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THE UNIVERSITY OF HULL

Fiscal Federalism:
The Study of Federal-State Fiscal Relations in Malaysia

being a Thesis submitted for the degree of

Doctor of Philosophy

in the University of Hull

By

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Abstract

The subject of fiscal federalism has been associated for many years with economics, in particular with the study of public finance. However, its political dimension is often neglected. This is the case in the conventional study of fiscal federalism in Malaysia, which focuses on the economic perspective. The aim of this thesis is to examine the design, implementation and problem of fiscal federalism in Malaysia as a political process in promoting national integration and the unity of the federation. This research is based on an intrinsic case study approach as the subject of fiscal federalism attracts strong public interest, which requires an in-depth study of the case. In doing this research, a combination of narrative report, statistical analysis and interview has been used.

One of the significant findings of this research is that the design of fiscal federalism in Malaysia is essentially based not on the federal spirit, but on the strong central government theme imposed by the colonial authority concomitant to the historical and political background to the formation of the federation. As a result, today, fiscal federalism displays a federal bias and mounting centripetal forces, even to the extent of coercion on the states, making the federal government grow bigger and more dominant, financially and politically. Thus, the working of fiscal federalism depends not on what is enshrined in the Constitution and federal spirit but on centre-state political interactions. If states' politics are not affiliated with the ruling political party that control the federal government, federal-state fiscal relations will be strained. The effects are felt in petroleum royalties payments, disbursement of grants, borrowing and other form of fiscal 'sanction' imposed by federal executive supremacy. On the other hand, if the states are ruled by the same political party, they become financially complacent. To all intents and purposes, the exclusive control of revenue sources by the centre has enabled the federal government to prevent most states from falling to the opposition party, thus ensuring a majority in parliament. The outcome is that the states are subordinated and subservient to the centre and hence the futures of the states are subject to the federal government's 'unilateral action'. In the long run, Malaysia is moving towards becoming a unitary state. This is the antithesis of the federal spirit, and thus becomes a threat to the federation. Therefore, fiscal federalism is a crucial acid test of the viability of any federation. Fortunately, thus far, Malaysian federalism had passed the test, though the states find more pain than gain. In the final analysis, this thesis suggests that structural reform of the federal-states' financial arrangements should be undertaken in order to strengthen the states' finances and subsequently reduce the states' dependence on the largesse of the federal government for funds.

Acknowledgements

This thesis would never been completed without fullest support from many people and organisations who assisted me while I was conducting research for this study. First and foremost, I am grateful to the Foreign Commonwealth Office (FCO) who awarded me the British Chevening Scholarship tenable at the University of Hull and the Government of Malaysia for giving me study leave to do my research.

Secondly, I wish to express my deepest gratitude to my supervisor, Professor Michael Burgess of the Department of Politics and International Studies, and Director of the Centre of European Study, the University of Hull, who supervised my work on this thesis. His invaluable guidance, advice and constructive criticisms on my draft are very much appreciated. Without him, this thesis would never been completed. His help and advice were a great encouragement to me during the years of my study.

Many thanks also go to my colleagues at the Ministry of Finance Malaysia and Economic Planning Unit, Prime Minister's Department, as well as state governments' Financial Officers. I am also indebted to the helpfulness of the staff of the libraries of the University of Hull, the University of Malaya, the INTAN Kuala Lumpur, the National Libraries, Malaysia, and last but not least to the Fiscal Library, International Monetary Fund (IMF), Washington. My thanks are also due to persons who prefer to remain anonymous, for giving me ideas and criticism, in particular with regard to the Malaysian economy and politics.

Last but not least, I would like to express my sincere appreciation to my mother, Semah Sidek, for her prayers and encouragement as well as to all my brothers and sisters for their moral support, and to my wife, Jamaliah, and my children for their tolerance and understanding during my course of study.

With all of them, I share the credit for this work.

ISMAIL H. BAKAR

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Abbreviations

AKAR	Parti Angkatan Keadilan Rakyat (Sabah) (People's Justice Party (Sabah))
BN	Barisan Nasional (National Front)
FDD	Federal Development Department
FLC	Federal Level Committee
FMS	Federated Malay States
GDP	Gross Domestic Product
GRM	Parti Gerakan Rakyat Malaysia (Malaysian People's Movement Party)
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
ISA	Internal Security Act
MCA	Malaysian Chinese Association
MIC	Malaysian India Congress
MOF	Ministry of Finance
NEP	New Economic Policy
NFC	National Finance Council
OLS	Ordinary Least Square
OPP	Outline Perspectives Plan
PAS	Parti Islam Se Malaysia (Pan Malaysia Islamic Party)
PBB	Party Pesaka Bumiputera Bersatu Sarawak (United Sarawak Native Inheritance Party)
PBS	Parti Bersatu Sabah
PDA	Petroleum Development Act
PETRONAS	Petroleum Nasional Berhad

PPP	People's Progressive Party
RM	Ringgit Malaysia (Malaysian Ringgit)
SAPP	Sabah Progressive Party
SNAP	Sarawak National Party
SUPP	Sarawak United People's Party
UMNO	United Malay National Organisation
UMS	Unfederated Malay States
UPKO	United Pasok Momogun Kadazandusun Organisation (formerly Party Democratic Sabah)

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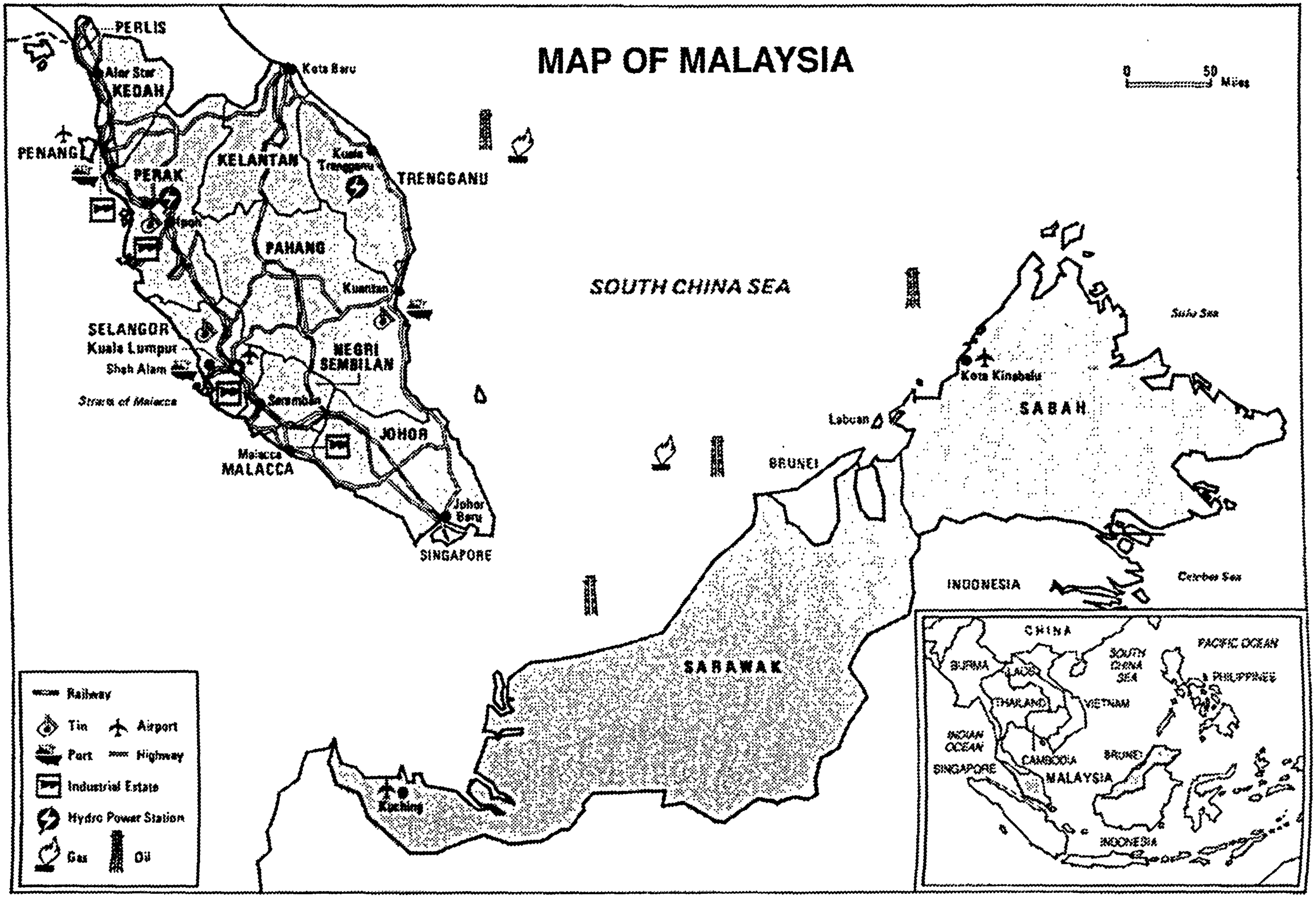
MAP OF MALAYSIA



Chapter 1

Introduction: The Problems Outlined

The fundamental aspect of political operations in a federal system is the financial arrangements between the centre and its constituent governments, referred to as fiscal federalism. According to Watts, 'their importance derives from the fact that the scope and character of their financial resources play a large part in determining the relative political and economic roles and influence of the different governments within the polity' (Watts, 2002:2). The conventional approach in the study of fiscal federalism views this important subject of federalism almost purely in economic terms (Watts, 2003a; Ter-Minassian, 1997; Oates, 1972), hence it fails to accentuate the political aspects of the particular federation in reference to the concept of federalism (Gramlich and Wood, 2000), for instance, the implications of the political and party system for federal-states' fiscal relations. Indeed, fiscal federalism is a kind of 'political device' (Birch, 1961: 113) as well as a 'political process' (Bhattacharayya, 2001) in conflict management, involving financial aspects of federalism to ensure stable and cordial federal-state relations. As a political process, fiscal federalism can be used to achieve the final aim of federating - unity in diversity - by facilitating flexibility and adjustment to accommodate diversity and changing socio-economic needs and political circumstances of the federation.

Due to the significant implications of politics as well as economics in the conduct of fiscal federalism, this thesis will examine the practice of fiscal federalism in Malaysia from both economics and political perspectives. To begin with, this chapter will provide a brief interpretation of intergovernmental fiscal relations and fiscal federalism in Malaysia, as well as outlining the background of Malaysian federation and the latest political developments as they affect the posture of fiscal federalism. The rest of this chapter will state the problems to be addressed in this research, and the research objectives, research question, and research methodology to be used in this thesis. The

scope of the research and significance of the study, as well as research delimitation, will also be discussed. The organisation of the thesis will be described at the end of this chapter.

1.1 Introduction to intergovernmental fiscal relations

Initially, it is useful to discuss in brief the definition of intergovernmental fiscal relations as used both in a federal and non-federal system of government. In general, the term intergovernmental fiscal relations can be defined as a system of financial arrangements between central government / federal government and state government / provincial government / regional governments, as well as local government (Bird and Vaillancourt, 1998; Bahl, 1995).

However, there are significant conceptual differences between intergovernmental fiscal arrangements in a federal and non-federal system or in a multi-level financial system. In particular, intergovernmental financial arrangements in a federal system of government, or fiscal federalism, are constitutionally entrenched, as a result of the political bargaining process at the time of federating, while intergovernmental fiscal arrangements in a non-federal system or in a multi-level financial system are not constitutionally entrenched; instead they are based on concession (Lockwood, 2004: 80; Hopkins, 2002: 170; Bhargava, 1953: 86).[1]

In the unitary system of government or multi-level governance, fiscal policy is centrally designed and fiscal functions undertaken by regional governments are merely an extension of the centre's fiscal policy by way of decentralisation or concession. In federal systems, on the other hand, both central and constituent units carry out fiscal policy and functions and the relations between them are constitutionally enumerated. Nevertheless, it remains the case that, although both central and constituent units in the federal structure

[1] This includes fiscal decentralisation, devolution, or delegation of powers and functions from the central government to lower level of governments – regional or local.

undertake fiscal functions, the degree of fiscal impact on macroeconomics is different, contingent on among others - constituent units' fiscal capacity and administrative capability to undertake functions, geographic characteristics and the nature of party system (Rodden and Wibbels, 2002; Raimondo, 1992).

The conventional study of intergovernmental fiscal relations is concerned with what functions and taxes should be the responsibility of federal government and which of these functions can be undertaken by the state governments. Other issues are what types of transfers should state governments receive, and whether state governments should be granted borrowing powers. However, as noted above, for fiscal federalism, it is more than a matter of financial arrangement: it involves the political aspect of federalism as well as the background to the particular federation. In a non-federal system, intergovernmental fiscal relations are primarily based on the economic functions of government (stabilisation, redistribution and allocation) as well as economic efficiency and equity. Intergovernmental fiscal relations in a federal system are guided by three principles: first, the economic functions of government (stabilisation, redistribution and allocation) and the principles of public / federal finance; second, the federal spirit (cooperation, partnership, respect, and mutual trust); and third, the political operation of federation / federalism (the political system and political party). However, the last two principles have constantly been overlooked or neglected in the design of fiscal federalism (Bird and Vaillancourt, 1998; Ter-Minassian, 1997; Oates, 1972).

Inappropriate design of intergovernmental fiscal relations leads to the problem of fiscal imbalance, defined as state governments' inability to raise sufficient own revenue sources to undertake the functions and responsibilities assigned to them. Fiscal imbalance arises between the centre and lower levels of governments (vertical imbalance) as well as among the lower levels of governments (horizontal imbalance), both of which have

detrimental effects on regional economic development. For a federal system, the effect goes beyond economic instability; it may cause conflicts and disunity and might even pose a threat of disintegration of the federation itself. However, thus far, no concrete theory of intergovernmental fiscal relations has appeared in the literature that relates to both economic and political aspects of federalism / federation (Watts, 2003a; Ter-Minassian, 1997; Oates, 1972). As a result, economists continue to seek the ideal design of intergovernmental fiscal relations. In 1972, Wallace E Oates recognised the importance of such relations, which he expressed thus:

> 'The increasing interest in intergovernmental fiscal problems has led over the past decade to a growing body of economic literature on fiscal federalism. There is yet to appear, however, a comprehensive theoretical and empirical treatment of the economic theory implies about the division of fiscal functions among levels of government, and examines the extent to which such a theoretical structure can explain the organization and workings of the publics sectors of different countries' (Oates, 1972: vi).

For this reason, economists and political scientists are renewing their study of intergovernmental fiscal relations, following the movement towards greater decentralisation of functions from central to lower levels of government, as well as the advancement in public finance management and political development toward democratic government (Litvack, *et al.*, 1998).[2] Consequently, in discussion of intergovernmental fiscal relations in federal and non-federal systems, the issues of decentralisation of functions are a major focus of the debate (Ter-Minassian, 1997; Tanzi, 1996; Bahl, 1995). This is because economists view fiscal federalism as tantamount to fiscal decentralisation (Bird and Vaillancourt, 1998). This is grossly inaccurate in the context of federalism and federation.[3] Although fiscal federalism is different from fiscal decentralisation, the design of fiscal federalism within the federal system can lead to a fiscal decentralisation process.

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[2] Substantial discussion on the movement toward greater fiscal decentralisation in developed, developing and less developed countries can be found from the World Bank official website: http://www.decentralization.org/; http://www1.worldbank.org/publicsector/decentralization/; and http://www.worldbank.org/wbi/publicfinance/decentralization/.

[3] See Chapter 2 for discussion on fiscal federalism and federalism.

1.2 Why does fiscal federalism matter?

As noted above, there are differences in the systems of intergovernmental fiscal relations between federal and non-federal countries. The design of intergovernmental fiscal relations in a non-federal system is regarded as a concession, devolution or decentralisation of fiscal matters to a local or regional government and hence can be rescinded without constitutional complication, while in a federation, it occurs by constitutional provisions resulting from the political bargaining process at the time of federating (Lockwood, 2004:80). Hence, it becomes the states' constitutional right and, therefore, any changes involve the judicial process and constitutional amendment. As discussed above, the system of intergovernmental fiscal relations in a federal system or fiscal federalism is based on the federal spirit (co-operation, partnership and respect between the federal and state governments) and political aspect of federalism, apart from the economic functions of government (stabilisation, redistribution and allocation) and the theory of federal finance / public finance. However, for economists, the term 'fiscal federalism' is used to refer to intergovernmental financial arrangements in the multi-level governance regardless of the system of government, as well as to refer to financial arrangements in decentralised fiscal systems.[4] This is because a certain terminological ambiguity has surrounded this subject, even among political scientists themselves. For instance, the term 'federalism' has been vaguely defined by many political scientists (Burgess, 1986; King, 1982), let alone the term 'fiscal federalism'. No clear distinction has been made between the terms 'federalism' and 'federation'; therefore they are often used interchangeably. Hence, it is not surprising if both political scientists and economists have defined the term 'federalism and fiscal federalism' vaguely. These interpretive differences are rooted in the fact that federalism is a concept used in political science, while fiscal is a public finance / economic term. However, due to a lack of harmonisation between the two disciplines regarding fiscal federalism, the economists'

[4] See Musgrave and Musgrave (1976: 613-614); Oates (1972), and Bird and Vaillancourt (1998)

design of fiscal federalism suffers from a lack of political values, especially when it comes to the understanding of the federal spirit - the pillars of federalism and federation. Therefore, the understanding of federalism and federation is an important prerequisite for the study of fiscal federalism.

Why does fiscal federalism matter? The answer should be considered from both economic and federalism perspectives. From the economic point of view, intergovernmental fiscal relations are an important element in public finance as they involve the fiscal interaction between levels of government in the provision of public goods and services in an efficient manner, in that goods and services that have nationwide benefit are assigned to the federal government and public goods and services with localised benefit are assigned to the state governments. This is important to achieve balanced economic growth throughout the federation. However, in most federal countries, the federating units are characterised as having different social characters, economic endowments or geographical advantages. As a result, some states experience strong economic growth and others do not. This scenario causes internal migration of labour and capital from the 'have-not' to 'have' states. Failure to undertake corrective measures to redress economic imbalances will push the level of economic development of the 'have not' states further behind, which poses a threat to the political stability of the federation. This is because the subject of finance is easily politicised, as it 'has (the) capacity to divide, to set the centre against the regions and the regions against each other' (Jeffery, 2003b: 183). Thus, the role of the federal government to undertake necessary corrective measures through fiscal adjustment is of paramount importance to eliminate inequalities among members in federation.

From a federalism point of view, intergovernmental fiscal relations in a federal system are regarded as an essential prerequisite for both levels of government to execute what Daniel Elazar called the 'self-rule and shared rule' principle (Elazar, 1987:5) originating

from the federating process. Proper design of intergovernmental fiscal relations can help to mitigate and manage tensions/conflicts within the federation to meet the objective of federalism. Based on the Canadian experience, Meekison (2002) identified the ten most common sources of conflicts in federation: disputes over (i) constitutional jurisdiction, (ii) revenue sharing or vertical imbalance, (iii) horizontal imbalance, (iv) federal spending power, (v) regional development policy, (vi) control of natural resources, (vii) social heterogeneity (cultural, linguistic or religious), (viii) political ideology, (ix) clash of personalities among political leaders, and (x) the lack of intergovernmental consultation. As can be seen, most of these issues are concerning intergovernmental fiscal relations. Therefore, fiscal federalism is more than a matter of economics; it is a political process of dealing with the financial conflict between federal and state levels by facilitating flexibility and adjustment to accommodate the diversity within the federation. This is so because in the federation, the federating units have 'states' rights and state powers' (Scott, 1964) which are constitutionally enumerated. States' rights imply that the federating units have the right to be treated fairly (especially in relation to economic wealth), while state power refers to the fact that in a federation, powers (taxation, spending and other administrative functions) are divided and some are shared between the centre and constituent states (Watts, 1999a). As such, both levels of government have their own fiscal functions, to be undertaken within their constitutional fiscal capacities. However, in reality, most federating units have different fiscal capacities, which in turn prevent them from delivering public goods and services at equal level between states in an efficient manner.

From the economic point of view, as noted above, public goods and services that produce nation-wide benefits should be provided by the federal government, while localised benefits are best provided by state and local governments (Oates, 1972; Boadway, 1979: 406). However, due to low fiscal capacity (as a result of the inappropriate design of

intergovernmental fiscal relations), constituent governments depend on federal government for financial assistance in the form of transfers to remedy inequality and fiscal imbalances as well as local externalities. This assertion strengthens the arguments that fiscal federalism is a political process as well as a political device to achieve the ultimate goal of federating: unity in diversity. In this regard, the words of Burgess and Gress (1999b: 180) that 'fiscal federalism can ... have an indirect impact upon both the legitimacy and long term political stability of the federal states' are worth noting as they justify the importance of fiscal federalism. Thus, fiscal federalism, as a political process, has a significant role in the federation to meet the objectives of federating.

In short, considering the importance of the subject, it is not surprising that the issue of fiscal federalism in federal countries has engendered considerable scholarly attention. Thus, from both economic and political points of view, intergovernmental fiscal relations are relevant issues in federation and hence should be designed in a way that takes into account both economic and political considerations.

1.3 The Federation of Malaysia in brief

Malaysia is a parliamentary federation. In the Federal Constitution, the word 'federation' was explicitly emphasised to codify the system of government for Malaysia and its structure (Article 1(1)).[5] The Federation of Malaysia consists of thirteen states: eleven states in peninsular Malaysia (Johor, Kedah, Kelantan, Malacca, Negeri Sembilan, Pahang, Penang, Perak, Perlis, Selangor and Terengganu) and two states, Sabah (formerly known as North Borneo) and Sarawak in the northern part of Borneo (Article 1(2)). In terms of geography, Sabah and Sarawak are separated from peninsular Malaysia by the South China Sea by about 430 kilometres (see Map of Malaysia). The present Federation of Malaysia is the successor to the Federation of Malaya of 1948, which comprised the existing eleven states in peninsular Malaya. These were the founding

[5] See Malaysia (1999).

members of the federation when it was first created in 1948, which subsequently gained independence from the British in 1957. In 1963, the Federation of Malaysia was formed when Sabah, Sarawak and Singapore joined the Federation of Malaya. However, in 1965 Singapore seceded from the federation to become an independent state, leaving the thirteen members of the federation as it exists today.

