.

³⁰ Warr (1987) found that in 1982, net value-added in the zones was a mere 23 per cent, while only 3.6 per cent of total material inputs was sourced within Malaysia's principal customs area.

The Malaysia Electric Corporation (MEC) was set up with government support and charged with nurturing the growth of an indigenous base of competitive component suppliers. The timing could not have been worse, and the highly leveraged MEC was swiftly bankrupted by the economic downturn. Both projects suffered from the double burden of achieving their own infant-industry development while simultaneously supporting the growth of a population of new infant supplier industries. After years of protection, it was doubtful that many of Proton's new vendors had begun to approach internationally competitive levels of efficiency (Leutert & Sudhoff 1999).

In a second policy thrust, the government sought to nurture linkages by playing a direct intermediary role between foreign corporations and local supplier firms. In 1993, the Ministry of International Trade & Industry (MITI) launched a Vendor Development Program, under which multinational and local "anchor companies" would provide guaranteed purchasing contracts and technical assistance to local vendors, who would also receive subsidised finance from local banks and technical support from government institutes. Though wary of interference in their supplier chain management, foreign companies joined when the government signalled that participation would be rewarded with favourable treatment in other incentive and administrative decisions. Seven MNCs joined in 1993, over thirty in 1994, and by the end of 1995, 45 MNCs had signed formal agreements with MITI along with nine large Malaysian firms. Together, these anchor companies had designated 59 vendors to supply a broad spectrum of components. In 1995, MITI established a Small and Medium-Scale Industries Development Corporation (SMIDEC) as a one-stop co-ordination agency for all assistance programs to SMIs; SMIDEC re-launched the VDP in a new Industrial Linkage Program. Despite its high profile, the program has grappled with several weaknesses. The implementing agencies lack sufficient technical expertise and manpower required to monitor progress, while the anchor companies themselves are often uncertain as to the extent of their responsibilities. Still, the program -- with its comprehensive scope combining match-making, financial, and technical support for vendors -- has offered a promising model, and can point to at least a few successes in encouraging linkage formation with Malaysian-owned suppliers.

Linkage development has been most evident in Penang, where a number of U.S. semiconductor multinationals had sponsored the growth of a handful of locally-owned machine tool suppliers by the late 1980s (Rasiah 1994). This successful example was followed by the establishment of several assembly sub-contractors who formed long-term supply relationships with local audio and computer electronics multinationals. The Penang Development Corporation (PDC) has played a pivotal mediating and supporting role in encouraging linkage growth. As MNCs' local sourcing has grown, the PDC has surveyed likely supplier firms, published sourcing guides, helped suppliers locate in the FTZs, and assisted them in winning investment incentives from the federal investment agency, MIDA. The federal government has sought to encourage the positive trends in Penang and to emulate them in the country's other major industrial areas. By providing a neutral and politically influential investment partner, the MTDC has enabled several Penang-based subcontracting firms to observe the ethnic equity distribution rules of Malaysia's Industrial Co-ordination Act (ICA) and thus to raise capital on the local stock market. Beyond the venture funding mechanisms of the MTDC, Technology Park, and Multimedia Super Corridor, successful technology-based start ups could hope to list on a

new special-purpose automated exchange, the MESDAQ, set up in 1997.³¹

Other support for technology diffusion has come from Malaysia's system of public technology institutes and universities. Several of these research and technology extension institutes played important research and extension roles in earlier decades to support the growth of Malaysia's primary product export industries, such as rubber, palm oil and forestry-based products. Technology support for manufacturing industries has been less effective, but a handful of institutions have been transformed from insulated bureaucratic outfits into more industry-focused and service-oriented organisations. The most important is the Standards & Industrial Research Institute of Malaysia (SIRIM), which aggressively promoted the spread of ISO9000 quality systems certification in the early 1990s, particularly among multinational subsidiaries and their local suppliers. Following its corporatisation, SIRIM has established several subsidiaries to provide subsidised testing and calibration services. Several of Malaysia's public universities have also become quite active in recent years in providing training, testing, consultancy and research services to local industries. The Science University in Penang and the Technology University in Johor have probably formed the most successful university-industry linkages in these fields. Meanwhile, the MTDC has worked with three universities to establish incubator facilities for the commercialisation of academic research results. MITI and MIDA have provided financial support to SMIs to avail of these technology extension services in the form of a matching grant scheme called the Industrial Technology Assistance Fund (ITAF). Over the six years from 1990 to 1996, however, the fund disbursed a modest RM36 million (about US\$14 million).

For all Malaysia's vigorous efforts, the growth of technologically dynamic linkages between mainly export-oriented foreign industries and their local counterparts has been limited. Reform of the public sector technology and industrial extension agencies has improved their operation and effectiveness, particularly in areas such as standards, testing, metrology, skills training and ISO9000 system diffusion. These agencies have nonetheless been hampered, to some degree, by poor relations between the Malay-dominated bureaucracy and the mainly ethnic Chinese medium-sized manufacturers. Perhaps more importantly, Mahathir's huge high-tech ventures have diverted attention and scarce bureaucratic and other resources from the vital, but mundane tasks of nurturing linkages and technology diffusion.

The Institutional Framework for Investment Policy

Malaysia's investment policy is comparatively well co-ordinated by the standards of the ASEAN 4. MIDA implements investment policy and serves as the primary locus of interaction for both foreign and domestic investment. Over the years, MIDA has built considerable expertise in its core investment promotion role, and is considered a reliable and neutral interlocutor by foreign and most local investors. MIDA's seven sector-specific divisions have enabled staff to develop considerable familiarity with the varying concerns and needs of investors in particular sectors, though the agency still lacks sufficient staff and expertise to monitor investor performance and compliance with incentive provisions. This weakness has become a more serious issue as the formal regime has shifted from general investment promotion to focus on higher-technology

³¹ The exchange developed slowly after its launch, with only a single listing in its first two years.

sectors and industrial clusters. The new, more discriminating investment incentives thus have not been strictly tied to reward firm performance. Yet, by spelling out objective criteria for the desired types of investments and administering them in a neutral fashion, MIDA has at least been able to implement some degree of *ex ante* screening. This, in turn, appears to have served as an important device to signal foreign investors about the types of activities that will gain priority treatment in administrative matters. Like the Thai BOI, MIDA has pursued a new emphasis on post-license investor services in recent years. In May 1999, it opened an Industry Support Division charged with several functions: to facilitate support activity from all federal and state government agencies, especially for infrastructure issues such as water, electricity, telecommunications and transport; to extend support to existing companies planning expansion, diversification or industrial linkages; and to achieve a higher rate of implementation of approved projects.

At the same time, MIDA lacks the policy influence as well as broader investor service and linkage-promotion roles of Thailand's BOI. These are performed by MITI and a number of corporatised government agencies, including the MTDC, SMIDEC, as well as productivity and export promotion agencies. MITI often negotiates directly with foreign investors over the terms of investment, including the government's desire for greater R&D activity and vendor development, and an inter-ministerial Foreign Investment Committee authorises acquisitions of major listed companies. In the end, however, major industrial policy initiatives remain closely controlled by the Prime Minister's office. Proton's corporate strategies for technology and vendor development, for example, were long inspired and monitored by Mahathir himself.³² And despite the bureaucracy's relative success in co-ordinating industrial strategies, there has been a tendency to proliferate new special purpose agencies with autonomous powers as the high-technology agenda has grown. For example, the Multimedia Super Corridor is managed by a wholly autonomous development corporation, the MDC, which undertakes its own investment promotion activity, approves foreign and local investments in the zone, awards its own incentives and sets its own performance conditions. Viewed as a whole, Malaysia's high-technology investment policies often reflect both relative strategic coherence on the one hand and a degree of disconnection from ground-level industrial realities on the other. In both respects, the investment policy regime contrasts with Thailand's investment incentives, which lack strategic focus (and are terribly redundant in the eyes of many economists), but are widely supported and accessed by Thai industry.

