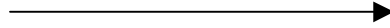


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**ETHNIC HETEROGENEITY,
PLURALISM AND GOVERNMENT SPENDING:
GLOBAL CONTEXT
AND THE CASE OF MALAYSIA**

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ETHNIC HETEROGENEITY, PLURALISM AND GOVERNMENT SPENDING: GLOBAL CONTEXT AND THE CASE OF MALAYSIA¹

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Abstract

This paper looks at the role of the State in ethnically diverse societies such as Malaysia, more specifically the relationship between the degree of ethnic fragmentation and the size and development of the public sector, an area that is rarely devoted to in the vast literature on public sector economics. Besides focusing on the statistical link between the degree of ethnic fragmentation and the level of public spending and other related variables, it also explores the complex relationship that tends to be obscured by the diverse socioeconomic experiences of individual nation states. The most prominent forces at work include, among others, the historical geography and numerical structure of ethnic composition, ethnoterritoriality, ethnic intensity and legitimacy and the particularities of public policy response towards exigencies engendered by ethnic diversity, from preferential policies to fiscal federalism to regional particularism. Finally, such a framework is further complicated by the existence of an inverse causal relationship that cannot be precluded. While State action, as reflected in the trend and development of public spending and other public policy variables, can be seen as a direct response to challenges from ethnic community organizations that seek to influence public policy, country experiences show that within an inverted and complementary paradigm, ethnic communities do take shape in response to public policy stimuli. Such stimuli induce a process of ethnogenesis or reethnicization which further influences public policy formulation, often resulting in a vicious cycle of ethnic resource contest and further State economic intervention, with political processes increasingly replacing market relations in a plural society.

1. Ethnic Diversity and Public Expenditure

While there have been abundant literature on the determinants of government size², interest on the impact of ethnic diversity is still relatively new since the early studies like Mueller and Murrell (1986) and McCarty (1993). Taking ethnic fractionalization as the explanatory variable, its possible effect on the size of the public sector is determined by the way it influences the process of public decision making. From a theoretical perspective, the degree of ethnic fractionalization has been thought to have an inverse relationship with the scale of government. Mueller and Murrell (1986) hypothesized that the greater the ethnic fractionalization, the smaller the expected size of government due to the greater difficulty of reaching collective decisions (the higher the transaction costs involved). Ethnic fractionalization is one of the independent demographic variables they included in the basic equation to test their hypothesis that the relative size of government is positively related to the number of organized interest groups³. McCarty

¹ An earlier version of this paper was presented at the "New Zealand-Malaysia Symposium: The State, Economic Development and Ethnic Co-Existence", University of Wellington, February 7-8, 2002.

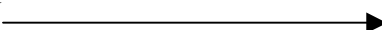
² See Yeoh (2001b), Table 1.

³ Besides the number of interest groups and ethnic fractionalization, the other independent variables included are population, mean income, median income, political fractionalization, income distribution, degree of enfranchisement, governmental centralization, educational level, and average of the years in which a country began the political and economic modernization processes.

(1993) observed that considerable variations in the size of the public sector (the level of government expenditure) may result from differences in the degree to which a country's citizens share preferences regarding public spending. Demographic diversity can bring about diverse preferences which make agreement on provision levels difficult. A rough comparison of US and the more homogeneous European societies shows the former seeming to choose to channel fewer resources via the government than the latter - heterogeneous societies choose fewer public goods due to lower utility derived by individuals from such goods (Alesina and Spolaore, 1995).

If publicly provided goods are supplied in uniform quantity to all residents, welfare losses occur for individuals whose willingness to pay for a good does not equal its marginal cost at that quantity. Therefore, the more diverse preferences are, the more inefficient is uniform provision of goods. (It is of course possible for governments to provide different quantities of goods to different individuals, but, as Wallis and Oates [1988] pointed out, they are likely to incur administrative costs in doing so, and in practice publicly provided goods are usually provided in uniform quantity, or on uniform criteria, to all residents.)

Public sector expenditure levels may be determined by negotiations among various factions rather than by the median voter. Since the median voter model assumes that elections involve single spending issues and that preferences are single-peaked, it is most applicable to a local referendum on a specific issue, but in the context of the public sector as a whole, the concept of a single decisive voter may be a fiction (McCarty, *op.cit.*). Negotiations are more likely to be lengthy and costly if preferences are relatively diverse. Consequently, voters may try to minimize these transaction costs by choosing lower levels of public spending. Thus it can be hypothesized that the higher the degree of ethnic fractionalization, the greater the difficulty of reaching collective decisions and therefore the smaller the expected size of government.

ETHNIC DIVERSITY  PUBLIC EXPENDITURE

Similarly, Easterly and Levine (1997) attributed the poor growth performance of African countries to the adverse effect of ethnic fragmentation (measured through linguistic diversity) on income, growth, and economic policies. Their study found a strong negative correlation across countries between linguistic diversity and indicators of public goods such as the number of telephones, percentage of roads paved, efficiency of the electricity network and years of schooling. They argued that polarized societies are prone to competitive rent-seeking by the different groups and have difficulty agreeing on the provision of public

goods such as infrastructure and education, and showed that most of the policy variables that affect growth are associated with ethnic heterogeneity (financial repression was found to be more severe and black market premia higher in linguistically diverse countries).

Two studies by Alesina, Baqir, and Easterly presented respectively evidence that US cities, metro areas and urban counties with higher ethnic fragmentation tend to spend a lower amount on pure public goods⁴, after controlling for other socioeconomic and demographic determinants (1998) and that there is a link from ethnic diversity to bloated government payrolls in US cities (1999). Counting fiscal consolidation as a public good, Alesina and Perotti's model (1995) shows that polarized societies face bigger problems in its implementation. Focusing on total non-defense government consumption, Annett's empirical model (2000) shows that greater heterogeneity brings about political instability which in turn leads to higher government consumption in the attempt to placate the opposition. Mauro (1995) and La Porta *et al.* (1998) both found that ethnic diversity causes poor quality of government services and Rothchild (1991) noted that "ethnic and other rivalries" over distributive goods are far-reaching. On more specific areas Svensson (1998) found that in more ethnically diverse places more foreign aid proceeds are diverted into corruption, and Rodrik (1999) observed that ethnically polarized countries tend to react more adversely to external terms of trade shocks. Social capital or "trust", which is associated with faster growth and higher output, is found to be inversely related to ethnic heterogeneity according to the studies of Knack and Keefer (1997), Zak and Knack (1999) and Alesina and La Ferrara (2000).

On sectoral expenditure, a recent paper by Kuijs (2000) looked at the impact of ethnic diversity on the amount of public spending on health and education. With partial evidence showing that more heterogeneous societies spend less on public goods, his results also pointed to the effect of ethnic diversity on the efficiency of public expenditure outcomes in terms of various social indicators. From a different perspective, Easterly (2000) found that institutional factors interact with ethnic diversity, which has a more adverse effect on economic policy and growth when institutions are poor. Good institutions not only mitigate the adverse effect of ethnic diversity on economic policy or growth, but also the risk of wars and genocides that might have resulted from such fragmentation.

2. Ethnic Diversity and the Provision of Education

In addition to diverse preferences about the *quantity* of public provision, tastes are also differentiated regarding the *kind* of service consumed. Private production of quasi-public goods is a

⁴ Education, roads, libraries, sewers and trash pick up.

response to the latter differentiation, if it is not accommodated by government production. A prominent good in this category is education. As Collins (1975:87) remarked:

Schools everywhere are established originally to pass on a particular form of religion or elite class culture, and are expanded in the interests of political indoctrination or ethnic hegemony. In these situations, education is nothing more than ethnic or class culture, although it can be taught to those who are not born into it.

As one of the most important contributors to cultural distinctions, education can be seen as *pseudoethnicity* - "a subcase of the same processes that also produce ethnicity" (*ibid.*:86). Diverse preferences on the type of education (in terms of the type of cultural norm or religious value transmitted, or the language medium of instruction) have led some researchers to suggest that, *ceteris paribus*, the higher the degree of ethnic fractionalization, the higher the proportion of private provision of education⁵.

James (1987, 1993) examined the relationship between demographic diversity and the relative size of the public and private sectors in the provision of education. She argued that one motivation for private spending on schools is heterogeneous demand stemming from cultural diversity. McCarty (*op.cit.*:227) cited the example of Catholic and "fundamentalist" schools in the United States which exist apart from the public school system as evidence that, minority groups dissatisfied with publicly provided goods that suit the tastes of the majority of voters, may create private markets for them. Each of these sources of private supply is motivated by ethnoreligious differences and ethnolinguistic diversity - for instance, the Chinese "independent" schools created and supported by private funds from the Malaysian Chinese community resistant to the monolingual national educational policy. As James (1987:4-5) noted:

The "melting pot theory" and the general belief in assimilation of minorities to majority values led to the "common school" movement in the nineteenth and twentieth century U.S.; the growth of Catholic private schools was a response by a group that did not want to be fully assimilated.

Specifically, in an earlier paper (1984) James argued that the "cultural heterogeneity" model best explains the development of large private sectors in advanced industrial countries such as the Netherlands and Belgium. Differentiated rather than excess demand is the moving force, especially at the primary level where linguistic ability and religious identification develop, and value formation takes place. In her 1987 study, she provided a theoretical model in which the relative size of the private sector in education is determined by excess demand, diverse preferences and the supply of nonprofit entrepreneurship in the society. Adopting Weisbrod's (1975, 1977) view that the private sector is a market response to a situation where large groups of people are dissatisfied with the level or kind of public provision, she argued that

⁵ For practical purposes, this can be measured either as "percentage of schools that are private" or "percentage of total enrollments in private schools" (James, 1987).

there are two different patterns of private education - one motivated by excess demand, the other by diverse preferences (e.g. religious education, medium of instruction).⁶

James' first type of demand is based on Weisbrod's finding that, with a given tax structure, if the vote-maximizing government satisfies the median voter, part of the population will have a "left-over" demand for public goods (or quasi-public goods like education, with a certain degree of excludability) which they will try to satisfy privately (Weisbrod, 1977). There are two variants of differentiated demand - differentiated preferences about the kind of service and those about quality. James hypothesized that due to barriers to mobility (*i.e.* the difficulty for people with like tastes to move and congregate), considerable heterogeneity often exists within a local political unit. The local government's inability (due to economies of scale, standardization or other political constraints) to satisfy such diversity results in private production as an institutional mechanism responding to diverse preferences without incurring the costs of overcoming barriers to mobility. Conducting regression analysis to explain variations in the size of the private sector across states within the United States, Japan, Netherlands and India, she found in all cases the religion variable to be highly significant. Her studies (1987, 1993) provide evidence that private spending on education is higher in countries with significant religious and linguistic heterogeneity.⁷ Two recent study by Goldin and Katz found that US states with higher religious diversity show lower high school graduation rates (1997) and lower public support for higher education (1999). Miguel (1999) also found lower primary school funding in more ethnically diverse districts in Kenya.

However, the relationship between ethnic fractionalization and private provision of education is subject to the influence of various external factors. Private provision may only be required when the government is constrained to offer a relatively uniform product, either the median voter's preferred choice or a constraint imposed by national education policy (which set conditions on public provision) in line with the preferences of the demographically/politically dominant ethnic group (e.g. an assimilationist monocultural, unilingual educational approach). In this case the ethnic intensity of the dominant group (minority-respecting/minority-oppressing) *vis-à-vis* those of the other groups is also crucial. It reflects the homeland-immigrant dichotomy, determined by the degree of ethnic intensity and the tolerance for cultural heterogeneity (Conner, 1986; van Evera, 1994).

