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Developmental Engines: Large Local Firms and Malaysia's Struggle to Foster Them

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Introduction

In recent works, Keun Lee[1] argues that world-class large local businesses, often organised as business groups, can play a pivotal role in the economic development of developing countries. These groups facilitate entry into high-barrier markets, foster the accumulation and diffusion of skills and capabilities, help address market failures and reduce transaction costs. Such attributes enable the growth of viable businesses focused on rapidly evolving technological products, which in turn create high-skilled, high-income jobs and contribute to poverty reduction. Lee primarily draws on the historical experience of Korea's chaebols—family-owned, diversified business groups—to support his arguments.

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[1] Lee (2019); (2024)

Korea's success in cultivating chaebols offers valuable lessons for other developing countries aspiring to build similar firms. It also provides a benchmark to understand why comparable strategies have failed in Malaysia, which pursued similar policies during the 1980s and 1990s.

This essay will first discuss the key features of large local businesses as drivers of economic catch-up. It will then analyse the steps Korea took to develop its chaebols, followed by a review of Malaysia's attempts to establish similar firms and the reasons for their limited success. The essay will conclude with key takeaways and policy implications.

It is important to note that while this essay emphasises the role of large local businesses in fostering innovation-driven technological development, this does not diminish the importance of other institutions in this process. The literature on innovation systems and industrial ecosystems highlights the interplay of various actors. However, as also acknowledged in industrial ecosystem literature[2], firms remain the central organisation within these ecosystems.

Finally, this essay is adapted from a forthcoming paper by Khazanah Research Institute on the challenges of green industrialisation in Malaysia.

How Big Businesses Foster Economic Catch-Up

Large local businesses in developing countries, often structured as business groups, play a critical role in driving technological innovation and economic catch-up, either complementing or substituting industrial policy[3]. A business group is a network of firms connected formally or informally, characterized by an intermediate level of binding—neither limited to short-term strategic alliances nor fully consolidated into a single legal entity[4].

Historical examples from Japan, Korea, and more recently, Chinese firms, illustrate how government industrial and competition policies initially supported the early growth and transformation of these business groups into competitive entities. Even without continued government backing, **business groups can use their substantial resources to overcome market entry barriers**. For instance, Samsung independently pursued entry into the memory chip industry, initially without government support, which was only extended later[5].

Business groups have the **unique advantage of sharing resources** among affiliates when exploring new markets or industries. As Penrose's resource-based theory of the firm explains, firms are bundles of resources and capabilities, and their growth depends on the variety and quantity of these assets[6]. Certain resources, such as R&D units and brand reputation, require substantial minimum investments and are tacit, indivisible, and internally developed. Being part of a business group allows firms to share these costs, providing a significant edge over stand-

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[2] Andreoni (2018)
[3] Lee (2019)
[4] Granovetter (1995)
[5] Shin (2017)
[6] Penrose (1959)

alone firms in entering new markets. Furthermore, the structure of the business group also provides advantages in building capabilities, which is discussed further in the next section.

Developing local R&D and brand strength is crucial for economic catch-up because many firms in developing countries are constrained by dominant players in global value chains (GVCs), which limit them to low-value-added activities. Oligopolistic lead firms at the top of the chain suppress markups and value creation by intensifying supplier competition, trapping developing countries in low-value-added segments[7]. This issue has hindered Malaysia's progress to high-income status. Similarly, reliance on multinational corporations (MNCs) often fails to bring high-value-added activities. While this is often attributed to talent shortages and weak institutional support in developing countries,[8] even in institutionally strong nations with strong talent attraction policies, such as Singapore[9], MNCs refrain from establishing frontier R&D and fabrication operations[10].

Access to financial resources is another key advantage of business groups, **enabling them to enter high-barrier, competitive markets**. This is particularly critical in developing countries with underdeveloped external capital markets. While Malaysia's capital market is relatively advanced, it still lacks funding for new technologies. For example, Malaysian banks and financial institutions are hesitant to fund green sectors due to limited risk assessment expertise[11]. Business groups can bridge these gaps by pooling resources to subsidise initial losses. Samsung exemplified this strategy during its early loss-making years in the memory chip business, which was subsidised by its business group until it became profitable[12].