Philippines

The Philippines came late to the region's FDI-driven export boom. Powerful domestic business interests combined with weak and fragmented state authority to hamper policy reforms in the immediate post-Marcos period. Early export-promotion policies lured a few investments in the 1970s, but the institutional conditions for the rapid growth of export-processing investment were not put in place until the Ramos administration (1992-98). Having only recently tasted the fruits of major FDI inflows, and with unemployment still a pressing problem, the Philippines has not been much concerned

³² At the Prime Minister's behest, the company has pursued expensive engine-design and manufacturing capabilities throughout the 1990s. In 1997, the company acquired Britain's Lotus corporation, and in 2000 was scheduled to launch a car model based on its own engine and transmission designs.

with refining its investment policies to encourage technological upgrading and linkage formation. Yet, investment authorities have begun to demonstrate an understanding of the need to continually enhance infrastructure and skills in order to sustain the country's attractions as a site for globally linked production.

Evolution Of The Statutory Investment Regime

The Philippines' post-independence investment regime was initially bound by constitutional provisions to grant U.S. companies national treatment, or *parity*, in access to the country's agricultural and mineral resources, while American products also enjoyed import tariff preferences. In the 1950s and 1960s though, the Philippines followed the global vogue for import-substitution industrialisation by encouraging industrial investment behind high tariff walls. Investment regulation was haphazard, but in the majority of cases, companies producing for the domestic market were required to have 60 per cent majority Filipino ownership. The Investment Incentives Act of 1967 deepened import substitution by extending tariff protection and investment incentives to capital and intermediate goods industries, including steel, cement, and chemicals. The Act also created the Board of Investments (BOI), and vested it with licensing, planning, and co-ordination roles. The BOI encouraged domestic investments through tax holidays and non-tax incentives such as exemptions and drawbacks on import duties for imported inputs. The following year, the Foreign Business Regulations Act established a positive-list system that specified the particular industries open to foreign investment and the conditions for investment approval. The express intent of the law was to reserve most growth opportunities for Filipino industry. Local content programs were imposed on the automotive sector as well as in animal feed, laundry soap, copper mining, and certain pharmaceuticals.

In 1970, the Philippines followed the regional fashion in passing an Export Incentives Act to attract some of the new export-oriented electronics and textiles FDI then entering Southeast Asia. The government set up four Free Trade Zones, and many of the same semiconductor companies that opened plants in Singapore and Malaysia also located branches in the Philippines. Yet, unlike those countries, the Philippines did not successfully nurture the growth of export production. Tax incentives for exporters were limited in duration, administrative provisions for import-export were inefficient, exchange controls were burdensome, and most of the zones were remote from Manila, all of which discouraged the expansion of export-processing investments. Corruption and bureaucratic obstacles continued to discourage investment inflows during the long Marcos administration, even as FDI picked up in other countries.

In 1987, the new Aquino government rationalised the investment regime by compiling all relevant laws into one Omnibus Investment Code. Like Thailand's Alien Business Law, the Philippines Investment Code switched the foreign investment regime to a less-restrictive negative-list system. "List A" banned foreign ownership in industries like mass media, retail trade, as well as rice and corn trading outright because of constitutional or other legal barriers, while imposing low ceilings on foreign ownership in air transport, public utilities, and public works. "List B" restricted foreign ownership to 40 per cent in a variety of sectors relating to "public health and morals", including pharmaceuticals, entertainment establishments, and gambling. "List C" set a similar bar for domestic-oriented industries with "sufficient capacity to meet domestic demand."

Finally, a range of craft and light manufacturing industries was set aside for small and medium sized industries (SMIs). At the same time, foreign investment in banking was restricted by separate legislation administered by the central bank. Land ownership was also constitutionally restricted to Filipino nationals.

The Omnibus Investment Code charged the Board of Investment with drawing up an annual Investment Priorities Plan (IPP) listing priority industries for investment incentives. Investors in the priority industries would receive tax holidays of varying durations, depending upon several criteria: use of local raw materials, high capital-labour ratios, and net foreign exchange saving/import substitution. Promoted firms would also receive import duty exemptions on capital equipment imports, while those not enjoying tax holidays could avail of a range of tax credits for labour expenses and training expenditures. In principle, FDI was permitted in priority or “pioneer” industries, even when selling on the domestic market, and was allowed for all projects that exported more than 70 per cent of output. In practice, however, the BOI used its discretionary powers to interpret regulations in ways that restricted access to the domestic market for foreign-majority owned firms. The rule of thumb was that any new investments should not harm existing producers.

Recognising that the regional FDI boom of the late 1980s was bypassing the Philippines, the government amended the Code with a new Foreign Investment Act in 1991. The new law trimmed the foreign investment negative list and suspended minimum capital requirements for FDI, and affirmed the acceptability of wholly foreign-owned subsidiaries, even in domestic-market industries, so long as they did not seek investment incentives and introduced advanced technology or employed at least fifty workers. The FIA opened the door for more foreign entrants, but domestic-market oriented projects still often faced considerable delays and bureaucratic obstacles unless allied with a domestic joint-venture partner.

The Ramos administration mounted a concerted effort to attract export-oriented FDI and to join the regional manufacturing boom. In 1992, foreign exchange controls were lifted for current-account transactions. A special law converted the former U.S. military bases at Subic Bay and Clark Field into autonomous free investment zones outside the national customs territory. In 1994, the government passed the Export Development Act to set up a distinct set of criteria, incentives, and procedures for export projects. Subject to the Foreign Investment Act’s negative list, projects exporting only half their output could be wholly foreign-owned. The new system attacked the administrative barriers to export production by establishing new zones outside the national customs territory and enlarging the program of bonded warehouse manufacturing, which permitted exporters to import components duty free without undertaking the cumbersome duty drawback scheme. Export promotion programs (trade missions, fairs, etc.) were to be privatised to the leading private sector exporters’ federation, PhilExport.

In 1995, a Special Economic Zone Act upgraded the Trade & Industry Department’s Export Processing Zone Authority into a semi-autonomous Philippine Export Zone Authority (PEZA). PEZA was empowered to grant investment incentives and tariff exemptions to investors in several categories of free trade and export processing zones. In addition to streamlined customs procedures, investors in the zones would enjoy tax holidays of up to eight years, duty free import of capital equipment,

spare parts, materials and supplies, and exemption from the pre-shipment inspection required for most classes of manufactured imports. Following the expiry of tax holidays, investors would pay a flat 5 per cent tax rate in place of all national and local taxes.

The Act's major innovation was to privatise zone development. Private zone developers themselves receive income tax holidays and exemptions on other national and local taxes, including those related to land acquisition and sales. In several cases, large, blue-chip Filipino real estate conglomerates partnered Japanese trading companies or Singaporean industrial estate developers to open new export zones. More than all the tinkering with investment incentives over the previous decade, the new PEZA-sponsored zones, together with the autonomous Subic and Clark Zones, unleashed the potential for substantial investment inflows. In particular, PEZA was granted the power to override virtually all other administrative barriers to investment, including local taxes and regulations.³³ The PEZA zones accounted for the great majority of new export-oriented manufacturing foreign investments into the Philippines after 1995.