⁶ A supply-side variable - the availability of religious educational entrepreneurs - helps to explain "why much private production in education is nonprofit [and] why much nonprofit production is in education" (*ibid.*:1). James argued that the one by excess demand is more likely to be the case in developing countries, the other more likely in advanced industrial societies. This generalization, as the Malaysian experience shows, is not always true.

⁷ McCarty (*op. cit.*), on the other hand, argued that such substitution of private for public schooling will lower the ratio of public to private spending in the economy.

On the other hand, private provision is only legally possible if the dominant ethnic group is not resolute in imposing its preferences. In addition, where preferential policy stipulates quotas on admission into public educational institutions in favour of certain ethnic groups - as under Malaysia's New Economic Policy (NEP) - private provision becomes an exit for the others.

Where ethnic groups are concentrated in different geographical areas, decentralization renders private provision unnecessary since local government can achieve the desired diversity. In other words, private provision is only required if the diversity in demand is so geographically dispersed that accommodation by local government provision is practically impossible. This is of course on the condition that the central government does not have the resolve to impose the dominant group's monocultural, unilingual educational policy to these ethnic regions.

In Malaysia, besides the other effects and ramifications of preferential policy, the NEP period also witnessed important development in conflict regarding the provision of education.⁸ However, private provision of education, such as the Malaysian ICSS Movement⁹, in an ethnically diverse society is not a unique phenomenon. James (1984) observed the development of large private sectors in education in advanced industrial countries such as the Netherlands and Belgium which she argued as resulted from differentiated rather than excess demand for education. Based on the aforesaid view of Weisbrod, James attempted to apply the "cultural heterogeneity" model to explain such private provision of education, especially at the primary level where linguistic ability and religious identification develop, and value formation takes place. It is evident that these sources of private supply is motivated by ethnoreligious differences and ethnolinguistic diversity. Therefore, private provision of such quasi-public goods like education can be seen as a response to the diverse preferences in a divided society regarding the *kind*, rather than the *quantity*, of goods that the State¹⁰ should provide.

⁸ The issue of education has always been a flashpoint in the country's interethnic relations. While the October 1987 crackdown owed more to intra-ruling party struggle than any other factors, its pretext has been the heightening racial tension ensuing from the Chinese community's protest against the appointment of non-Chinese speaking principals to "government-aided" Chinese primary schools.

⁹ The Independent Chinese Secondary Schools Movement spearheaded by the United Chinese Schools Teachers Association and the United Chinese Schools Committees Association (jointly known as *D_nǐjiàoz_ǐng*) since the 1970s was a reaction to the conversion of the majority of Chinese secondary schools to either Malay-medium "National" secondary schools or English-medium "National-type" ones (which were later also converted into Malay-medium) in 1962. Completely funded by donations from the Chinese community, these independent schools which total 60 at present, together with the Chinese primary schools (categorized as "government-aided" eligible for limited matching grants but whose survival depends crucially upon financial support from the Chinese community), have always been viewed as the last bastion of Chinese ethnic identity.

¹⁰ "State" (with a capital "S") is used in this paper (except in quotations) to refer to the central body politic of a civil government, whereas "state" (with a lower-case "s") refers in general to other senses of the term, including a "country" or a political territory forming part of a country (see Yeoh, 2001a:2).

While this argument seems generally applicable to the existence of private and semi-private Chinese schools in Malaysia, McCarty and James' emphasis on cultural heterogeneity (based on religious or linguistic "primordial sentiments") as the source of such diverse preferences should not be taken for granted. Socioeconomic factors may actually play a more important role in the Malaysian case. For one thing, the cultural model is unable to explain why increasing number of Chinese parents were sending their children to English-medium schools during the 1960s. Loh (1984) observed that the enrolment in Chinese-medium primary schools declined from 33.3 per cent of total enrolment in 1957 to 27.8 per cent by 1970. The same trend was also evident in the case of Malay-medium schools albeit at a slower pace (from 47.3 down to 42.8 per cent). On the contrary, enrolment in English-medium schools rose significantly from 14 per cent of total enrolment to 23.8 per cent during the same period. It was only after the conversion of the English-medium schools into Malay-medium ones after 1970 that witnessed the increasing popularity of Chinese-medium schools.

What should not be overlooked is the role of language not only as a cultural pride but also as an instrument for socioeconomic advancement. Prior to 1970, English-medium education was perceived to be offering the best opportunity for social mobility¹¹. Deprived of this instrument after 1970, Chinese parents began to turn to schools using their own vernacular based on considerations more economic than cultural. With the implementation of the NEP since 1970, job market in the private sector has become increasingly important for the non-Malays since job opportunities in the public sector are extremely limited for them. Familiarity with the Chinese language becomes economically valuable for social advancement, especially for the Chinese families of the lower classes, given the strength of the Chinese in the country's private sector economy. The case of Chinese private education in Malaysia, therefore, may serve to point out the inadequacy of the "cultural heterogeneity" model as advocated by James and McCarty in their explanation of how ethnic diversity affects the issue of public v. private provision of quasi-public goods. Additional factors, especially those regarding class mobility, need to be considered in addition to ethnic diversity to enhance the explanatory power of the hypothesis concerned.

3. Further Empirical Evidence of the Impact of Ethnic Fragmentation

As a fresh contribution to the study of the link between ethnic diversity and public expenditure, we

¹¹ It is also for the same reason that there has been student protest in Cambodia against the continuing preference for French, rather than English, in the country's education policy. It is in fact not unreasonable to doubt the survival of these Chinese schools in Malaysia if national education policy has not brought about the demise of the English-medium schools. It is interesting to note that in neighbouring Singapore, which is 76 per cent Chinese, the vast majority of Chinese students are today enrolled in English-medium schools. More revealing is the substantial number of Chinese students from Malaysia (more than 10,000 in 1985, according to Sowell, 1990:50) attending secondary schools in Singapore which teach in English, mainly to escape compulsory Malay-medium instruction in government schools in Malaysia.

tested a model with a sample of a total of 119 countries. Besides using the total sample for analysis, four different sets of countries are established according to the level of affluence reflected in their gross domestic products (GDP) per capita, to observe the variation in the influence of ethnic diversity on the level of public spending between economically less affluent countries and those more affluent ones.¹²

To investigate the possible link between ethnic diversity and government size, an index of ethnic fractionalization (EFI) is employed here as a measure of a country's degree of racial, ethnolinguistic and ethnoreligious fragmentation¹³. We use the term "racial" to describe group distinction on the basis of phenotypical (*i.e.* physical) characteristics, while "ethnic" refers to those based solely or partly on cultural characteristics. The term "cultural" here mainly covers the ascriptive attributes "ethnolinguistic" and "ethnoreligious".

To derive a better understanding of the influence of ethnic fragmentation on public spending in the presence of additional institutional complexity, we tested the following function that includes various other possible determinants of public expenditure for the total sample of 119 countries¹⁴ and the four categories of countries introduced earlier:

$$GE = c + a_1PCY + a_2POP + a_3EF + a_4SNR + a_5PF + a_6UNE + a_7EQU + a_8CEN + u$$

where PCY is income per capita, POP population, EF ethnic fractionalization, SNR proportion of senior

¹² For details of sample description, selection and categorization, see Yeoh (2001b:5-16).

¹³ See footnote 12 above. For the EFI of 240 countries/regions, see Yeoh (2001a), Table 1.

$$EFI = 1 - \sum_{i=1}^n \left(\frac{n_i}{N} \right) \left(\frac{n_i - 1}{N - 1} \right)$$

where n_i = the number of members of the i th ethnic group and N = the total number of people in the population (Yeoh, 2001a:8). The index is constructed through the computational procedure of Rae and Taylor's index of fragmentation (F), defined as the probability that a randomly selected pair of individuals in a society will belong to different groups (Rae and Taylor, 1970:22-3). The index varies from 0 to 1. The value is zero for a completely homogeneous country (the probability of belonging to different groups is nil). The value 1 occurs in the hypothetical society where each individual belongs to a different group. The fragmentation index is identical to Rae's measure of party system fractionalization (Rae, 1967:55-8) and Greenberg's measure of linguistic diversity (Greenberg, 1956):

$$F = 1 - \sum_{i=1}^n (P_i)^2 \quad \text{where } P = \text{the proportion of total population in the } i\text{th language group.}$$

Partial correlation between public expenditure and ethnic fractionalization, both inclusive of and excluding defence spending, indicates significant negative correlation between the two variables for all the country categories (Yeoh, 2001b:21-25).

¹⁴ A cross-sectional approach is deemed more appropriate here compared to a time-series analysis due to the fact that ethnic diversity is a factor that exhibits a high degree of temporal stability. Barring exceptional instances of large-scale demographic transfers or movements of "ethnic cleansing", as witnessed in the India-Pakistan partition, the Nazi's destruction of European Jewry, the expulsion of Sudeten Germans, or the more recent events in Bosnia-Herzegovina and Krajina, ethnic composition of most countries rarely experiences drastic changes over time.

population, PF political fractionalization, UNE unemployment, EQU income equality, CEN governmental centralization, u the error term and c the constant.¹⁵

Our results provides strong evidence that ethnic fractionalization plays an important role in influencing the size of the public sector. The two most important variables explaining government size prove to be GDP per capita and ethnic fractionalization, especially among the lower income countries. The negative sign of the coefficient indicates an inverse relationship between government expenditure and EF. On the other hand, GDP per capita is found to be positively related to the level of public expenditure, a phenomenon in line with the Wagner's Law. The other demographic variable - the proportion of the aged in the population (SNR) - is found, as expected, to be positively related to public spending. The link is observed to strengthen moving up from the lower income categories to countries higher in economic affluence. Despite the demographic fact that increasing economic affluence inevitably brings about an aging population, such finding is logical from the theoretical perspective since welfare spending, including that on senior citizens, is expected to be positively related to the percentage of the aged in societies not only where such citizens form a substantial part of the population but also where economic deprivation is no longer a constraint on the implementation of welfare policies.

While ethnic fractionalization is consistently inversely related to the size of public spending¹⁶, its influence varies according to country group, being particularly strong for the developing country categories. The influence of EF is found to be strongest among countries backward in economic development and weakens as we move upwards to categories of countries higher in economic affluence wherein the influence of such primordial attachments like race, tongue and religion on public decision-making gradually gives way to more modern, professional procedures (as noted earlier, the term "ethnic" is here generalized to be a blanket concept - Hoetink's attribute "socioracial" - to cover all these three aspects of ethnicity - racial, linguistic, and religious¹⁷).

¹⁵ For detail elaboration on the selection and definition of variables and the predicted sign of coefficients, see Yeoh (2001c:11-17).

¹⁶ The consistently negative relationship is noteworthy since it not only supports the hypothesis that higher ethnic fractionalization increases the difficulty in reaching agreement on public expenditure allocation that satisfies all fractions, but also implies that the potential or real upward pressure on government size from the State's response to conflicts engendered by such fragmentation, whether through the implementation of State-sanctioned preferential policies or fiscal federalism, is not strong enough to offset or reverse the said negative influence of the variable from a generalized multinational perspective (see the following sections).