Table 1.1
Malaysian Population

	Total (million)	% of total			
		Bumiputera*	Chinese	Indian	Others
1947	4.908	49.8	38.4	10.8	1.0
1957	6.279	49.8	37.2	11.3	1.7
1961	7.232	50.0	36.0	11.3	2.7
1970	8.819	50.0	37.0	11.0	2.0
1980	11.473	55.1	33.9	10.3	0.7
1991	18.380	60.6	28.1	7.9	3.4
2000	23,275	65.1	26.0	7.7	1.2

Note * : Comprises of Malays and other natives of Sabah and Sarawak
Source: Department of Statistics, Malaysia

As with other federations, the Malaysian federation displays wide diversity, as it is composed of heterogeneous ethnic groups (multi-cultural, multi-religious, multi-lingual), different levels of economic development (different natural resources), and different political beliefs. In 2000, the total Malaysian population was 23.3 million; of which *Bumiputera* (which literally means 'sons of the soil', and comprises Malay and other indigenous/natives group) represented the largest proportion, followed by the Chinese and Indians (see Table 1.1). Among *Bumiputera*, Malays are dominant. Despite these differences, Malaysia has maintained 'unity in diversity', the common objective of federal creation, to the present day. However, tensions between unity and diversity surface from time to time over a variety of issues: language, culture, education, religion and, predominantly, economic issues.[6] Hence, in a country such as Malaysia, where the population is heterogeneous, national unity is vital for political stability and stable economic development. In the first Outline Perspective Plan (OPP1) (1971-1990), and

[6] For further discussion on the issue of unity in diversity in Malaysia, see Ismail (2003).

OPP2 (1991-2000),[7] it was paramount that the ultimate goal of national development was to be national unity. These development plans have been implemented within the framework of the New Economic Policy (NEP),[8] which was introduced in 1970, after the racial riots in 1969.[9] Thus,

> 'National unity remains the ultimate goal of socio-economic development because a united society is fundamental to the promotion of social and political stability and sustained development. Development policies and strategies under the National Development Plan take cognizance of the diversities of Malaysians – ethnic, linguistics, cultural, and religious as well as regional – so that a harmonious, tolerant and dynamic society could be progressively created. Aside from socio-political and cultural considerations, continued social and political stability as well as the efficient management of the economy are factors crucial to the realization of its goal and objectives' (OPP2: 3).

Nevertheless, the problem faced by the federation is not only due to multi-ethnicity issues, but also to political issues. In Malaysia, political conflict arises due to political rivalries between the ruling party and the opposition as to who should control the state governments. The result is aggressive party competition to win over states: this, in turn, causes difficulty in every sphere of federal-states relations, most notably in the conduct of fiscal federalism. Thus, Malaysia's ability to maintain unity in diversity is dependent on two factors: first, how the government of the day deals with issues of multi-ethnicity, and second, to what extent cordial federal-state relations (including its fiscal arrangements) can be maintained - and conflicts that arise are solved according to the federal spirit, regardless of which political party controls the federal and state governments.

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[7] The OPP is a long-term economic blueprint for Malaysian economic development in which Vision 2020 is the ultimate goal of this plan.

[8] The NEP aimed at promoting greater national unity by reduction and subsequently eradication of poverty as well as restructuring of society to correct economic imbalance between *Bumiputera* and non-*Bumiputera*, thus reducing and eventually eliminating the identification of race according to economic function.

[9] The May 13, 1969 social unrest was strong evidence of the importance of national unity in the process of nation-building. This incident was blamed partly on the failure of economic policies to bring about economic well-being to the Malays in comparison to the non-Malays. The events of May 13, 1969 were 'sparked as a result of political and economic differences between two communities *[Malays and Chinese]*. The Malays were dissatisfied with their economic welfare, while the Chinese, economically superior, wanted more political rights' (Rais Yatim, 1994: 47).

1.4 Research background: The problem of Malaysian fiscal federalism

Intergovernmental fiscal relations or fiscal federalism is only one aspect of the wider spectrum of federal – state relations. In Malaysia, intergovernmental relations are constitutionally entrenched, in that the division of powers between the federal and state governments is clearly spelled out in Part VI of the Federal Constitution, under the heading, 'Relations between the Federation and the States'. This Part comprises seven chapters: Distributions of legislative powers (Chapter 1), Distributions of executive powers (Chapter 2), Distributions of financial burdens (Chapter 3), Land, National development (Chapter 4), Federal Surveys (Chapter 5), Advice to states and inspections (Chapter 6), and National council for local government (Chapter 7).

Intergovernmental fiscal relations between the federal and the individual states are set out under special financial arrangements in Part VII, entitled 'Financial Provision'. This consists of two chapters: Chapter 1 on general financial arrangements between federal and state governments and Chapter 2 on specific arrangements with Sabah and Sarawak. Both Parts VI and VII of the Federal Constitution determine the kind of fiscal federalism to be employed in Malaysia; they remain the basis of present federal-state fiscal relations. Looking at these provisions, clearly federal-states fiscal arrangements in Malaysia is very detailed, giving almost no room for conflict to occur. However, one notable observation is that fiscal arrangements in Malaysia are heavily centralised, with some elements of fiscal autonomy for the states of Sabah and Sarawak. But the question is why fiscal arrangements were heavily centralised and to what extent the federal-state relations as set out in the Constitution are implemented according to the federal spirit. If they are not appropriately implemented, is there any structural shortcoming that prevents the proper working of fiscal federalism? This will be investigated in Chapter 3.

As noted above, the most salient feature of federal – state relations are its fiscal arrangements, involving expenditure and revenue assignment, intergovernmental

transfers and borrowing powers between federal and state governments. However, the design of fiscal federalism in Malaysia has led to the federal government controlling most of the productive revenue sources, leaving states with only limited and unproductive revenue sources. The result is persistent fiscal imbalance on the part of state governments, which requires regular fiscal adjustment. Fiscal imbalance exists in two forms, vertical and horizontal imbalance. Vertical imbalance exists as a result of limited revenue collections compared to the expenditure functions to be carried out, while horizontal imbalance occurs due to differences in fiscal capacities among state governments (Wilson, 1995; Holzhausen, 1974). This creates the serious problem of fiscal imbalance which further exacerbated by the centralise nature of the Malaysian political system. [10]

Fiscal imbalances need to be corrected through proper financial adjustments, notably through federal transfers. In the general terms of public finance, 'transfers' refer to special payments made from a higher level (national, central or federal) of government to a lower level of government (sub national, state or local). It is a form of 'compensation' for what state governments have given up (that is powers to tax) to the federal or central government. Theoretically, the role of transfers is to address financial problems faced by the constituent government. From the economic point of view, transfers act as a redistributive agent to correct any imbalances in socio-economic development and, politically, it is a form of political contract between federal and state governments. This is important to achieve optimum distribution of income and wealth and ultimately to foster and to achieve a more balanced growth throughout the federation, and, more importantly, to achieve national integration and national unity in the federation. However, in the Federal Constitution, redistributive purposes, such as those involving equalisation, are not constitutionally entrenched or recognised, unlike in Canada and

[10] See Chapter 4 for a detailed discussion on fiscal imbalance and fiscal adjustment. Also see Chapter 5 on the determinants of federal transfers to states and their significance to state governments.

Germany.[11] Furthermore, although flexibility provides for proper fiscal adjustment, the problem of fiscal imbalance persists. Initial investigation shows that the design of fiscal adjustment was not intended to negate revenue – expenditure discrepancies. This problem will be discussed in Chapter 4 and Chapter 5 of the thesis.

Another important aspect in the fostering of cordial relations is the need for the establishment of an institution of intergovernmental relations. For this purpose, the Federal Constitution provides for the establishment of councils for specific matters to facilitate relations between the federal and state governments. These councils are the National Land Council to deal with land matters (Article 91), the National Council for Local Government (NCLG) for local government affairs (Article 95A) and the National Finance Council (NFC) for federal – state fiscal matters (Article 108). Recognising the fact that the NFC is an important institution to mitigate federal-states fiscal conflicts, as envisaged by the framers of the Constitution, the pathology in the role of the NFC is of significant importance to this study.

The NFC is an important body within the Malaysian fiscal federalism, particularly as it acts as an institution to foster federal-state fiscal relations, as well as to ensure the smooth running of intergovernmental fiscal relations between the federal and state governments, should conflict arise. However, the function of the NFC is purely advisory. The federal government may consult the NFC in respect of any matter relating to federal – state fiscal matters, and similarly the state governments may consult the Council in respect of any matter that affects the financial position of the state. Article 108 (4) and (5) of the Federal Constitution outlines the main function of the NFC, that is, the making of grants, assignment of revenue, states' borrowing requirement, states' development plans, and

[11] For Canada, see Section 36 (2) of the 1982 Constitution Act, and for Germany, see Section 72, Basic Law (Constitution).

any other matters regarding federal-state fiscal matters. Thus, the Council has a crucial role in presiding over the direction of intergovernmental fiscal relations.

However, this Council is not an impartial one, unlike the Commonwealth Grants Commission in Australia and the Finance Commission in India. In practice, the NFC is politically influenced in its operation because the members of the NFC represent the political echelon of the ruling party, which are the majority in the Council and are presided over by the Prime Minister. Hence, looking at the structure of the NFC, political influences on centre-state fiscal relations are inescapable. This is due to the fact that the executive supremacy of the ruling party in the council is forceful: it can be used to reinforce states' political allegiance toward the ruling party. As a result, states are continually subservient and subordinated to the centre. Undoubtedly, the conduct of the NFC is the antithesis of the federal spirit. Hence, it is not surprising that the NFC can become an important instrument of strong centralisation. The influence of the executive supremacy of the ruling party on the NFC will be examined in Chapter 7.

The working of fiscal federalism also suffers as a consequence of serious party competition. Political party competition arose due to political differences, in particular between the ruling party (the *Barisan Nasional* led by the United Malay National Organisation [UMNO]) that control the federal government and the opposition party, which controls the states. For instance, when Kelantan and Terengganu were under the Pan Malaysia Islamic Party (PAS) and Sabah under the *Parti Bersatu Sabah* (PBS),[12] political conflict was intense, which made every sphere of federal-state relations more difficult, especially with regard to fiscal matters, as proved by the formation of the Federal Development Department (FDD) and other 'fiscal sanctions' imposed on the opposition government aimed at weakening the credibility of the opposition to rule the

[12] Kelantan has been under the opposition party (PAS) since 1990 and Terengganu between 1999-2004. Sabah was under the PBS from 1985 to 1994.

states. For those states ruled by the opposition party, issues of the fiscal relationship between the federal and state government frequently emerge in the political debates. These could lead to political instability. The contemporary issue of federal-state relations, in particular with the PAS led-Terengganu government (1999-2004), over the cessation of petroleum royalties payments, is indeed a manifestation of severe party competition. The upshot is incessant 'cold war' between the federal and Terengganu government. The contemporary significance of these events and circumstances will be examined in Chapter 6.

1.5 Research questions

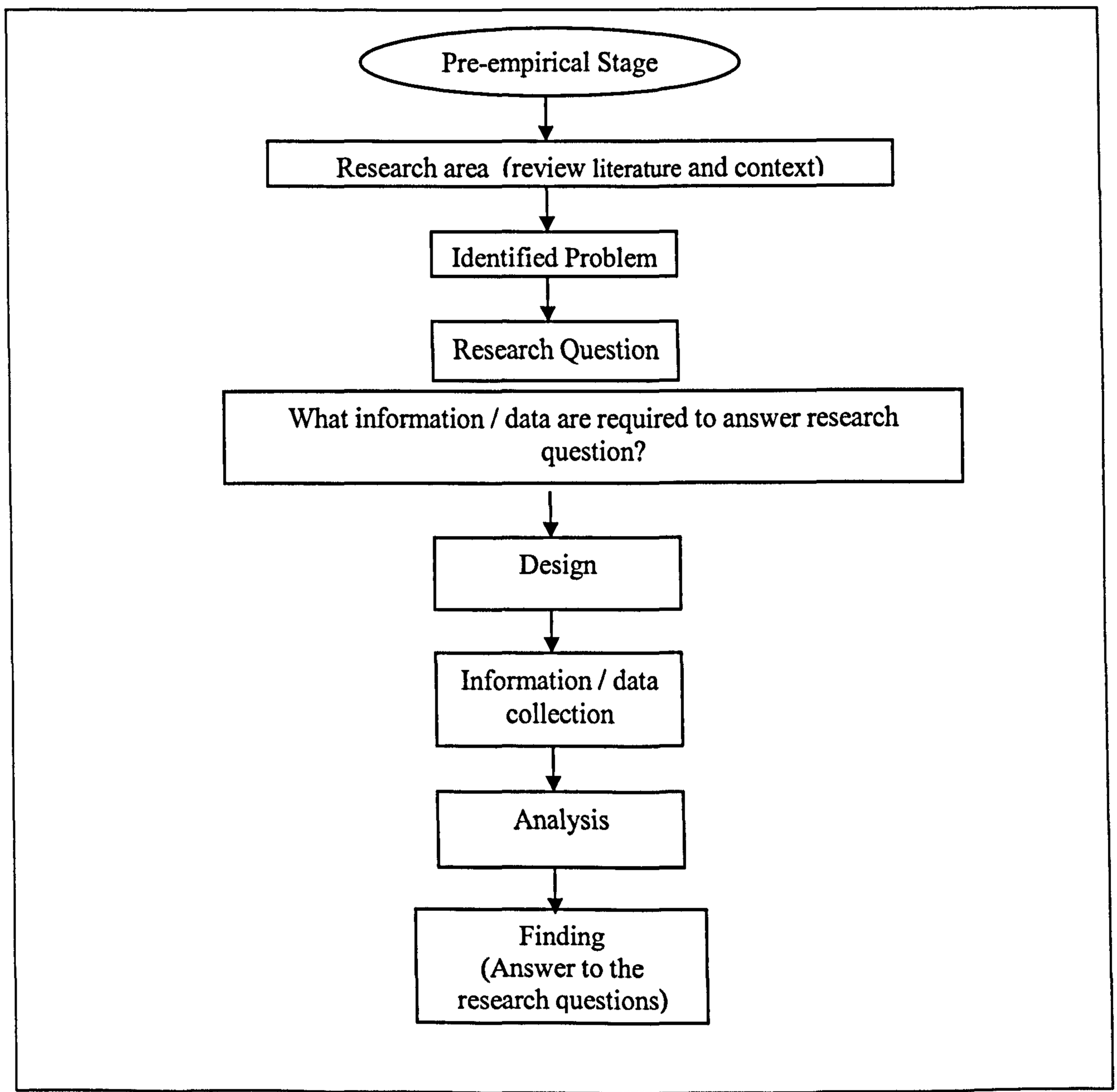
Research questions are pivotal in designing the research process. They define what the researcher is trying to find out from the research. Research questions can serve to organise the research (give direction and coherence); delimit the project (by showing its boundaries); keep the researcher focused on the project (clearly stated research questions can help the researcher to bring the research back on track when unforeseen problems arise in the course of research); provide a framework for writing up the project; and determine what data and information are needed (Punch, 1998). Although 'there is no foolproof, automatic way of generating research questions' (Robson (1993: 25), the general rules that can be applied are as follows: first, decide on a general research area (focus area); and secondly, refine (identify) more specific research questions (Punch, 1998). In developing research questions for this study, the researcher discussed the issues with fiscal practitioners, as well as carrying out a literature review related to the subjects to be studied (Punch, 1998; Robson, 1993). Table 1.2 highlights the research process of this study.

There are many ways of developing research questions. It can be done either deductively or inductively. Punch suggests that one way to develop research questions 'is to identify a

general to specific questions. Another is more inductive; to begin with some specific questions and to work from these back to more general questions' (Punch, 1998: 34). As such, it is useful to identify the research area before developing general research questions and subsequently defining specific research questions. According to Punch, general research questions can serve as a guide to the researcher's thinking and help the researcher in organising the research project. On the other hand, specific research questions, which ideally follow from the general question, can 'direct the empirical procedures, and they are the questions which actually answered in the research' (Punch, 1998: 34).

Table 1.2

Simplified Research Model



Source: Punch (1998: pp 42)

Based on the suggestions by Punch (1998) and Robson (1993), as well as a literature review and discussions with the fiscal practitioners in Malaysia, the researcher developed the following research questions to be answered in this study. The research area / focus of the thesis is on intergovernmental fiscal relations in Malaysian fiscal federalism, that is, what financial arrangements exist between the federal and state government with regard to the assignment of expenditure functions, revenue sources, transfers system and finally borrowing powers between the levels of governments. The general research question, which is derived from the above research area, is 'why is fiscal federalism as set out in the Malaysian Constitution not working effectively according to the federal spirit as it should be?' From this general research question, the researcher formulated the following specific research questions.

a. How was fiscal federalism in Malaysia designed in the first place? Is there any shortcoming in the design of intergovernmental fiscal relations that causes persistent fiscal imbalance? Does the design follow the federal spirit, as well as economic considerations?

b. How effective / significant is the transfer system to overcome the persistent problem of fiscal imbalance? The main objective of intergovernmental transfers is to equalise the differences in states' financial position and to fill up the budgetary deficit to meet their constitutional obligations.

c. How can the state governments' finances be improved / strengthened for better intergovernmental relations in the quest for unity in diversity within the federation? In relation to this question, how can the role of the NFC be enhanced from merely being an advisory body to the government to become a more effective institution in intergovernmental fiscal relations? and,

d. In view of current political developments and circumstances, how severely was fiscal federalism affected?

1.6 Research objectives

In the light of problems identified in relation to intergovernmental fiscal relations in Malaysia, the objectives of this research are as follows:

i. To examine the design of fiscal federalism, (the assignment of expenditure, revenue / taxes, grants systems and borrowing powers) and how it conforms to the concept of federalism and the theory of fiscal federalism;

ii. To investigate and analyse the development and characteristics of the grants system in Malaysia. This investigation should furnish some insight into the problems of the existing grant / transfer system;

iii. To analyse the implementation of the existing grant / transfer system designed to remedy the financial difficulties of the state governments and to investigate empirically the determinants of federal transfers and the significance of grants to the state governments' expenditure;

iv. To examine the role of the National Financial Council as an institution of intergovernmental fiscal relations to foster federal – state fiscal relations; and

v. To analyse the importance of fiscal federalism as a political process in promoting national integration and unity within the federation. This is an important prerequisite for a stable government and sustainable economic development, in line with the objective of achieving Malaysia's Vision 2020 - to be a developed nation.

1.7 Research methodology: A case study approach

There are many research methodologies available for doing research (Mauch and Birch, 1983). However, as this research is devoted to an investigation of a specific case of public interest, a case study approach has been selected. According to Yin (1994), the case study is one of several ways of doing social science research; others include

experiments, surveys, histories and the analysis of archival information (Yin, 1994). Indeed, the case study is a research strategy and as such, is used in many situations, including policy analysis and political science research (Yin, 1994; Robson, 1993). According to Stake (1994) and Punch (1998),[13] there are four characteristics of a case study; first, the case must be a bounded system, that is, the case must have boundaries. The researcher should clearly define the boundaries of the case. Secondly, the case must be a study of something specific, that is, the researcher must focus the research and decide the logic and strategy of the research. S/he must be clear about the selected case. Thirdly, the wholeness, unity and integrity of the case should be preserved; and finally, multiple sources of data and multiple data collection methods are likely to be necessary. Many case studies use methods such as observations in natural settings, interviews, and narrative reports as well as questionnaires and numerical data. Hammersley (1989) defined the term case study as 'the collection and presentation of detailed, relatively unstructured information from a range of sources about a particular individual, group, or institution' (Hammersley, 1989: 93).

1.7.1 What is the case?

The 'case' in the case study research approach could be anything. To Punch, 'almost anything can serve as a case, and the case may be simple or complex' (Punch, 1998: 150). Huberman and Miles (1994) define a case as a 'phenomenon of some sort of occurring in a bounded context - the unit of analysis, in effect' (Huberman and Miles, 1994: 440). Yin (1994) describes a case as the unit of analysis, which forms part of the research design in the case study approach (Yin, 1994). Normally, there is a focus of attention and a more or less specifically defined temporal, social, and/or physical boundary involved. Similarly, Robson (1993) defines a case as a 'situation, individual, group, organization or whatever it is that we are interested in' (Robson, 1993: 51). Thus,

[13] See Stake (1994: 236), and Punch (1998: 156)

it can be concluded that the 'case' in case study could be anything, from the simple to a complex phenomenon. In this study, the 'case' is specific, that is, the conduct of fiscal federalism in Malaysia, and the boundary of the case is 'within the context of federalism and the Malaysian political system'. This is the basis of the general research question indicated earlier: why is fiscal federalism as set out in the Constitution not working effectively according to the federal spirit as it should be?

To substantiate the case, however, there is no best single method available. Instead, researchers use a combination of methods including observation, interviews, narrative reports, questionnaires or numerical data. According to Bell, although observation and interviews are most frequently used in case study, other methods cannot be ignored (Bell, 1993: 6). Methods of collecting information are selected based on their appropriateness for the task. Certain case studies involve observation, recording and analysing of the background, development, current condition and environmental interaction of one or more individuals, groups, communities, business or institutions for stages or patterns in relation to internal and external influences (Mauch and Birch, 1983: 72). As such, a combination of narrative report, statistical analysis and interview are used in this research.

1.7.2 Why a case study?

The case study approach used in this study draws on Yin (1994). It also follows suggestions from Punch (1998), Stake (1994), Bell (1993), and Robson (1993). Different researchers have different purposes in studying a case and basically, case studies can be classified into three categories; first, the intrinsic case study, that is, a study that is undertaken for better understanding of the particular case; second, the instrumental case study, where a particular case is examined to provide in-depth knowledge of the issues or refinement of the relevant theory; and third, the collective case study, in which an

intrinsic case study and an instrumental case study are combined in order to inquire into the phenomenon or general condition.[14]

According to Robson (1993), 'case study is a strategy for doing research which involves an empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence' (Robson (1993: 52) and case studies often deal with matters of public interest (Stake, 1994). Besides, a case study can be used as a means of identifying key issues in a particular phenomenon which merit further investigation, although the majority of case studies are carried out as free-standing exercises (Bell, 1993). Using a case study helps the researcher to study the problem in depth using a variety of sources (Yin, 1994; Bell, 1993). As Bell (1993) puts it, 'the case study approach is particularly appropriate for individual researchers because it gives an opportunity for one aspect of a problem to be studied in some depth within a limited time scale' (Bell, 1993: 7). Furthermore, according to Bell (1993), although a case study is a study of a single event, this is 'not to say that the study of a single event is not worthwhile' (Bell, 1993: 7). Again, as confirmed by Bassey (1981), an important criterion for judging the merit of a case study is the extent to which the details are sufficient and appropriate. Punch (1998) also agrees that a case study allows the selected case to be studied in depth appropriate to its complexity. Further, according to Punch, 'the case study aim is to understand the case in depth, and in its natural setting, recognizing its complexity and its context. It has also a holistic focus, aiming to preserve and understand the wholeness and unity of the case. Therefore the case study is more a strategy than a method' (Punch, 1998:150).