Meanwhile, the Ramos administration made steady progress in its efforts to liberalise the broader investment regime. In 1996, the foreign investment negative list was amended once again to abolish List C restrictions on industries with "sufficient capacity". This had long been a major regulatory justification for limiting new entrants. The government progressively loosened restrictions on foreign banks and allowed foreign-majority ownership of finance companies. The Build-Operate-Transfer (BOT) Law of 1994 opened wide swaths of the infrastructure, power, transport, water, telecommunications and construction industries to foreign participation. The law established a new agency, the BOT Centre, to prepare projects and undertake pre-selection, joint-venture matchmaking, and competitive bidding exercises. In 1997, the law was amended along with the foreign investment negative list to permit wholly foreign-owned construction companies to bid for most BOT projects.

The Philippines did not mount any dramatic changes to the investment regime in the wake of the economic crisis. Although investment inflows declined, export growth continued to be robust, led by zone production. Domestic deregulation and privatisation became increasingly controversial, however, and the liberalisation drive has slowed since the crisis struck. The introduction of competition into the oil refining industry in 1996, which saw a sharp price rise, sparked considerable protest and was struck down by the Supreme Court as violating constitutional provisions. Likewise, draft laws for opening the advertising industry, retail sector, and other service industries to foreign investment were tied up in legislative debate. President Joseph Estrada called in 1999 for constitutional amendments to expressly permit foreign investment in land, public utilities, mining and professional services, but the move was widely seen as inspired by other, political motives and he was forced to shelve the proposal. Under pressure from the IMF, the government passed additional laws in April, 2000, to open the banking and power industries to full foreign ownership. Despite this, mounting controversies surrounded the Estrada administration's erratic economic policies and negatively affected the investment

³³ The fact that the private investors in zone development were often powerful commercial and property companies with close ties to local power structures had something to do with this success.

environment.³⁴ In a bid to shore up investor interest, the government in 1999 proposed legislation to overhaul the Investment Code and expand the range and duration of incentives.

Strategic Deployment Of Investment Incentives

Despite issuing an Investment Priorities Plan each year, the BOI has not effectively used its investment incentives as a tool for implementing a discernible industrial strategy. The list of investment priorities is exceptionally wide, and embraces a host of resource-based and labour-intensive sectors in addition to “advanced” manufacturing industries. The wide scope of investment incentives in part reflects the Philippines’ lower level of industrial development and large labour surplus. Yet, even if broad sectoral coverage is appropriate, investment incentives have not been tied effectively to criteria reflecting market-failure (high risk, long return), positive externalities (skill-intensive), or social development (decentralisation) goals. The Board’s incentive scheme distinguishes between pioneer investments, which ostensibly introduce new technology or products, and non-pioneer investments, which comprise “ordinary” investments in favoured industries. In recent years, the categorisation of priority industries has become more complex, reflecting new investment policy concerns: (1) export-oriented industries; (2) “catalytic” industries, or domestic industries that have the potential of being competitive in the export market; (3) industries undergoing adjustment due to the effects of tariff cuts and the general opening of the Philippine market; (4) industries that support the priority projects of the government, such as infrastructure, environment, and R&D projects; and (5) activities or industries afforded incentives by various laws, such as the mining, iron and steel industries, and projects as defined under the Build-Operate-Transfer Law. In practice, however, the criteria distinguishing pioneer from non-pioneer industries and “catalytic” from other industries are determined and applied in *ad hoc* fashion.³⁵ The indiscriminate approach drew criticism from the Department of Finance, as the Ramos government sought to increase tax collection in line with IMF-sponsored fiscal reforms, and the DOF has pressured the BOI to pare down its wide list of promoted activities. An inter-agency Task Force on the Rationalisation of Fiscal Incentives proposed eliminating income tax holidays, but instead the government proposed new legislation to extending tax holidays up to twelve years and provide new tax credits and import duty exemptions. Ostensibly, these more generous incentives would apply only to projects involving the manufacture of products “distinctly and completely new” in the Philippines and exporting at least 70% of output, either directly or indirectly through OEM subcontracting.

Existing legislation also offers incentives to foreign investors establishing regional headquarters (RHQs) to provide managerial support to affiliated companies abroad. The scheme met with little response, and so in 1997 eligibility was extended to a wider range of managerial activities and relaxed to permit RHQs to generate sales

³⁴ In May 2000, Taiwanese computer maker Acer, one of the largest investors in Subic Bay, suspended expansion plans because of the government’s abrogation of an air-access agreement with Taiwanese airlines.

³⁵ News reports suggested that half of the BOI’s incentives in 1999 were given to government-linked projects associated with the BOT program (*Today* (Manila) 7 February 2000).

revenue in the local market.³⁶ Another major thrust was to decentralise investment planning and promotion to provincial governments. Since the Investment Code of 1987, projects locating in Metro Manila have generally been ineligible for tax holidays, while projects locating in remote provinces are given the most generous terms. In preparation for the 1999 Investment Priorities Plan, the Board helped provincial governments to identify their comparative advantages in supporting investment based on their endowments of resources, infrastructure, transport links, and workforce availability. The BOI also offered tax deductions for R&D and training expenses, but the uptake for these incentives was also weak. Many BOI-promoted firms enjoyed tax holidays and thus did not require additional tax breaks, while very few undertook formal R&D in any event. In 1998, the Board did initiate some post-investment service programs through a new Office of External Affairs. Its most notable effort was a drive to encourage all promoted firms to attain ISO9000 quality certification status, yet even here, its role has been limited to providing information. President Estrada's first Secretary of Trade and Industry proposed a concerted government effort to lure an investment in wafer fabrication, but his successor shelved the plan, citing the exorbitant cost of the associated specialised infrastructure and the need to "concentrate on intermediate technologies".³⁷

As noted above, the Philippines' belated response to Southeast Asia's export-oriented FDI boom came via the creation of a distinct set of investment incentives rather than by a thorough-going reform of the BOI and its policies. The PEZA and Subic and Clark zone authorities have been far more proactive in marketing the Philippines' attractions as an investment site, and hence have become more attuned to international investment trends and the requirements of multinational producers. Zone growth itself has been striking: from sixteen zones in 1994, the total reached 40 in 1998 with 20 more under construction. Investments in the zones between 1995 and September, 1999 totalled P600 billion (approximately US\$22 billion), of which some 45 per cent comprised developers' investments in zone infrastructure, and the rest actual manufacturing projects by zone tenants. The leading growth sector in the zones was electronics assembly, which accounted for 55 per cent of zone investments during 1995-1998, with another 22 per cent in electrical machinery. Not coincidentally, Japanese investors accounted for a similar 58 per cent of manufacturing investments. Spurred by this influx, electronics' share in the Philippines' total manufacturing exports rose from 24 per cent in 1990 to 51 per cent in 1997.

The zone authorities' overriding mission has been investment promotion, and unlike the Board of Investment, they shunned attempts to screen investments or impose performance conditions on zone investors. Eligibility guidelines simply referred to a minimum export level of 60 per cent, while the PEZA could authorise exceptions, as when it provided incentives to a domestic-market auto assembly project by Ford Motor Co. in exchange for a promise to bring in parts suppliers who would also export. At the same time, the Zone Authority's promotional efforts have become tailored to specific sectors. Electronics was pre-eminent, but the authorities sought to create conditions for cluster development by encouraging investments in plastics and metal components,

³⁶ As in other countries, the original exclusion of in-country revenue generation was designed to distinguish genuine RHQs, with their skill-intensive managerial control and co-ordination functions, from mere representative offices, which simply arrange local sales.