¹⁷ Nevertheless, there is an emphasis on language and religion in empirical research due mainly to the fact that they are the relatively less vague factors in the fourfold categorization of ascriptive loyalty (Hoetink, 1975:23-4) - the other two being territoriality (ancestral homeland), notions of common descent ("race"). For accuracy in the measurement of ethnic fractionalization we take account of all three major types of non-class cleavages in society - racial (phenotypical), linguistic and religious. Most of the existing studies on public policy and ethnicity either included only one of these components - Mueller and Murrell's work which employed linguistic groups as the units of measurement - or considered them as separate variables - McCarty's "ethnic variance" and "religious variance". While following similar computation procedure as in this paper, language

Statistical analysis specifying two separate public expenditure variables - transfer and non-transfer expenditures - shows that the effect of ethnic diversity is more pronounced on central government transfer expenditure, *i.e.* that with the explicit purpose of income redistribution. This finding is also in line with that of McCarty (*op.cit.*) who considered this as precisely the reason the US Social Security programme, which mostly transfers income within the middle class, is much larger than the US welfare programmes which transfer income across races.

Finally, our results with an extended ACOV model incorporating four dummies - numerical structure, territoriality, historical geography of ethnicity and crosscutting/reinforcing nature of ethnic cleavages - show that territorial division along ethnic lines is positively related to public sector size and that the homeland-immigrant division of ethnicity and the crosscutting nature of ethnic cleavages have a positive and negative effect respectively on public sector size. However, there is a lack of strong and consistent evidence supporting the hypothesis that the existence of a numerically dominant ethnic group leads to larger public sector.¹⁸

4. Countervailing Influences from Preferential Policies

The most prominent finding presented above is the establishment of a statistical link between the size of the public sector (reflected in the level of public spending) and the factor of ethnic diversity, more robust and consistently significant than that found in previous researches on the subject with similar coverage. The relationship has been found to be negative, supporting the hypothesis that higher ethnic

is the only marker used in constructing the ELF (ethno-linguistic fractionalization) in a recent paper by Kuijs (2000) which covers a population of 54 to 79 countries, and race (phenotype) that employed in another by Alesina, Baqir and Easterly (1998) that focuses on U.S. cities, metropolitan areas and urban counties. With a bigger sample, however, we regard it pertinent to consider these components as different manifestations of one single characteristic. In other words, racial (phenotypical), linguistic and religious characteristics represent different markers of ethnic (or socioracial) distinction (often more loosely termed "ethnic markers"). To treat them as separate variables or to employ one to the exclusion of the others inevitably leads to the mismeasurement of the degree of fragmentation. In actual practice, the most significant ethnic marker of a country is employed as the unit of measurement, for instance, race (phenotype) in Rwanda, language in India and religion in Bosnia-Herzegovina, since in reality it is the most prominent cleavage that counts in the polarization of society, though it is in itself often a symbol for social mobilization finding its root in some politico-economic differentiation. Thus, while EF represents the degree of fragmentation in terms of one of the following cleavages: racial, linguistic and religious (with the possibility of some conceptual overlapping among them), exactly which type of cleavage is selected depends on the particular context of the country concerned. For instance, ethnoreligious cleavages provide a more accurate picture of the situation in Bosnia-Herzegovina - so do racial differences in Rwanda and Burundi - than linguistic ones, since linguistic homogeneity of these countries is far from reflecting the true degree of their ethnic fragmentation. For further elaboration on the definition of ethnicity for empirical research, see Yeoh (2001a).

¹⁸ For details of the analysis, functional forms, elasticity coefficients, *F* test, tests for heteroscedasticity and multicollinearity, the breakdown into transfers and other (exhaustive) expenditures, and further details on the four dummy variables, see Yeoh (2001c), pp. 17-35, and pp. 37-39 for a summary of empirical findings and implication.

fractionalization increases the difficulty in reaching agreement on public expenditure allocation that satisfies all factions. However, such conclusion does not seem to fit in well with the case of Malaysia, which has often been considered to be a plural society *par excellence*, a "deeply divided society" with mutually reinforcing ethnic and economic cleavages. How does one reconcile the results of the above analysis with the tremendous growth of the Malaysian public sector during the past three decades?

While the analysis presented above seems largely to lend support to the argument that the impact of ethnic diversity on government size from the economic perspective is negative, such generalized picture derived from international comparative data analysis, nevertheless, obscures the fact that the economic histories of individual countries may show a more complex picture of the link between ethnic fractionalization and the size of the public sector. Ethnic diversity, reflected in a high degree of pluralism, can lead to the expansion of the public sector through the State's assumption of the role of an agent promulgating ethnic reform policies, in particular to reduce real or perceived ethnic income inequalities¹⁹. Central to this is the role of the State in an ethnically diverse society, its relationship with the numerically/politically dominant ethnic group and the form of ethnic reform policy involved. Although countries which have implemented such explicit ethnic-reform policies at certain stages of their economic histories, which is the result of a combination of individual necessity, urgency and objective politico-economic situation, are not that numerous in the world context, their experiences should be considered an important complement to any cross-national statistical analysis attempted. At certain stages in a country's socioeconomic development, ethnic diversity can lead to an expansion of the public sector through ethnic reform policies implemented by the State especially in a country where the demographic majority is dominant in the political structure but not in the economy.²⁰

5. The Malaysian Enigma

¹⁹ Conventionally, the main rationale for government intervention to overcome interethnic inequalities seems to lie in the hypothesis that ethnic groups act in their own self interest since human capital or knowledge spillovers they may received are only or mainly from those in their own ethnic or neighbourhood group - "ethnic capital" à la Borjas (1992, 1995). Inequality may persist through such neighbourhood externalities, together with local school finance and endogenous segregation between rich and poor (Benabou, 1993; Durlauf, 1996), leading to the poor groups being unable to finance human capital accumulation (Galor and Zeira, 1993), thus lowering growth and exacerbating ethnic tensions. Among Boston inner city youths strong neighbourhood effects were found on their economic and social outcomes, according to Case and Katz (1991). Exporters with an ethnic connection to business groups inside the importing country have an advantage over those without such ties, so argued Casella and Rauch (1997), a phenomenon that is long viewed as self-evident by observers of the economic miracle of the Chinese diaspora.

²⁰ Prominent examples of such countries include Malaysia where such policy impact has been an integral part of the politico-economic structure of the country since the 1970s, Fiji where such policy imperative has been in progress since the mid-1980s coup and the new South Africa where such policy direction is increasingly inevitable to allay the growing social discontent of newly empowered but economically backward ethnic majority. Among other countries where the politically dominant ethnic majority has in one way or another voted themselves preferences over the economically more successful minorities are Sri Lanka, Nigeria, various states of India, Indonesia, Uganda, Guyana, Trinidad and Sierra Leone (see *e.g.* Sowell, 1990).

Malaysia, or more precisely Peninsular Malaya, consists of a major diaspora community (the Chinese) residing within a host (Malay) society regarding itself as the homeland community. Both of these can be defined as "corporate groups". A "corporate group" is defined by Weber (1947:145) as a "social relationship which is either closed or limits the admission of outsiders by rules". It possesses a formalized system of authority, a concept Fried (1947) and Fortes (1953) later applied to descent groups. The corporateness of ethnic groups in Malaysia is marked by their relative stability. Religious boundaries play the most important role in perpetuating the practice of endogamy which serves to maintain ethnic group separateness over time.²¹

To be sure, there are other ethnically diverse countries, for instance Spain and Belgium, which also experienced a tremendous expansion of public spending partly traceable to influence from their ethnic diversity, but the reason for such expansion there is very different from the case of Malaysia. While in Spain and Belgium, the State response to exigencies engendered by ethnic diversity involves political decentralization and a high degree of fiscal federalism, in Malaysia, where the demographic majority is dominant in the political structure but not in the economy, the State responded to similar exigencies by implementing ethnic reform policies. In both cases, the result is an expansion of the public sector over time. A close look at Malaysia will reveal the way the interrelated forces were at work to bring about an expansion of public sector over time as the State expresses its response towards the exigencies engendered by increasing ethnic conflict. The most prominent among these forces are a homeland-immigrant mix of ethnic composition, a bi-ethnic numerical structure (a most problematic type of multiethnic structure)²² and a political regime Mauzy (1993) termed "coercive consociationalism" (or what Smooha [1990] called "ethnic democracy"²³). A comparison with some other countries, *e.g.* Spain and Belgium, especially the

²¹ The importance of this factor is evident in the prevalence of interethnic marriage in the early days, resulting in the emergence of the "Straits Chinese" or "Baba" community, in the absence of the present legal requirement for the conversion of the non-Muslim partner in an interethnic marriage. In contrast to the Chinese in Malaysia, the Chinese community in Thailand is a non-stable corporate group (Zenner, 1967) whose members are less resistant to assimilation, because of the absence of religious barriers and because in the early days Chinese women could not immigrate to Thailand, thus making interethnic marriage a necessity.

²² See Lijphart's description of a dual segmentation as one which entails a constant tension between "a [majority] hegemony or a precarious balance ... [and leads] easily to an interpretation of politics as a zero-sum game" (1977:56).

²³ The deviation from the ethnic-neutral position of the State has led Smooha (1990) to proclaim the limitation of the explanatory powers of the two conventional models of multiethnic democracies, majoritarian and consociational, and propose a third regime type: the "ethnic democracy". In an ethnic democracy, while individual civil rights are enjoyed universally and certain collective rights are extended to ethnic minorities, the State is institutionally dominated by the majority. The imbalance in ethnic intensity between homeland and immigrant communities enables the former to exercise, or attempt to exercise, politico-economic hegemony within the framework of democracy by seizing the control of the State and implementing government-mandated preferential policies (*e.g.* Malaysia, Fiji, the Indian state of Assam). This leads to the expansion of the State, reflected in an increase in public expenditure. If the two communities are homeland-based with equal ethnic intensity, such an attempt by one may result in a breakdown of the democratic machinery, violent ethnic strife and ethnoregionalism,

latter that has a similar bi-ethnic social structure, shows that the absence of territorial division along ethnic lines (among the major ethnic groups) makes federalism an unfeasible outcome, while imbalance in ethnic intensity and legitimacy with regards to land claim (due to the homeland-immigrant dichotomy²⁴) also makes it less plausible. Instead, the trend of Malaysian public finance resulted principally from the homeland group-dominated State's using public expenditure as a tool to advance the group's economic interest in an economy still heavily relying on the more prosperous immigrant community. For a deeper understanding of the enigma presented by the case of Malaysia in the context of the relation between ethnic diversity and public spending, it is important to observe that the relationship between public policy and ethnic conflict and antagonism is influenced by the subordinate group's aspirations, the dominant group's orientations and by their dynamic interaction²⁵.

There is, in fact, an important numerical aspect in the maintaining of ethnic corporateness among the Malaysian Chinese. Unlike the case of Indonesia, the Chinese in Malaysia are sufficiently sizeable not to constitute a demographic minority in the strict sense of the term. At independence in 1957, the dominant ethnic group - the Malays, together with the aboriginals, constituted about 50 per cent of the population of Malaya (the Peninsula and the predominantly Chinese Singapore which later left the federation in 1965), followed by 37 per cent Chinese, 11 per cent Indians and 2 per cent others. The figures today are as follows: 54 per cent *Bumiputera*²⁶, 35 per cent Chinese, 10 per cent Indians and 1 per cent others (Figure 1). All Malays in Malaysia are by legal definition Muslims while the non-Malays are mostly non-Muslims. Although the population of Malaysia consists of three major ethnic communities, it has always been recognized as a bi-ethnic society, in terms of its intergroup power relationships. While ethnicity is essentially non-territorially based, it is as true today as Furnivall's observation (1948:304) half a

e.g. Sri Lanka, Cyprus and Northern Ireland.