The great strength of the case study method is that it allows the researcher to concentrate on a specific instance or situation and to identify, or attempt to identify, the various interactive processes at work. As such, a case study can be used as a means of identifying

[14] See Stake (1994: 242), and Punch (1998: 152)

key issues, identifying which are worth of further investigation, especially if the case is of interest to the public. According to Punch (1998), the basic idea of a case study 'is that one case (or perhaps a small number of cases) will be studied in detail, using whatever methods seem appropriate ... and the general objective is to develop as full an understanding of that case as possible' (Punch, 1998: 150). Although there are arguments promulgated by such as Stake (1994) and Goode and Hatt (1952) as to whether or not the case study is a type of research methodology or technique, the most important thing is that the case study approach can be used in studies involving a variety of disciplines because it provides holistic and meaningful characteristics and it is able to provide a variety of evidence on the phenomenon studied (Yin, 1994; Merriam, 1989). According to Yin (1994):

> 'The case study contributes uniquely to our knowledge of individual, organizational, social and political phenomena...the case study is common research strategy in psychology, sociology, political science (Yin, 1994: 2). ... the case study allows an investigation to retain the holistic and meaningful characteristics of real-life events...the case study's unique strength is its ability to deal with a full variety of evidence - documents, artifacts, interviews, and observation...' (Yin, 1994: 8).

Hence, the case study is an appropriate approach to study a specific issue or particular case in-depth, such as issues of public interest, and this is in line with this study of intergovernmental fiscal relations, which is a very specific topic within the area of federalism.

Yin (1994) highlighted three types of case study strategies: exploratory, descriptive and explanatory (Yin, 1994: 3-4). In a case study, all research strategies (exploratory, descriptive and explanatory) might be relevant in some situations; in other situations, only two strategies may be relevant. In practice, more than one strategy is normally used in any given study, for example a survey may be included within a case study or a case study within a survey. For instance, explanatory case studies can be complemented by other types strategies -'exploratory' and 'descriptive' case studies. To this extent, the

various strategies are not mutually exclusive. But, in certain circumstances, one specific strategy has a distinct advantage.

Based on works by Stake (1994) and Yin (1994), this study adopts an 'intrinsic single case study' approach with 'explanatory and descriptive strategies', that is, the research is undertaken to obtain a better understanding of the particular case by explaining and describing the theories in relation to the subject being studied. This is in line with Stake's comment that,

> 'The bulk of the case study work is done by people who have intrinsic interests in the cases. Their intrinsic case study designs draw the researcher towards understanding of what is important about the case within its own world, not so much the world of researchers and theorists, but developing its issues, contexts, and interpretations' (Stake, 1994: 242)

On the question of generalisability of research findings from the case study, that is, how far the research findings can be generalised or transferred to other settings or to the population as a whole, most researchers agree with Bassey (1981: 73) that relatability of the findings is more important than generalisability. Lincoln and Guba (1985) concur with Bassey's (1981) statement that research outcomes may usefully to be thought of as the lessons to be learned from the study and these lessons are not generalisations but working hypotheses that relate to an understanding of the problem under study (Lincoln and Guba, 1985). Thus, the most important thing in a case study is whether or not the finding is relatable to the theory and principles in relation to the subject under study and what lessons can be learned. According to Punch (1998), there are two types of case study situations where generalisation would not be the objective. First, the case may be so important, interesting, or misunderstood that it deserves study in its own right. Or it may be unique in some very important respects, and therefore worthy of specific study (intrinsic case study). Secondly, a strong argument can often be made about studying a negative case (instrumental case study), such as where a particular case seems to be so

different from others, or even sometimes completely opposite to others, that it needs special attention.

Denzin (1983) claims that whether or not a case study should seek generalisation and representativeness depends on the context and purposes of the particular case. As such, generalisation should not necessarily be the objective of all research projects, whether case studies or not (Denzin, 1983). Nevertheless, according to Punch, there are many case studies where the researcher has in mind more than just the case being studied, and where researchers want to find something more broadly applicable (Punch, 1998). In short, how can generalisability be produced from a case study? It depends on the purposes of the case study and the way its data are analysed. Taking the experience of these researchers, it suggests that for the case study approach, generalisation of research findings is not the main issue. This is because the case being investigated is so important, and attracts such public interest, that it deserves to be studied in its own right.

1.8 The significance of the research

The choice of this topic is important for several reasons. First, there is a noticeable void in the existing body of literature concerning fiscal federalism in Malaysia, especially on the political background leading to the design of fiscal federalism. There is, to date, no single study which traces how fiscal federalism evolved, from a federalism perspective, since the early days of the first federal idea in Malaysia. Previous studies on fiscal federalism were conducted merely for economic purposes, concentrating in particular on whether or not the federal principle was adhered to in the design process, and therefore provide little analysis on the design of fiscal federalism in Malaysia. It is important to analyse the root cause of the problems facing Malaysian fiscal federalism and to examine why fiscal federalism is not working as effectively as it should within the federal spirit.

Second, it has been found that only limited study has been done on fiscal federalism in Malaysia from both federalism and the political perspective. Most of the studies on fiscal federalism in Malaysia are devoted to meeting economic objectives, and hence are focused on economic considerations of equity and efficiency. Examples are the studies by Lai (1968), Holzhausen (1974), and Umikalsom (1991). Lai (1968) focused on the working of federal finance in the context of the plural society in Malaysia, while Holzhausen (1974) analysed the working of federal finance in the context of economic development. Umikalsom (1991) also analysed the performance of federal-states financial arrangements from a public finance point of view, especially with regard to revenue, expenditure, and borrowing performance. For this reason, this study utilises a combination of economics and politics approaches rather than a purely economics perspective. Furthermore, past studies lack analysis on the proper interpretation of federalism in reference to fiscal federalism. Therefore discussion of the terminological interpretation of federalism is useful to link the theory and practice of fiscal federalism. This has been the principal shortcoming of the past studies on fiscal federalism in Malaysia. This study therefore intends to fill the gap left by previous studies. It is in this spirit of enquiry that the researcher undertakes this study to provide increased understanding of fiscal federalism in Malaysia.

Third, a review of past research and theses on intergovernmental fiscal relations in Malaysia confirms the fact that no similar study has been attempted concerning federalism and the political perspective. In this respect, this study is different from previous studies, which largely adopted an economic approach. Moreover, most of the studies were conducted more than twenty years ago and were not specifically devoted to intergovernmental fiscal relations / fiscal federalism. Since then, important changes and developments have taken place in the Malaysian Federation which have reshaped the conduct of intergovernmental fiscal relations. Thus, it is timely to undertake a study of

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intergovernmental fiscal relations in the light of these developments in order to suggest how intergovernmental fiscal relations can better contribute to economic progresses and the achievement of the Vision 2020, which is the long term vision for Malaysia to be a developed nation by the year 2020. The former Prime Minister Mahathir Mohamed in his statement affirmed that:

> 'There can be no fully developed Malaysia until we have finally overcome the nine central strategic challenges that have confronted us from the moment of our birth as an independent nation. The first of these is the challenge of establishing a united Malaysian nation with a sense of common and shared destiny. This must be nation at peace with itself, territorially and ethnically integrated, living in harmony and full and fair partnership...' (Mahathir Mohamad, 1991).

Finally, research on intergovernmental fiscal relations has engendered considerable scholarly attention from all over the world[15] following the increasing trend towards political and fiscal decentralisation and the growing demand for fiscal autonomy by subnational governments. However, these researches are based purely on economic considerations.

In line with the new political development in Malaysia, federal states' fiscal arrangements have attracted strong public reaction, especially after the federal government terminated the payment of petroleum royalties to the Terengganu government. Therefore, it is timely to study the current practices of fiscal federalism in Malaysia to explore the problem and to investigate ways to improve intergovernmental fiscal relations to promote and strengthen national integration (between states in the federation) and national unity (among different ethnic groups) within the federal system, towards the achievement of the Vision 2020 - to be a developed nation.

1.9 Focus, scope and delimitation of research

According to Punch (1998), 'delimitation means the drawing of boundaries around a study, and showing clearly what is and is not included' (Punch, 1998: 272). As described

[15] See for instance Ter-Minassian (1997), Wildasin (1997), Bird and Vaillaincourt (1998), Litvack,*et.al*, (1998), and Bahl 2000).

earlier, this study focuses on the intergovernmental fiscal relationship between the federal and state governments. As such, the coverage of the study is limited to the following:

i. Analysis of the intergovernmental fiscal relations in Malaysia as stipulated in the Federal Constitution, that is, revenue and expenditure function, federal transfers and borrowing powers.

ii. An investigation into the problems of intergovernmental fiscal relations within the Malaysian federation, that is, fiscal imbalances (vertical and horizontal) as a result of (i) above, as well as the implications of the political system for the conduct of fiscal federalism.

iii. Analysis of how to improve the intergovernmental fiscal relationship, notably in respect of revenue-raising powers, expenditure assignment and the grant system.

This study combines both economic and political perspectives. It also discusses the structure of government, as well as the Malaysian political and party systems, as these aspects directly affect the conduct and efficiency of intergovernmental fiscal relations. However, this study does not include research on fiscal relations between the federal and local governments, interstates fiscal relations, and fiscal relations between state and local governments. This is the delimitation of this research.

1.10 Organisation of the chapters

The research is divided into eight chapters, including this introductory chapter, and the rest of this research is organised as follows:

Chapter 2 reviews the literature on the 'theory of fiscal federalism', the nature of fiscal federalism and the problems of fiscal federalism. The definitions of federalism and intergovernmental fiscal relations are also discussed extensively in this chapter, as they are relevant to this study. The discussion on the terminological interpretation of

federalism is important in order to understand how intergovernmental fiscal relations in a federal system should work. According to Punch (1998), 'in the traditional model of research, the literature is reviewed (often comprehensively) as part of the research planning and question development stage ... the literature can be a fruitful source of concepts, theories and evidence about the topic' (Punch, 1998: 43). The theory of public finance is also briefly examined and discussed in this chapter. This is important to link the theory and practice in the conduct of intergovernmental fiscal arrangements.

Chapter 3 surveys the kind of fiscal federalism practiced in Malaysia. This includes discussion on the evolution of federalism in Malaysia from the historical perspective, the design of fiscal federalism, and the structure of the government. Discussion on the evolution of federalism is essential in order to gain deeper understanding of the design of fiscal federalism in Malaysia; in particular, the division of power (legislative and executive) as well as other aspects of fiscal federalism, as enshrined in the Constitution. From this chapter, we will see how strong the power of the federal government is, as compared to the states, and why the federal government assumes it supervisory role as a 'care taker' or 'stakeholder' of states.

The main issue of intergovernmental fiscal relations arising from such a design of fiscal federalism is a problem of fiscal imbalances, originating from the fact that the federal government controls most of the more productive and flexible tax sources, whereas the states, despite their dynamic and expanding functions, are left with less productive sources of income. This is the main focus of Chapter 4. The upshot of inappropriate assignment of revenue sources is that the individual state revenue is rarely suffices to fulfil its constitutional obligations. This type of fiscal imbalance, known as vertical imbalance, denotes the need of all the states for financial support from the federal government. Another type of fiscal imbalance, horizontal imbalance, shows fiscal

imbalances between states arising from differences in their fiscal capacities and from the differences in the cost of fulfilling state functions to a certain minimum standard. These fiscal imbalances require financial adjustment by way of federal transfers to the state governments. Hence, this chapter is mainly devoted to the discussion and analysis of fiscal imbalances and transfers to remedy this problem.

Chapter 5 investigates the determinants of federal transfers to states using regression analysis. The aim of this analysis is to examine whether or not significant factors such as the federal and state governments' revenue and expenditure, national Gross Domestic Product (GDP), and size of population have any significant relationship in the making of the grants system to redress fiscal imbalances. This analysis is followed by an examination of the significance of federal transfers to the state governments' finance. From empirical assessments, it has been found that the current transfers system does not take into consideration federal government revenue performance, as the amount of transfers is still far too low compared to the amounts of federal government revenue collection. Hence the current system fails to negate states' revenue-expenditure gap. The situation is exacerbated by the political considerations influencing the disbursement of grants; payments are not forthcoming smoothly if the states are led by a political party different from that of the centre.

In Chapter 6, the actual working of fiscal federalism, the problems and challenges facing intergovernmental fiscal relations in Malaysia, are analysed, in particular the implications of the political operations and the party system. This is important because fiscal federalism is a political process inherent in the quest for unity within the diversity of a federation. In particular, this chapter considers to what extent the working of fiscal federalism in Malaysia is actually shaped by the states' political affiliation with the ruling party at the centre. Because of their particular importance, the federal-state conflicts over fiscal matters are also discussed. The petroleum royalties payment issue is used as a case

study to examine the implications of different political parties governing at the federal and state levels and their effect on the working of fiscal federalism. It is found that if political cohesion cannot be maintained at both levels of government, there is no guarantee that fiscal federalism will work effectively. Therefore, state governments' finances need to be strengthened.

The issue of strengthening state governments' finances is the focus of discussion in Chapter 7. To investigate this issue, interviews have been conducted with the fiscal practitioners, chosen on the basis of their expert knowledge of the specialist technical nature in the field of intergovernmental fiscal relations. The main objective of these interviews has been to obtain opinions about how to make improvements to the state governments' finance. The role of the NFC as an institution to foster federal-state fiscal relations is also examined. In short, this chapter suggests ways to overcome the existing shortcomings of intergovernmental fiscal relations, with the aim of strengthening state governments' finances, and hence reducing states' over-dependence on funds from the federal government.

The last chapter, Chapter 8, discusses the overall research findings in reference to the research questions set out in Chapter 1. One of the significant findings of this research is that fiscal federalism can only work well when the same party is in control at both federal and state levels. Otherwise, fiscal federalism will be strained and engulfed with conflicts. This is due to structural shortcomings in the design of fiscal federalism that gave exclusive powers, both legislative and executive, to the central government. Due to the centralised nature of the Malaysian political system and given the strong central financial power, any state government that is not politically affiliated to the centre's political elites will be subject to financial sanctions from the federal government. Based on the research findings, this chapter also highlights the contribution of research to the general body of knowledge as well as to the enrichment of literature on Malaysian fiscal federalism. It is

an important aspect of research, as pointed out by many researchers such as Bell (1993) and Punch (1998) that research findings should contribute to the enhancement of the body of knowledge. Finally, this chapter will offer some observations and directions for future research.

Chapter 2

Federalism and Fiscal Federalism

2.1 Introduction

There has been a resurgence of interest in fiscal federalism within most federal systems of government, following the renewal of interest in fiscal decentralisation in recent years and advancements in economic theory, as well as new sources of financing in public finance and public expenditure management (Bird, *et al.*, 2003; Bird and Vaillancourt, 1998; Ter-Minassian, 1997). Fiscal federalism, which refers to the intergovernmental fiscal arrangement between the federal and the constituent governments in the federal system, is the salient feature of the federation.[1] As briefly discussed in Chapter 1, the economic aspects of fiscal federalism are concerned with

a. the assignment of the expenditure function;

b. the assignment of revenue sources (taxation) to each level of government; and

c. how fiscal adjustments are designed to solve the problem of fiscal imbalance arising from these arrangements.

However, for the political scientist, fiscal federalism is not merely an economic matter, but is a political process towards achieving unity in diversity. Hence, the problem of federal-state fiscal arrangements is a fundamental problem in most federations, both in politics and economics, and has been the source of much federal-state dispute and conflict. Unlike in a unitary system, intergovernmental fiscal relations in federal systems are constitutionally entrenched, and cannot be changed unilaterally without consent from all members in the federation. Economists have debated the issue of fiscal federalism for many years in order to find the ideal fiscal arrangement that suits the theory of public finance and overall macroeconomic management. But political scientists have argued that

[1] The terms federal government or central government and the constituent governments or subnational governments (governments below the federal government) will be used throughout in this chapter. Central government refers to the upper tier of government in the federation while constituent governments or subnational government refer to state, Länder, canton, or province. The terms federal government and central government will be used interchangeably.

fiscal federalism should not be viewed strictly from the economic perspective *per se*, as it involves government and politics.[2] Consequently, political scientists regard fiscal federalism as part of the political economy issue (Inman and Rubinfeld, 1997; Beer, 1977) and hence the design of fiscal arrangements should also take into account both fiscal and non-fiscal issues, in particular, the political aspects of federalism 'within which these financial arrangements operate' (Watts, 2002: 2). This development has engendered great interest among many scholars and policymakers in every federation to reinvigorate the intergovernmental fiscal arrangement, and consequently calls for structural reform of federal-state fiscal relations.

In this chapter, the discussion will focus on the theoretical aspects of fiscal federalism as found in the current literature. However, before embarking on this task, it is imperative to review the terms 'federalism and federation' from the perspective of political science. This is of key importance, as the term federalism is drawn from the study of politics rather than economics. That is why a substantial portion of this chapter will be devoted to a discussion of terminological interpretations of such terms, in order to understand the working of fiscal federalism. Then the study will move on to the examination of federalism from an economist's point of view. There seem to be contrasting views among social scientists regarding the term federalism, as well as federation, due to the absence of linkage between the two disciplines. By making such a link, the thesis hopes to ensure impartiality in the analysis of fiscal federalism in Malaysia, which is the essence of this study. Hence, this chapter is in part intended to investigate that missing link. Analysis of the mainstream literature of fiscal federalism reveals that this aspect of political science has not been given due consideration. Therefore the lack of convergence between economics and the political science perspectives in the study of fiscal federalism results in a serious deficiency in the body of knowledge. From here, the study will examine

[2] Beer (1977), for instance, suggests that the design of fiscal federalism should take into consideration both fiscal and non-fiscal issues of the particular federation. See also Watts (2002).

fiscal federalism and its theory, concerning the question of assignment of powers: taxation, expenditure functions, borrowing powers as well as intergovernmental fiscal transfers. The analysis of terminological interpretation of federalism and federation, division of powers and functions will serve as a guideline for the study of fiscal federalism in Malaysia in the subsequent chapters.

2.2 Federalism and federation

What is meant by federalism? This is a simple and very basic question in the study of federalism and fiscal federalism. However, there is no direct answer to this simple question, and the term is 'notoriously difficult to define with precision' (Watts, 1998: 5). A review of federalism literature reveals that different writers give different interpretations of federalism, 'it has meant different things to different people' (Carnell, 1961: 16), which, more often than not, creates more confusion than clarification. Some see little difference between the terms 'federalism', 'federation' and 'federal government'. Hence, most of them have used the words federalism and federation interchangeably. In actual fact, there is a clear interpretive terminological difference between federalism and federation. Therefore, it is vital to begin with a terminological clarification before any analysis of the fiscal aspects involved in federalism can be made.

As noted in Chapter 1, there have been many debates among scholars, especially political scientists, about the definition of federalism and federation. Scholarly debate on the definitions of federalism and federation is not new (Watts, 1999a; Burgess, 1986; King, 1982). It has been debated for long a time and, still, the importance of the distinction between federalism and federation is not fully appreciated. As a consequence, the terms 'federalism and federation' have been perceived as synonymous, and hence continue to be used interchangeably (Burgess, 1986: 16).

Early discourses on federalism were mainly based on the work of Kenneth C. Wheare, which implicitly used the terms federalism and federal government interchangeably for describing federalism, federation, and federal government. Wheare, in his book, *'Federal Government'*, first published in 1946, claimed that for the government to be federal, it should have a federal principle, which he defined as 'the method of dividing powers so that the general and regional governments are each, within a sphere, coordinate and independent' (Wheare: 1953: 11). In this definition, Wheare focuses on the method of dividing powers to determine whether or not the country is federal. In his view, 'if the powers of the regional governments are specified and the residue is left to the general government' (Wheare, 1953: 12), the particular government is not federal. Therefore, 'the question where the residue of power is to rest is an important question in framing a federal government' (Wheare (1953: 13). This interpretation of federalism caused much confusion, as Wheare viewed federalism in terms of the division of powers, in particular who should hold the residuary powers - general or regional government, - and how the federal government should be organised. In essence, Wheare's interpretation of federalism essentially described the characteristics of federal government, with particular reference to the United States Constitution. However, one important observation is the kind of relationship that should be established between the federal government and the constituent units in a federation. According to Wheare, the functions of government are divided in such a way that the relationship between the national legislature, which has authority over the whole federation, and those state legislatures, which have authority only within the constituent units, should not be the relationship between superior and subordinates, but of co-ordinate partners in the governmental process. In other words, no government level must be subordinate to the level above.

Realising the fact that federalism is more than merely the division of powers, many scholars have attempted to redefine the term federalism, but the outcomes remained

unsatisfactory. Preston King commented that 'the fact, however, that a few writers have been inclined to make this distinction between federalism and federation is in no way to suggest that most do – for most make no distinction at all' (King, 1982: 20). Livingston (1956), for instance, attempted to define federalism in sociological terms. He described federalism essentially as a phenomenon of social diversity and argued that the essence of federalism lies not in the constitution or institutional structure but in the society itself:

> 'the essential nature of federalism is to be sought for, not in the shadings of legal and constitutional terminology, but in the forces – economic, social, political, cultural – that have made the outward forms of federalism necessary...*the essence of federalism lies not in the constitutional or institutional structure but in the society itself*' (Livingstone 1956: 2). (Emphasis added).

William H. Riker also defined federalism differently from previous writers. He saw federalism as a bargain between national leaders and officials of the constituent governments for the purpose of political enlargement[3] due to advancement in technological transport that 'makes it possible to rule a larger geographic area from one centre, to fill a treasury more abundantly, to maintain a larger bureaucracy and police, and, most important of all, to assemble a larger army' (Riker, 1964: 2) and as a result help one government 'to enlarge its area of control' (Riker, 1964: 2). Finally, Riker concluded his interpretation of federalism as follows:

> '...I interpreted federalism *as a bargain between prospective national leaders and officials of constituent government for the purpose of aggregating territory, the better to lay taxes and raise armies.* This bargain can be defined quite precisely so that, when presented with an instance of a constitution, one can say whether or not it belongs to the class of federalisms. The rule for identification is: A constitution is federal if (1) two levels of government rule the same land and people (2) each level has at least one area of action in which it is autonomous, and (3) there is some guarantee (even though merely a statement in the constituent) of the autonomy of each government in its own sphere' (Riker, 1964: 11). (Emphasis added).

Daniel Elazar also described federalism in terms of the characteristics of federal states, with reference to the United States Constitution. Federalism, according to Elazar, is the unification of political organisations to unite separate polities where power is distributed

[3] In his analysis, Riker (1964) employed two assumptions, namely, expansion condition and military conditions. In the final analysis he claimed that 'the military and expansion conditions are necessary to the occurrence of federalism' (pp 48). Riker's interpretation, however, cannot be generalised to cover all federations, and hence, it can be challenged.

between general and the constituent units (Elazar, 1972), according to the self-rule and shared rule principles (Elazar, 1987).[4] However, he argues that federalism is more than an arrangement of government structures. He puts it as follows:

> 'Federalism can be defined as the mode of *political organisation that unites separate polities within an overarching political system by distributing power among general and constituent governments* in a manner designed to protect the existence and authority of both. By requiring that basic policies be made and implemented through a process of negotiation that involves all polities concerned, federal systems enable all to share in the overall system's decision-making and executing process. In its simplest form, federalism means national unification through the maintenance of subnational systems. *In a larger sense, however, federalism is more than an arrangement of governmental structures; it is a mode of political activity that requires the extension of certain kinds of cooperative relationships throughout any political system it animates'* (Elazar, 1972: 2-3). (Emphasis added).