³⁷ *Today* (Manila), 7 February 2000

specialised chemicals, and auto-parts. Some zones were dedicated to agro-export processing. In 1999, the PEZA sponsored the Philippines' first two information-technology parks; unlike all other zones, these were permitted to locate in metro Manila near the country's leading universities. Perhaps most interesting, the new zones attracted major investments in value-added services. The most well-known was Federal Express' choice of the Subic Bay Free Trade Zone for its regional logistics and flight operations headquarters in 1994. In 1998, America On Line (AOL) set up a customer call centre in the Clark zone, citing the low costs and high English language proficiency of the work force. The Zone authorities and the Department of Trade & Industry (DTI) reacted by formulating a promotional drive to consolidate the Philippines' status as a primary regional centre for "back-office" operations like customer services, accounting, and computer coding and data processing.³⁸

The Philippines offered little in the way of special physical infrastructure or skills to nurture higher-technology investment, apart from the superior transport facilities at Subic Bay. The shift towards private zones meant that private developers with their foreign (Japanese, Malaysian, Singaporean) partners were responsible for assuring the quality of infrastructure support. In the core Cavite-Laguna industrial zone south of Manila, a few of the private parks style themselves as "Techno" or "Science" Parks due to their higher quality infrastructure, including redundant power supplies, purified water, and waste disposal facilities. In a few cases, zone associations have contracted with private and state community colleges to provide short training courses in quality control, CNC programming, and other skills. In short, with the export-processing trend still immature, the Philippines' policy and institutional framework had not yet come to grips with the question of whether and how to lure investments with technology or skill-creating content.

The Enclave Dilemma, Linkage Promotion, And Technology Indigenisation

For similar reasons, the desire to attract foreign export investment largely overrode questions of linkage formation and technology spill-overs. The BOI lists a 20 per cent local content level as a benchmark for evaluating applications for its main incentive programs, but has rarely if ever withdrawn licenses for failure to comply. Like other Southeast Asian countries, the Philippines pursued automotive localisation under its Car Development Program. The program both specified a local content level of 40 per cent and mandated the subcontracting of specific sets of auto-parts to locally owned suppliers, while also imposing a foreign-exchange balancing requirement that would offset components imports with exports. The localisation program compelled "satisficing" investments in local auto parts production, but failed to induce either significant indigenous participation in the industry or technology transfer to locally owned industry (Doner 1992; Hill 1985). Many auto-parts producers are themselves foreign investors who have followed their principal assemblers to the Philippines, while local companies supply mostly simple plastic, metal, or rubber parts. Auto-parts exports have lagged, though some have come through the official ASEAN-wide brand-to-brand complementation scheme, in which auto makers Toyota, Honda, and Isuzu exchange

³⁸ In April 2000, Amazon.com announced it would locate distribution, accounting and data-coding operations in the Philippines.

parts with their affiliates in Thailand, Malaysia, and Indonesia. In fact, the primary pressure to maintain the localisation program has come not from local companies, but from established Japanese assemblers, who have objected when new American entrants have been allowed to bring in completely knocked-down assembly kits (CKDs) rather than meet full local sourcing requirements.

As the WTO's year-2000 deadline for lifting local content rules approached, the BOI was prompted to initiate a modest linkage promotion effort. In 1998, it launched a "Reverse Investment Fair" program in which large assemblers (like Toyota) displayed components eligible for local sourcing to invited potential suppliers. The BOI has lacked the resources and ability to better co-ordinate its new outreach to suppliers with financial or technical support programs, as in Malaysia and Thailand's vendor development efforts. It was hampered, even in its modest matchmaking role, by the lack of comprehensive information about potential supplier firms; a database is only now being compiled to provide sourcing guides to large investors. The Car Development Program has only been used strategically to promote further foreign investment, rather than for technology transfer to indigenous industry. The Ministry of Trade & Industry has sought to trade waivers from full compliance for commitments by new assemblers, notably Ford and GM, to bring in their own suppliers, who are expected to export as well as supply local assembly.

Most new export zones are production enclaves *par excellence*, and foreign investors have little incentive or opportunity to build local linkages. In part this is due to the fact that import exemptions from import duties, and even access to bonded warehouses associated with export zones, are not available to indirect exporters. Prospective local suppliers must thus pay import duties on their own inputs, with their sales incurring value-added taxes. Although they are eligible for import-duty drawbacks and VAT "zero-rating", the documentation requirements and procedures for both incentives are so onerous as to deter most local firms. At the same time, MNCs operating in the zones are able to import inputs duty free. The PEZA authorities recognise that few of the multinational manufacturers located in the Philippines' zones have autonomy in procurement matters, but instead rely on their parent companies or on regional headquarters in Singapore or Hong Kong for procurement decisions and supply-chain management. The PEZA has sought to lay the groundwork for more integrated production by encouraging foreign investments in components and supporting industries, whether they produce for direct export or as part of local supply linkages.

Hopes for linkages and technology transfer to indigenous suppliers are thus modest, perhaps due to a realistic appreciation of the large gap in scale, technical capacities, and quality standards between the new exporters and the majority of local SMIs. There are, however, some provincial zones populated by Filipino agro-processing and textile firms; some of these have access to the four regional bonded warehouses managed by the private PhilExport federation and the textile federation. There is also a small cadre of Filipino-owned semiconductor assembly sub-contractors. These instances remain small exceptions to a general rule – Filipino companies accounted for only 7.5 per cent of zone investments by value during 1995-98. The PEZA has also recently initiated "reverse investment fairs" in conjunction with the electronics industry association, representing firms in the "Calabarzon" provinces south of Manila. Yet, the agency lacks the resources and authority required to implement a comprehensive program for linkage

development, such as detailed sourcing information, matchmaking, technical, skills, or financial support; in any event, it remains heavily focused on its core investment promotion mission.

The Institutional Framework for Investment Policy

The Philippines political system features a fragmented bureaucratic structure with considerable administrative overlap and often-contradictory policies. This general character is reflected in the evolution of the investment policy regime. Even as statutory barriers to foreign investment were dismantled, the BOI remained largely embedded in the regulatory approach of the import-substituting era. The 1987 and 1991 foreign investment reforms set performance parameters for BOI approval of investment applications, with a targeted two-week turnaround time. In the fashion of all such investment agencies, the BOI established a one-stop action centre to handle investor relations in the early 1990s. Yet, this has served more as a consultant in the often-complex approval process rather than as a powerful expediter. The Board lacked the power to compel prompt attention from the wide range of government departments typically involved in checking investment proposals. Most export applications were accorded neutral if often laborious treatment, yet in cases of large-scale foreign investments in the domestic market, such as in the automotive or agro-processing industries, the investment approval process could become politicised as the proposal circulated among various departments for approval.