²⁴ The basic problem with this type of society (homeland-immigrant) stems from the primal title to a homeland claimed by the indigenous ethno-national group. As Conner (1986:20) explained:

Though it may never be exercised, the power of eviction that is inherent in such a title to the territory may be translated into action at any time. Members of a diaspora can therefore never be at home in a homeland. They are at best sojourners, remaining at the sufferance of the indigenous people.

The groups are unequal and bargaining is often one-sided in a democracy that Mauzy (1993:124) called "coercive consociationalism" - consociationalism on the terms of one side. In this case, the political mobilization of the homeland peoples has been triggered and sustained by the fear of being overwhelmed and dispossessed by the (economically) aggressive immigrants. The reactive homeland movements by the native peoples thus aim to retain control of the State, economy and of their ancestral homeland. Their strategy is to "terminate and if possible to reverse the flow of immigration, to entrench the political, economic, and cultural position of native sons by preferential rules and by limiting the rights and opportunities of immigrants" (Esman, 1985:438).

²⁵ See footnote 38 below.

²⁶ *Bumiputera* ("prince of the land"), a term of Sanskrit origin, is post-1969 official designation for the Malays, though as an official collective term it also includes the aboriginals and the natives of Sabah and Sarawak (both on the Borneo island) after the these two regions joined the Peninsula in 1963 to form Malaysia, while excluding "immigrant races" like Chinese, Indians and Europeans, but not Arabs and Malays from Indonesia.

century ago that, even where the ethnic groups are adjacent, they tend to maintain their separateness. They remain divided by the mutually reinforcing cleavages of language, religion, customs²⁷, education, areas of residence and, though decreasingly, type of occupation.

6. Ethnic Diversity and the Malaysian Public Sector

The size of the public sector in Malaysia, measured by any standard, has been undeniably large. It consists of the federal government, thirteen state governments, local governments and statutory authorities. The overall involvement of the government in the economy as a percentage of GNP rose from 29.2 per cent in 1970 to 39.9 per cent in 1979 and reached its peak of 58.4 per cent in 1981. Aggregate public sector deficit and public sector debt also showed upward trends during the period (Figure 2)²⁸. A large proportion of public sector investment in the late 1970s and early 1980s was in the form of capital intensive projects with long payback periods. These included infrastructure projects, heavy industry investment and the non-financial public enterprises (NFPEs) which were entrenched in almost every branch of manufacturing especially in the chemical, iron, transport equipment, cement and wood-based industries.

There were four distinct phases of development planning (Table 1). The purpose of the colonial State (phase one) was to increase Malaya's sterling balances accumulated in London (by increasing public sector savings through maintaining a fiscal surplus), leading to a strict adherence to surplus budgets which continued throughout the Draft Development Plan (DDP, 1950-55) and First Five Year Plan (FFYP or First Malaya Plan/A Plan of Development for Malaya, 1956-60) periods. These kept the level of public development expenditure dependent on the availability of revenue. Spending on social services in this phase was considered extravagant and often subject to criticism (Toh and Jomo, 1987). The preference was for public sector resources to be mobilized to fight the communist insurgency (the "Emergency"). With the bulk of energies committed to the Emergency, planning efforts were for the most part modest.

Under the DDP, 80.6 per cent of the total public development expenditure was allocated to the economy while 7.1 per cent was for social services. Public development expenditure was heavily skewed in favour of the export and urban sectors, with priority given to the provision of infrastructure such as

²⁷ For instance, strict religious dietary prohibitions. Uproar has not been uncommon when conversion made leaving home necessary to observe such prohibitions as well as dress code.

²⁸ Figures 2, 4, 5, 6 are based on computation with data from the Malaysian Ministry of Finance, *Laporan Ekonomi/Economic Reports*.

telecommunications, electric power, roads, railways and port facilities to service the primary commodity export economy. The emphasis of the State was on projects that could yield revenue to help finance the costs of providing that infrastructure. Conversely, expansion of social services would have meant less funds available for investment. Expenditure for agricultural development during the DDP period was mainly for the development of Chinese New Villages set up to cut off supplies to the communist-led insurgents, who were predominantly Chinese. The DDP and the FFYP were basically programmes for capital formation in the public sector (*ibid.*).

Accommodation and compromise among ethnic group leaders were reflected in the non-interventionist approach of the post-colonial government in the economic sphere in the first decade after independence²⁹. During the Second Five Year Plan (SFYP or Second Malaya Plan, 1961-65) and First Malaysia Plan (IMP, 1966-70) period, which can be distinguished as phase two of the development planning in the country, the State followed a *laissez-faire* development strategy with minimum State interference except in ensuring suitable conditions for rapid capital accumulation (Lim, 1983). The increased provision for social services, especially education, reflected the need for educational expansion to meet the manpower requirements of the Malaysian economy. Education was no longer regarded as consumption but as an investment with potential future returns through increased output from a more productive labour force.

The main thrust of rural development strategy took the form of new land development by the Federal Land Development Authority (Felda) and the provision of facilities such as roads, schools, clinics and irrigation. Efforts at diversification were carried out to reduce the country's reliance on tin and rubber which were subject to the vagaries of world demand. Under the diversification programme, plantations were encouraged to grow other crops, especially oil-palm. However, Malaysia continued to rely heavily on the international economy for both export markets and capital.

The State also encouraged the expansion of manufacturing by offering incentives and providing the necessary infrastructure. The proportion of public development expenditure allocated to commerce and industry in the 1960s was low, never exceeding 3.3 per cent. It reflected the *laissez-faire* development strategy during this period, by which the State refrained from direct participation in profitable activities such as commerce and industry. During the 1960s, the industrialization policy initially pursued was a low-key approach of import-substitution, recommended by the World Bank. The growth of manufacturing output was particularly rapid in these years mainly due to its low base. However, it soon became evident

²⁹ Class fractional identity across ethnic groups, at least among their ruling élites, had for this period overshadowed any need for interethnic economic restructuring (Beaglehole, 1969).

that the domestic market was nearing saturation and that import substitution could not ensure continued growth of manufacturing output and employment. Therefore, after 1968, there was a policy switch from import substitution to export promotion. Both strategies were pursued in parallel, but with a stronger emphasis on the latter. Export-oriented industrialization encouraged "labour-intensive" industries (such as electronics), sought "cheap" labour supplies and generated considerable employment opportunities.

Two features marked the change of planning in the 1960s from its 1950s character. First, the State increased its willingness to incur budget deficits instead of sacrificing plan implementation. The direct result was an increasing reliance on borrowing from both domestic and foreign sources to meet increasing public sector development expenditures. The second distinctive feature was the adoption of more sophisticated planning techniques, involving the use of the Harrod-Domar model to estimate the rate of investment needed to attain targeted growth rates of income and employment. During this period the emphasis was on growth rather than distribution. Inequality in the distribution of income grew within all three major ethnic groups. Regional disparities of income distribution also widened, whilst unemployment in the urban centres deteriorated, reaching 7.3 per cent by the end of the period.

Although the economy remained a *laissez faire* system, it was marked by specialization of economic activities along ethnic lines. Most Malays continued to live in rural areas, playing their traditional roles as padi farmers, fishermen and rubber smallholders. The majority of the Chinese population were concentrated in urban and semi-urban areas, engaging in trade and commerce or working in tin mines. Most Indians, on the other hand, were rubber estate workers, the rest being mainly professionals. The type of cohesive forces - common economic and political interests - working among the élites was conspicuously missing among the masses. It has been said that economically the Malay and Chinese peasants may belong to a common "class in itself", but they do not enjoy much opportunity to act politically as a "class for itself" (Husin Ali, 1984:28; Husin Ali, 1975:169-170). Ironically, the Malaysian ruling élites at that time - whose obvious social class identity often overshadows, if not transcends, ethnic differences - have not preferred a race-neutral approach focusing on socioeconomic stratification, choosing instead to lean towards race-conscious alternatives³⁰, thus injecting further contradictions into the post-colonial consociationalism, while suppression and proscription of class-based organizations and ideologies transcending ethnic lines led inevitably to increasing political mobilization on such lines. In such a situation, as Adam observed in South Africa, "few prospects exist for a traditional consociational élite-cartel which is based on a de-ideologized integration by deference". Since the grand élite coalition of the divided segments "hinges on the acceptance of controversial alliances and disappointing compromises by

³⁰ Affirmative action and preferential treatment are "race-conscious" and "group-centred" strategies in contexts where the dominant policy form, particularly in liberal democracies, is individual-centred and "colour-blind" (Edwards, 1994:55).

the grass-roots following ... tolerance threshold towards ambiguous manoeuvring by group representatives stands much lower once those represented have become mobilized" (Adam, 1985:285). Against the backdrop of a harsh economic environment, growing inequality and increasing unemployment, the visibly ethnic patterns of employment and the strong identification of ethnicity with class led to a displacement of class-based frustrations by ethnic ones. Furthermore, while class mobilization may act to override ethnic distinctions, ethnic mobilization can obliterate internal class distinctions (Brass, 1985:23). As a result, the deteriorating socioeconomic and political situation in the 1960s was increasingly interpreted in ethnic terms, as the State became the greatest resource sought by élites in conflict and ethnicity as a "symbolic" instrument to wrest control of this resource:

Elites who seek to gain control over or who have succeeded in gaining control over the state must either suppress and control ... or establish collaborative alliances with other elites. When elites in conflict lack the bureaucratic apparatus or the instruments of violence to compete effectively, they will use symbolic resources in the struggle. When elites in conflict come from different cultural, linguistic, or religious groups, the symbolic resources used will emphasize those differences.

(*ibid.*:29-30)

Linking ethnic fragmentation to class differentiation, it should be noted that the extent to which various ethnic cleavages cut across or reinforce the socioeconomic ones is particularly important underlying the tragic events of 1969. Lijphart's remarks on religious cleavage is equally applicable to racial and linguistic ones:

If, for example, the religious cleavage and the social class cleavage crosscut to a high degree, the different religious groups will tend to feel equal. If, on the other hand, the two cleavages tend to coincide, one of the groups is bound to feel resentment over its inferior status and unjustly meager share of material rewards.

(1977:75)

The grave consequences of non-crosscutting socioracial and socioeconomic cleavages are evident in the case of pre-1970 Malaysia (a similar case is Northern Ireland). Such cases seem to vindicate Newman's proposition that "[the] greater the degree of reward disparity and social segregation between a dominant and a subordinate group, the greater the likelihood that conflicts between them will be relatively intense" or even violent (see Newman, 1973:158-9). Newman, however, also proposed that while conflicts in this case tend to be intense, they are relatively infrequent due to limitation in intergroup contacts and the resource deprivation of the subordinate group. This is the case where each social conflict situation produces exactly the same pattern of domination and subordination. Dahrendorf (1959) called this phenomenon "superimposition" of conflict, which reflects the coinciding of cleavages stated above. Infrequent it may be, the ascent by an economically subordinate group to political dominance proved to be a fertile ground for turning suppressed grievances into open intergroup strife which in May 1969 led to the tragic ethnic

riots in the capital and elsewhere in the country.