But to A. H Birch, federalism is a concept that has no fixed meaning. The meaning depends on the approach used to define the term. In his view, federalism is 'a political device, which is adopted, to further ends which are always partly and sometimes predominantly economic' (Birch 1961: 113). A prominent scholar of federalism and the comparative analysis of federalism, Ronald L. Watts, defined federalism as multi-tier government, which combines the principles of self-rule and shared rule that are based on the ability to accommodate socio-economic and political diversity. According to Watts,

> 'Federalism is basically not a descriptive but *a normative term and refers to advocacy of multi-tiered government combining elements of shared rule and regional self-rule*. It is based on the presumed value and validity of combining unity and diversity and accommodating, preserving and promoting distinct identities within a larger political union. The essence of federalism as a normative principle is the perpetuation of both union and non-centralisation at the same time' (Watts (1999a: 6). (Emphasis added).

To summarise the above discussion, terminological interpretations of federalism by most writers have been, by and large, confined to the debate surrounding the characteristics and the act of federation. Three conclusions can be drawn from the early literature on federalism: first, federalism has not been given a clear meaning – the meaning has been dependent upon the aims of the writers. Second, most of the definitions of federalism refer to unions of states / multi-levels of government and how powers are divided

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[4] *Self-rule* means that the respective members of the federation govern its jurisdiction based on constitutional distribution of powers and functions, while *shared rule* means the sharing of powers between federal and state government to achieve the common goal of federation (Watts, 1999: 83). This concept was first introduced by Elazar (1987).

between them; and finally, for many years, scholars perceived the terms federalism and federation as synonymous and used them interchangeably. Burgess summed up the early discourses on federalism as:

> 'this legacy presented the study of federation and federal government in essentially historical, constitutional and juridical terms. It was a very static interpretation of the subject, which understandably reflected the political science scholarship of the age' (Burgess, 2000a: 24).

However, in 1982, more than forty years after Wheare, scholars reconceptualised the term federalism. These developments stem from advances made in the study of political science as well as the influence of other disciplines. According to Burgess,

> 'studies of federation, federal political systems and federal government have progressed and expanded *pari pasu* with the overall advances made in political science itself. The so-called 'behavioural revolution' in the post-war social sciences exposed the narrow, rigid and legalistic view of the subject and brought it under the intellectual influences of economics, sociology and psychology, resulting in much wider, more inclusive, scholarly ambit' (Burgess, 2000a: 24).

Among them is Preston King, who defined federalism in a manner distinct from the previous writers. In his book, *'Federalism and Federation'*, published in 1982, Preston King espoused the new discourse on federalism and described federalism as a philosophy or ideology that brings socio-economic and political diversity into larger political union of federation.[5] To shore up King's argument, Burgess (1986) asserted that federalism is 'unquestionably ideological in the sense that it is a prescriptive guide to action. It seeks to achieve federation' (Burgess, 1986: 14). He further emphasised,

> 'federalism to mean the recommendation and (sometimes) the active promotion of support for federation. It is ideological in the sense that it can take the form of an overtly prescriptive guide to action, and it is philosophical to the extent that it is a normative judgement upon the ideal organisation of human relations and conduct' (Burgess, 2000a: 26-27).

King's and Burgess's arguments that federalism is an ideology can be traced back to the origin of the word 'federal'. According to McCoy and Baker (1991) cited by Burgess (2000a: 6), the original word federal was derived from the Latin word *'foedus'*, which means 'covenant'. According to S. Rufus Davis, the word *'foedus'* is linguistically related to the *'foederal* phenomenon of Rome and after' (Davis, 1978: 3). This has a

[5] See King (1982), especially Chapter 2.

similar meaning to faith and trust - the basis of a covenant. Covenant could mean a league, treaty, or compact. To Davis,

> 'the idea of covenant betokens not merely a solemn pledge between two or more people to keep faith with each other, to honour an agreement; *it involves the idea of cooperation, reciprocity, mutuality, and it implies the recognition of entities* – whether it be persons, a people, or a divine being. *Without this recognition there can be no covenant*' (Davis, 1978: 3). (Emphasis added).

Thus, the meaning of federal embodies the concept of a covenant. According to Burgess (2000a: 6), 'a covenantal order is federal and a federal order is covenantal'. Thus, to a great extent, federalism is deep-rooted in the idea of covenantal theory;[6] 'the concept of covenantal federalism embodies a set of normative principles which bind partners together in a moral contract or agreement of trust ... based upon mutual recognition, tolerance, respect, obligation and responsibility' (Burgess, 1999: 58), which form the moral basis of the federal spirit. The underlying principle of the federal spirit is federal trust or comity, or *Bundestreue*. It has two meanings:

> 'first, it denotes the duty of all governments in the federation *to take each other's interests into account* in the exercise of their respective public responsibilities. And secondly, it refers *to the totality of the federal relationships, the well being of the whole state*' (Burgess 2000a: 17). (Emphasis added).

Taking account of all of these, Burgess described the federal spirit in the following way: 'faith, mutual trust, partnership, respect, friendship, loyalty, public duty, consent, consultation and cooperation resonate with the preconceptions and presumptions of what is at its core a moral discourse' (Burgess 2000a: 17). Thus, a federal system which is established as a result of the voluntary joining together of a number of previously independent states into a new and larger political system[7] should adopt the federal spirit in the conduct of federal-state relations. With the federal spirit, a genuine federal relationship could be established and maintained.

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[6] A comprehensive analysis of covenantal theory can be found in Burgess (1999: 56-62) and Davis (1978), especially Chapter 1.

[7] There was no single reason for federal creation in most federal countries. However, the most common reasons are: common threats / enemies, common markets, political, historical, and geographical linkages (see Birch, 1966).

Conversely, the word federalism adds the suffix 'ism' to the root word of 'federal'. This suffix has various uses and meanings[8], such as (i) an action or its result (such as hypnotism, baptism); (ii) a condition or state of being (such as barbarism, despotism); (iii) a doctrine, theory, belief, or practice (such as stoicism, Platonism, liberalism, conservatism, communism); and (iv) a peculiarity of speech (such as a localism, or an Americanism). With regard to federalism, the third meaning, that is, to indicates a doctrine, theory, belief, or practice is more appropriate to be used as a basis to understand the core of federalism. Within these meanings, the words 'theory and belief' are closer to covenantal theory. In covenantal theory, the partners are bound together in a moral contract or agreement of trust based on a common belief, and the relationships between partners are essentially federal (Burgess, 2000a; Burgess, 1999). The 'liveliness' of this contract is based on the federal spirit.[9] Thus, with the combination of the covenantal concept as a basis of federal spirit and the suffix 'ism' to the root word federal, the definition of 'federalism' is now unambiguous. However, no theory of federalism or model of federalism has been found in the literature (Watts, 2002).

In summary, for a federation to exist, its founders should possess the fundamental ideology of federalism. However, King argues that federalism does not necessarily end with the creation of a federation. According to him 'although there may be federalism without federation, there can be no federation without some matching variety of federalism' (King, 1982: 76). Thus, from the political scientist's point of view, these definitions of federalism are more practical than those found in the early literature, which were based on the method of dividing the powers, that 'reflected the political science scholarship of the age' (Burgess, 2000a: 24). Further, Burgess emphasised that:

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[8] See Webster's Third New International Dictionary. Vol. 11, 1986, Merriam – Webster, Inc. United States, pp 1198

[9] See Burgess (2000b) for detailed discussion of the federal spirit.

'whichever perspective of federalism is adopted – and each is both highly contentious and contestable – the concept is anchored in the belief that political authority should be organised, as far as possible, in a manner, which accurately reflects natural socio-economic diversities. This means that in practice, authority should be divided and power dispersed among and between different groups and organisations in society. But if we are to fully understand and appreciate its significance, federalism must be viewed through conceptual lenses, which are sensitized to different political cultures. Only when we consider its application to specific cultural and historical milieux can we begin to fill out the concept with particular meaning. Like federation, federalism is rooted in its context, and meaning derives from context. We must therefore locate the concept in its own distinct setting: historical, cultural, intellectual, social, economic, philosophical an ideological' (Burgess, 2000a: 27).

In line with Burgess's (2000a: 24) reference to the 'behavioural revolution' in social science in the post war years, the study of federalism grew beyond the boundaries of politics; notably into the field of economics. In the 1950s, economists began to show their interest in federalism after realising that some theories of public finance that had been developed in a unitary setting had only a limited application to federal systems of government, since the constituent units differ in their financial strength, level of economic development (due to differences in natural endowment), and more importantly the notion of the political aspects of federalism that neither level of government is subordinate to the other (Watts, 2002). The conventional study of public finance was developed based on the unitary setting of government as founded by Adam Smith (The Wealth of Nations, 1776). The same setting was also apparent in Keynes's well-known general theory (The General Theory of Employment, Interest and Money, 1936). According to Musgrave, 'the traditional approach to fiscal theory has been in the context of unitary government' (Musgrave, 1965: 1). However, as it had been realised that the theory of public finance had practical difficulties in settings other than that of unitary states, economists revisited the theory of public finance in the context of the federal setting of government. Since then, fiscal federalism[10] has continuously developed in line with the movement towards greater fiscal decentralisation[11] of central governmental

[10] See Section 2.3 of this chapter.

[11] Bird and Vaillancourt (1998: 3) define fiscal decentralisation in relation to the degree of independent decision-making exercised at the local level. It involves deconcentration, (dispersion of responsibilities within a central government to regional branch offices), delegation (the situation in which local

functions in both federal and non-federal countries. Alas, the focus remains on the economic considerations, that is, equity and efficiency in the provision of public goods and services.

Following this development, economists arrived at their very own set of definitions of federalism, based on Wheare's method of dividing powers. A definition of federalism that gained considerable influence was that of Wallace E Oates from his book *'Fiscal Federalism'* published in 1972. He offers an economic definition of federalism as:

> *'Federal government: A public sector with both centralised and decentralised levels of decision-making* in which choices made at each level concerning the provision of public services are determined largely by the demands for these services of the residents of (and perhaps who carry on activities in) the respective jurisdiction' Oates (1972: 17). (Emphasis added).

Obviously, from the point of view of economists, federalism has a similar meaning to the term federal government, in which the decision-making process for the provision of public services is both centralised (at the federal government level) and decentralised (at the state governments level) taking into account local preferences for public services. Therefore, it was not surprising if Oates' economic definition of federalism was largely guided by Tiebout's local expenditure functions (Tiebout, 1956) and Musgrave's economic functions of government: the principles of stabilisation, allocation and redistribution, in a quest for efficiency and equity[12] in the provision of public goods and services (Musgrave and Musgrave, 1976; Musgrave, 1959), but not the federal spirit although he discussed the larger subject of federalism, that is, fiscal aspects involving federalism. This is because each discipline serves a different purpose. Henceforth, the

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government acts as an agent for the central government) and / or devolution (when the decision-making process and implementation of function is done at the local level). According to Osaghae (1990) decentralisation is 'the dispersal of power from this centre to other centres of power, which may be functional or territorial units' (Osaghae, 1990:98).

[12] In the economic context, efficiency has to do with how much wealth can be generated given available resources, while equity concerns how that wealth is to be distributed in society. In other words, equity has to do with the distribution of resources based on the concepts of fairness and social justice. In theory, allocative efficiency is achieved when the market is at equilibrium level (price equals marginal cost), in that there is no way to reallocate the goods or services without hurting someone. Pareto defined allocative efficiency as a situation where no-one could be made better off without making someone else worse off. However, there is often a trade-off between economic efficiency and equity, as both involve value judgments.

economic debate on fiscal federalism leaned heavily upon the work of Oates.[13] Although Oates' definition of federalism is contrary to the interpretation of federalism offered by political scientists; little attempt was made by economists to rationalise the differences. Only recently, economists have begun to realise the importance of political structure and the system of government in the working of intergovernmental fiscal relations (Gramlich and Wood, 2000).

Oates' definition of federalism is highly deficient because public sector fiscal operations involve not only the federal government but also state governments, local governments, statutory bodies, and non-financial public enterprises (NFPEs) as well as quasi public enterprises (IMF, 1983). While it is true that government finance is part of the public sector fiscal operation, to define federalism in the purely economic terms offered by Oates is singularly inappropriate. The economic definition of federalism should also be concerned with the fiscal operation of federal, state, and local governments, and the interaction between and among them. This should be the scope of the economic understanding of federalism. Hence, in economic terms, federalism could be appropriately defined as the fiscal conduct of the federal - state governments (and local government) based on self-rule plus shared rule principles in discharging the constitutionally entrenched fiscal responsibilities, to achieve the goal of federation. Fiscal conduct should be based on the spirit of federalism, that is, cooperation, partnership, respect, trust, participation and representation, as underlined by the covenantal theory, as well as based on the economic functions of government, that is, stabilisation, allocation and redistribution functions.[14] This should be the basis of fiscal federalism, which is then orchestrated with other aspects of federalism, in particular, the political system and socio-economic diversity, to achieve the ultimate common objective of federation. Therefore,

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[13] See among others Bird and Vaillancourt (1998), Ter-Minassian (1997a), Ter-Minassian (1997b), Shah (1994), and King (1992).

[14] See footnote 19 page 53 of this chapter for explanations of stabilisation, distribution and allocation function.

fiscal federalism is not just an economic but a political process, in the quest for unity in diversity, for the promotion of a stable government. With unity, the goal of federating will be achieved and federalism will also survive and be preserved. Thus, the economic definition of federalism should not be strictly confined to economic considerations, but should also reflect the political science perspective of federalism. In this regard, the statement by Gramlich and Wood is worth noting:

> 'Fiscal federalism has been an important topic for many years now. The usual analysis of fiscal federalism has considered various expenditures and taxes, asking which expenditure and tax programs should be carried out by what level of government. However, *the more fundamental question regarding the shape of the nation, or federation, is typically not asked'* (Gramlich and Wood, 2000: 1). (Emphasis added).

2.3 Fiscal federalism: The financial aspects of intergovernmental relations in the federal system

The preceding discussion on interpretations of federalism and federation is a useful basis to understand the subject of this study, that is, fiscal federalism. By now it is clear that there appear differences in interpretation among economists with regard to the term 'fiscal federalism'. Economists use it interchangeably with financial aspects of multi-level government in a non-federal system, as well as with fiscal decentralisation. These two terms – multi-level finance and fiscal decentralisation – are related to fiscal federalism but not synonymous. As fiscal federalism involves two disciplines, fiscal (economic / finance) and federalism (political science), the question is how the study of fiscal federalism fits into federalism and public finance.

Public finance is a branch of economics and economics is the study of allocation of scarce resources. In particular, public finance is concerned with how the government raises revenue (through taxation policy), how it spends these revenues (through the budgetary operation), and how deficit is to be financed (through borrowing). In short, public finance is about government budgeting and fiscal policy. In a nutshell, the objective of public finance is to maximise the welfare of the people (tax payers) so that

taxes paid by people to the government are equal to benefits derived from goods and services provided by the government on the basis of efficiency and equity considerations. Theoretically, when taxes paid are equal to benefits received, the optimum of public finance is reached (Aronson, 1985). Therefore, the essence of public finance lies in the financial activities of governments and the public sector as a whole in the provision of public goods and services. It describes and analyses the expenditures of government and the techniques used by governments to finance these expenditures (taxation and debt financing). Public finance analysis helps to understand why certain services have to be supplied by the government, why governments have to rely on particular types of taxes, and why government have to embark on certain fiscal policy (either expansionary or contractionary). Economic theory provides insights into government budgeting, that is, the optimum and efficient use of limited resources (efficiency) to promote high growth with equity. Clearly, public finance involves all government financial activities, including the financial relation / arrangement between centre and regional / state government (and local government). The application of public finance in a federal system is referred to as the federal finance, which primarily concerns the fiscal arrangement between the federal and state governments in the federal system and how the governments deal with differences in federation, as constituent states differ in many respects, such as size, natural endowment, population, ethnicity, and economic development.[15] For economists,

[15] The term 'federal finance' was for the first time espoused by Adarkar in his book *The Principles and Problems of Federal Finance*, published in 1933 and refined by Bhargava (1953) and Scott (1964). (See also Shirras (1944: 222-243) and Hicks (1947: 224-226)). Although there was no literature found to show exactly when the term 'fiscal federalism' was first invented, most economists refer to Buchanan in his article 'Federalism and Fiscal Equity' published in 1950 and Richard Musgrave in his book *The Theory of Public Finance: The Study in Public Economy* published in 1959, which both discuss fiscal aspects of federalism. According to Musgrave, earlier discussion of public finance had been in terms of fiscal system involving one level of government and hence it became complicated when applied in a federal or multi-level financial system, as the state has its own fiscal functions. Subsequently, the subject of fiscal system in a federal or multi-level financial system, which economists refer to as 'fiscal federalism', attracted economists' interest. The term 'fiscal federalism' gained further popularity among economists notably after a first book on *Fiscal Federalism* by Wallace E Oates was published in 1972. Since then, the term 'federal finance' has been rarely used by economists or by political scientists. However, Bird and Chen posed the question, 'are 'federal finance' and 'fiscal federalism' just different names for the same thing?' (Bird and Chen, 1996: 51). They found that the two are not the same, but surprisingly they defined fiscal federalism as a financial arrangement between states and local

therefore, fiscal federalism is a part of the wider issue of federal finance, which has a similar objective to public finance.

The definition of federalism by economists originates from Musgrave, who defined federalism as multi-levels or multi-units of governments (Musgrave and Musgrave, 1976; Musgrave, 1965; Musgrave, 1959). This definition implies that every country is federal, since multi-units of government can be found in any type of government setting, not only in the federal system. Based on this definition, economists defined fiscal federalism as 'the fiscal relations between hierarchically ordered units or multi-unit finance (the fiscal relations between coordinate units)' (Musgrave, 1965: 2). Shah (1994) also defined fiscal federalism similarly to Musgrave (1965), that is, 'public finances of a state with more than one fiscal tier' (Shah, 1994: 5). Another prominent scholar on fiscal federalism, Richard M. Bird, interpreted fiscal federalism as 'the analysis of the problem that give rise to, and arise from, the existence of more than one level of government within the same geographical area' (Bird, 1999: 151). Even more confusing, some economists defined fiscal federalism similarly to the decentralisation of fiscal functions - expenditure and taxation powers from the central to the constituent governments in order to find the most efficient ways of providing public goods and services.[16] This understanding of fiscal federalism has become the economists' 'conventional wisdom' in the study of fiscal federalism and fiscal decentralisation. As we will discuss later, this definition is singularly inappropriate in the context of federalism / federation. Today, fiscal decentralisation has become a major economic agenda in most countries – federal and non-federal – and is actively pursued by both economists and policy-makers (Sphan, 2000; Bird and Vaillancourt, 1998; Ter-Minassian, 1997). According to Sphan (2000), the theory of fiscal federalism argues in favour of the decentralised provision of public

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government, and federal finance as a financial arrangement between federal and state governments in a federal system (see also Bird, 1994).

[16] See Bird, *et al.*, (2003); Bird, (1999); Sphan, (2000); Thöni, (1992); King, (1992); and Oates, (1972).

services, which would: firstly, increase efficiency because the constituent governments are closer to the people than national government and hence has an information advantage concerning their constituent's wants and preferences; and, secondly, population / labour mobility and competition among the constituent governments for delivery of public services will ensure the matching of citizens' preferences with governments' preferences. Thus, economists expect that decentralised government (as in federal countries) would be able to promote higher growth potential and efficiency in delivering public services.[17]

From an economic point of view, federalism and the structure of a federal system is the most suitable platform to carry out fiscal decentralisation (Shah, 1994). To some extent, the federal system itself is a form of decentralised government (Bird and Vaillancourt, 1998). However, Osaghae (1990) argues that in a federal system, the division of power or assignment of fiscal function between levels of government cannot be considered as decentralisation of functions. This is because in a federal system 'decentralisation is only partially right because the soul of federalism actually lies in non-centralisation' (Osaghae, 1990: 98) and not decentralisation. Based on the federalism point of view, the state is not just the implementing agent of central government but it has own functions to perform. The states' functions in federation, as enshrined in the constitution, are a result of political bargaining at the time of federating. Thus, the powers that belong to the states are not the result of fiscal decentralisation process but of the states' exclusivity, being members in the federation. Any attempt to usurp states' functions as agreed at the time of federating cannot be made unilaterally; as such an attempt would be regarded as unconstitutional. Consent by all constituent units must be obtained, followed by any necessary constitutional amendments. In short, the powers or functions belonging to states are irrevocable, unlike in the unitary system. As demonstrated earlier, the division

[17] Some economists argue that fiscal decentralisation does more harm than good to the economy. See Tanzi (2001); Tanzi (1996); Ter-Minassian (1997); Prud' homme (1995) and Zhang and Zou (1998).

of power in a federal state is a product of a constitutional compact *(foedus)* between the two levels of government. Thus, Osaghae (1990) asserted that 'decentralisation can only be applied meaningfully to federalism in matters that belong to the central government' (Osaghae, 1990: 84). In other words, the federal government can only decentralise its powers / functions to the state, provided the state willingly accept those functions, as it affects the state's financial position. Similarly, if the centre decided to take state assigned functions, it could only be done through constitutional amendment, otherwise it would be regarded as a usurpation or encroachment by the central government on state affairs, which negates the principle of non-centralisation in federalism (Osaghae 1990). Finally, decentralisation with regard to federalism is best described in Osaghae's (1990) words:

> 'In fact, decentralisation is best applied and understood in relation to federalism *when its usage is restricted to the policy making and administrative aspects rather than the legal and constitutional aspects of federalism.* The substance of federalism is captured by the concept of non-centralisation which best describes the legal and constitutional aspects of federalism. Therefore any attempt to divest federalism of the principle of non-centralisation by conceiving of it simply as a degree of decentralisation undermines its essence' (Osaghae, 1990:85) (Emphasis added).

Based on the above arguments, therefore, to regard fiscal federalism and fiscal decentralisation as synonymous, as many economists do, is singularly inappropriate. Although both fiscal federalism and fiscal decentralisation are concerned with how expenditure, revenue (tax) and borrowing powers are assigned to lower levels of government (based on the economic functions of government, that is, stabilisation, allocation and redistribution functions, as well as taking into account local preferences in the provision of public services), the underlying force of fiscal federalism is the federal spirit that binds together the constituent governments into a larger political union (federation), while the driving force of fiscal decentralisation is purely one of economic efficiency and equity in the provision of public goods and services (Bird and Vaillancourt, 1998). However, it is recognised that the division of powers between central government and the constituent governments in a federal system gives more room for fiscal decentralisation to grow further. Hence, it is not surprising that economists

extended the scope of fiscal federalism to include non-federal systems. As such, from the economists' viewpoint, fiscal federalism is not confined to federal countries, but is also applicable to non-federal countries. Related to this, Oates says,

> 'in economic terms, most if not all systems are federal. Aside from an absolute degree of centralisation of decision making – which in practice is almost impossible to imagine – the public sectors of all countries would be federal, with distinctions being made in terms of differing degrees of centralisation' (Oates, 1972: 18).