The BOI remains an important point of contact for investors serving the domestic market, and retains its core tax incentive powers. Like Thailand's equivalent, the BOI's semi-autonomous status has enabled it to play a significant policy role, as when Board officers represent the Philippines in international negotiations over investment policy. Yet the Board's previously formidable power to shape the overall investment environment has been steadily eroded and bypassed in the 1990s. In 1992, the power to administer the import-duty drawback scheme was removed from the BOI and given to the Department of Finance.³⁹ Likewise, PEZA and PhilExport assumed control over the regional bonded-warehouse program associated with the zones. In 1996, the law authorising the BOI to grant duty-free imports of machinery and equipment expired and was not renewed. PEZA, by contrast, is able to offer zone investors complete duty-free import privileges, even for those zones that are within the national customs territory. In fact, the new export-oriented manufacturing infrastructure operates with virtual autonomy.⁴⁰ In 1999, the various investment-promotion agencies (BOI, PEZA, Subic, Clark, and four other bodies) began negotiations to harmonise their incentive policies, but it is unlikely that an integrated incentive system will soon emerge.

This acute fragmentation reflected the larger difficulties of bureaucratic reform in the Philippines. Rather than transforming the regulatory missions embedded in the traditional bureaucracy, and strengthening the BOI's analytical and administrative

³⁹ In 1997, a scandal erupted when it was disclosed that the Department of Finance had issued tax credits for millions of dollars worth of bogus export invoices over several years.

⁴⁰ The degree of administrative fragmentation became glaringly evident in 1998 when the founding head of the Subic Bay Economic Zone, Richard Gordon, refused to vacate his post for weeks after being dismissed by the new President, Joseph Estrada. Only the threat of armed clashes between police and his own security force persuaded him to vacate the zone.

capabilities, the Ramos administration often fostered reforms by establishing entirely separate administrative agencies. So long as the Philippines' export manufacturing development remained enclave in nature, administrative fragmentation did not pose an immediate constraint on expansion. However, integrating investment promotion more effectively with investor services, specialised infrastructure, skill development, and supplier-base development requires a higher degree of co-ordination. It is doubtful that the Philippines' existing administrative infrastructure is positioned to address these challenges.

Indonesia

Indonesia's investment policy regime was transformed through a protracted reform process during the decade of Southeast Asia's growth boom. To a greater extent than any other country in the region, Indonesia's regulatory policies resulted in a profound dualism between those for the often cartelised domestic heavy and other manufacturing industries, and the increasingly liberal posture towards export-oriented FDI. Neither the goal of nurturing technological upgrading and diffusion from the manufactured export sector, nor the maturation of strategic infant industries into internationally-competitive exporters, were well served by the investment policy regime. The devastating economic collapse in 1998 made the restoration of investment and employment the paramount challenge, superseding issues of investment quality and linkage formation.

Evolution of the Statutory Investment Regime

Indonesia's investment regime has swung through several cycles of opening and tightening. Rising nationalist sentiment and internal rebellions supported by outside powers prompted founding President Sukarno to nationalise all Dutch-owned enterprises in 1957, accounting for the bulk of the modern commercial and industrial sectors. Subsequently, the government pursued a relatively determined (by Southeast Asian standards) import substitution program involving the expansion of state-owned enterprise. Following a period of growing economic chaos, including collapsing trade and hyperinflation, a change of government led to a reorientation of economic strategy.

The core elements of President Soeharto's new policy were macroeconomic stabilisation, a rationalisation of exchange rate policy, and trade liberalisation implemented by an elite cadre of Western-trained technocrats. In line with these priorities, the government promulgated a new Foreign Investment Law in 1967, subsequently amended in 1970. The law provided basic guarantees for the security of foreign investments and offered a range of incentives, including two- to six-year tax holidays, duty and sales tax exemptions on imported capital goods, and provisions to carry forward losses. One hundred per cent foreign ownership was permitted in many industries, though domestic distribution was reserved for domestic enterprise. At the same time, however, the law maintained a negative investment list of sectors closed to foreign investment, set a US\$1 million minimum investment threshold, and called for eventual divestment towards majority-Indonesian ownership after a thirty-year period.

The comparatively liberal investment regime was short-lived. When the first oil price hike flooded the state's coffers in the mid-1970s, Indonesia advanced its import-substituting program into heavy and intermediate industries, and SOEs were set up to produce fertiliser, steel, cement, paper and petrochemicals. A contemporaneous surge in

economic and political nationalism (including student riots directed, in part, against Japanese penetration of consumer goods markets) caused the government to tighten formal and informal restrictions on foreign investment. In 1973, the government set up the Investment Co-ordinating Board (BKPM) to issue investment licenses for investments in all sectors excluding oil, forestry, and banking. Where FDI was neither banned nor restricted to a minority shareholding, the new investment regulations mandated a general principle that foreign equity be progressively diluted over ten years until it reached a minority position. In 1977, a new investment law sought to restore investor confidence after the collapse of the state oil company, Pertamina (Hill 1988: 31). The law simplified the investment approval process, ostensibly made the BKPM a one-stop approval agency, and introduced a priority investment list to make the licensing process more transparent.⁴¹ With the second oil boom of 1979, however, more sectors were closed to FDI, and apart from a few large investments in mining and oil exploration, foreign investment levels remained minimal until the late 1980s.

When oil prices declined in the mid-1980s, however, Indonesia again shifted direction and actively courted new FDI in an effort to diversify exports away from an overwhelming reliance on petroleum products. In addition to a more concerted investment and export promotion drive, the Soeharto government undertook decisive steps to clean up the notoriously inefficient trade administration system. In April 1985, customs administration was contracted to the Swiss consulting firm SGS to cut the Gordian knot of corruption. A May 1986 reform set up a more effective import-duty drawback scheme for exporters under the state agency BAPEKSTA, and exporters were allowed to bypass the government-licensed import agents that had cartelised wide swaths of the trade sector. Exporters were allowed to sell up to 15 per cent of output locally (later increased to 35 per cent), and foreigners permitted to hold up to 95 per cent equity at the time of company formation (gradual divestiture was still required unless 100 per cent of output was exported). The reforms also enabled joint ventures with 75 per cent Indonesian equity (later reduced to 51 per cent) to avail of export credit facilities and loans from state banks. Investment and capacity licensing were significantly deregulated in 1987 to facilitate expansion or diversification projects by existing producers. In 1986, and again in 1989, the BKPM pared down the negative investment list to 64 restricted sectors, most of them in agriculture, mass-media, resource based, food or craft industries, or activities related to national security (such as ammunition and explosives). The change effectively opened a wide range of manufacturing sectors to foreign investment, albeit with equity limits and divestment requirements. Fully foreign-owned enterprises were permitted for the first time, but only in the special Batam FTZ near Singapore, and only on condition that 100 per cent of output was exported and at least 5 per cent of the investment stake would eventually be divested to Indonesian partners.

This series of reforms firmly launched Indonesia's non-oil exports. Plywood led the growth of non-oil exports after the government banned raw log exports, but textiles, garments, and footwear soon followed. As the regional boom in FDI-led trade matured, Indonesia moved to reduce tariffs and non-tariff barriers on a variety of inputs, and to liberalise entry barriers for foreign investors. In a 1992 decree, wholly foreign-owned

⁴¹ Though, as Pangestu (1996: 156) relates, "The problem with the list was that there is [sic] a lot of room for interpretation since it was not comprehensive and accurate. The product definitions were not precise enough so that it was not always self-evident which sectors were open for foreign investment."

subsidiaries were allowed to invest in 100 per cent export-oriented projects in customs-bonded zones, in eastern Indonesian provinces, or when investing at least US\$50 million, though some eventual divestment was still required.⁴²

In June 1994, a major liberalisation package was issued, marking a turning point in FDI policy. Foreign investors could either set up a wholly-owned subsidiary, with a proviso that a nominal amount be divested later, or else, a joint-venture with a 5 per cent minimum Indonesian holding, with no further divestment required. Unlike previously, wholly foreign-owned subsidiaries had no export condition, but were required to meet one of three conditions: US\$50 million minimum, location in an outlying province, or production of intermediate or basic materials used in a wide range of existing industries. The package also opened nine previously closed “strategic” sectors to foreign participation, subject only to a minimum 5 per cent Indonesian ownership. These included big-ticket investment areas such as ports, electricity, telecommunications, shipping, air transport, railways, and mass media. The same decree initiated a program whereby the Ministry of Finance would grant bonded-warehouse status (known as an export-oriented production entrepot, or EPTE in Indonesian) to large investors, thus enabling exporters to avoid the cumbersome import duty-drawback scheme. The negative investment list was pared down even further in 1995.