The New Economic Policy

The aftermath of the riots saw the replacement of the Alliance by the National Front (a considerably expanded grand coalition), the Constitution (Amendment) Act 1971, revisions to the Sedition Act "entrenching" ethnically sensitive issues in the Constitution, and prohibiting the questioning, even in Parliament, of these issues. A "new realism" was called for - meaning a reformulation of the terms of consociation into accommodation on essentially the dominant group's terms: as Mauzy (1993:111) put it, "the fiction of a government of nearly equal ethnic partners was no longer maintained". Brass (*op.cit.*:23) observed that interethnic class collaboration may take two forms: a limited, informal economic collaboration or identity of interests that does not extend to social and political relationships where ethnicity may remain primary, or one involving more institutionalized relationships where élites from different ethnic groups collaborate on a regular basis to preserve both ethnic separateness and interethnic élite dominance in relation to the subordinate classes. Crossing the watershed of 1969, the Malaysian political scene moved from the latter to the former. The political realignment resulting from the "new realism" was termed by Mauzy (*op.cit.*) "coercive consociationalism". This is what Smooha (1990) called "ethnic democracy" - a regime type which Rumley and Yiftachel (1990) believed succeeded in maintaining stability in Malaysia due to its homeland majority-immigrant minority ethnic composition, but failed in bi-ethnic homeland states and regions like Cyprus, Sri Lanka and Northern Ireland, where the ethnic sentiments of both groups are equally intense (Yiftachel, 1992).

After the 1969 election and riots there came a drastic reorientation of some government policies and programmes. Thus commenced the third phase of planning that spanned the period of the Second (1971-75), Third (1976-80) and Fourth (1981-85) Malaysia Plans, which began with the launching of the First Outline Perspective Plan (OPP1, 1971-90) involving an enlarged, more interventionist role for the State. The new development strategy, the New Economic Policy (NEP), officially possessed two major objectives. First, it aimed to reduce and eventually eradicate poverty, by raising income levels and increasing employment opportunities for all Malaysians, irrespective of race. Secondly, it sought to accelerate the restructuring of Malaysian society by correcting economic imbalances in order to reduce and eventually eliminate the ethnic division of labour (*OPP1*³¹:1). Specifically, it was expected that by the year 1990 "at least 30 per cent of the total commercial and industrial activities in all categories and scales of operation should have participation by Malays and other indigenous people in terms of ownership and

³¹ *Outline Perspective Plan, 1971-1990*, Kuala Lumpur: Government Printers, 1971.

management" (2MP³²:158). To achieve the second prong of the NEP, it was envisaged that the State will "participate more directly in the establishment and operation of a wide range of productive enterprises" (*ibid.*:7). This was to be accomplished through wholly-owned enterprises and joint ventures with the private sector. Direct participation by the government in commercial and industrial activities was a significant departure from past practice. The objective of an interventionist role of the State was to establish new industrial activities in selected growth centres and to create a *Bumiputera* commercial and industrial community.

Thus development policy in the 1970s witnessed the partial abandonment of laissez-faire in favour of greater State involvement over resource allocation and in the ownership and control of business enterprises. In line with the enlarged role of the State, public development expenditure increased to 10.3 billion Malaysian ringgit (RM) under the Second Malaysia Plan. It more than tripled under the Third Malaysia Plan (RM31.1 billion). Under the Fourth Malaysia Plan it rose further to RM46.3 billion. While modifying and redefining government policy in some areas, these subsequent five-year plans and mid-term reviews reaffirmed the State's commitment to create a *Bumiputera* middle class. The novel aspect of the strategy was the greatly expanded use of the "public enterprises" - which include public corporations established by statute by either the federal or state governments, government-owned companies and subsidiaries of either - for advancing *Bumiputera* capitalism, supposedly in trusteeship for all *Bumiputeras*.

Thus from the 1970s the widening scope of the public sector was manifest in the growth of public enterprise. Among them were public utilities, *e.g.* National Electricity Board, Telecommunication Department, Waterworks Department, the fully government-owned public corporations and statutory bodies established by the various state and federal statutes, *e.g.* FELDA (Federal Land Development Authority), MARDEC (Malaysian Rubber Development Corporation), as well as the State-owned companies established under the 1965 Companies Act. They were involved in commercial or industrial activities and competed with the domestic and foreign enterprises. Examples are HICOM (Heavy Industry Corporation of Malaysia), Petronas, MISC, MAS, several hundred enterprises created by the federal government and the State Economic Development Corporations (SEDCs), the investment arms of the states.

The existence of public enterprises in Malaysia, however, predates the promulgation of the NEP. There were a total of twenty-three public enterprises at the time of independence. Most were engaged in activities traditionally associated with public utilities, transportation, communication, agricultural development, and finance. Their counterparts, established later, took on additional functions. For

³² *Second Malaysia Plan, 1971-1975*, Kuala Lumpur: Government Printers, 1971.

instance, RISDA (Rubber Industry Small Holders Development Authority) and FELDA were created to address income and racial inequalities. RISDA is responsible for modernizing and enhancing the productivity of the rubber small-holders through the use of high-yielding varieties of rubber. FELDA served to open new areas for the resettlement of the landless and those without sufficient land for maintaining their livelihood. The number of public enterprises grew to address specific development issues when disparities in income and wealth became more pronounced. According to the government, public enterprises were the principal NEP vehicle to enable the *Bumiputera* community to participate more fully in modern commercial and industrial activities.

In addition to the conventional case in support of government intervention based upon market failures, there are factors unique to Malaysia that prompted the rapid expansion of public enterprises. One of these is government intervention in the development process to ensure growth without sacrificing equity. This contributed to the high government economic presence, as it assumed a more direct responsibility for promoting development especially after 1969. The subsequent government participation in commerce and industry represented a significant departure from past practice. Public enterprises were chosen as one of the main instruments to pursue the NEP objective of achieving a redistribution of income in favour of the *Bumiputera* community and to restructure the ownership of assets. For this purpose, public enterprises were given a specific role as patrons of the *Bumiputera* community, providing all the necessary assistance to accelerate its participation in commerce and industry; or in official parlance, public enterprises were only a temporary means for advancing *Bumiputera* economic interests, acting as trustees holding the *Bumiputera* equity in various ventures until the time when these equities could be taken over by private *Bumiputera* interests themselves. Moreover, public enterprises participated in pioneering commercial ventures that the *Bumiputeras* alone were unable to undertake due to various reasons. With expansion beginning in 1970, such public enterprises continued to proliferate strongly during 1975-89. A total of at least 901 enterprises, constituting nearly 80 per cent of all public enterprises today, were created during the mid-1970s and 1980s. There was an increase in the number of government corporations and companies in the 1980s due to the new emphasis placed on heavy industry. Among them were the Heavy Industries Corporation of Malaysia (HICOM) and its subsidiaries, which undertook many large projects in the automotive, petro-chemical, steel and cement industries.

Another direct result of the implementation of the NEP is the tremendous growth of public sector employment. The total number of employees in the public sector grew by an average of about 5 per cent per year from 1970 to 1987. Besides the general growth of the total economy, the implementation of the NEP played a key role in this phenomenon. Total employment grew during the same period by 3.5 per cent per year. Public sector employment as a percentage of total employment increased steadily from a moderate 12 per cent in the early 1970s to 15 per cent in 1981, though declined slightly to 14.2 per cent by

1987. Part of the reason for the decline was the privatization programme since 1983, besides the general slow growth in all sectors of the economy due the economic recession during the 1981-87 period.

Excluding the local authorities, the federal sector experienced more rapid growth during 1981-86 than the state sector, reflecting a tendency towards higher federal participation in non-administrative economic affairs and greater centralization (Ismail and Osman-Rani, 1991:39). The level of centralization in the public sector is also reflected in the "bottom heavy" pattern of employment in the state departments and local authorities which had a disproportionately high percentage of Group D employees (with lowest qualification) and low percentage of Groups A and B employees (with highest qualification), in stark contrast to the case at the federal level. During the 1970s, when most of the public sector employment growth occurred, most of the new posts created represented jobs with the federal government, which was more concerned with policy objectives compared to state governments which were mainly involved in purely administrative affairs (*ibid.*:36).

Within the federal government, posts in statutory organizations - which represent the State's direct participation in economic activities under the NEP - increased more rapidly than those in ministries and departments. One of the main objectives of these statutory bodies was to increase *Bumiputera* participation in business management. As a result, management level posts were increasingly created within these statutory bodies to absorb as many qualified *Bumiputeras* as possible (*ibid.*:37). The same also occurred in the ministries and departments, albeit on a lower scale. Until the new intake freeze in 1983 due to the recession and alarming fiscal deficit, the government actually acted as a last resort employer to all unemployed *Bumiputera* graduates. Azmeer (1983) noted the resulting so-called "grade creep" phenomenon in which many paper-qualified bureaucrats in the federal government were doing the same type of work that some clerks were doing at the state and district levels.

However, the policy of creating new jobs to absorb more *Bumiputeras* into the government services applied also to the whole public sector, a process intensified towards the end of the 1970s and early 1980s. Wong (1983) computed the *Bumiputeras'* share of the new government jobs created between 1970 and 1977 to be 68 per cent, which rapidly increased to 83 per cent between 1977 and 1980. Within the police and armed forces, the *Bumiputeras'* share grew from 70 per cent in 1967-70 to 86 per cent in 1979-80. In addition, the NEP period also witnessed tremendous growth in employment by the public enterprises, which rose from less than 3 per cent of total public sector employment in 1975 and 1980 to 5.6 per cent by 1985.

Besides, Malaysia has a highly regulated economy, with government rules being looked upon as an important policy instrument. In addition to the rapid growth of the public enterprises in the 1970s and

1980s to spearhead *Bumiputera* participation in commerce and industry, the expansion of the public sector was accompanied by an increase in the number of regulations, procedures and licences. These were justified for the attainment of the NEP objectives and to offset weaknesses in certain policies. These regulations and procedures, many of which revolved around the NEP such as the Industrial Coordination Act (ICA) and the Companies (Amendment) Bill 1984, had been criticised as the cause of increasing production costs, productivity falls and a disincentive to capital investment.

However, seeking solutions through regulations tends to increase the State's bureaucratic machinery. When unforeseen consequences arose from existing regulations, new ones were imposed, further enhancing the bureaucracy. As it still does today, in 1984 Malaysia possessed one of the biggest State administrations in the world with 46 civil servants per every thousand people, compared with figures for Africa (20), Asia (30), Latin America (38), OECD (8) and all developing nations (29). Government expenditure on salaries, fixed allowances, overtime payments plus other benefits and indirect costs constituted about 46 per cent of its operating budget. For every ringgit the public pays to the government, 46 sen went towards maintaining the bureaucratic machinery, 27 sen being accounted for by wages alone (Yip, 1987).

In short, during the last three decades, the public sector played a crucial role in the Malaysian economy, not only in terms of the continuing increase in the expenditure to GNP ratios and the employment created, but also in terms of growing active State intervention in the economy, a particularly notable shift from the colonial legacy of *laissez faire* philosophy of the 1950s and 60s.

The determinants of expenditure growth

Looking at the phenomenon of rapid expenditure growth in Malaysian economic history, in particular in the light of the change in the role of the State since the riots of 1969, some of the obvious causes of this trend seem to be the rapid increase in development expenditure to accelerate and enhance social and economic infrastructure and the rapid emergence of new public corporations and agencies with the implementation of the New Economic Policy. To investigate the underlying causes of expenditure growth in this country, we tested a time-series model covering 28 years, from 1963, the year of the formation of Malaysia, to 1990, the year when the New Economic Policy officially came to an end. Two versions of the dependent variable are utilized, namely public expenditure per capita (GE) and public expenditure as a proportion of GDP (E/G). The explanatory variables incorporated in the model include GDP per capita (PCY), the ratio of public consumption to private consumption (PCON), government employment as proportion of total employment (PEMP), population size (POP), the openness of the economy measured by the ratio of the sum of imports and exports to GDP (IMPEX) and the price level

measured by the consumer price index (CPI). All these variables, except CPI, are expected to be positively related to public expenditure. All data are in real terms, at 1985 constant prices. To take into account the difference between the NEP and the pre-NEP period, two alternative policy dummy variables are specified: NEP1 which takes the value of zero for the years before 1970 and one otherwise, and NEP2 which employs 1975, instead of 1970, as the threshold. The reason for including NEP2 as an alternative is the possibility that the substantial impact of the implementation of the New Economic Policy on public spending may involve a time lag of several years. The year 1975 is selected since that is the year from which the investment in the non-financial public enterprises (NFPEs) began to experience very rapid growth (Figure 3)³³. If there is one particular phenomenon that can best reflect the underlying purpose of NEP, it is the expansion of the NFPEs since, as has been observed in the preceding section, these institutions were explicitly used as tools during the two decades of ethnic reform acting as surrogates to promote *Bumiputera* capitalist interests. Lastly, government expenditure with one year lag (GE_{t-1} , E/G_{t-1}) is also included as one of the explanatory variables.