Although this statement is contentious, especially from a political science point of view, it has been received among economists as an appropriate interpretation of the economic definition of federalism (Bird and Vaillancourt, 1998). Of particular importance, political scientists argue that what most economists such as Oates (1972) mean by the term fiscal federalism does not actually concern federalism. One critic of Oates' view is Beer (1977), who argues, 'Oates is talking not about federalism but about the larger subject of multi-level government' (Beer, 1977: 22). He further asserts, 'What economists and others actually talk about under the nominal heading of fiscal federalism is usually the broader and more interesting subject of the political economy of multi-level of government' (Beer, 1977: 23). Indeed, Beer's arguments are valid to a great extent. For instance, economists such as Inman, Rubinfield and Bird, observe that fiscal federalism is nothing more than the issue of rational choice, as the underlying assumption of fiscal federalism has similarities between public choice theory (Muller, 1992) and federalist theory (Ostrom, 1987).[18]

A review of literature on fiscal federalism suggests that the discussions on fiscal federalism have been largely dominated by the economists, simply because fiscal federalism involves fiscal matters, that is, the aspects of taxation and expenditure of the government, upon which fiscal arrangements between levels of government are based. Thus far, a literature review of fiscal federalism shows that little attempt has been made

[18] The basis of the rational choice theory is the notion of constrained choice. People are all motivated to seek the highest level of satisfaction given limited resources available to them compared with their unlimited wants (see Ostrom and Ostrom, 2004; Muller, 1992; Caporaso and Levine, 1992).

by political scientists to devise a comprehensive theory of fiscal federalism. As a result, fiscal federalism is handicapped when dealing with non-fiscal issues, due to the absence of the political aspects of federalism. In examining the application of fiscal federalism to public finance theory, economists merely look at the fiscal aspects. Hence, they overlook the importance of non-fiscal aspects of federalism, especially the federal spirit and political operation of federalism (Watts, 2003a; Watts, 2002). Raju Das asserts,

> '*economic processes are everywhere political in that in order to operate they require political conditions*, both at state and local levels. These processes are also political in that their inegalitarian and exploitative character leads to political struggles over the ways that the economic processes work and over their distributive outcomes. Similarly, the political conditions require, and are influenced by, economic conditions' (Raju Das; 2001: 103). (Emphasis added).

Therefore the incorporation of the political scientists' views in the development of a comprehensive theory of fiscal federalism is essential, as it involves the structure of the government as well as the political operation of federation. As such, it is relevant to discuss fiscal federalism not merely on the ground of economic expediency but also in terms of political aptness. In a nutshell, the design of intergovernmental fiscal relations should put the federal spirit at the apex. This should be the approach to the study of fiscal federalism. As Watts asserts,

> 'This political significance places financial relations between central and constituent-unit governments at the heart of the process of intergovernmental relations...*Thus, understanding intergovernmental financial relations require an understanding of the political context within which they occur*' (Watts, 2003a: 2). (Emphasis added).

Following political scientists' arguments, therefore, fiscal federalism is more than merely a system of fiscal arrangements between levels of government as argues by economists. It is more than the question of which level of government is best assigned with provision of public goods and services and what kind of tax should be assigned to each level of government to finance their assigned functions; it is a set of federal-state financial arrangements in a federal system designed from political bargaining at the time of federating based on a federal spirit, and therefore the design is constitutionally guaranteed, protected and cannot be changed unilaterally. More importantly, fiscal

federalism would ensure that the self-rule and shared rule principles of the federation are attained, respected and preserved. As noted in Chapter 1, fiscal federalism is a form of political process in search of unity in diversity, the ultimate aim of federation. Therefore, the understanding of federalism and its principles is essential in the design of intergovernmental fiscal arrangements in the federal system. However, until now, there appears to be no comprehensive theoretical and empirical treatment to federalism in the design of fiscal federalism even from economic perspective, let alone from a political economy point of view (Watts, 2002; Ter-Minassian, 1997; Inman and Rubenfeld, 1997; Oates, 1972). Inman and Rubenfeld, for instance, suggest that there should be a balance between states' representation in the federal government and the assignment of function between both levels of governments. If the objective is to strengthen democratic government, states' representation should be large enough. On the other hand, if the objective is to achieve a high degree of efficiency in the economy, more functions should be assigned to the federal government. Ideally, the design of fiscal federalism should aim at achieving both objectives - democratic government and a high degree of efficiency in the economy. However, the choice depends on the economic and political conditions specific to the particular federation.

Poor design of intergovernmental fiscal relations will not only cause problems of fiscal imbalance between the centre and states, as well as among the states, but it will also raise problems of public governance and political implication. Of particular importance, the design of intergovernmental fiscal systems should promote good governance and accountability in the management of public resources at all levels of government (Ebel and Yilmaz, 1999). According to Oates (1972), the design of intergovernmental fiscal relations should answer the following questions: first, which level of government is best suited to provide a particular public service; second, what are the justifications and optimal arrangements in the design of intergovernmental grants; third, what general and

theoretical principles serve as guides in the design of a system of taxation under federal arrangement; fourth, how are economic federal systems actually organised and what cross-national similarities and differences exist in intergovernmental fiscal relations; and finally what are the dynamics of fiscal federalism, that is, what trends are present in the degree of fiscal centralisation or decentralisation over time. However, according to Bird and Vaillancourt (1998), intergovernmental fiscal arrangements seek to answer four key questions, that is, first, who does what (the question of expenditure assignment), second, who levies what taxes (the question of revenue assignment), third, how revenue-expenditure imbalance (vertical imbalance) is to be resolved, and finally, how differences between states (horizontal imbalance) are to be remedied. King (1992) added another question: how these arrangements can be tailored to suit the macroeconomic policies.

These are the main issues in the design of intergovernmental fiscal relations in a federal system. Although there are no hard and fast rules in the design of intergovernmental fiscal relations, some guidance is found in the literature of public finance and political economy. All things being equal, services provided by lower levels of government are more likely to correspond to the demands of the majority of citizens than services provided by the higher level of government, due to the distance factor and the larger size of population (Tiebout, 1956; Musgrave, 1959; Oates, 1972). This is because lower levels of government will be better at perceiving, responding and delivering the utility functions of the citizens due to closeness to them, as compared to the federal government (Bryson and Cornia, 1999).

According to Oates (1972: 17) 'the problem of federalism is, however, quite different for an economist. In particular, the economist's central concerns are the allocation of resources and the distribution of income within an economic system'. The economic functions of government, according to Musgrave (1959), and Musgrave and Musgrave

(1976), are threefold[19]: macroeconomic stabilisation, income distribution and resource allocation. The stabilisation function is to assure the achievement of high employment and price stability, while the distribution function is to achieve an equitable distribution of income. The allocation function, on the other hand, is to ensure that resources (through annual budgetary allocation) are available and used efficiently, to avoid fiscal profligacy. In other words, the decisions about how much to spend on each service and how to finance these expenditures are the prime concerns of the allocation function.

In the federal setting, the assignment of economic functions is more complicated than in the unitary state. This is because, according to Wheare,

> 'The federal principle requires that the general and regional governments of a country should be independent each of the other within its sphere, shall be not subordinate one to another but coordinate with each other. Now if this principle is to operate not merely as a matter of strict law but also in practice, it follows that *both general and regional governments must each have under its own independent control financial resources* sufficient to perform its exclusive functions. Each must be financially co-ordinated with the other.' (Wheare, 1953: 97) (Emphasis added).

Besides the need to achieve the economic objectives, the division between the expenditure and revenue / taxation functions in a federal system involves constitutional issues, and to some extent is determined by political and historical factors specific to each particular federation. More importantly, appropriate assignment of functions will ensure the self-rule and shared rule principle are properly implemented by both levels of government. Based on the economic functions of government discussed above, the question is, which function is best suited to which level of government. Musgrave and Musgrave (1976) and Oates (1972) suggest that taxation and expenditure can be divided

[19] The *stabilisation function* refers to public policies that are designed to maintain full employment, stabilise prices, achieve a favourable balance of trade, and assure economic growth. Public sector taxes and expenditure decisions that influence these policies are referred to as fiscal policy. Generally, increasing spending and cutting taxes during economic downturns to increase domestic aggregate demand and cutting spending and raising taxes during economic upswings to reduce aggregate demand are the most appropriate policies. The *redistribution function*, on the other hand, refers to distribution of income fairly and equitably across the population. These policies normally range from cash transfers from rich to poor, subsidies and the like. Government uses its taxing and spending powers to redistribute resources from one group or community to another. Finally, *allocation function* refers to public policies that restore an efficient allocation of resources for use in the market. Under this function, the public sector normally acquires factor inputs (land, capital and labour) for the production of public goods and services.

or shared between levels of government according to whether or not it suits the stabilisation, distribution and allocation functions. Table 2.1 briefly shows which levels of government should undertake stabilisation, distribution and allocation functions. Musgrave and Musgrave (1976) strongly recommend that the stabilisation function should be assigned to the central government. Thus, any taxation and expenditure functions that could be used as stabilisation tools should be assigned to the centre. This is because lower levels of government cannot much affect macroeconomic conditions (McLure, 1999). Besides, the lower level of government, in most federations, usually has limited or even no borrowing power and monetary policy. This makes it difficult for the lower level of government to undertake fiscal expansionary or contractionary programmes when it is needed by the national economy.

Table 2.1
Economic Functions of Government

Functions	Which level of government should undertake these functions?		
	Federal	State	Local
Stabilisation	Yes	No	
Redistribution	Yes	Yes with administrative assistance	
Allocation	Shared		

Source: Musgrave and Musgrave (1976) and Oates (1972)

The stabilisation tool that is most commonly used to influence economic conditions is taxation policy, primarily through corporate tax and progressive personal income tax. This is because corporate tax fluctuates more than general economic conditions, while personal income tax has strong stabilising effects, especially if a progressive rate is used. As such, most literature on taxation suggests that these two taxes should be assigned to central government. Hence, taking this argument, it is impossible for the lower level of government to carry out the macroeconomic stabilisation in the economy. However, according to McLure (1999), this does not mean that state governments cannot levy taxes on the income of individuals. As found in the United States, state governments can and do levy taxes on the income of individuals within their respective jurisdiction apart from federal income tax (Watts, 1999a).

In addition to the stabilisation function, the redistribution function should also be assigned to the central government. This is because the lower level of government, which operates in its respective locality, is not capable of carrying out this function beyond its economic and political boundaries. The redistribution function aims to achieve an equitable distribution of income in the economy, notably through progressive taxation. However, according to McLure (1999), if the redistribution function is assigned to the lower level of government, progressive taxation intended to soak the rich may drive out capital and high-income individuals. If this occurs, taxation that appears progressive may actually be regressive. This is against the principle of redistribution and may not achieve the intended goals of income redistribution. From the point of view of federalism, the redistribution principle should reflect the federal spirit in that the state and its citizens should not be denied its right to benefit from the wealth of the nation. Hence, based on this argument, the redistribution function should properly be assigned to the federal government.

However, Musgrave (1959) suggested that both levels of government should share the allocation function. This means that the design of fiscal arrangements, that is, the assignment of revenue (taxation) and expenditure, should allow the lower levels of government to undertake the allocation function (McLure, 1999; Bahl and Linn, 1994). By assigning the allocation function to the lower level of government, the constituent units will be able to match the revenue available and the demands of their constituency, which, in the long term, will increase efficiency, because lower levels of government have better information about their residents' needs than the central government. The constituent units are closest to voters / people and as such they are in the best position to read local preferences for public services and for various kinds of taxes and user charges to finance those services. According to Shah (1994), good design of intergovernmental fiscal relations can enhance fiscal accountability and transparency, and increase public

governance, that is, eliminate corrupt practices in the delivery of public services. Thus, the design of intergovernmental fiscal relations in a federal system should follow the assignment of economic functions of government as well as the federal spirit. This is important to avoid an adverse impact on macroeconomic stability and more importantly not to undermine the principle of federalism, in that neither level of government is subordinate to the other (Watts, 2002). Thus, according to Shah (1994: 9), 'the assignment problem or the allocation of expenditure and tax function to various levels of governments is the most fundamental issue in federation'.

2.3.1 Expenditure assignment

The most important elements in intergovernmental fiscal relations are the division of function or expenditure assignment between levels of governments. Before assigning revenue function, types of expenditure should first be identified. Assigning expenditure function after revenue assignment is like putting the cart before the horse. According to Shah (1994: 9), 'the literature on fiscal federalism argues that assigning responsibility for spending must precede assigning responsibility for taxation, because tax assignment is generally guided by spending requirement at different levels and cannot be determined in advance'. As such, from the government finance point of view, the division of functions takes precedence over the division of resources because the government needs to determine the amount to be spent on their functions first and then raise the funds necessary to finance the assigned functions (Ter-Minnasian 1997; Ahmad *et al.*, 1997; Gandhi, 1995; Holzhausen 1974).

Economists remain divided as to which level of government (central or state) will be responsible for which public services (Oates 1972). The answer is often the result of the historical, constitutional, social and political development of the particular country (Gandhi, 1995). However, there seems to be a consensus of opinion among politicians and economists that, as far as possible, functions should be divided according to the

principles of efficiency and equity. The problem of assigning expenditure functions arises not only in federations but also in unitary states. The way in which functions have actually been divided in various federations differs widely depending on such divergent factors (Watts, 1999a; Holzhausen, 1974) as traditional patterns of administration, political and socio-economic circumstances prevailing at the time of federating, and the relative bargaining powers of the parties to the federation. Table 2.2 shows the assignment of expenditure functions in selected federations. The division of functions of the particular federal country can determine the degree of centralisation or decentralisation of the federation. The more functions are assigned to the centre, the more centralised the federation (Malaysia) and the more functions are assigned to the states, the more decentralised the federation (Canada, the US, and Australia).

Table 2.2

The Distribution of Powers and Functions

	Canada	United States	Switzer land	Australia	Germany	India	Malaysia
Finance and fiscal relations							
i. Taxation							
a. Customs /Excise	F	F/C	F	F	F	F/FS	Fa
b. Corporate	FS	C	F	C	C	F	F
c. Personal income	FS	C	FS	C	C	FS	F
d. Sales	FS	C	F	C	C	FS	Fa
ii. Debt and borrowing							
a. Public debt of federation	F	F	F	F	F	F	F
b. Foreign borrowing	FS	FS	FS	C	FS	F	F
c. Domestic borrowing	FS	FS	FS	C	FS	FS	FS
iii. Expenditure function							
a. Defence	F	FS	F	FS	F	F	F
b. Roads and bridges	S	FS	FS	FS	C+	FS	FS
c. Railways	FS	FS	F	FS	FC+	F	Fa
d. Air	F	F	F	FS	F	F	F
e. Telecommunications	FS	FS	F	C	F	F	F
f. Agriculture	C	S	F	Sc	C+	SC	SCa
g. Education (primary/secondary)	S	S	C+S	S	S	CS	Fa
h. Health / hospitals	SF	SF	S	FS	C+	S	Fa
i. Public health/sanitation	S	S	C+	S	C+	S	FC
j. Internal security/Police	FS	FS	C	SF	C+S	FS	F

Note: F = federal power; S = state (provincial); C = concurrent power with federal paramountcy; C+ = federal legislation; a = asymmetrical applications of powers

Source: Adapted from Watts (1999a: 126)

The theory of public finance suggests that economic efficiency and equity require that expenditure responsibilities be allocated between levels of government according to citizens' preferences and at the lowest possible resource cost (Aronson, 1985). Stauffer (1999), and Inman and Rubinfield (1998) suggest that the assignment of expenditure should be based on the principle of 'subsidiarity'.

> 'Subsidiarity is a principle of governance designed to give meaning to the divisions of power and responsibility between the central government and the constituent states in a federal system. The principle seeks to allocate responsibilities for policy formulation and implementation to the lowest level of government at which the objectives of that policy can be successfully achieved' (Inman and Rubinfield, 1998: 545).

In the Preamble of the Treaty on the European Union (EU) it was stated that the signatories pledged 'to continue the process of creating an ever closer union among the peoples of Europe, in which decisions are taken as closely as possible to the citizen in accordance with the principle of subsidiarity'. This was then strengthened by the Article 3b of the Treaty, which provided that:

> 'The community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. *In areas which do not fall within it exclusive competence, the community shall take action, in accordance with the principle of subsidiarity,* only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member states and can therefore by reason of the scale or effects of the proposed action, be better achieve by the Community. Any action of the community shall no go beyond what is necessary to achieve the objectives of this Treaty' (Article 5 / ex Article 3b). (Emphasis added).

Thus, taking the EU as an example, the distribution of functions is best made according to the principle of subsidiarity, as well as efficiency and equity considerations. Gandhi (1995) also supports the assignment of expenditure responsibilities according to efficiency and equity consideration. However, it can be attained only if the following conditions are met: first, public services that have localised benefit are assigned to state government (such as public policing, fire services, water and sanitation, urban transport and road network), while public expenditures whose benefits accrue widely and far beyond state jurisdiction (for example, provision of education at university level, financing the construction of major roads and highways, or specialised hospitals) are assigned to the federal governments. Second, public expenditures that can be quickly

accelerated or slowed down (for example, public works programmes) or which can automatically be adjusted according to the economic cycle (such as unemployment benefit and social safety net programmes) are assigned to the federal government, as the federal government has the fiscal capacity to accommodate economy fluctuations to stabilise the macroeconomic conditions. Third, public services whose overhead costs do not grow in line with economic expansion or which do not suffer from 'diseconomies of scale' (for example, provision public order or maintenance of smaller roads and urban streets) are assigned to the state governments; and finally, expenditures which have large potential benefits to other regions (spillover effects) or other jurisdiction (for example environmental improvement/protection) are assigned to the federal government.

Raimondo suggests that 'the size of the benefit area of the public goods and services is very influential in determining whether the central or decentralised level of government is responsible for the particular service. However, the size of the benefit area is not the only consideration in determining the delegation of service responsibility' (Raimondo (1992: 64). He further suggests considering other factors: economies of scale, fiscal equivalency, fiscal capacity, political accountability, and administrative capability. First, economies of scale which means that the benefit area should be large enough to take advantage of a lower average unit cost of provision of public services to gain benefit from economics of scale. With a large coverage area, public services can be mass-produced, which means a reduction in the average unit cost. Clearly, the best level of government to undertake this type of public services is the federal government.

Second, fiscal equivalency which means that the benefit area of the public goods and services must coincide with the political boundary. Based on this consideration, the benefit from the public goods and services provided by one jurisdiction should be enjoyed only by the people of that particular jurisdiction. In other words, people from outside the jurisdiction should not gain benefit from the services provided by it. In this

case, there should be no free riders[20] and spill-over effects in the provision of the public goods and services.

Third, fiscal capacity which means that any constituent units that undertake the provision of public goods and services should have sufficient resources. This is to avoid the problem of fiscal imbalance and subsequently interstate disparities created by insufficient resources. Fourth, political accountability meaning that the government officials of the particular jurisdiction should be accountable to the residents for the quality and efficiency of the delivered goods and services. Finally, administrative capability which means that in order to ensure that the constituent units could take-up the functions efficiently with minimum disruptions the constituent units should have administrative capabilities (including technical and managerial know-how).

As observed by Watts, there is a clear pattern showing that 'the distribution of expenditure powers in each federation corresponds to the combined scope of the legislative and administrative responsibilities assigned to each levels of government within federation' (Watts 1999a: 44). The problem always arises when legislative and administrative responsibilities do not correspond. This suggests that expenditure functions in federal systems should correspond to the legislative responsibilities to avoid administrative and financial difficulties, in particular the problem of vertical imbalance, as in the case of German's fiscal federalism (Jeffery, 2003b; Watts and Hobson, 1997). Watts also noted that in most federations, if the constitution assigned substantial administration of federal legislation to the constituent governments, the constituent expenditure responsibilities are greater, as found in Switzerland, Austria, Germany, India and Malaysia. This is to ensure high degree of efficiency in the provision of public services and minimises bureaucratic red tape. Watts further noticed that the federal

[20] In economic terms, free rider refers to those people that benefit from public services but evade paying taxes for the services they enjoy.

government's spending power is far-reaching, beyond its constitutionally stipulated functions (Watts, 1999c), notably in the area of the concurrent list, in order to pursue certain objectives that benefit all constituent governments. If this is the case, the federal encroachment on constituent governments' affairs is significant.

Based on the above considerations, the general rule in assigning functions should be based on the benefit principle, with the maximum efficiency and equity possible, taking into account the economic function of the government and the federal spirit. If the benefit from the public services goes beyond one state and requires national coordination, provision of these public services should rest on the central or federal government. On the other hand, functions that are localised in nature / character and benefit specifically local people should be assigned to state governments. However, the problem arises in distinguishing which functions are regional and which are nation-wide in nature, due to the ambiguity of functions such as education and public health. Theorists suggest that, for efficiency purposes, a centralised policy is desirable (Ahmad *et al.*, 1997) for those ambiguous functions. Besides, the size of the country matters in designing the expenditure functions (Ter-Minassian, 1998). In large countries like the United States, India, Canada and Australia, decentralisation of functions to lower levels of government is more appropriate than in small federations like Malaysia.[21]

In practice, there is no guaranteed best way of deciding which level of government should be responsible for a particular public service. It depends on the historical, political and economic development of the particular country. Expenditure assignment should be tailored to the objectives set up by the governments (Martinez, 1999; McLure, 1999) as well as the economic functions of government (Musgrave, 1959). This is the economic consideration in the assignment of expenditure functions between federal and state

[21] Abdul Rahim (2000) argued that fiscal decentralisation in Malaysia is a non-issue as the federal government has a strong commitment to the states' economic development.

governments. As discussed earlier, according to Musgrave, the economic purposes of government are to stabilise growth, redistribute income, and allocate fiscal resources. These functions 'have long been the starting point for discussion of the division of fiscal powers and responsibilities among units of governments' (Bahl and Linn, 1994: 3). However in federal systems, expenditure assignment has been determined within the constitution as a result of a long bargaining process between the central and the constituent governments. Unfortunately, the framers of the constitution may not have foreseen the growing need for public services and the appropriateness of certain functions to the level of government. As a result, any change in the expenditure function between both levels of government to suit growing and changing needs will take a long time to be implemented, as it involves a long judicial process and constitutional amendment. In older federations, most expenditure functions have been increasingly reassigned to the constituent governments in line with the movement toward fiscal decentralisation (Bird *et al.*, 2003; Bird and Vaillancourt 1998; Ter-Minassian 1997).