A January 1996 reform package reduced tariffs on imports of capital goods and inputs used for export production. In June of that year, another reform eliminated minimum capital investment thresholds, and the requirement that foreign investors progressively dilute their share-holdings was removed. Henceforth, joint ventures with a minimum 5 per cent Indonesian share holding would be exempt from further divestment requirements. The bonded warehouse status program was extended to privately developed industrial zones, and the BKPM began guiding new foreign investment into these designated zones, which totalled 21 by 1998. Meanwhile, compulsory inspections of export commodities by the government auditing agency, Sucofindo, were suspended for exporting firms. By the time the crisis struck in 1997, a combination of FDI liberalisation, tariff reductions and duty-exemption programs had brought Indonesia’s investment regime into close parallel with its ASEAN compatriots in terms of institutional and policy conditions for export-manufacturing FDI. Barriers were still significant in domestic retailing, banking, transport, natural resource extraction and commercial agriculture, though foreign retailing chains began to enter the market through franchising agreements.

Much of Indonesia’s foreign investment also flowed into infrastructure, utilities, telecommunications and transport projects beginning in the late 1980s. The foreign investment negative list was amended to permit and require joint ventures in these formerly closed sectors. The presidential palace became the functional equivalent of the Philippines’ BOT Centre, insofar as most such projects were allocated to joint ventures involving Soeharto’s friends and relatives. Indeed, the President personally signed off on all foreign investment projects before a 1998 reform allowed the BKPM to grant permits for investments of less than US\$100 million on its own authority.

Running parallel to this progressive liberalisation, however, were illiberal trends in domestic manufacturing and non-tradeables. In the industrial sector, great controversy

⁴² Pangestu (1996: 162-3), from which the next paragraph also draws.

attended the promotion of eight “high-technology” industries under the direction of the Minister for Research & Technology, B. J. Habibie (later vice-president briefly and then president for a year and a half). Habibie had built his economic fiefdom under Soeharto’s patronage from the late 1970s, and by the 1990s, it encompassed shipbuilding, armaments, land transportation, telecommunications equipment, agricultural equipment, and an infamous multi-billion dollar project to produce civilian aircraft. In 1996, the government announced its intention to launch a “national car” project, similar to Malaysia’s Proton venture, under the direction of President Soeharto’s youngest son, Tommy. Another Soeharto son controlled the giant Chandra Asri petrochemical complex, which was controversially granted tariff protection in 1996 at the expense of downstream plastics industries.

The massive devaluation of the rupiah from late 1997 led to the swift collapse of Indonesia’s financial sector, with devastating knock-on effects in the real sector. The strategic aircraft and national car projects were among the first casualties of the IMF restructuring package, which also mandated that Indonesia remove its remaining restrictions on foreign ownership and introduce an investment regime based on national treatment for foreign investors. The Indonesian government committed to open infrastructure, utilities, retailing, finance and other non-tradable sectors, and to privatise major state-owned industries. In October 1998, Parliament passed a law allowing 100 per cent foreign ownership in the banking sector. Monopolies in supply and downstream industries linked to the national oil company Pertamina were to be dismantled and opened to foreign bidders. A raft of other liberalisation measures were announced throughout 1998 and 1999, including the lifting of bans on foreign ownership in mining, oil palm and other plantation industries, as well as retail trade. The only major sectors remaining on the negative investment list for FDI are forestry, gambling and casinos, aircraft production, cinemas, taxi and bus transportation.

As it now stands, Indonesia’s investment regime is the most liberal and neutral in statutory terms, and in early 2000 the government was preparing a new foreign investment law to enshrine a national-treatment principle. Yet, foreign investment has yet to return in a significant way, and privatisation has proved contentious and slow. An initial sale of insolvent Bank Bali to Britain’s Standard-Chartered was scuttled by opposition from the bank’s management, for example, while in another case, regional authorities exploited the ambiguous decentralisation policy to temporarily shut down a major foreign mining operation to press demands for higher royalties. In a more successful instance, the leading auto-assembler, Astra, was disposed to a Singaporean-led investment consortium. Yet the politicised character of the early M&A cases suggests that Indonesia’s liberal investment regime might become even more compromised in terms of implementation and enforcement, especially as growth resumes and domestic investors regain access to credit.

Strategic Deployment Of Investment Incentives

Indonesia pursued the most interventionist industrial policy of any of the ASEAN 4. Yet, it relied far more on regulatory barriers and state-guided credits and public enterprise than on policy-driven investment subsidies. In the language of Indonesia’s investment policy, “strategic” sectors indicated areas reserved for state control, rather than activities designated to receive special incentives for investment. On the other hand, in periods

when policies moved in a more market-oriented direction, Indonesia's liberal-minded technocrats also shunned using investment incentives to influence private investment flows in strategic ways. In fact, as liberalisation got underway in the early 1980s, the government suspended the use of tax holiday incentives during the period 1983-96 and focused instead on pruning restrictive regulations.⁴³ In evaluating applications for investment licenses, the BKPN administered a complicated Priority Scale List (Daftar Skala Prioritas, DSP) for investment from 1977 until 1990. The list served more as an instrument of discretionary control over both foreign and domestic private investors than as a tool for guiding investment incentives into potential high-growth areas. Expanding on the statutory negative investment list, the DSP banned foreign participation in particular sectors on three grounds: a) sufficient capability among domestic entrepreneurs; b) strategic activities reserved for state enterprise; c) sectors set aside for small-scale enterprises or co-operatives. The list also regulated capacity and the number of licenses granted in given sectors. The Board could grant exceptions enabling foreign investment in closed sectors, however, for projects that located in Indonesia's outer islands, were 100 per cent export-oriented, or generated significant employment (Pangestu 1996: 156-7). In theory, these exceptions might influence foreign investment patterns towards their desired goals, but the differential impact of less-unfavourable treatment was mitigated by general deterioration in the investment environment.

In 1996, tax holidays were restored for up to twelve-years and by the time Soeharto's government collapsed two years later, eleven foreign and domestic investment projects had applied for the incentive, with six receiving approval. In the absence of clear criteria, and with the President exercising personal approval power, the incentive program was viewed as a setback for transparent investment policy, particularly as several of the awardees were connected with the first family. The program was suspended pending the eventual issuance of objective criteria, and it was reported that incentives would, in future, entail shorter tax holidays, varying in duration according to investment location. Using investment incentives to encourage industrial decentralisation was rather belated in Indonesia's highly centralised economic policy system. In 1995, the government announced 15 provincial "integrated investment zones" (KAPETS), in which investors would receive exemptions from VAT and dividend taxes, be free to employ expatriates, and enjoy import-duty exemptions on capital goods and inputs, though little new investment appears to have resulted.