Business groups in developing countries often emerge to **address market inefficiencies and institutional gaps that lead to high transaction costs**[13]. As Coase argued, firms minimise these costs by consolidating production processes, avoiding expenses related to finding suppliers, negotiating contracts, and monitoring compliance[14]. Lee identifies four reasons for institutional gaps in developing countries[15]. First, weak information systems and transaction mechanisms make brand-building costly, but business groups can spread these costs across subsidiaries. Second, underdeveloped financial markets discourage investment in unfamiliar ventures, while diversified groups are better positioned to secure funding. Third, limited skilled labour and inadequate education force firms to develop talent internally, allowing groups to optimise costs and enhance flexibility through in-house labour markets. Finally, extensive government intervention creates regulatory challenges, which larger groups can navigate more effectively. These factors underscore the critical role of business groups in addressing institutional voids and fostering economic growth.

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[7] Milberg and Winkler (2013)
[8] Rasiah (2017)
[9] Rikap and Flacher (2020)
[10] Rasiah and Yap (2019)
[11] Chandran, Baskaran, and Selvarajan (2022)
[12] Shin (2017)
[13] Lee (2019)
[14] Coase (1937)
[15] Lee (2019)

How Korean Big Businesses Build Capabilities

Firms in developing countries often lack the capabilities to enter high-barrier markets during the early stages of catch-up. Thus, understanding how firms acquire, develop, and sustain capabilities over time is crucial for innovation and market entry. Teece[16] describes this process as dynamic capabilities, or the ability to integrate, build, and reconfigure competencies to adapt to changing environments. Korean businesses demonstrate this progression, as many began as resource-poor, opportunistic rent-seekers with little technological connection between ventures. Through diversification, they developed "project execution capabilities," encompassing skills such as feasibility studies, project engineering, management, construction, procurement, and operational startup[17]. These capabilities laid the foundation for future successes in competitive markets.

Korean firms like Samsung progressed through three stages of capability development before reaching a stage capable of technological innovation[18]. In the initial stage, business groups had limited competencies and **relied on rent-seeking strategies**. Their competitiveness largely depended on building and leveraging relationships with the government, which controlled significant resource allocation. In Korea, this phase was facilitated by the distribution of US aid, managed by government officials who directed resources to an emerging entrepreneurial class, often in return for campaign contributions[19].

During the second stage, business groups **diversified into both related and unrelated industries, driven by industrial policies and market opportunities**. The government played a key role by providing subsidised working capital credit for exporters, long-term credit for targeted industries, and credit guarantees for foreign borrowing[20]. Additionally, competition policies spurred firms to improve performance. Price controls pushed firms to compete on quality rather than cost, merit-based subsidies incentivised productivity improvements and talent acquisition, and export targets stimulated production, generating Kaldor-Verdoorn effects that reinforced investment and productivity gains[21].

In the third stage, diversification laid the foundation for integration benefits. Business groups began **horizontally integrating across distantly related sectors or vertically integrating within specific industries**. These integrations offered advantages over outsourcing, particularly in overcoming market inefficiencies in externally sourced inputs. Vertical and horizontal integration enabled firms to maintain high quality, ensure efficient coordination, and enhance punctuality.

[16] Teece (2007)
[17] Lee and He (2009)
[18] Lee (2019)
[19] Amsden (1989)
[20] Ibid.
[21] Ibid.

Finally, in the fourth stage, business groups **developed the capabilities needed for technological innovation**, often evidenced by the creation of new products or patents. Vertical integration from the prior stage proved instrumental, fostering close buyer-seller interactions that encouraged learning and innovation. The organisational structure of business groups supported this stage by enabling shared development costs and leveraging "lumpy" intangible resources, such as R&D capabilities, across affiliates. These arrangements also facilitated higher levels of knowledge spillovers within the group compared to arm's-length market relationships, further enhancing innovation.