However, there is an argument that fiscal decentralisation will not result in greater efficiency in the provision of public goods and services. This is because, generally, many state governments, notably in developing federations (such as Malaysia, India, Nigeria) are characterised by inefficient administrative capacity due to overstaffing, poor technical skills and training of employees, inability to formulate and implement effective spending programmes, and inability to fully exploit potential revenue sources. Thus, the theoretical efficiency gained from fiscal decentralisation can be significantly undermined in practice by structural and institutional constraints which reduce its absorptive capacity to undertake more functions. The level of public governance at the lower level of government is another constraint. Besides, public expenditure management systems (financial control, reporting and accounting, and evaluation) in most state governments are not yet properly developed and not transparent. Therefore, some literature, such as

that found in Prud'homme (1995), Tanzi (1996) and Ter-Minassian (1997), shows that fiscal decentralisation entails significant cost in terms of distributional equity and macroeconomic management. The specific design of intergovernmental fiscal relations as well as institutional arrangements between, within and amongst the two levels of government play a crucial role for the fiscal decentralisation process to take place. According to Prud'homme (1995), fiscal decentralisation can increase disparities, jeopardize stability and undermine efficiency (allocative efficiency, production efficiency, and corruption). In Germany, fiscal decentralisation has been opposed by weak Länder due to their limited fiscal capacity, as such fiscal decentralisation is politically unpopular. Therefore, as far as fiscal decentralisation is concerned, weak Länder are in favour of cooperative federalism, whereas strong Länder are in favour of competitive federalism through the promotion of fiscal decentralisation. For rich Länder, fiscal decentralisation means less contribution towards the cost of equalisation transfers (Adelberger, 2000).

In summary, although economic theory offers limited guidance for assigning expenditure to different levels of government (Ahmad *et al.*, 1997), assigning or reassigning expenditure should be guided by at least five economic considerations, on which economists and political scientists are in agreement. First, public services that benefit every citizen in the federation, such as national defence, and those which generate benefits from economies of scale, such as electricity generation and water supply, should be provided by the central government. Second, public services that benefit local citizens, such as maintenance of law and order, and fire services and for which different people can have different preferences (for example, local roads) should be provided by lower levels of government. Third, public services whose benefits spill over to jurisdictions other than those where they are actually provided (for example, public education and public health) should either be provided centrally or be subsidised by the central

government, depending on the estimated value of the spillover benefit. Fourth, assignment of expenditure functions should follow the assignment of legislative and administrative functions. Finally, as far as possible assignment of expenditure functions should match with the assignment of revenue (taxation) functions.

2.3.2 Revenue assignment

Revenue assignment is an important element in the design of intergovernmental fiscal relations after expenditure assignment (Ter-Minassian, 1997; Ahmad *et al.*, 1997; Shah, 1994). According to Shah, 'once expenditure assignment has been agreed on, tax assignment and design of transfers become critical elements in matching expenditure needs with revenue means at various levels of government' (Shah, 1994: 18). Hence, in the design of intergovernmental fiscal relations, expenditure assignment should be followed by adequate revenue assignment. The biggest mistake in the design of intergovernmental fiscal relations, according to McLure and Martinez, is when 'revenues were assigned to subnational governments and transfers put in place before it was decided what functional competencies would be transferred from the central government to subnational government' (McLure and Martinez, 2000: 2).

The assignment of revenue sources involves tax arrangements, as taxes are the main source of government revenue to finance government operation. In practice, governments rely upon a wide variety of tax sources, which at the same time can promote equity and efficiency. The range of taxes includes taxes on the income of households (personal income tax, payroll tax), taxes on the income of firms (corporate income tax), taxes on property and wealth (local property tax), taxes on purchases by households and firms (generals sales tax, specific excise taxes), taxes on imports (tariffs), and taxes on bequests or inheritances. The question is: which level of government (central or constituent government) will have the right to levy, collect, and retain which categories of taxes and

what will the right methods of their collections and administration be? However, tax arrangements in the context of federal system are more complicated than the theory may suggest. They involve not only economic considerations (efficiency and equity criteria) but also historical, political, institutional and demographic characteristics and economic aspects of the particular federal country (Ebel and Yilmaz, 1999; Gandhi, 1995) and political considerations, and more often than not, the outcomes work against the theory of taxation (Gandhi, 1995). Consonant with the spirit of federalism and the principles of self-rule and shared rule, each constituent government should have enough revenue to discharge its constitutional responsibilities. This means some degree of tax autonomy should be granted to the constituent government.

According to Shah (1994), tax assignment can be either dependent on the expenditure assignment or independent of expenditure assignment, as commonly practised in developing countries. If assignment of taxes is taken independently of expenditure assignment, the centralisation of tax administration is likely. In this situation, the federal government collects almost all taxes and in return redistributes part of the revenue to lower levels of government. However, 'where the theoretical guidance of tax assignment is unclear, expenditure assignment can provide a powerful argument for assigning responsibility to the government with greatest need for more money' (Shah, 1994:18).

As discussed above, the assignment of tax is always influenced by the historical, constitutional, social and political developments of the particular federation. However, economists have come up with the broad principle of tax assignment in the design of intergovernmental fiscal arrangements. Musgrave and Musgrave (1976), and Musgrave (1983), for instance, suggest using the equity and efficiency criteria in tax assignment.

2.3.2.1 Efficiency criterion.

According to this criterion, taxes should be assigned based on which level of government can collect and administer taxes at the minimum possible cost. In other words, assignment of taxes should be based on how efficiently and cost effectively tax can be administered. If the efficiency criterion is to be used as the guiding principle for tax assignment, then it has to be decided for each tax whether it would be handled more efficiently by the federal or by the state government. So, based on the efficiency rationale, the level of government that has the best information on a certain type of tax base would be the appropriate governmental level to be held responsible for the relevant tax. For example, in the case of corporate income tax, the federal government is most likely to have more accurate information (and a larger data base) on corporate income originating from domestic and foreign sources of income. For property taxes, on the other hand, the constituent governments are in the better position to assess property values. Based on these criteria, therefore, corporate income taxes would be best assigned to the federal government, and property taxes to the constituent governments.

In addition, based on this rationale, the federal government can competently administer taxes with an interstate basis, such as customs duties, excise duties (because large interregional differentials in rates would lead to the problems of smuggling on state borders) as well as inheritance taxes. On the other hand, taxes having a local base, such as land tax; taxes on income from agricultural activities and mineral rights; licence, registration and entertainment fees; and estate duties in respect of land ownership, are likely to be administered more efficiently by the states. In general, capital taxes in one form or another may be suitable to be administered by the constituent governments. However, in some federations the constituent governments encounter enormous practical difficulties in collecting capital taxes. Consequently, the efficiency goal may not be achieved and hence assigning capital tax to federal administration may be more practical.

2.3.2.2 Equity criterion.

The most important element of equity criterion is that tax bearing redistributive effects (such as income tax and wealth tax) should be assigned to the federal government. This is because the federal government is responsible for income redistribution across the federation, as the ability of the constituent governments is limited within their own boundaries, although in some federations the constituent governments do undertake a redistributive function (Bird, *et al.*, 2003). Based on this argument, according to Shah, 'progressive redistributive taxes, stabilisation instruments, and resource rent taxes are suitable for assignment to national government' (Shah (1994: 19). In addition, according to this criterion, tax assignment should also be designed taking into account the expenditure responsibility or fiscal need of the constituent units. In other words, revenue must match the expenditure needs of the constituent governments having the responsibility for such public services.

Based on the above criteria, Shah (1994) suggests that the major tax instruments that are suitable to be assigned to various levels of government are as shown in Table 2.3. Briefly, Shah (1994) provides guidelines for tax assignment in the design of intergovernmental fiscal arrangement, that is, progressive taxes for redistributive purposes, taxes suitable for economic stabilisation purposes, taxes on mobile factors of production and unequal tax bases between states should be assigned to federal government. On the other hand, residence-based taxes, such as excises, and taxes on completely immobile factors (such as land tax and property tax) should be levied by the states. However, all levels of government can levy benefit taxes and user charges appropriately. The most important thing in tax assignment between the differing levels of government is that no state can tax the subjects of another state, as this would violate the efficiency criterion in tax assignment. In designing tax assignment, in practice, there is always likely to exist a 'concurrent' zone of taxes, when tax jurisdictions overlap. Items

which are difficult to characterise as falling exclusively into either the federal or state category are taxes which have bases extending beyond the boundaries of the individual states, such as tax on motor vehicles. Shah (1994) suggests for motor vehicle tax, state responsibility is desirable, as it has the capacity to administer this tax efficiently since information on motor vehicles are locally available.

Table 2.3
Conceptual Basis of Tax Assignment

Type of tax	Determination of		Collection and administration	Comments
	Base	Rate		
Customs	F	F	F	International trade taxes
Corporate income	F	F	F	Mobile factor, stabilisation tool
Resources taxes				
Resource rent (profit, income) tax	F	F	F	Highly unequally distributed tax bases
Royalties, fees, charges	S,L	S,L	S,L	Benefit taxes/charges for state/local services
Conservation charges	S,L	S,L	S,L	To preserve local environment
Personal income	F	F,S,L	F	Redistributive, mobile factor, stabilisation tool
Wealth taxes (capital, wealth, wealth transfers, inheritances, and bequests	F	F,S	F	Redistributive
Payroll	F,S	F,S	F,S	Benefit charge (e.g. Social security coverage)
Multistage sales taxes (VAT)	F	F	F	Border tax adjustment possible under federal assignment: potential stabilisation
Single stage sales taxes (manufacturer, wholesale, retail				
Option A	S	S,L	S,L	High compliance cost
Option B	F	S	F	Harmonized, lower compliance cost
Sin taxes				
Excises on alcohol and tobacco	F,S	F,S	F,S	Health care a shared responsibility
Betting, gambling, lotteries, race tracks	S,L	S,L	S,L	State and local responsibility
Taxation on 'bad'				
Carbon	F	F	F	To combat nationwide pollution
BTU taxes	F,S,L	F,S,L	F,S,L	Pollution impact may be national, regional or local
Motor fuels	F,S,L	F,S,L	F,S,L	Tolls on federal/provincial/local road
Effluent charges	F,S,L	F,S,L	F,S,L	To deal with interstate or local pollution issues
Congestion toll	F,S,L	F,S,L	F,S,L	Tolls on federal /provincial/local roads
Parking fees	L	L	L	To control local congestion
Motor Vehicle	S	S	S	State responsibility
Business taxes	S	S	S	Benefit tax
Excises	S,L	S,L	S,L	Residence-based taxes
Property	S	L	L	Immobile factor – benefit tax
Land	S	L	L	Immobile factor – benefit tax

Note: F is Federal, S is State, L is Local.
Source: Shah (1994)

However, according to Bhargava (1953), when overlapping of tax jurisdiction exists, it may be desirable to have the federal administration collect it and to assign all or part of the proceeds to the states under tax revenue sharing[22] arrangement (Ahmad and Craig, 1997; Shah, 1994). Economically, it would be unwise to leave the problem open to both levels of government, as this may lead to duplication and unnecessary conflict in tax collection and administration. This is because, as discussed above, the assignment of resources must ensure that no state can tax the subjects of another state, a situation which would create unhealthy tax competition. According to Adelberger (2001), the present trend of fiscal federalism is towards competitive federalism as against cooperative federalism, that is, each constituent units set its own taxation and other fiscal policy, which finally creates strong tax competition among constituent units, as evident in the US, Canada, and Australia. However in centralised federations, such as in Germany, cooperative federalism is more evident. In Malaysia, fiscal federalism is neither cooperative federalism nor competitive federalism. Goodspeed (1998) also argues that heavy tax competition would result in inefficient tax administration and may cause unnecessary distortion to the economy.

In practice, according to Gandhi (1995), it is difficult to meet both efficiency and equity criteria in the assignment of taxes between the differing levels of government due to the following reasons. First, any taxes that could easily be shifted or exported to consumers of other jurisdiction (for example, natural resources tax, sales tax or excise duty, import and export duties at the ports, airports or border areas, taxes on tourism) were assigned to state governments, would cause detrimental effect to the economy as state government would pitch those taxes at excessively high levels. Second, for taxes whose administration required detailed information (for example, property tax and land tax)

[22] See pages 85-89 for discussion on tax revenue sharing as a part of fiscal adjustment. Briefly, tax revenue sharing means that two or more levels of government levy rates on a common basis, in which the rate base is determined by federal government with state government levying a supplementary rate while collection is made by the federal government.

were assigned to central governments, such taxes would be poorly administered and easily evaded, as the cost of their collection could be undesirably high. Therefore, this type of taxes should be assigned to a state government. Third, for taxes that are redistributive in character (such as progressive personal income tax, progressive wealth tax, or progressive inheritance tax) were not levied by the central government, the overall equity objective of the tax system could be seriously jeopardised. Fourth, if taxes that have large built-in elasticity whose revenues grow automatically in boom periods and decline in recessionary periods (such as personal income tax, enterprise profits tax, sales tax, or value-added tax), were not assigned to the central government, the ability of the government to undertake macroeconomic stabilisation would be impossible.

Whatever basis is used in assigning taxes to each level of government, it should support the desired goals of the economy, that is, economic growth with equity and overall macroeconomic stability. In other words, tax policies should not have an adverse effect on economic stability, but instead should promote strong economic growth. More importantly, taxes should be assigned to each level of government according to their capacity to administer the particular tax, to avoid the possibility of tax evasion. As such, source-based taxes should be allocated to the centre while states should be assigned residence-based taxes such as consumption taxes. In actual fact, the division of resources in the existing federations does not follow any particular pattern and has usually been the outcome of some political compromise. What may suit one federation need not always suit another. In developing countries, the question of the division of resources should be viewed in the light of the problem of efficiency in tax administration (the need for simplicity and uniformity in tax administration as well as well-trained personnel) and the prevention of large-scale tax evasion. In the absence of this, centralisation of tax administration and collection are likely.

The most important finding of the foregoing discussion of division of tax responsibility or revenue assignment in federal systems according to economic considerations is the adoption of the efficiency and equity criteria in determining which level of government should be responsible for which types of taxes. As with expenditure assignment, revenue assignment should coincide with economic functions of government, that is, stabilisation, redistribution and allocation (see Table 2.1). However, other considerations affecting the wider interest of the national economy should also be taken into account, such as suitability of fiscal policy, overall economic development policy and political feasibility, with a view to achieving a greater measure of social justice and equity throughout the federation. As such, the efficiency and equity criteria should not be the exclusive guiding principles in determining the division of resources between federal and state governments.

Finally, for the sake of efficient tax administration and as long as not contrary to the economic functions of government, a centralisation of tax collection is most likely. However, if this is the case, state governments are unlikely to have enough revenue to discharge their constitutionally assigned responsibilities and duties. As a result, it is found that the central governments in most federations have more funds than functions, while the states have more functions than funds, notably in developing federations (such as Nigeria, Malaysia and India). The imbalance between functions and resources, or the issue of non-correspondence, thus poses the question of financial adjustment. Indeed, the issue of fiscal imbalance is a common feature of all federations. In most developing federations, even in developed federations such as the United States, Canada, Australia and Germany, the issue of non-correspondence is crucial. This can cause intergovernmental conflicts that necessitate financial adjustments and subsequently the design of appropriate intergovernmental fiscal transfers. This is the price that the federal

government have to pay for not having sufficient revenue sources assigned to the constituent governments.

2.3.3 Intergovernmental transfers

In a realm of intergovernmental fiscal relations, intergovernmental transfers are important instruments in mitigating states' financial hardship arising from lopsided revenue-expenditure assignments. As discussed above, the design of intergovernmental fiscal relations requires sufficient revenue assignment (taxes) to the constituent governments to finance its assigned functions. However, in practice, it is impossible to match revenue and expenditure responsibilities between the two levels of government. This is due to the fact that in a federal system the central government has more functions to perform, and so requires more taxing power compared with the state governments, which have limited revenue-raising power compared to their functions. To Courchene, 'in virtually all federal systems, the central government has, *de facto* if no *de jure*, access to revenues in excess of its expenditure responsibilities' (Courchene, 1998:10). As a result of this arrangement, imbalance between resources and functions (non-correspondence), commonly known as fiscal imbalance (vertical and horizontal imbalance), is likely in most federations (Watts, 2001; Shah, 1994). Hence, this gives rise to the problem of fiscal adjustment. The appropriate way to overcome this imbalance is to design a proper transfers system based on the need-revenue gap so that transfers given as of right to states meet any revenue-expenditure mismatch (Bradbury, *et al.*, 1984). However, fiscal adjustment to undo this imbalance requires strong political commitment within the spirit of federalism especially on the part of the federal government, which poses significant revenue yielding taxes. The absence of the spirit of federalism in the design of fiscal adjustment would cause intergovernmental conflicts and subsequently could result in political instability. Hence, one way to see whether the federation is adopting a true federal spirit is to look at how fiscal imbalance is resolved.

There are at least three methods of fiscal adjustment to remedy this imbalance: first, by reassignment of revenue sources to the constituent governments; second, by changes in tax components and third, by way of intergovernmental transfers, that is, transfers from the federal government to the constituent governments (Holzhausen, 1974). Watts (2001) also suggests that fiscal imbalances could be corrected through; first, reallocating or reassignment of revenue sources; second, by reallocating or reassignment of expenditure functions, and third, by fiscal decentralisation and any imbalances arises to be corrected by federal transfers. However, the most practical method of fiscal adjustment, as found from the literature, is by means of intergovernmental transfers. Hence, the design of intergovernmental transfers is crucial in the design of fiscal federalism after expenditure and revenue assignments. In general terms, transfers refer to a number of kinds of public financing instruments; including grants, shared taxes, subsidies and subventions (Bahl, 2000a). They may be intended to address a wide variety of different issues (see below for rationale for intergovernmental transfers). Some are set out in the constitution, while others are based on legislation.

Improper design of an intergovernmental transfers system (failure to eliminate the revenue-expenditure gap) undoubtedly gives rise to financial constraint and, as a result, other sources of financing, such as through borrowing, are needed. However, borrowing by state governments may cause macroeconomic instability if improperly designed. Borrowing by state governments will be discussed later in this chapter. Thus, intergovernmental transfers are the cornerstones of constituent government financing in every federation. This is the real challenge of fiscal federalism of every federation, in particular to what extent the spirit of federalism is adhered to. According to Bahl and Linn (1994), and Bahl (2000b), transfers are a compromise in that lower levels of government allow the centre (by virtue of constitution) to hold control over the public

financing system while they offer a way to channel funds into the budgets of the lower levels of government. According to Bahl and Linn,

> 'Grants are a compromise solution in the debate over the division of revenue raising authority and expenditure responsibility. They permit national governments to retain the authority to tax productive resource bases, but guarantee state and local governments a flow of revenues' (Bahl and Linn, 1994: 6).

Intergovernmental transfers are dynamic in that they follow changes in economic conditions and structural changes such as movement toward greater decentralisation (Watts, 2001). Keneath C. Wheare argues that, 'There is and can be no final solution to the allocation of financial resources in a federal system. There can only be adjustments and reallocations in light of changing conditions' (Wheare, 1953: 123). Therefore, they should not be looked upon as a static kind of arrangement. The design of intergovernmental transfers differs from federation to federation. Hence, the design of intergovernmental transfers cannot be uniform, although they may adopt the same principle (Courchene, 1998). However, still 'no optimal grant structure exists. What is a good feature of a particular type of grant depends on whether one takes a local (constituent government) or national government view, and on which objectives the government wants to achieve' (Bahl and Linn, 1994: 16).

In summary, with the assignment of significant revenue-yielding taxes (productive tax) to the centre, while at the same time increasing the constituent governments' responsibility for provision of public services compared with their limited revenue raising capacity, transfers of federal funds are inevitable. It is the right of state governments to obtain necessary financial assistance from the federal funds and, therefore, it is against the federal spirit to deny the states' right to access federal funds. Indeed, federal transfers are regarded as political as well as economic contracts, in which when the constituent units call for financial assistance the federal government should provide them adequately. In other words, 'he who pays the piper calls the tune'. Therefore, it is the political and

economic responsibility of the federal government to carry out any necessary fiscal adjustment to remedy fiscal imbalance in the federation. In most federations, this can be achieved through intergovernmental fiscal institution, such as the Finance Commission (India), the Commonwealth Grant Commission (Australia) and the National Finance Council (Malaysia). These institutions provide a place for federal and state government to arbitrate for any intergovernmental fiscal disputes.

2.3.3.1 Rationale for intergovernmental transfers

There are four rationales for intergovernmental transfers: the federal rationale, the citizenship rationale, the economic efficiency rationale and the equity rationale (Courchene, 1998: 11; Boothe, 1998: 6). The design of intergovernmental transfers may be based on one of this rationale or combinations of these rationales.

2.3.3.1.1 The federal rationale

According to this rationale, if the federal principle and federal spirit is to be effective and continue to flourish, then the constituent governments must have sufficient revenue to exercise the powers assigned to them under the constitution in line with self-rule and shared rule principle. In other words, each level of government in a federation should have the requisite financial means and financial security to discharge their constitutional responsibilities, especially in the provision of at least a minimum standard of public services for their citizens. According to Boothe (1998: 6) and Ma (1997), in the presence of vertical fiscal imbalance, that is, when tax revenue and spending do not match, and when central government collects more revenue than it spends while the constituent governments collects less revenue than it spends, transfers are needed and inevitable. This is because in most federations, the central government retains the major tax bases, leaving insufficient fiscal resources to state governments to finance their expenditure needs (Ma, 1997). The question is how much of the available resources should be given to state governments and how these resources are to be divided among the constituent

units in the federation. One popular suggestion is to make transfers based on fiscal needs. This is because the needs of citizens for public services increase with economic progress, resulting in large financing requirements by the constituent governments. This gap must be filled either by giving states more revenue raising powers (assignment or reassignment of taxes) or by revenue transfers from the central government (grants), to maintain states' interest in a federation. Therefore, the final objective of federal transfers is always political.

As noted, a federation is characterised by its diversity, such as differences in endowment of natural resources, demographical factor, and level of economic development. Therefore, some states may have access to national resources or other tax bases that are not available to others. Some states have higher income levels than other jurisdictions. Conversely, some states may have extraordinary expenditure needs due to demographic factors such as high level of poverty, high number of old and young age groups, and other uncontrollable factors. As a result, a fiscal gap, measured by the differences between fiscal capacity and fiscal need, becomes a common feature in federation. These differences in fiscal capacities result in horizontal fiscal imbalance and therefore should be addressed by federal transfers. Hence, states without sufficient resources to reach the minimum level of services should receive federal funds in the form of transfers. According to Scott, under the state's right 'the majority is not usually free to encourage the concentration of income, wealth or privilege in one region. All citizens are to a greater or lesser extent constitutionally aware of the need to be fair to all regions' (1964: 248) and thus, it is the right of every state to have a fair share of the national fortune.