Our results show that all the statistically significant coefficients of the explanatory variables have signs which are consistent with *a priori* expectation. Public spending is found to be significantly related to income per capita and the openness of the economy. The ratio of public consumption to private consumption is also shown to be an important factor determining public sector growth in the country. An increase in this ratio indicates a higher degree of State intervention in the Malaysian economy, resulting in a higher level of purchases of goods and services by the public sector. Equally significant is the influence from public sector employment (PEMP), bearing in mind the crucial role it plays (the State as the employer of last resort for the Malays) in the ethnic restructuring policy under NEP. The level of public spending per capita in the previous period is also found to be a significant explanatory variable. While the policy dummy with 1970 as the threshold (NEP1) is not found to be related to the level of government expenditure, the alternative variable taking 1975 as the year of change (NEP2) is a persistently significant determinant of the level of real government expenditure in log form. This vindicates the existence of a lag of several years for the ethnic reform measures of NEP to exert their impact on public spending. Since NEP has its origin in the ethnic fragmentation of the country, the statistical significance of this variable reflects the ultimate influence of such fragmentation on the public sector during those years. The elasticity coefficients show that the demand for public goods and services is income elastic (thus rendering public goods and services luxury products) in the equations with real expenditure per capita as the dependent variable, consistent with Herber's interpretation of Wagner's Law (Herber, 1975:147). Also having elasticities greater than or close to unity are the variables PEMP, PCON, CPI and IMPEX.³⁴

³³ Figure 3 was adapted from Ismail and Osman-Rani (1991).

³⁴ Due to space limitation, the detailed results of the analysis are available on request from the author.

The significance of the variables NEP2, PCON and PEMP is a reflection of the influence of ethnic economic restructuring and the ascendance of Malay middle class with the NEP, as manifested in the scale and nature of expansion of public development expenditure during this period. Such expenditure grew in the 1970s and early 1980s with the percentage accounted for by the commerce and industry sector increasing from 3.3 per cent during the First Malaysia Plan period (1966-70) to 14.6 per cent for the Second Malaysia Plan (1971-5), 13 per cent for the Third (1976-80) and 16.5 per cent for the Fourth (1981-5) (*ibid.*:266). The trend of public expenditure allocation was heavily influenced by the ethnic economic restructuring aim of the government. There has been an obvious trend in terms of the relative emphasis given to the two main "prongs" of the NEP. Since launching the NEP, the government has increasingly shifted emphasis in terms of allocation of funds from poverty eradication to ethnic economic restructuring. The official documents (the *Malaysia Plans* and *Mid-Term Reviews*) show that the ratio of allocations for ethnic restructuring to that for eradicating poverty increased steadily from 22 per cent during the Second Malaysia Plan period (1971-75) to 37 per cent under the Third (1976-80) and 47 per cent under the Fourth plan (1981-85) - later revised upward to 57 per cent, while the ratio for actual expenditure was estimated at 59 per cent, according to the Fifth Malaysia Plan (1986:231). On the other hand, the allocation for "poverty eradication" was 4.7 times that for "restructuring" during the Second Malaysia Plan period (1971-75), then declined to 2.7 per cent for the Third (1976-80), 2.1 per cent for the Fourth (1981-85), and further to 1.6 under the Mid-Term Review of the Fourth Malaysia Plan (Jomo, *op.cit.*:266). The table in the following pages shows that the allocations for "restructuring" grew from RM508.3 million for the 1971-75 period to RM2,376 million for 1976-80 and RM4,397.6 million for 1981-85 (revised upward to RM6576.8 in 1984). The allocation for "commerce and industry" alone accounted for 71 per cent of the "restructuring" allocation for 1971-75, then increased to 81 per cent for 1976-80 and 79 per cent for 1981-85 (*ibid.*:268). The above figures reflect how ethnicity-based considerations heavily influence the direction of public expenditure allocation.

Policy reorientation after mid-1980s

Throughout the 1970s public sector expenditure was relatively high as a percentage of GDP, rising from 36 per cent in 1970 to 53 per cent in 1982. Overall public investment increased at an average annual rate of about 12.6 per cent in real terms throughout the 1970s. Expenditures specifically designated for public enterprises increased even more rapidly, from 4 per cent in 1970 to 34 per cent in 1982. Public sector direct investment increased steadily throughout the 1970s before taking a sharp upturn in the 1980s (Figure 4). The ratio of total public expenditure to GNP increased from 27.9 per cent in 1970 to 38.8 per cent in 1979. It rose by another 10 per cent in 1980 to reach a level comparable to that of OECD countries.

During the 1971-75 period, real GDP growth was 7.3 per cent per annum. It increased to 8.5 per cent per annum between 1975 and 1980. During the 1970s the fiscal activities of the government were managed in an environment of strong economic growth. There was also a persistent surplus in the balance of payment despite unstable world trade.

The 1980s witnessed another phase of the State's participation in the national economy. The rapid expansion of the public sector during the 1980s was mainly the result of an effort to accelerate the achievement of NEP targets. The public sector deficit had been increasing up to the early 1980. Since it was financed mainly by foreign and domestic borrowings, the strain on the capital market led to an increase in the external debt which exacerbated structural problems in the balance of payments service account. While the public deficit began to decline after 1981, it remained substantial up to the mid-1980s. The contractionary fiscal policy adopted in 1982-83 led to sectoral capital and labour dislocation; cuts in government spending played a major role in slowing down economic growth after 1982 and in increasing unemployment.

In the early 1980s the major industrialized countries suffered the longest and deepest recession since the 1930s Great Depression. As a consequence, the Malaysian economy began to slow down in spite of government counter-cyclical policies. These interventions, in the form of accelerated public investment and expenditure programmes, did protect the economy against the global recession of 1981-82 by sustaining real growth at a high level, but only at the cost of soaring current account deficits in the balance of payments. The economy recorded a negative growth rate in 1985, with the collapse in the prices of all major export commodities (Figure 5). The government, already strained by its past policies, was unable to undertake anti-recessionary measures. The unemployment rate rose from 5.8 per cent in 1984 to 6.9 per cent in 1985. The collapse in commodity prices, while worsening the 1985-86 recession, further exacerbated the public sector deficit in 1986 which reached a high of 9.8 per cent of the GNP and declined thereafter.

Revising its role in the economy after mid-1980s, the government bureaucracy began to loosen numerous laws and regulations. In the face of significant decline in economic growth during the 1980s and a heavy debt burden, the government began to adopt a more flexible stance towards the private sector, encouraging it to play a more active role. Changing the public-private mix requires a reassessment of the State's role in the provision of public goods and services, a new approach to distributional objectives and a revision of macroeconomic adjustments. The need to reduce the role of the State, especially after the 1985-86 crisis, led the government to adopt austerity measures by cutting public expenditures. Although size does not necessarily imply inefficiency, the rapid expansion of public sector investment over the past decades might have led to inefficient resource use. In 1982 public expenditure contributed a substantial

4.8 per cent to the nearly 6 per cent growth of GDP, but its contributions have been negative since 1984. Consequently the State began to reverse its economic role, reduce its size and divest its activities that are in direct competition with the private sector.

In the economic environment of the early 1980s, the direction of public finance created a lot of concern. The ratio of public expenditure to GNP had increased from 27 per cent in 1970 to 58.4 per cent in 1981. Likewise, the consolidated public sector deficit as a proportion of GNP increased from 3.6 per cent in 1970 to 22.1 per cent in 1980. The government faced increasing difficulty containing operating expenditure (in particular the emoluments, debt-service charges, pension payments and gratuities), in the wake of the slow growth in public revenue. Increasingly, development expenditure was financed by borrowing. Domestic and external borrowings increased to fund the expansion of public enterprises. The amount owed to the federal government by statutory bodies, government-owned companies and state governments increased from RM1.2 billion in 1970 (equivalent of 24 per cent of the federal government's outstanding debt) to RM17 billion in 1982 (37 per cent of government's total debt). Interest payments grew with the rapid accumulation of the total federal government debt (external and domestic) used to finance its own development expenditures. The federal government's total interest service charges grew from RM0.24 billion in 1970 to RM1.55 billion in 1980, increasing thereafter to RM5.04 billion in 1985. Accordingly, interest service charges as a proportion of total operating expenditure rose from 11.0 per cent in 1970 to 25.1 per cent in 1985.

The higher budgetary resource flows to public enterprises, statutory bodies and *Bumiputera* companies, especially during 1970-82, may have been partly caused by the early 1980s economic recession. The downward rigidity of these resource flows, even during a period of austerity, demonstrates the potential social costs of permanent, institutionalized protectionism (Mehmet, 1986:135). These agencies, which were dependent upon State subsidies, operated as if they were insulated from business cycles. Performance tended to be determined not only on the basis of productivity and efficiency but upon non-competitive, bureaucratic criteria. In particular, the financial performance of the NFPEs had been a matter of grave concern. Total accumulated losses of the NFPEs reportedly amounted to over RM2.3 billion by the end of 1987. Four major problems in the Malaysian public enterprise management have been identified (Soenarno and Zainal, 1985). First, the lack of clear objectives led to overlapping and duplication of functions among public enterprises. Secondly, the criteria (for instance, commercial versus social goals) for the selection of programmes and projects seem ambiguous. Thirdly, public enterprises had been affected by a lack of experienced managers, and had recruited managerial staff from within government bureaucracies. Finally, weak coordination, regulation and control (in particular, financial control) are compounded by data-base deficiencies. Overlapping jurisdictional authority among central government agencies resulted in unclear responsibility. Parliament failed to secure public accountability of

a large number of the government enterprises. Only in 1985 did the government set up a Central Information Collection Unit (CICU), followed by the establishment of the Unit for Monitoring Government Companies and Agencies (UPSAK), to undertake more detailed analyses of the NFPEs. These problems generated the widespread view that the State had become too big and bureaucratic to deal effectively with the rapidly developing Malaysian economy.

Since 1982 Malaysia experienced an exceptionally high level of resource imbalance (investment larger than saving). The balance moved from a "surplus" of 4.6 per cent of GNP in 1979 to a "deficit" of 14.1 per cent of GNP in 1982. After 1977 the public sector maintained a high profile in the composition of total investment. By contrast, private investment grew only marginally in the early 1980s and declined in the mid-1980s. The bulk of the public sector saving was from the NFPEs, especially Petronas, the national oil company. With the collapse of commodity and oil prices as well as the increasing number of NFPEs, the public saving rate has declined since 1986. As investments grew faster than savings, the resource "deficit" (saving-investment gap) widened during the 1980s. In fact, both private and public savings declined over the decade. The gap was financed largely through borrowing from both domestic and foreign sources, with interest payments on external debts straining the current account of the balance of payments.