Malaysia's Attempt to Build Local Big Businesses in Comparison to Korea

Malaysian businesses have not experienced the same trajectory of development as their counterparts in South Korea. While Malaysia does have large businesses, they have not evolved from rent-seekers into innovators, largely due to a combination of economic and social pressures that undermined the effective use of government allocated rents intended for learning and capability-building[22]. A notable example of this failure can be seen in the collapse of major corporations in the heavy industries and the Bumiputera capitalists nurtured under Mahathir's administration in the 1980s and 1990s.

During this period, the government aimed to foster private capitalists, particularly Bumiputeras, to promote industrialisation. It intervened in markets to alter incentives and allocated rents for capital accumulation through preferential treatment, including licenses, privatised projects, and directly negotiated contracts. These measures sought to transform Bumiputera entrepreneurs into dynamic, diversified conglomerates[23]. Additionally, rents for learning were allocated through protective policies, such as domestic content requirements in the automobile industry and vendor development programs to support local companies. However, these efforts largely failed. The 1998 Asian Financial Crisis exposed the fragility of Bumiputera conglomerates, many of which faced financial collapse, necessitating bailouts and renationalisation of their holdings. This marked the failure of rents for accumulation, epitomised by DRB's inability to sustain Proton's R&D investments amid competition and high debt, leading it to pivot to more protected, non-tradable sectors[24].

Proton's struggles further underscored the challenges of balancing rent allocation for capability-building with the demands of social appeasement. Proton's dependence on Bumiputera vendors, who supplied 80% of its components, reflected the state's obligation to accommodate UMNO's intermediate Bumiputera class. Patron-client relationships within UMNO led to factionalisation, weakening the state's ability to enforce discipline on rent recipients[25]. This blurred the distinction between rents for learning and rents for social accommodation, ultimately preventing Proton from achieving technological competitiveness or cost efficiency[26]. Proton's case symbolised

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[22] Tan (2014); (2018); (2021); Sen and Tyce (2019)
[23] Sloane (1998)
[24] Tan (2007); (2014)
[25] Tan (2014); (2018)
[26] Tan (2018)

broader failures in Malaysia's industrial upgrading and the state's inability to ensure firms utilised rents to enhance productivity.

Korea, in contrast to many developing nations, had a strong state with minimal opposition from excluded social groups, while the weak power of lower-level factional supporters in the ruling social faction ensured high state enforcement capacity[27]. This favourable political environment persisted from General Park's coup in 1961 until the democratic transition in 1987. During this period, the developmental state's capabilities remained intact, even amidst political conflicts. Relative political stability allowed the ruling coalition to adopt a long-term horizon for policymaking, creating the ideal conditions for sustained growth and social stability[28]. These factors collectively enabled the construction of a robust developmental state.

Korea's lack of entrenched, powerful social networks made it easier for the Korean state to discipline rent recipients[29]. Policymakers were able to make rents conditional on export performance without businesses leveraging alliances with influential political factions to protect their rents. Lower-level politicians and informal organisations lacked the independent power to shield *chaebols* from state-led restructuring or discipline. This dynamic allowed the Korean government to enforce policies effectively and ensure that *chaebols* aligned with national development goals.

Furthermore, by the 1990s, Malaysian businesses faced increasing competition due to external liberalisation pressures from the WTO, ASEAN, and APEC. These forces, driven by the geopolitical dominance of the USA and its allies, ushered in an era of "compressed development," characterised by reduced policy space and the removal of incentives and tariffs[30]. In this environment, uncompetitive Bumiputera capitalists shifted towards protected, low-productivity sectors like construction, real estate, and share trading, further diverting rents away from manufacturing and capability-building. The state's inability to discipline rent allocation compounded this shift, leaving businesses ill-equipped to innovate[31].