2.3.3.1.2 The citizenship rationale

The citizenship rationale suggests that the citizens of a federation have the right to benefit from publicly provided social and economic services, regardless of where they live, because the central government has the obligation to provide and to maintain a minimum

standard of public services in all constituent units. In other words, federal transfer, according to the citizenship rationale, is based on the moral obligation of the federal government to treat citizens fairly. This rationale serves both economic as well as political purposes, so as to strengthen the sense of nationhood and belonging among the citizens as well the constituent units in a federation. Hence, to ensure that residents have fair access to public services, adequate resources should be provided to states due to fiscal differences. In contrast to the federal rationale, this rationale implies that transfers should be conditional (Courchene, 1998; Boothe, 1998).

2.3.3.1.3 The economic efficiency rationale

Intergovernmental transfers can serve to alleviate economic efficiency problems in a federation due to the mobility of factors of production (labour and capital). The mobility of labour could be influenced by net fiscal benefit, that is, the difference between the value of public services received and taxes paid. If a state has large net fiscal benefits because of a substantial endowment of natural resources or locational factor or other advantages, people may be induced to move there to capture those benefits, as well as to take advantage of better job opportunities. This may cause detrimental effects on the have-not states in the long run as the policies of one state can have effects on the other state. Thus, the distribution of labour and capital in the federations is distorted and the national economy runs less efficiently if remedial action through federal transfers is not taken by the federal government (Boothe, 1998: 7).

The second efficiency rational for transfers is due to spillover effects or externalities, which originate from the operations of one constituent government on other constituent governments. Spillover effects arise if a particular constituent government in the federation does not take into account the effects of its policies on other jurisdictions (Shah, 1994; Ma, 1997: Ter-Minassian, 1997; Ahmad and Craig, 1997; Boothe, 1998). Spillover effects can be positive or negative. An example of a negative spillover effect is

air pollution that affects one jurisdiction as a result of the economic activities of a neighbouring jurisdiction. Due to insufficient resources, there is a need for federal transfer to the 'offending' jurisdiction to invest in air pollution preventions and control.

2.3.3.1.4 The equity rationale

The equity rationale is closely related to the citizenship rationale. Unlike citizenship rationale, the focus of the equity rationale is on individuals rather than on governments' ability to provide comparable basic public services (Boothe, 1998). Since the constituent governments have fiscal authority only within their own boundaries and their fiscal capacity varies from one state to another, it is the duty of the federal government to ensure equity is achieved across the federation. In doing so, there is a need to examine whether each of the constituent governments has the fiscal capacity to deliver an equivalent level of public services to their citizens and which level of government should have primary responsibility for income distribution. However, the term 'equity' in intergovernmental finance is often politically contentious (Ahmad and Craig, 1997) and has different interpretations. States may interpret equity differently from the federal government, which could cause conflicts.

Based on the above discussion, federal transfers would serve as a means of financial adjustment with the objective of putting the fiscal position of the federal and state governments on an equal footing in line with their expenditure functions. In addition, federal transfers also help states to provide at least a minimum standard of public services by making-up shortfall in their fiscal needs and undoing any cost disadvantages in providing public services due to factors beyond their control. This is because states' fiscal capacity varies from one state to another, due to differences in their state of socio-economic development and natural resources endowments.

2.3.3.2 Types of intergovernmental transfers

Intergovernmental transfers, that is, payment from federal to state governments, can take two forms: grants system and tax / revenue sharing.[23] As discussed above, both are designed to remedy the shortcoming in revenue and expenditure assignment to enable state governments to discharge constitutionally assigned functions.

2.3.3.2.1 Grants systems

There are a number of grants available from the federal to the constituent governments. Each type of grant is designed for a specific purpose, to meet intended objectives. Within the grants system, there are two types of grants that may be used by the federal government to remedy fiscal imbalance.

a. Conditional grants

Conditional grants refer to specific purpose grants or categorical grants. Conditional grants enable the federal government to exercise a measure of control over the direction of state expenditure. Under conditional grants, the government specifies the purpose for which the state government can use the funds. This type of grant is often used to address issues that are highly important to the centre but normally are considered less so by the state governments. Examples are projects which have inter-regional spill-over effects. Within conditional grants, there are three types of grants. The first is matching open-ended grants, which means that for each unit of money given by the federal government to support a particular activity or projects, the state government must also expend a certain sum. For example, if a grant requires a state government to spend a certain percentage on education, the central government will contribute a percentage agreed upon. With matching open-ended grants, the cost to the federal government ultimately depends upon the state government fiscal operation. If the state government decides to

[23] See Ter-Minassian (1997); Ahmad and Craig (1997); Ma (1997); Shah (1994); Bahl and Linn (1994); Bahl (2000a).

increase expenditure, then the federal government's contributions will be large and if it decides to reduce expenditure, the contributions will be small (Ma, 1997).

The second type of conditional grant is matching close-ended grants designed for specific purposes, in which a ceiling is put on the cost borne by the federal government. In other words, the federal government may specify some maximum amount that it willing to contribute. In most federation, matching close-ended grants are preferred by the federal government due to concerns over financial implication on their budgetary allocation. The third type is non-matching grants, in which the federal government offers a fixed sum of money to the state governments, with the condition that it will be spent on specified public goods or services. However, the state government is not required to match the contribution made by the federal government.

In the case of conditional grants, the choice of whether to impose a matching requirement or not depends upon the purpose of the grant. The disadvantage of the matching requirement is due to the fact that the state governments may be required to redirect the resources to projects or investments considered a priority by the federal government but not so by the states (Ma, 1997). As a result, matching requirements may put greater financial constraints on poorer state governments compared with the richer state governments in the utilization of federal grants. Thus, matching provisions could discriminate against poor states, in that wealthier states that have ability to raise their own revenue would gain greater advantage from such grants, as rich states could more easily meet the matching requirement than poor states For this reason, graduating matching provisions inversely with the relative wealth of states may reduce the degree of discrimination in designing such grants. On the other hand, open-ended grants may affect the federal government budgetary position and macroeconomic management compared with close-ended grants (Ter-Minassian, 1997), especially when the state government increases its expenditures, which requires greater contribution from the federal allocation.

However, there is an advantage of the matching requirement, in that it could promote prudent fiscal management, as states are required to make a contribution before payments can be taken of federal assistance.

b. Unconditional grants

As the name suggests, the federal government places no restrictions on the use of funds by state governments. Thus, unconditional grants are designed to enhance the degree of states' autonomy. This type of grant is also called lump-sum grants or general-purpose grants. This means that state governments can use the grants to finance the operations at their disposal (Ter-Minassian, 1997; Ahmad and Craig, 1997; Raimondo, 1992). The purpose of unconditional grants is primarily to address vertical imbalance, although they can also be used to address horizontal fiscal imbalances among state governments to ensure the provision of a minimum / reasonable level of public services. According to Sphan, 'if there is a vertical fiscal imbalance between local fiscal capacity on the one hand, and outlay responsibilities to lower tiers of government on the other, the gap is typically bridged through financial transfers in the form of unconditional revenue grants or through revenue sharing with the central authority' (Sphan, 2000: 8). Unconditional grants to address horizontal fiscal imbalance are generally designed in the form of equalisation grants. An equalisation grant is a transfer made from the federal government to the state governments, as practised in Canada, Australia and Germany. In Australia and Canada,[24] equalisation transfers are made by the federal government to lower levels of government, while in Germany, equalisation transfers are unique in the sense that equalisation transfers are made from Länder with above-average fiscal capacities to Länder with below-average fiscal capacities. In some other countries, equalisation is in

[24] In Canada, fiscal equalisation programme was first implemented in 1957 upon the recommendation of the Rowell-Sirois Commission of 1941. Successive governments have stated that the purpose of equalisation is to make it possible for all provinces to provide reasonably comparable levels of public services at reasonably comparable levels of taxation. A commitment to a federal programme with this goal is set out in the Canadian Constitution.

the form of general revenue sharing. According to Shah (1994: 30), 'an equalisation programme can foster a greater sense of participation in a federation of member states and therefore is often viewed as the glue that holds a federation together'. Thus, from the point of view of federalism, equalisation is most suitable to foster national integration in federation and, from the economic point of view, it can promote horizontal equity and efficiency.

To summarise, the difference between these two types of grant is that unconditional grants are not tied to any particular objective, whereas conditional grants are tied to specific expenditures to be incurred by the recipient states. With conditional grants, the federal government, as grantor, retains the right to ensure that the funds are actually used for the purpose for which they were allocated. Both unconditional and conditional grants have their particular merits and can be used for specific purposes. The former allow the recipient states complete freedom in allocating funds to finance their expenditures, while the latter usually represent extraordinary income and are made in support of certain current state services. Generally, matching or conditional grants are preferred by the federal government to non-matching or unconditional grants, since they can encourage local tax effort, discourage wasteful spending, and at the same time will ensure that grant objectives will be achieved, while close-ended grants are preferred than open-ended grants since close-ended grants can help the federal government to control its budget. However, for the purpose of the adjustment of fiscal imbalance, unconditional grants are more desirable, although conditional or specific grants have also been used for this purpose. In practice, the choice between conditional and unconditional grants will depend on the importance of the principle of financial responsibility and accountability in that the federal government who raise revenue control over the direction of expenditure to achieve intended national economic objective (Watts, 1999a). Generally, however, very

strict financial responsibility is not apposite as federation progresses and the role of fiscal policy expands.

Conversely, where fiscal adjustments involve large financial implication there is a strong reason for the federal government to take some form of control over the way in which the funds are spent. For this reason, conditional grants are preferred by the federal government, in line with the principles of financial responsibility and accountability. However, from the state governments' point of view, conditional grants may undermine their fiscal autonomy, especially when their revenue is very much dependent on federal transfers. Thus, a combination of both conditional and unconditional grants is more preferable in the design of fiscal adjustment. As a general guideline, where services are of national interest and importance, but are assigned to states, conditional grants would be more suitable. However, for services that have localised benefit, conditional grants could constitute central interference into state fiscal affairs, especially if meticulous monitoring is required to ensure conditions are met. This conflict over the type of grants is the nature of the political aspect of federalism and constitutes one of the central problems of public finance. However, the final decision on which grants are suitable, conditional or unconditional depends on the objective of the grant and the particular issues to be addressed.

A study by Watts (1999a) shows that most federal transfers (more than 50%) were made in the form of conditional grants, as shown in Table 2.4. The dominance of conditional transfers can be explained by the financial responsibility and accountability principle in the conduct of government finance (Watts, 1999a; Holzhausen, 1974). Based on this principle, the federal government 'that has the nasty task of raising the funds by taxation should, in the interests of accountability to the tax payers, control and set the conditions for the use of these funds by the state governments' (Watts, 1999a: 49).

Table 2.4
Conditional Transfers as a Percentage of Federal Transfers

	1996
United States	100
Switzerland[1]	73.1
Malaysia	67.9
Germany	64.5
Australia	53.0
Canada[2]	43.6
India	38.0

Note: [1] Include Canadian Health and Social Transfers (CHST)
[2] These figures are for 1995.
Source: Adopted from Watts (1999c: 156)

However, the design of intergovernmental transfers has its limitations and constraints, depending on the nature of the particular federation itself. Hence, one design of transfers might not be workable for another federation (Courchene, 1998: 5). Thus, the design of intergovernmental transfers should take into account the history and background of the particular federation (such as the structure of the economy and politics) and to some extent it very much depends on the political bargain between the levels of government.

Regardless of the type of grant, economists suggest that at least five principles must be adhered to in designing a grants system. First, grants must make a measurable contribution to a clearly defined objective. Second, grants must be inversely related to the recipient government's fiscal capacity and directly related to its fiscal needs. The fiscal capacity and fiscal needs of each recipient government must be estimated with a clear, quantifiable, and transparent formula. In other words, the grant must be able to link with the expenditure and revenue raising power. Third, grants must be transparent and stable – the formula should be announced so that each constituent government is able to forecast the amount (together with their own revenue) they may receive in order to prepare their annual budget estimate. In addition, the formula should be stable to allow long term planning and, more importantly, the disbursements of grant should be stable and not subject to political wrangling. Fourth, grants should be able to provide incentives for states to improvise tax collection efforts and encourage prudent spending. Finally, the

system should able to accommodate the preferences of local citizens regarding the public services to be provided by their constituent governments.

2.3.3.2.2 Tax base and revenue sharing

The second types of intergovernmental transfers are in the form of tax base and revenue sharing mechanisms. By this mechanism, arrangements can be made either by tax base sharing or by pooling of taxes collected and then sharing them between the federal and the state governments (Ahmad and Craig, 1997; Shah, 1994). The advantage of tax revenue sharing is that each state government can benefit from tax collected from its jurisdiction and subsequently can enhance tax collections efforts. This benefit is not assured under a grants system, as discussed above. Tax revenue sharing could also promote good governance in that it increases accountability in the public decision-making process since resources derived from this arrangement are considered as the states' own revenue.

Tax base and revenue sharing can be used to address a variety of objectives in the design of intergovernmental fiscal arrangement. According to Shah,

> 'Tax base and revenue sharing mechanisms are customarily used to address fiscal imbalance or mismatched revenues means and expenditure needs arising form constitutional assignment of taxes and expenditures to different levels of government [vertical imbalances]...they often address multiple objectives, such as bridging fiscal gap, promoting fiscal equalisation and regional development, and stimulating tax effort at lower levels' (Shah, 1994: 23).

Generally, tax sharing or revenue sharing arrangements are made on a derivation basis, while some countries adopt formula-based systems. However there are criticisms about the inherent danger of tax / revenue sharing based on the derivation principle (Bahl and Linn, 1994). This is because the derivation principle can have a counter-equalizing effect or antithesis of distributive objective to overcome inequality as there is tendency to promote and exacerbate invidious interstate disparities by rewarding states not on the basis of any superior productive or revenue mobilisation effort but on the basis of

geographical advantage. This could undermine the national economic and political integration of the federation. As a result, it is doubtful that nationwide redistributive and macroeconomic reforms can be implemented. Thus, the practical alternative to the derivation principle is revenue sharing based on a revenue-pooling arrangement (Bahl, 2000a; Ahmad and Craig, 1997; Bahl and Linn, 1994). Under a tax-sharing arrangement, tax collection is made by the federal government for efficiency purposes (Shah, 1994) but both levels of government levy rates on a common basis, in which the base rate is determined by the federal government, and the state government levying a supplementary rate on it. By this arrangement, the proceeds are shared with the particular state government based on a derivation basis (point of tax collection). In other words, a portion of *X* specific tax may accrue to the federal government and the residual (100-*X*) accrue to the state government from which taxes are collected. 'Tax base sharing is quite common in industrial countries and almost nonexistent in developing countries' (Shah, 1994: 23).

Under the second approach, pooling tax revenues, the central government collects all taxes, which are paid into a special pool, and then shared with state governments based on a formula agreed by both levels of government. In other words, the federal government will retain *X* percentage of the pool and the balance will be allocated to the constituent government based on either a derivation basis (from where taxes are collected) or a variety of indicators, as practised in Brazil, India and Nigeria where indicators such as population, per capita income, school enrolments, indexes for backwardness, remoteness, and minimum expenditure responsibilities are used. In some other countries, such as Malaysia, the arrangement is simple: it is, based on derivation or point of collection.

The design of intergovernmental transfers hence suggests using a combination of the above methods, the grants system and tax / revenue sharing arrangements. Bahl and Linn

(1994) and Bahl (2000a) suggest that transfers can be designed[25] based on two approaches: (a) the method of determining the size of total fund to be distributed / transferred to the constituent units, and (b) the method to be used for the distribution of the fund. These approaches provide a taxonomy of the grant systems (see Table 2.5), that is, a combination of two types of transfers as discussed above (combination of grants system and tax / revenue sharing arrangements). There are three methods of determining the size of total fund (see row 1 of Table 2.5), namely (a) by a specified share of the federal government tax revenue, (b) on an ad hoc basis such as through annual budget, and (c) by reimbursement on approved expenditure. On the other hand, the distribution of funds could be done in four ways (see column 1 of Table 2.5) which are (a) on a derivation basis, that is, based on the origin of collection of the tax, (b) by a specific formula agreed by both levels of government, (c) on an ad hoc basis, and (d) by way of reimbursement on approved expenditure incurred by constituent units. Thus, based on the suggestions of Bahl and Linn (1994) and Bahl (2000a), there are eight types of transfer as illustrated in columns 2, 3 and 4 of Table 2.5.

Table 2.5
The Design of Intergovernmental Transfers

Methods of allocating the divisible pool among eligible units	Method of determining the total divisible pool		
	Specified share of national or state government tax	Ad hoc decision	Reimbursement of approved expenditures
Origin of collection of tax	A	–	–
Formula	B	F	–
Total or partial reimbursement of costs	C	G	K
Ad hoc	D	H	–

Source: Bahl and Linn (1994: 7)

Types A, B, C, and D (see column 2) are types of grants given to the constituent governments from a fund pooled from tax revenue collected from the constituent governments and then distributed to the constituent governments based on the origin of

[25] For a detailed discussion see Bahl and Linn (1994) pp 6-16.

the tax collection (type A), a formula (type B), projects (type C) or on an ad hoc basis (type D). Type A is a type of transfer based on tax / revenue sharing arrangements and as such it is unconditional or closed-ended in nature. The federal government may collect a portion of tax revenue from constituent units and then distribute to the constituent governments based on the origin of the tax collection. With this type of grant, the constituent government is allowed to keep a specified share of what is collected within its boundaries. Types B and D are also unconditional but type C may be conditional. The way funds are distributed to the constituent units is based on an agreed formula (for example based on population and area) (type B) or on an ad hoc basis (type D). Both types of grants are common in most federal countries. The type C method suggests the distribution of tax revenue on the basis of project costs. For example, a fixed percentage of national tax revenue may be distributed among state governments on the basis of the approved cost of public projects.

On the other hand, types F, G, and H (see column 3) are given to the constituent governments based on funds pooled by the federal government on an ad hoc basis and distributed to the constituent governments based on a formula (type F), based on projects (type G) or on an ad hoc basis (type H). The type H method is completely centralised, with the central government making all decisions about which (constituent governments) should get the money and how much is to be given to each recipient government. Type G would be conditional, but types F and H could be for general purposes or unconditional.

Finally, type K (see column 4) is a grant given to the constituent governments from the federal government's annual budget allocation for reimbursement of approved expenditure. Under this method, the distribution is subject to certain conditions such as type of projects or expenditure approved by the federal government. However, this method is always subject to political wrangling (some projects that are economically viable are not necessarily politically viable, and vice versa). Projects that are eligible for

such grants may be in the national interest, but not important from the point of view of the constituent units. This is why this type of grant is highly politically contentious.

The foregoing discussion on the design of intergovernmental transfers provides three policy choices in the design of a grant system to remedy fiscal imbalance: first, each fiscal imbalance could be corrected by separate policy measures. For instance, vertical imbalance could be resolved by tax revenue sharing or a grant system, while horizontal imbalances could be resolved by federal transfers or transfers from a higher fiscal capacity state government ('have' state) to a lower fiscal capacity state government (equalisation grants), as practised in Germany. Second, by the implementation of an integrated system of equalisation grants by which the vertical and horizontal imbalances could be dealt with simultaneously, as implemented in Australia and Canada; and third, to correct only a horizontal imbalance using the grant system (both conditional and unconditional grants), as well as tax sharing / revenue arrangements. By doing so, in the long term each constituent government will be able to raise its fiscal capacity and subsequently will undo vertical imbalance.

2.3.4 Borrowing

Borrowing is one source of financing for government operations. Borrowing could be sourced either domestically or externally. External sources include the international capital market, bilateral sources (from foreign government borrowing) or multilateral sources (from international lending institutions such as the International Monetary Fund (IMF) and the World Bank). Domestic borrowing is mainly from bank and non-bank sources such as from investible funds (such as life insurance and pension fund) or the domestic capital market.

From the literature, there is no uniformity of opinion on whether borrowing should rest with the central government alone or be assigned to the constituent governments. In some federal countries, only the central government can borrow to finance its operations and consequently lend to state governments to finance its development projects. This is mainly to ensure that the national and public debt level remains at prudent levels. Indeed, constituent governments' borrowing can have a large effect on macroeconomic stability. According to McLure (1999) if the constituent governments have borrowing power, the result is commonly irresponsible fiscal behaviour that could threaten macroeconomic stability. This is a primary concern of the central government as far as state borrowing is concerned, especially if borrowing is made from foreign sources with federal governmental guarantee. To reduce this possible moral hazard (the assumption by capital markets that states' borrowing is ultimately backed by the federal government) from states' borrowing, the World Bank (1999) suggests using tax bases and unconditional grants as collateral that can be pledged against their borrowing. This would provide direct fiscal backing instead of loans being implicitly backed by the central government, as traditionally practised in most developing countries. 'Having their own fiscal base is therefore an important prerequisite for subnational governments' access to finance and for limiting moral hazard problems' (World Bank, 1999: 3).

Literature review shows that borrowing power should rest with the central government for three main reasons (King, 1984; Oates, 1972). First, for counter cycle measures and stabilisation purposes. Central government is usually in a stronger position to raise loans from internal and external sources than the constituent governments, due to the fact that central government has a higher credit standing arising from its greater financial capacity, compared to that of the constituent governments. In a federal system, the purpose of debt financing by the central government differs from the state government's. Debt financing by the central government helps to influence the aggregate demand to stabilize the

economy, level of employment and price stability. If the purpose is to stimulate spending, deficit financing is desirable. This policy is primarily appropriate as a counter cyclical measure, especially during a recession or economic downturn. Thus, the aim of debt financing is to control the level of aggregate demand in the economy for stabilisation purposes. However, debt financing by constituent governments plays a different role from that of central government. This is because a counter cyclical measure is the central government fiscal function. The constituent governments' borrowing is mainly to finance the provision of public goods and services in accordance with local preferences. In view of this reason, borrowing power should be exclusively assigned to central government.

Second, borrowing power should rest with the central government for the standardisation of national development policy purposes. In federations where economic development policy is centralised, the central government's expenditure is undoubtedly large. This is because the central government needs to provide development allocations across the federation. In most cases, it is the central government itself that undertakes the provision of public goods and services throughout the federation (although some functions are constitutionally assigned to respective federating units). Consequently, large financing is required by the central government to implement nationwide development programmes. Two possible ways to finance these functions are through tax revenue or debt financing. If the financing from taxes is not possible, the only option is through borrowing from banks and the capital market (although in some countries drawing from reserves is possible). Based on this view, the central government should be granted borrowing power to have recourse to domestic and external sources and hence the constituent governments will be directly benefited from the central government borrowing through national development policy. However by doing so, the central government enforces further centralisation through centralised development policy.