The Investment Co-ordinating Board's (BKPM) main incentives have been import duty exemptions on capital goods, and two years of duty-free imports of raw materials. Use of raw materials has, however, been audited by a special government agency in a procedure that often requires onerous documentation. These incentives were

⁴³ As Winters (1996: 168-184) narrates, the removal of tax incentives did indeed create a perception among some private investors that Indonesia was less keen to attract foreign investment. Even wholly export-oriented foreign investors began to desert Indonesia in the early 1980s, culminating in the exit of long-time semiconductor assemblers Fairchild and National Semiconductor in 1985 and 1986, respectively (Pangestu 1994: 157). This was despite survey evidence, (often cited in discussions of investment incentives), that incentives are low on the list of private investors' priorities in deciding where to locate new projects. After an initial decline, investment flows recovered in the late 1980s, but it is not clear whether the lack of incentives created significant opportunity costs in terms of Indonesia's position in the unfolding, MNC-created regional division of labour.

granted to all successful applications for an investment license, rather than to those matching a list of priority industries. Likewise, the incentives were available in principle to all foreign and local investors, subject to the negative foreign investment list and its equity guidelines, and to a minimum investment of US\$1 million for foreign investors. In practice, the BKPM (or perhaps the President, who approved foreign investments) appeared to favor larger-scale foreign projects and joint ventures.

Reforms in the late 1980s added new incentives tied to exports, in the country's bid to attract export-oriented manufacturing investments. Firms exporting all of their output were granted import duty exemptions, though this required them to negotiate the duty-drawback system administered by a government agency (BAPEKSTA), with evidently low efficiency. The EPTE system, launched in 1994, gave exporting firms licenses to operate bonded warehouses. This system proved extremely popular, and facilitated the influx of new manufacturing investments in electronics exports. Later, under a scheme known as PET, investment incentives were used to promote private development of industrial parks. These, in turn, would receive customs-bond status, thereby obviating the need for individual firms locating in the zones to obtain EPTE permits.

While Indonesia thus created the policy framework to support export oriented manufacturing, it did little to influence the quality of FDI to attract or induce technologically-advanced or skills-intensive activities. In part, this reflected Indonesia's status as a labour-surplus economy. Simply put, manufacturing export development had not matured to the point of requiring substantial technical inputs to remain competitive. On the other hand, concern for fostering technological deepening and structural upgrading was the hallmark of B. J. Habibie's controversial program of import-substitution in heavy and engineering industries (Thee 1998). It appears that Indonesia's technology development efforts were heavily concentrated in the activities under the minister's direct control, but he was not permitted to exert much influence on the broader investment policy regime. The system of public science and technology institutions remained disconnected from the industrial sector generally and from the new export-oriented manufacturing industries in particular (Thee 1998; All 1998). Preoccupied with the struggle for economic recovery after the recent crisis, the Indonesian government has not articulated a coherent set of policies to foster investments in the IT field.⁴⁴

There was one intersection between Indonesia's manufactured export growth and Habibie's high-tech mission, however, and this was the industrial park on Batam Island near Singapore. Habibie was given control over the Batam FTZ in 1978, but his insistence on reserving the island for indigenous high-tech production resulted in stagnation until he agreed to integrate the zone into the Singapore-led growth triangle linking Batam, Singapore, and Malaysia's Johor state (Smith 1998). Batam did soon become linked to Singapore's technologically dynamic manufacturing development, but primarily as a site for the relocation of labour-intensive assembly operations by electronics multinationals. The IMF pressed Indonesia to remove the VAT exemption

⁴⁴ Private initiatives for IT parks have been floated. In 1999, Indonesian tycoon Edward Soeryadjaya announced a CyberCity project to be built at Jakarta's old Kemayoran airport, though the proposal has been met with widespread skepticism. The project's plans include a multimedia training academy, business incubator, redundant power supplies, and commercial and residential buildings.

granted to Batam, a move which drew vociferous objections from the island's 370, mostly Singaporean, investors.

The Enclave Dilemma, Linkage Promotion and Technological Indigenisation

Habibie's ventures were the primary thrust of Indonesia's effort to indigenise advanced industrial technologies. Unfortunately, one of the chief criticisms of his ambitious state-owned engineering industries was that they lacked linkages to local private sector suppliers. This might have been excusable if the projects had shunned linkage development to source competitively priced inputs through imports. But in fact, it reflected an emphasis on vertical integration and a curious lack of concern with the practicalities of technology diffusion through sub-contracting linkages and other spin-offs to local industry, ostensibly the projects' primary rationale. In the late 1970s and early 1980s, the Ministry of Industry implemented a series of local-content programs in auto-motives, heavy equipment assembly, diesel engines, and electronics. Indonesia's drive to localise auto-parts production met with considerable success in encouraging the quantitative growth of production, but the technological benefits of local sub-contracting appeared limited. The program was suspended in June 1999 as part of its IMF-sponsored adjustment package.

Small and medium sized industries have important political significance in Indonesia's economic policies, as they bear the standard of *Pribumi* economic interests in an economy dominated by ethnic Chinese conglomerates and state owned enterprises. During the New Order regime, banks were mandated to set aside 15 per cent of their credit for SMIs. The Small Enterprises Development Program provided subsidised credit to *Pribumi* SMEs from 1973 to 1990 under the supervision of the central bank, though manufacturing firms received less than 13% of the funds disbursed under the scheme (Thee 1994: 103). A long list of craft and light industries were reserved for small firm production. On several occasions, Soeharto issued directives for large conglomerates to "adopt" SMIs through sub-contracting linkages. Most of these programs were highly political in intent, and focused on the domestic controversy over the spread of large conglomerates through government monopoly favours. As such, they had little bearing on the question of fostering industrial clusters or technology diffusion. The Ministry of Industry's Small Industries Development Program operates an extensive network of technology extension service centres, but these have had little impact (Berry & Levy, 1994: 47). Finally, Indonesia launched in 1989 a "Foster Father-Business Partner Linkage" program in emulation of the sub-contracting promotion schemes seen in many countries in the region. The program, widened in 1991, sought to pressure state-owned and private large firms to assist SME subcontractors with financial and technical assistance. Suharto's personal emphasis on the program resulted in 4,698 "large foster father firms" (the majority of them state-owned firms) signing agreements by the end of 1991, yet the program faded from view in subsequent years with little measurable achievements (Thee 1994: 106-07, 114).

Like its counterparts in other ASEAN countries, the chief investment agency, BKPM, sought to deepen the import-reliant foreign export sector by promoting investment in supplier industries. In October 1993, the Board allowed wholly foreign-owned subsidiaries to invest in critical supplier and intermediate industries, subject to a minimum US\$2 million capital threshold. Among indigenous industries, meanwhile,

clusters of dynamic SMIs were observed in such labour-intensive industries as the production of furniture, batik and crafts. However, Indonesia's formal SMI extension programs were largely irrelevant to these successes. SMIs are clearly slated to receive greater emphasis in Indonesia's new political environment, however, and a new decree in 1998 set forth a new list of sectors reserved for small-scale industry.

Indonesia's offer of duty-free imports to promote export industries also created some disincentives for local linkage formation. In 1996, however, regulations were amended to exempt from VAT taxation the local purchases made by EPTE-status firms and their counterpart customs-bonded zones. This gave local indirect exporters an added advantage, and was particularly useful to agro-export processing industries.