The reappraisal of the State's functions undertaken by the Malaysian government in the wake of these difficult circumstances led to a gradual eclipse of its role as an entrepreneur and its emergence as a facilitator. The policy of privatization, first announced in early 1983, represents a significant departure from earlier approaches to development, one which signalled the Malaysian government's intent to realign the balance between public and private sector responsibilities.

Five objectives were given as the rationale for privatization: to relieve the financial and administrative burden on the government; to promote competition, raise productivity and increase efficiency; to accelerate economic growth; to reduce the presence of the public sector in the economy; and to enhance the opportunities for meeting the ethnic equity-ownership target of the NEP (*GP*³⁵:17-18). The underlying impulse for the policy change after two decades of what may be termed "State capitalism", seems to have been driven more by economic pragmatism than by ideological motives. The sharp reversal of the previously buoyant economic performance had begun to cast doubt on the role of the public sector by the early 1980s. Privatization was a policy response to the demonstrated poor recent performance of many State-owned enterprises, to increasing external and domestic debt levels, and to public sector deficits that became difficult to sustain.

³⁵ *Guidelines on Privatization*, Kuala Lumpur: Economic Planning Unit, Prime Minister's Department, 1985.

Although at first sight the structural changes being made in the economy under liberalization appear to reverse some leading features of the NEP, this might not be the case in reality. If privatization has been launched earlier, say a decade or so after the implementation of the NEP, it would have transferred a large number of government operations into the hands of the non-*Bumiputeras* or foreigners, thus negating a major objective of the NEP. However, by the mid-1980s, restructuring had progressed sufficiently to make liberalization politically feasible for the government. The supply of *Bumiputera* managers had become substantially greater at that date. Moreover, the amount of *Bumiputera* funds which could be tapped for capital had increased. Shortages of *Bumiputera* managers and capital were no longer such as to require a huge structure of government institutions to act as surrogates (Milne, 1986). The ratio of allocations for restructuring to those for poverty eradication, which had been steadily rising from the Second to the Fourth Malaysia Plans, was for the first time revised downward to 33 per cent under the Fifth Malaysia Plan (1986-90), and then further down to 26 per cent, and then 20 per cent with its Mid-Term Review.

With this came the fourth phase of planning covering the period of the Fifth (1986-90), Sixth (1991-95) and Seventh Malaysia Plan (1996-2000). The end of the NEP period saw the launching of the Second Outline Perspective Plan (OPP2, 1991-2000), embodying the National Development Policy (NDP). The Sixth Malaysia Plan (1991-95) represented the first phase in the implementation of the OPP2. The new economic philosophy of the State was reflected in its identification of the private sector "to provide the leading role and dynamism in the economy, given the resource constraints encountered by the public sector" (5MP³⁶:22). Furthermore, the Fifth Malaysia Plan envisaged the streamlining of "the complex laws, regulations, and controls in order to provide a conducive environment for business activities", with steps taken to "gradually reduce the size and role of the public sector" (*ibid.*:22). This new orientation is in line with changing role of the State envisaged since the official beginning of the privatization programme in 1983. Its effect is reflected in the fact that the ratio of public to private investment, which had previously risen, declined after 1983 (Figure 6). As a whole, the new economic liberalization strategy undoubtedly brought about many policy changes favoured by private capital. These also included, besides privatization, a reduction of public, especially development, expenditure; restraint of non-financial public enterprise (NFPE) expansion; as well as less emphasis on ethnic redistributive considerations. However, these policy changes may, as Professor Jomo noted in his 1993 inaugural lecture, tend to favour Malay and foreign, rather than domestic non-Malay investors:

Although there is little official evidence of such a preference for foreigners in terms of explicit government

³⁶ *Fifth Malaysia Plan 1986-1990*, Kuala Lumpur: Government Printers, 1986.

policies and regulations, this view is widespread, not only among Chinese businessmen, but also among many Malay officials. This is reinforced by a common view that long-term Malay interests are better served by encouraging foreign, rather than domestic Chinese investment.

(Jomo, 1993:23)

Furthermore, the fact that the "Malay rentier-business cadre", which had been successfully created during the NEP period, were "positioned to take advantage of the reforms, which were structured in ways to ensure that they would derive disproportionately greater benefit from them", is the most important factor behind the supportive constituency for these latest government policy changes (*ibid.*:25). Therefore, the latest policy changes, which were manifested in a sharp change in trend and pattern of public expenditure allocation, should be seen as reflecting the continuing, rather than weakening, influence of ethnic considerations.

As a closing remark for this perusal of the Malaysian experience, the positive pressure we witnessed here on public spending from ethnic fragmentation needs not be viewed as contradicting the negative link we observed in our cross-national analysis earlier in the paper as the former relates more to certain stages of a number of individual countries' socioeconomic development. First, not many countries have a State-sanctioned preferential policy in favour of the politically dominant ethnic group as consistent and persistent as that of Malaysia. In many countries, the economy is not dominated by the politically subordinate ethnic group and preferential policies implemented by the politically and economically dominant group need not go as far as that in terms of such use of public spending. It is interesting to note again Driessen's finding that the benefit structure of the US Social Security system is biased against blacks (1982) and the relatively small size of transfer programmes that transfer income across races in the US compared to the country's Social Security programme that mostly transfers income within the middle class (*ibid.*; McCarty, *op.cit.*), despite the fact that the "affirmative action" policies have already gradually evolved since as early as the 1960s. Also unlike the explicit way preferential policies have been legislated, both in terms of directions and tools, in Malaysia (commencing on a specific date, generating specific benefits for a specific group by means of specific fiscal and other instruments), preferential policies have seldom been explicitly legislated in the US. Group preferences in the US have instead emerged gradually and unevenly since the 1960s, and not always openly (Sowell, 1990:109). The explicit positive impact of preferential policies on public sector size experienced by Malaysia from early 1970s to mid-1980s is, in other words, not always true for all countries with certain forms of ethnic preferential policies. It remains a possible direction countries in similar circumstances will take, *e.g.* Fiji, South Africa. However, variations in various socioeconomic factors, including political culture, international environment, economic realities *etc.*, will influence the exact nature of this development.

Secondly, such effect of ethnic diversity-induced policy on public sector size has a time

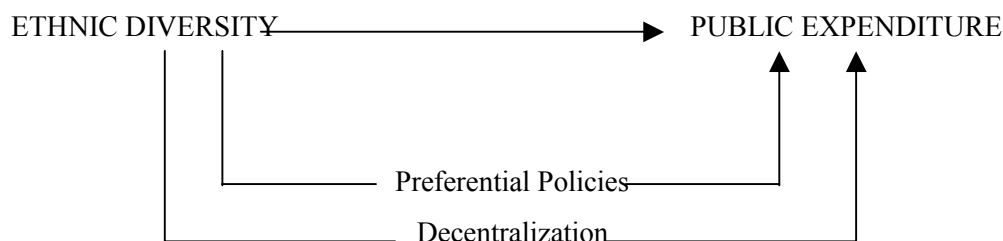
dimension.³⁷ Different countries, even if they have adopted similar policy response, implemented them at different stages in their economic history. Such policies also do not last for ever with the same vigour due to changing socioeconomic reality, backlash from the unpreferred groups and other factors. Malaysia's NEP was supposed to span two decades, from 1970 to end of 1980s. However, economic difficulties in the mid-1980s had already greatly mitigated public sector expansion after 1985. One good indicator is the amount of government investment in NFPEs (non-financial public enterprises) - the chief vehicle of the ethnic restructuring prong of the NEP acting as surrogates for *Bumiputera* economic interests - which reached the zenith in 1984 and thereafter suffered a steep decline in real terms. The effect is also reflected in the decline in overall public expenditure, public investment and consumption since mid-1980s. Besides changing socioeconomic situation, backlash from the unpreferred groups can also cause policy reversals (see *e.g.* Grove, 1993), more possibly in countries where preferential policies have been for the economically subordinate minorities and the unpreferred group or groups are in politically dominant position to effect change.

7. Decentralization

Given the above, there remains a possibility that ethnic diversity can still exert an influence on the size and development trend of the public sector in countries where the State does not respond to the exigencies engendered by the ethnic conflict by resorting to ethnic preferential policies. One of the important alternative response is ethnic accommodation through political decentralization and fiscal federalism which can have an impact on government size not only as an independent explanatory variable, but also as an exogenous factor influencing the link between ethnic diversity and the size of the public sector, or as a conduit through which such diversity indirectly exerts its influence on the latter. In short, ethnic diversity can have an influence on the size and development of the public sector of a country where the State response to exigencies engendered by such diversity involves not ethnic preferential policies but

³⁷ Hage, Hanneman and Gargan (1989:89-91) remarked that theories of the determinants of public spending should not only be problem specific but also period specific. The historical dimension - the timing of State involvement - is a crucial factor (*e.g.* the attempt at government-mandated preferential policies came almost two decades later in Fiji than in Malaysia). Levi-Strauss (1967:281-3) perceived time not solely in mechanical, cumulative or statistical terms, but also in social terms - deriving its properties from concrete social phenomena. Complementing his view of ethnicity as a special case of stratification, an analytical perspective concerned with conflict and power (the Weberian approach), Katznelson (1971:69-70) emphasized the importance of the notion of "critical structural periods" - historical periods when "critical structural decisions" are made. In other words, *social time* rather than *historical time*, which can be misleading, is the crucial variable. The "critical structural period", when definitive State response to exigencies generated by a country's ethnic diversity, came in the year 1970 both in Malaysia (the implementation of NEP) and in Belgium (beginning of the federalization process), and at the end of the 1970s in Spain (the 1978 Constitution that saw the emergence of the Autonomous Communities, and the approval of the Statutes of Autonomy for all of these Communities from 1979 to 1983).

political decentralization and fiscal federalism.³⁸



8. The Inverted Paradigm

While at some stage in a country's development ethnic fractionalization may stimulate public sector expansion (as in Malaysia), an inverse causal relationship cannot be precluded. For instance, while government responds to challenges from ethnic community organizations that seek to influence public policy, "within an inverted and complementary paradigm ... ethnic communities take shape as response to stimuli which induce a process of ethnogenesis" (Gheorghe, 1991:842-3).³⁹

³⁸ Ethnopolitical conflict brought about by the annexation of East Timor obviously has an effect on fiscal allocation in Indonesia, as Bird and Vaillancourt (citing Shah and Qureshi, 1994) noted below:

... in Indonesia, Timor (one of the poorest provinces) has a per capita own-source revenue equivalent to 4 percent of Jakarta's ... however, owing to transfer from the central government, Timor's per capita expenditures are 40 percent of those in Jakarta.

(1998:18)

Figure 7 (based on computation with data from *Anuarios Estadísticos de España*, Instituto Nacional de Estadística/Ministerio de Economía y Hacienda, Madrid) shows the remarkable growth of the Spanish regional expenditure due to the *Comunidades Autónomas* project. While this occurs at the expense of central government expenditure, it is also a source of overall public sector expansion in the longer term. In Belgium, the extension and dispersion of development zones due to ethnic sensitivity inevitably call for increases in public spending in the form of additional regional aids, the distribution of which has always been a focus of contention between Flanders and Wallonia. In the so-called "War of Apothecaries' Accounts", a decision made to benefit one region always became the basis for a campaign to obtain a comparable benefit for the other region. Such demands for interregional parity have led to acute competition over national revenue allocations and, especially for economic development projects, economic efficiency is often sacrificed since projects funded in one region often have to be offset by funding for other undertakings in another region, hence resulting in economically inefficient increase in government expenditure. For a detailed discussion of the influence of decentralization and the importance of the typology of dominant-subordinate relations in this regard, see Yeoh (2001b:26-30).