Malaysia's inability to develop innovative business groups also stems from the timing of its industrialisation efforts. South Korean conglomerates like Samsung had already advanced through the stages of capability development by the 1990s and were competing in high-value-added, innovation-driven industries[32]. By contrast, Malaysian business groups, both Bumiputera and non-Bumiputera, were still in the early stages of diversification during this period. Even firms like the Hong Leong Group, which entered the electronics and electrical industry in the 1970s, lacked significant technological innovation capabilities by the 1990s—a situation that persists today. The compressed development era, with its diminished policy space and lack of robust infant industry protection, further constrained Malaysian firms' ability to acquire and develop

[27] Khan (2010)
[28] Khan (2016)
[29] Ibid.
[30] Whittaker et al. (2020)
[31] Tan (2018)
[32] Lee and He (2009)

new capabilities. Consequently, they were discouraged from entering high-entry-barrier markets, especially without substantial state support. Meanwhile, South Korean firms, already equipped with innovative capabilities by the 1990s, were well-positioned to compete independently.

Conclusion

The development of large businesses plays a pivotal role in driving technological innovation and enabling countries to achieve economic catch-up, as demonstrated by the experiences of nations like Korea. Big businesses, often organised as business groups, bring significant advantages to industrialisation and economic progress. They pool substantial resources, share costs for developing critical capabilities like R&D, and they can overcome barriers to entry in high-value-added sectors. Furthermore, their organisational structure facilitates knowledge spillovers, efficient coordination, and integration across supply chains, which are critical for fostering innovation and competitiveness.

Korea exemplifies how large businesses can act as engines of growth when the political conditions also support the creation of a strong developmental state. The chaebols benefited from strategic government policies, including conditional rents tied to export performance and a political environment conducive to disciplining rent recipients. This alignment enabled Korean firms to evolve from rent-seeking entities into globally competitive innovators, propelling the nation into the ranks of advanced economies. The state's ability to manage rents effectively and focus on long-term industrial goals underscores the potential of big businesses to catalyse economic transformation.

In contrast, Malaysia's experience highlights the challenges of fostering innovative big businesses in a fragmented political and institutional landscape. Efforts to develop Bumiputera capitalists and industries, such as the national automobile sector, were often hampered by the inability to effectively discipline rent-seeking behaviour. Strong lower-level ruling party factions hindered accountability, leading to inefficiencies and stalled progress. The constraints of the compressed development era, coupled with limited state capacity to enforce accountability, further restricted Malaysian firms from moving into high-value-added activities.

Despite these challenges, the potential of big businesses to aid economic catch-up remains undeniable. They can serve as vehicles for resource mobilisation, capability development, and entry into high-value-added markets, provided they operate within a conducive policy environment. Korea's example demonstrates that aligning state capacity, political stability, and institutional discipline with the needs of large businesses can unlock their transformative potential.

The decline of the WTO's Appellate Body may present a window of opportunity for Malaysia to re-engage with industrial policy. This shift in the global trade landscape could empower the Malaysian government to utilize a broader range of policy tools to support the growth of domestic big businesses.

However, several challenges may hinder the effective implementation of such policies. The current ruling coalition, comprised of diverse interests – a multiracial urban middle-class, a Malay party with a rural base, and regional parties seeking greater resource allocation – necessitates a delicate balance in policy allocation, potentially diluting resources available for focused industrial policy. Furthermore, the fluid nature of coalition politics can create instability. Shifting political alliances and internal disagreements may lead to policy paralysis or even reversals, hindering the development of consistent and effective industrial policies.

Despite these challenges, Malaysia can explore avenues for nurturing big businesses in strategically important industries. Khazanah Nasional, with its past experience in nurturing industries like microchip fabrication through its ownership of Silterra, could play a crucial role. Khazanah's diverse holdings and capabilities may provide unique advantages. For instance, the company can leverage existing capabilities within its portfolio to foster synergies and facilitate knowledge transfer across different sectors.

While the specific sector may differ, long-term financial support and a sustained commitment to industrial development are crucial for success. However, the success of such initiatives hinges on the political will and commitment of the government. Past shifts in policy priorities under different leaderships highlight the importance of fostering a consistent and sustained focus on industrial development.

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