The Institutional Framework for Investment Policy

The Indonesian governmental system suffered simultaneously from excessive centralisation and bureaucratic fragmentation. Though jurisdiction over investment in petroleum, finance, forestry and other sectors, as well as taxation and tariffs, were distributed across different government agencies, President Soeharto would issue the final decisions on most major investment matters. The main investment co-ordinating agency, BKPM, has exercised considerable authority over investment trends, primarily by enforcing controls and restrictions. The Board did have the power to review the mandatory biennial production performance reports of promoted firms, but mainly used these powers to monitor compliance with equity, production, and export goals. The BKPM has not wielded much independent policy influence, and as its power stemmed from its ability to enforce or exempt the application of restrictive regulations, its incentives have been largely superseded as tariff reductions and equity restrictions were relaxed in the 1990s. Although organised along sectoral lines, the BKPN lacked interest in developing detailed expertise in particular industries, or in taking on the range of new functions (such as post-approval investor services, match-making and vendor development) taken on by its sister agencies in other ASEAN countries. The agency simply had no real mandate to nurture structural or technological change in the industries under its purview.

As the economic reform package has moved ahead, the IMF has suggested removing the Board's remaining discretionary powers -- in particular, the ability to grant VAT exemptions to purchases by firms with EPTE or PET customs-bonded licenses -- in an effort to plug tax loopholes and to increase the neutrality of the incentive regime. The Board has responded to the post-crisis drop in investment in several ways. First, the power to approve investment applications has been decentralised to BKPN offices in Indonesia's overseas missions. Second, the Minister for Investment has declared that each province will, in future, be empowered to approve or reject investment proposals, though the power to grant customs-bond licenses will remain a central prerogative. If fully implemented, decentralisation is likely to create a highly uneven and inconsistent set of investment rules, and foreclose the possibility of a comprehensive and integrated approach to refocusing the investment policy regime on national developmental strategies.

In sum, Indonesia's economic collapse has put a halt to efforts to engineer industrial transformation through strategic intervention. For the foreseeable future, the country will be preoccupied with reforming its financial and governmental institutions

and restoring investment inflows. Yet, the continued elaboration of infrastructure and incentives for promoting export-manufacturing investment is likely to remain an important tool for whatever investment policy emerges from the current economic chaos.

Conclusions

ASEAN's experience with investment policy reform points to the considerable complexity – administrative, economic, and political – of developing countries' integration into the expanding international division of labour in manufacturing. As their reform histories show, liberalisation is only one element, albeit a crucial one, of the process by which developing countries adjust to the forces of globalisation. Countries' comparative advantages as hosts for globally-linked production increasingly depend upon a range of qualitative factors that affect the costs and competitive advantages of multinational corporations and create conditions for the emergence of dynamic local supporting industries able to locate supply niches in MNC-dominated manufacturing industries. Beyond political stability and investment security, multinational corporations are increasingly responsive to the quality of physical and administrative infrastructures, skill endowments and proximity to quality suppliers. For host countries, shaping a productive investment environment demands considerable public expertise, institutional flexibility, and judicious investments in the quality of local skills and technical capacities.

Investment incentives and other efforts by Southeast Asian governments to shape the investment environment have had partial success at best, and are often constrained by the limited technical expertise of implementing agencies, not to mention the constraints of the broader political and policy environment. Yet, in aggregate, they have complemented MNCs' changing strategies and investment patterns to shape the unfolding regional division of labour. Inasmuch as current reform programs, e.g. as prescribed by IMF agreements, exclude *a priori* the possibility that government investment policies can have positive impacts, e.g. in encouraging technology transfer, linkage formation, skill development and other externalities, they overlook an important dimension of sustainable recovery, namely the strengthening of expertise and flexibility in public agencies that supervise industrial development.

Meanwhile, it is evident that, as the ASEAN 4 return to growth, authorities are pursuing new ways to encourage industrial and technological progress, even as their ability to pursue infant industry-style ventures is severely curtailed. In so doing, they face a new international investment environment. Over-capacity in a range of manufacturing sectors, together with the slow recovery in Japan, suggest that the volume of new manufacturing FDI will not quickly resume the dizzying rates and totals recorded earlier in the decade. A more fundamental issue is the related shift in FDI flows towards mergers and acquisitions and away from new green-field investments. The implications of this trend for the development of locally rooted skills as well as industrial and technological capabilities are urgent issues for research and policymaking (UNCTAD 1999). Though facilitating such investments has become a central aspect of broader reform and re-capitalisation throughout the region, it may also have significant downside risks. For example, to the extent that managerial autonomy is significantly reduced throughout the industrial sector, opportunities for localised learning and expansion into

more value-added activities, such as design and R&D, might be constrained by the wider regional strategies and divisions of labour fostered by MNCs.

Even if this pessimistic interpretation is dismissed, it is likely that active and nuanced policies to shape host-country investment environments will remain important determinants of new investment trends. As described above, the ASEAN 4's opening to export FDI in the 1980s and 1990s did not result in the same sorts of linkages and technology spill-overs evident in Taiwan and South Korea at equivalent levels of development, particularly because of poorer Southeast Asian economies' co-ordinated policy and institutional support for linkages and technology diffusion. In the same way, whatever the potential advantages of M&As in modernising finance, retailing, transport and other non-tradable sectors, it is doubtful that the ASEAN 4 will derive their full benefits without appropriate institutional support, skills, and policy incentives, together with the ability to effectively link these to the evaluation of foreign acquisition proposals.

Indeed, the crisis has, ironically, forced ASEAN governments to assume greater discretionary powers to screen and approve investments, inasmuch as special government restructuring agencies control the fate of a vast amount of assets taken over from insolvent financial institutions. Yet, consideration of how to use such powers to maximise investment quality and positive externalities has been pre-empted by more basic concerns with ensuring transparency. Assisting the region's governments to regulate foreign investment in positive ways is low on if not absent from the agenda of the international financial institutions as well as many domestic reformers, given the general discrediting of discretionary interventions by the abuses of various Southeast Asian political leaders. In Indonesia, the need to restore investor confidence is likely to constrain government policy activism for some time, no matter how well-conceived and "market-friendly" proposed policies might be. Likewise, the Philippines' recently dynamic export manufacturing growth only thinly disguises the wariness of many international and domestic investors about the potential for governmental interference and damaging policy shifts. In Thailand, there are a few more positive signs of emerging public-private co-ordination in fostering skills and technology development as the domestic economy is opened to more foreign competition. Yet, a considerable share of the indigenous industrial capacities built up in recent decades has been lost through the financial recklessness and subsequent liquidation of many large and medium-sized manufacturers. In Malaysia, Mahathir's defiance of orthodox prescriptions for economic restructuring has proved politically successful for the time being, as the government rejected the IMF prescriptions imposed on the rest of the region. The government thus retains important policy instruments to set terms for investor entry. If used judiciously in conjunction with appropriate "supply-side" support for technical and skill development and linkage growth, Malaysia might retain an ability to adjust to the new international environment on more advantageous terms. Yet, politics will ultimately determine how such capacities are used. The recent heavy-handed drive to restructure the financial system by policy fiat does not inspire confidence that the leadership has learned either caution or subtlety in its efforts to guide structural change.

Finally, the prospects for the ASEAN-4 to rebuild their investment-management capacities are clouded by the current multilateral efforts to proscribe most forms of discretionary government interventions and regulations affecting investment flows. If current negotiations result in a multilateral investment regime more restrictive of national

governments, the scope for abuses of investment policy might be reduced, but only with the loss of the important potential contributions of such policies to long-term industrial development.

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