³⁹ An example of this interesting phenomenon of public policy-induced ethnogenesis is evident in the large southern impoverished Spanish region of Andalucía, which shares the linguistic identity of the Spanish (Castilian) centre, triggered by the post-Franco *Comunidades Autónomas* project. "The rapidity with which a politically disciplined and powerful regional cultural identity has emerged in Andalucía shocked everyone ..." commented Greenwood (1985:222-3), "... the idea that the Andalusian movement is something qualitatively different from the 'true' ethnic movements in the Basque Country and Catalonia must be exploded."

Pluralism, in turn, has been identified as a major cause of social conflict. There are numerous models describing the relationship between the degree of pluralism and conflict. Tilly and Snyder, for instance, argued that collective violence tends to occur "when one group lays claim to a set of resources, and at least one other group resists that claim" (Tilly and Snyder, 1972:526). Accordingly, the greater the frequency of contested claims, and the greater the mobilization⁴⁰ in their support, the greater the conflict is likely to be. Therefore the more plural a society is, the more conflict there will be (Cooper, 1974). Plural societies are segmented into divergent corporate groups with narrow interests, whose claims are parochial and less likely to coincide with claims arising in other groups, thus generating conflicting demands upon resources. Furthermore, pluralism may increase the intensity with which claims are put forward, because there is a greater difference between groups and greater homogeneity within groups. Consequently individuals are able to collectivize their discontent more readily due to their similarity of interests with other group members.

Theories had been proposed that larger public sector may be the cause of greater likelihood of ethnic conflict.⁴¹ Accordingly, preferential policies always carry the risk of resulting in a vicious cycle of government expansion and ethnic discord. Under voluntary exchange in free markets, it was argued, ethnic tensions are kept at a minimum. Individuals, as members of specific ethnic groups, stand to gain or lose on the basis of their marginal productivity, which may be conditioned by generic, historical, political or cultural influences. In a competitive market, because individuals are paid on the basis of their marginal productivity, ethnicity does not become a salient concern⁴². Moreover, any consumer or producer who displays a desire to discriminate pays a price for doing so (the "cost of discrimination" which may explain the tendency of white South African private sector businesses to employ more blacks and in higher positions than the former apartheid laws permitted, and white private sector resistance to Jim Crow laws in the American South [Sowell, 1990:36]).⁴³

⁴⁰ Marx's mobilization principle, postulated in *The German Ideology* (with Engels, 1846), suggests that the political power of an interest group is proportional to its degree of mobilization. In other words, it is not sheer numbers that count in politics but effective mobilization (Collins, 1975:385).

⁴¹ A notable one is the controversial hypothesis of Rabushka (1974).

⁴² However, since ethnicity consists of both the elements of "race" (phenotype) and "culture", it has always been thought to exert certain influence on marginal productivity, giving rise to speculations from Weber's seminar study (1905) of the causal link between Protestantism and capitalism right down to the now-fashionable, rather spurious argument that attributes overseas Chinese economic success to the Confucian tradition (contrary to what Weber believed) and the ill-defined "Asian value" in general.

⁴³ A pitfall in such theorizing is the assumption of a competitive market. Furthermore, since not all groups in society are equally placed or equally inclined to take advantage of the opportunities for advancement provided by the market, there is always a danger of ethnic imbalances that generate considerable social costs. Another problem with this theory lies in the existence of three different contexts for preferential policies. It seems to be more applicable to countries practising strategies favouring the demographic/political majority in a minority-dominated

The activities of government in a multiethnic environment tend to convert private economic competition among individuals in markets into political conflict between ethnic groups. Political processes replace market relations in determining the terms on which individuals compete, resulting in the inability of democratic institutions to resolve the intense but conflicting preferences which characterize a plural society (Rabushka and Shepsle, 1972:217). The same idea reoccurs in the key proposition of applying rational choice theory to ethnic relations:

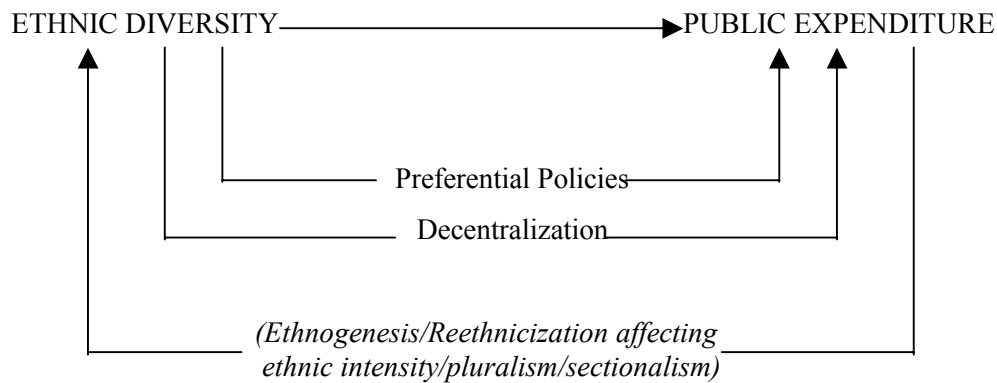
When groups interact, processes of change affect their boundaries in ways determined by the form and intensity of competition; and, in particular, when people compete as individuals this tends to dissolve the boundaries that define the groups, whereas when they compete as groups this reinforces those boundaries.
(Banton, 1983:104)

Moreover, government itself may violate the conditions for efficient provision of public goods. State officials, by conscious choice, may exclude members of minorities or politically dispossessed communities from consumption of public goods, while government actions can impose external costs upon minority community members who are not in agreement with majority policy. Rationing criteria which can be almost exclusively racial in a multiethnic society tend to turn public goods into the private preserve of the politically advantaged group. On the other hand, ethnic minorities, who forego private resources via taxation, may be excluded from consuming public goods which their funds pay for. While government often lacks the knowledge necessary to achieve an efficient allocation of public goods because information is scarce and costly in the absence of markets, it is often not interested in obtaining such knowledge in multiethnic societies. Ethnic minorities frequently have their preferences disregarded and may be forcibly oppressed by the use of police power which they help to finance. In short, when the economic well-being of groups is significantly affected by political activity, politics may become a fight between groups for survival. In a society where ethnicity is politically salient, the greater is the public sector, the greater is the likelihood of ethnic conflict, according to Rabushka (1974).⁴⁴ The Malaysian experience reveals to a large

economy and those with majority preferences in a majority-dominated economy, than to those with minority preferences in a majority-dominated economy. The first category consists of cases like Malaysia, Sri Lanka, Nigeria and the Indian states of Assam, Maharashtra and Andhra Pradesh, the second of the American South during the era of segregation laws and South Africa under apartheid, and the last of policies favouring the untouchables in India, blacks in United States, Sephardim in Israel, Central Asians in the former Soviet Union, Maoris in New Zealand, and various minority groups in China, Canada, and Britain. The thesis that a larger public sector leads to an increased likelihood of ethnic conflict does not seem to find apparent support in countries like United States or Britain which, at least partially, reflect minority preferences in a majority-dominated economy.

⁴⁴ The reason that the said inverse causal relationship (the "inverted paradigm") is not taken into account in the cross-national analysis earlier in the paper is that ethnic fractionalization, the relevant variable used in the analysis (measured by EFI), refers only to the objective phenotypical, linguistic and religious characteristics (given, inherited ethnic markers) of the population, not the subjective and more fluid constructs of pluralism and sectionalism (see Yeoh, 2001b:30) which underlie the ethnogenesis which can be responsive to stimuli such as public policies (see e.g. Gheorghe, *op.cit.*).

extent the attractiveness of such reasoning, albeit short-term economic inefficiency (as succinctly described by a former Belgian premier: "buying out political discords at the expense of the public treasury"⁴⁵) may not mean inefficiency in the long run because social stability is also an essential factor to be reckoned with in long-term economic development.



9. Concluding Remarks

This paper begins with an exploration into the possible link between ethnic fragmentation and government size using data from over a hundred countries at various stages of economic development. Preliminary analysis suggests that ethnic fractionalization is inversely related to the size of public spending and the relationship is particularly strong for the developing country category. Moving upwards to categories of countries higher in economic affluence seems to weaken the link when such primordial attachments like race, tongue and religion on public decision-making gradually gives way to more modern, professional procedures. This reflects the fact that while ethnic diversity is not an exclusive feature of today's developing societies, it is nevertheless particularly relevant to them, since economic deprivation or desperate poverty "unduly heightens sensitivities and breeds a general atmosphere of unreasonableness and distrust, making it immensely more difficult to attain solutions to outstanding problems on the basis of a reasonable give and take" (Vasil, 1984:1-2).⁴⁶

⁴⁵ Pierre Harmel, so complained in 1965 (Lyon, 1971:135), as linguistic conflict in Belgium was resulting in unproductive increase in government expenditure when the support for separate educational systems and the need to carefully balance programmes of public works in Flanders and Wallonia inevitably imposed strains on the Treasury.

⁴⁶ It is pertinent here to note again Easterly's finding (2000:19) that institutional factors interact with ethnic diversity by affecting whether ethnic conflict is destructive or is contained by the rules of the game:

Besides differences in sample selection⁴⁷, the adoption of a holistic approach here to use a measure that regards race, language and religion as merely different markers of a single variable of ethnic diversity, is in contradistinction to the previous studies that either included only one of these components to the exclusion of the others or considered them as separate and distinct variables, which may lead to mismeasurement. The results, together with those from similar studies surveyed in the paper, address a public choice issue, and deserve attention from researchers and policymakers. As Kuijs (*op.cit.*) observed, the recognition of the impact of ethnic diversity on public spending implies that a discussion on the appropriate size and role of the State should always pay due attention to such ascriptive fundamentals of society. Subsequently, we acknowledge the additional complexity posed by the existence in the real world of countervailing influences from preferential policies and decentralization, which themselves represent possible State responses to exigencies engendered by ethnic fragmentation, that have to be taken into account in any further analysis of the subject matter. This, as Alesina, Baqir and Easterly (*op.cit.*) noted, also points to a possible temptation on the part of policymakers, especially in countries with certain extent of ethnoterritoriality, to choose decentralization and segregation to enforce relatively homogeneous communities in view of the problems in the provision of social goods associated with ethnic fragmentation. While stratification may be more efficient in the short run to deal with diversity in the production process (Benabou, 1996), it also increases diversity and in long run risks decreasing economic efficiency. Finally, country experiences show that within an inverted and complementary paradigm, ethnic communities do take shape in response to public policy stimuli, which induce a process of ethnogenesis or reethnicization which further influences public policy formulation. This is a pitfall that deserves the attention of policymakers, for mismanagement of however well-intentioned preferential policies especially those for the majority in a minority-dominated economy can easily deflect them from the objective of ethnic co-existence to goals based on sectarian interests, while the State embeds itself in what Sowell (1990) called "the illusion of morality and compensation".

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Ethnic diversity has a more adverse effect on economic policy and growth when institutions are poor. To put it another way, poor institutions have an even more adverse effect on growth and policy when ethnic diversity is high. Conversely, in countries with sufficiently good institutions, ethnic diversity does not lower growth or worsen economic policies.

⁴⁷ For instance, with her sample limited to only 46 countries "with democratically elected governments", McCarty admitted that her study might have erred on the side of being inclusive in cases where the democratic process may not be fully formed since ambiguities abound in judging whether or not a particular country has a democratic election process (p.237). Such restriction is also based on a questionable assumption that racial/linguistic/religious fragmentation has no role to play in the public decision making process of an authoritarian ruling hierarchy.

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