Third, borrowing power should rest with the central government for the purpose of national debt policy and prudent debt management. As discussed above, state governments' borrowing can cause a destabilising effect on macroeconomic stability if borrowing is at the disposal of state governments. This is the primary concern of the central government with regard to constituent governments' borrowing. Therefore, debt policy should be coordinated in view of the fact that large-scale government borrowing (by both central and constituent governments) will have an impact on the money and capital market as well as a possible adverse influence of extensive public borrowing on capital formation in the private sector, due to crowding out effects. Public debt management is an important aspect of macroeconomic management, especially in relation to anti-cyclical policy. For this reason, government borrowing policy should be designed in line with both fiscal and monetary polices, as well as prevailing macroeconomic conditions. For the sake of prudent debt management, only central government should be granted borrowing powers. However, where borrowing power is extended to the constituent governments, it should be coordinated and monitored at central level to limit and restrict excessive borrowing, so as to avoid a destabilising effect on the macroeconomic level.

Based on the above justifications, borrowing should be assigned to the central government, since loan coordination is necessary for integrated national development programme and economic stability. Thus, based on this argument, the federal dominance over borrowing powers appears logical. However, if the constituent governments are granted borrowing powers, they should be limited, monitored and controlled. This is mainly to avoid contingent liabilities on the part of the central government and to minimise the likelihood of central government bailout (Ter-Minassian and Craig, 1997), especially if borrowing by the constituent government is guaranteed by the federal government. Excessive and unrestricted borrowing by the constituent governments may

cause debt-servicing problems, especially when their fiscal capacity is limited. In some countries, such as Malaysia, the central government may deduct debt service from the federal grants if the constituent governments fail to service its debt. Doing so may discourage the constituent governments from making excessive borrowing out of their fiscal capacity and minimise the likelihood of contingent liability on the part of the central government (Dellinger and Webb, 1999). There are instances (in federal and non-federal states) where the central government has had to bail out constituent governments for excessive borrowing, such as in Colombia (which bailed out Bogota in 1991 and Medellin in the late 1990s) and in Brazil, as well as in Mexico in the early 1990s (Dellinger and Webb, 1999). 'The debt crises of state governments in Brazil, the inflationary impact of states financing in Argentina, and city-level bankruptcies in the United States have often been used to illustrate the possible macroeconomic implications of decentralising borrowing powers' (World Bank, 1999: 1). Thus, according to the World Bank (1999), the core of the argument for not granting borrowing power to the constituent government is related to the issue of moral hazard, that is, access to financial markets by state governments may create unplanned fiscal liabilities for central government.

However, some economists favour constituent governments having equal access to borrowing to finance part, if not all, of their development projects. However, the question remains whether the constituent governments should be allowed to borrow from external sources or only from domestic sources. For the constituent governments, borrowing from domestic sources, especially from the banking system, to finance their development projects are legitimate (Gandhi 1995), provided their borrowings are not excessive, as it has a crowding out effect on the private sector's access to finance. However, borrowing from the banking system should be limited to ensure the constituent governments finances do not become a major cause of macroeconomic instability and inflationary

pressure in the economy. Borrowing from the central bank should be prohibited; otherwise, the central government will lose its control over the country's monetary policy. However, borrowing from the capital market should be encouraged, as it could help to develop the domestic capital market (both primary and secondary), provided the funds are raised at the market interest rate without any implicit or explicit government subsidy.

According to the World Bank (1999), there are three primary reasons why states' access to financial markets is encouraged. The first is for the purpose of financing capital expenditure. State governments often have responsibility for long life public investments that are lumpy in nature. Since state governments have limited sources of revenue, financing of such capital investment through increases in current taxes would be insufficient. As such, financing of long term investment through borrowing is considered appropriate. Furthermore, because the benefits of long-term public investments often last for several decades, equity considerations would suggest that future generations should participate in the financing of such projects. Second, access to financial markets can provide alternative sources of financing when a deficit is incurred in any fiscal year. Third, access to financial markets may foster state governments' political accountability and good governance, as markets may signal which state governments have poor financial performance.

However, it is of particular importance that the proceeds from borrowing by a state government should not be used to finance current spending (or finance current account deficit[26]) as this is against the principle of intergenerational equity effects of borrowing. Financing current spending by borrowing is socially and politically unfair, because future generations are subjected to repayment of loans (in the form of tax burden), when they

[26] Current account deficit occurs when the total revenue collected is lower than current expenditure incurred in any fiscal year.

have not benefited from that public spending. At the same time, interest payments and loan repayments will reduce future spending. However some writers such as King (1984) argue that borrowing could also be used to finance current spending provided the repayment and debt servicing is to be made by property tax. This is, however, an unpopular view, as property tax is very volatile and subject to economic conditions. Thus economists' consensus on this issue is that borrowing should be used only to finance long-term public investments, as the benefit generated from the investment stretches across generations (Prud'homme and Shah, 2002; World Bank, 1999; Konrad, 1995; Oates, 1972).

According to Oates (1972) the conventional view is that the constituent governments should issue bonds to finance capital projects, provided the capital project is a long-term investment which has benefits spread over the years. Hence, both the present and future residents will benefit from such a project. Concomitantly, present and future residents should share the costs of the project, including the repayment of the debt. Based on the benefit principle of taxation, that taxes should be apportioned among people in relation to the benefits they receive from publicly provided goods and services (Aronson, 1985), debt financing through bond issuance is apposite. This means that through bond financing, repayments for capital projects can be spread over future years according to the life-span of the project, in tandem with the stream of future benefits. This is why Oates (1972) suggests that state governments should have access to funds to finance the construction of long-term public investment projects. According to the World Bank (1999) and King (1984), this conforms to the theory of intergenerational equity effects, which suggests that long-term public investments that produce benefit across generations could be financed by debt financing.

However, in most countries, debt financing by state governments is almost impossible, due to legal or constitutional constraints, poor credit rating as well as limited revenue

sources. As a result, the ability of state governments to increase public investment is relatively low. Oates (1972: 161) argues, 'those states that for one reasons or another have not placed much reliance on debt finance have exhibited relatively low levels of public investment ... it appears that debt finance along with taxation should be an integral part of local operations'. Thus, if state governments are not granted borrowing powers, the state governments should benefit equally from the federal government's borrowing (Holzhausen, 1974) to enable them to finance their public investment.

For constituent governments that face hard budget constraints, that is, those that are given fiscal autonomy but are required to balance their budgets without recourse to any assistance from the central government (Bahl, 2000a), these state governments must find other sources of financing, which potentially include contractual borrowing from domestic or foreign banks, or the issue of domestic or foreign bonds (Dillinger and Webb, 1999). Although hard budget constraint is universally accepted as essential to ensure proper fiscal behaviour (Dillinger and Webb, 1999), borrowing by state governments, especially through bonds, to finance capital investment should be allowed, subject to the state's financial capacity (Bahl, 2000b). The rationale, as discussed above, is that capital investments are long-lived assets and as such should be financed through bonds whose maturity approximately matches the asset's life.

However, it is necessary for the central government to put a proper regulatory framework in place (Bahl, 2000b). In line with this view, the World Bank (1999) and Ter-Minassian and Craig (1997) suggest a mechanism of control to be adhered to by the constituent governments, that is, reliance on market discipline, reliance on legally binding rules and direct control by central government. Of these, central government direct control is widely practised. This could be done in many ways, such as by setting annual limits on the overall debt of individual state governments; by review and authorisation of individual borrowing operations; and / or the centralisation of all government borrowing

and in turn on-lend to state governments for approved projects. There are advantages in the direct control approach, especially if borrowing is raised from external sources. First, for macroeconomic management purposes, as macroeconomic policies are the responsibilities of central government (through the central bank). Second, to obtain better terms and conditions on borrowing due to a well coordinated approach of borrowing. Third, to avoid contagion effects of poor state governments' rating on other state governments. Finally, the requirement of a central government to guarantee states' borrowing (central government to bear responsibility for states' foreign debt).

Among federal countries that impose direct control on states' borrowing are India and Malaysia. In India, the constitution states that only central government can borrow abroad while state governments' borrowing requires approval from the centre. Approval is not granted if they have outstanding indebtedness to the federal government (Rao and Chelliah, 1996). In Malaysia, the constitution totally prohibits state government borrowing from external sources, while borrowing from domestic commercial bank requires the approval of the federal treasury (see Chapter 3).

However, in other federal countries, machinery for the coordination of the federal and state public debt does not exist, as in the United States, Canada and Switzerland, where the states may borrow freely within their financial capacity. In the United States, there are, however, certain restrictions imposed on state borrowing, not by the federal government but from the states' legislation. Most of the new federations have solved the problem of coordination by some sort of federal dominance, which is often enlarged by constitutional power given to the federal government to make loans to the states. The successful Australian solution to the problem of borrowing, as well as public debt coordination, deserves special attention. Under the Australian system, both the Commonwealth and the states' borrowing are coordinated by an independent Loan

Council, composed of representatives of both orders of government. The Loan Council[27] in Australia provides the forum for both negotiation on the borrowing requirement and debt limits for individual states and the monitoring of compliance with such limits. The Council also promotes effective market discipline on state government borrowing by facilitating the collection and dissemination of timely information on developments in state governments' finances. Holzhausen (1974: 98) suggests there should be a central authority to ensure that the central and the constituent governments' borrowing (domestics and foreign) remain within prudential levels. The central authority should be an independent body, composed of representatives of the central and the constituent governments. This is a best practice, as it can enhance cooperation between federal and state governments so that the growth of public debt can be monitored within prudential level. In Australia, the Loan Council is responsible for coordinating borrowing by both central and the constituent governments. Finally, the statement by Ter-Minassian and Craig is worth noting,

> 'the growth of subnational public debt is frequently a symptom of an inappropriate design of intergovernmental fiscal relations in the country in question, involving, for example, large vertical or horizontal imbalances or a system of intergovernmental transfers lacking transparent criteria and conducive to ad hoc bargaining or ex-post gap filling' (Ter-Minassian and Craig, 1997: 156).

2.4 Conclusion

The literature on fiscal federalism and intergovernmental fiscal relations has been expanding rapidly in recent years, in line with a growing worldwide trend toward fiscal decentralisation, advancement of the economic theory of public finance as well as growing demand for lower levels of government participation in the provision of public

[27] For a detailed coverage of the Australian Loan Council, see Saunders (1990) and also Jay (1977). The Australian Loan Council was established in 1927 under the Financial Agreement between the Commonwealth and the States and continued in existence under the Financial Agreement between the Commonwealth, States and Territories which became effective in 1995. The Australian Loan Council is a Commonwealth-State Ministerial Council which co-ordinates public sector borrowings under voluntarily agreed arrangements. It comprises the Commonwealth Treasurer as Chairman and his counterparts from the States and Territories, and usually meets in conjunction with the annual Premiers' Conference. Commonwealth-State cooperation in this area derives from a common interest in ensuring that overall public sector borrowing in Australia is consistent with sound macroeconomic policy and that borrowings by each government are consistent with a sustainable fiscal strategy.

services. The literature review of fiscal federalism (intergovernmental fiscal arrangements within the federal system) discussed in this chapter encompasses both the economic and political perspectives. A consideration of these perspectives is of major importance, due to the fact that fiscal federalism should not be looked at solely from an economic viewpoint, but also from a federalism perspective, in particular the federal spirit. Thus, fiscal federalism is an ongoing political process of mitigating fiscal conflicts involving federations. The final objective of fiscal federalism is to achieve the aim of federation, that is, unity in diversity, based on a self-rule and share ruled basis.

To summarise: this chapter has investigated the various aspects of federalism and its relations to fiscal federalism and the theory of public finance, in an attempt to establish a link between federalism and fiscal federalism. The most important findings of the discussion are: first, there is no concrete theory of federalism and fiscal federalism that is universally applicable for every federation. Second, in the design of intergovernmental fiscal relations, expenditure should be assigned to the constituent governments based on the benefit area and subsidiarity principle, and revenue sources (taxes and non-taxes) should be assigned accordingly, taking into account the three economic functions of government, that is, macroeconomic stabilisation, income redistribution and resources allocation. Of significant importance, the assignments of both revenue and expenditure functions to the state governments should correspond between administrative and legislative responsibilities to avoid financial difficulties. However, in practice, it is impossible to make a perfect match between expenditure and revenue, which raises the question of the appropriate design of intergovernmental fiscal transfers, as well as of borrowing powers.

Third, the design of intergovernmental fiscal relations should also promote transparency and accountability at each level of government, in order to ensure a high degree of governance in the public sector. The literature on fiscal federalism also suggests

enforcing hard-budget constraints on the financial operation of the state of governments, to avoid macroeconomic instability, especially when deficit financing is obtained from excessive borrowing. However, politically, this would be hotly contested, as states would lose their fiscal autonomy and it would cause a strain in federal-state relations.

Fourth, of paramount importance, the design of intergovernmental fiscal relations should take into account the federal spirit, which is the underlying force of the federation's creation. Incorporating the federal spirit into the design of fiscal federalism would certainly promote unity in diversity, as this is the ultimate objective of federating. Unfortunately, the existing literature shows that the intergovernmental fiscal relations in the federal system is predominantly geared towards economic efficiency and equity, due to a lack of understanding of the concept of federalism. As such, the economists' approach to the study of fiscal federalism is indeed akin to the fiscal arrangement of the multi-level government and fiscal decentralisation. The next chapter will examine and analyse the application of the theory of fiscal federalism as discussed in this chapter, in relation to fiscal federalism in Malaysia.

Chapter 3

The Federal Idea and the Design of Fiscal Federalism in Malaysia

3.1 Introduction

In Chapter 2, the terminological interpretation of federalism and fiscal federalism was discussed, as well as the theory of intergovernmental fiscal relations in the context of federalism and federal finance. This chapter will trace how fiscal federalism in Malaysia was designed and to what extent it relates to the concept of federalism and the theory of fiscal federalism. By so doing, it will then be possible to comment on the character of fiscal federalism in Malaysia and to answer the research question posed in this study. Hence, it is of fundamental importance to consider first, political developments leading to the establishment of the federation, secondly, how the fiscal arrangements were designed, that is, what functions reside in the central government and what functions should be given to state governments, and finally how fiscal adjustment was considered to remedy fiscal problems arising from this arrangement.

3.2 The idea of the federal system in retrospect

The first idea of a federal system in Malaysia was closely related to the history of British colonialism. The British colonial history of Malaysia began when Captain Francis Light, acting for the British East India Company, obtained Penang from the Sultan of Kedah in 1786, in return for protection against Siamese aggression.[1] This event is important, as it was the turning point in 'modern'[2] Malaysian history. From Penang, the British sphere of influence expanded to other Malay states when in 1819 the British gained Singapore. In 1824 the British obtained Malacca from the Dutch in return for the British surrender of its

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[1] However, Kedah failed to receive any military protection and in 1821 Siam conquered Kedah, which it ruled until 1842. See Bedlington (1978).

[2] The term 'modern' is use to differentiate the early history of Malaya, especially the history of Malacca when was a commercial port in the region during the Malacca Sultanate (1400-1511). In 1511, the Portuguese gained Malacca and thus controlled the spice and tin trade in the region until 1641 when the Dutch overthrew the Portuguese. See Emerson (1964).

interest in Bencoolen (Bangkahulu), Sumatra, Indonesia, to the Dutch by the Anglo-Dutch treaty of 1824. Bencoolen had proved a most unsatisfactory and expensive station from which to oversee British interest in the regions. So the British sought a more suitable station in the region as the new base (Milne and Mauzy, 1980). The British interest in the Malay states was essentially motivated by British growing interest in trade, especially spice and tin. During this period, the British maintained a policy of non-intervention in local affairs, but, as will be discussed shortly, they later changed this policy for fear that local political developments might put British interests in the Straits Settlements (Penang, Malacca, and Singapore) at risk.

As the British successfully controlled the Strait Settlements and their trade grew, their sphere of influence expanded to other Malay states, namely Perak, Selangor, Negeri Sembilan and Pahang, due to the demand for rubber and tin. Before that, the British had shown little interest in the other Malay states' internal affairs, as they did not impinge on British trade interests. However, as demand for rubber and tin increased following the Industrial Revolution in Europe in the second half of the 18th century, and in fear that the internal affairs of the Malay states' might affect British interests in these commodities, the British began to take an interest in other Malay states' affairs,[3] especially in the middle of the 19th century. Perak was the first Malay state outside the Straits Settlements to attract British interest, prompted partly by political turbulence in Perak and also due to its large tin deposits. In 1874, the British interest became a reality when the Pangkor Treaty was signed between the British and the Sultan of Perak. According to Bedlington, the Treaty of Pangkor 1874 'became the political instrument that served as a model for British intervention and control in other Malay states' (Bedlington, 1978: 33). This treaty marked the beginning of British colonial rule in all the Malay states outside the Straits

[3] Internal affairs in the Malay states could affect the British interest in tin mining, as in the case of Perak, where heavy fighting between Malay chiefs and violent conflict between rival Chinese secret societies over tin mining disrupted the supply of tin. Apart from this, brigandage activities in the Straits of Malacca also affected the British interest. For further discussion on this, see Khoo Kay-Kim (1972), especially Chapter 8.

Settlements: Perak, Selangor, Negeri Sembilan and Pahang, leading to the formation of the Federated Malay States[4] (FMS) by the Treaty of Federation 1895. The FMS was headed by the Resident General, who would be accredited to his Court, and whose advice had to be asked and acted upon regarding all questions other than those touching Malay religion (Islam) and custom. Later, in 1911, this position was replaced by that of the Chief Secretary. The resident system was initially designed primarily as a means of bringing law and order to the Malay states (Means, 1976).

The Treaty of Federation 1895 marked the beginning of the federal tradition in the history of Malaysia. Nevertheless, it is difficult to recognise the FMS as a proper federal form of government, because of its centralised administrative structure. The treaty did not define the respective functions of the federal and state governments. As such there was no division of powers between 'central government' and state governments. Indeed, there was not even a formal central or federal government except the federal authority and Federal Council. The federal authority (which undertook the role of the federal government) was not assigned a legislative function: law was drafted by a Federal Officer, the Legal Adviser, and passed by the respective State Council. In terms of centre-state financial relations, states had limited power in both revenue raising power and spending power until decentralisation took place in 1927 (Yeo, 1982; Ghosh, 1977; Braddell, 1931). Expenditure was undertaken by the centre and mainly concentrated on infrastructure developments designed primarily to assist the expansion of the rubber and tin industries, to accommodate the British interest in these commodities. However, the socio-economic well being of the people in the states was disregarded (Emerson, 1964). There was no constitution except for the Treaty.[5] Thus, the FMS was not a proper federal

[4] See Emerson (1964) especially Chapter IV, for detailed discussion on the Federated Malay States (FMS).
[5] The treaty is simple, consisting of only five articles. See Appendix i of this thesis for the full text of the Treaty of Federation of 1895.

system of government[6] in the accepted sense of a federal system as discussed in Chapter 2. Indeed, the FMS only intended to put the four states under a single administration for the sake of uniformity and to impose law and order primarily to safeguard the British interest in Malay states.

Therefore the first idea of a federal system in Malaya was not intended to unite the Malay states into larger political union for their future self-government but merely represented the British intention to control the Malay states in order to safeguard their business interests. According to Yeo (1982: 292) 'the British officials never had in mind a real federation with a rigid division of powers between the centre and the states' during the formation of the FMS. Despite these limitations, the importance of the FMS is that the idea of a federal form of government already existed, long before a formal federal form of government was introduced in 1948.[7] As Hickling argues,

> 'apart from the administrative significance of the Treaty [the Treaty of Federation 1895], its real importance in the constitutional history of Malaya lies in the idea of federation implicit in it: an idea which paved the away for the ultimate establishment of true federal government in Malaya' (Hickling, 1960: 4).

In 1909, however, a step towards a proper federal system of government took place with the establishment of the Federal Council, located in Kuala Lumpur.[8] Legislative power was transferred from the state to the Council, although executive power remained with the states. The main task of the Federal Council was to make legislation for the FMS. With the inauguration of the Federal Council, any laws passed by the State Council would not be valid if they were inconsistent with the provisions of laws passed by the Federal Council. Although the State Councils existed, their function was limited to Islamic affairs and Malay culture, as other important functions were centralised. The members of the Federal Council comprised the Resident General, the British Residents

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[6] See Section 2.2 of Chapter 2 for the interpretation of federalism and federation.

[7] See Section 3.3.1 for a discussion of the Federation of Malaya 1948

[8] See 'Agreement for the Constitution of a Federal Council, 1909'. This agreement was signed on the 20th October 1909 between the High Commissioner of the FMS (Sir John Anderson) and the Rulers of the FMS (Perak, Selangor, Pahang and Negeri Sembilan).

and Sultans of Perak, Selangor, Negeri Sembilan and Pahang, four unofficial members nominated by the Governor and one Malay representative. All members were appointed rather than elected. Legislation passed by the Council required the endorsement of the British Residents, but not the Sultans, which was a cause of discontent among them. As will be discuss shortly, the Sultans finally demanded the British authority to amend this arrangement, which resulted in a decentralisation of powers, including financial matters, to States' Councils.

With the rapid development of the rubber and tin industries in the FMS, it became increasingly necessary for the Federal Council to undertake functions on an interstate basis and as a result there was a steady transfer of executive power from the states to the central authority, especially after 1909. In 1911 the post of Resident General was abolished and his functions were assumed by the Chief Secretary, mainly to reassure the Rulers who feared that administration was becoming too centralized, as the legislative powers of the states were diminished (Milne and Mauzy, 1980). In the early 1920s, due to over-centralisation of power, the Sultans called on the British authority to redefine federal and state functions (Yeo, 1982; Ghosh, 1977). Subsequently an agreement was signed between the High Commissioner and the four Sultans of the FMS, by which the Federal Council was reconstituted and a number of federal departments were transferred back to the states under the 1927 decentralisation scheme (Yeo, 1982; Ghosh, 1977).[9] The four Sultans were also withdrawn from active participation in the Federal Council and instead they met in an annual Durbar (Conference of Rulers). All legislation passed by the Federal Council now required the Sultans' assent. At the same time, the unofficial membership of the Federal Council was further enlarged. The legislative and financial authority of the Council was also outlined. Under the new arrangement, general policy was controlled by the High Commissioner, who retained the power to give advice

[9] This was the first decentralisation process in the FMS. For detailed discussion of the decentralisation process, see Yeo (1982) especially Part Two and Ghosh (1977) especially Chapter 7.

through the Residents. However, the states' financial matters remained under the control of the Federal Council.[10] Each year the Federal Council voted block grants to each of the states to meet their annual budget deficit. Despite the strict standing financial instructions and limited grants, the states were free to allocate the expenditure at their disposal. In summary, as a result of these reforms, the division of federal and states functions, which the Treaty of Federation 1895 had failed to make, were now defined, which resulted in the transfer of a number of departments to states and the abolition in 1935 of the post of Chief Secretary, to be replaced by a Federal Secretary. Accordingly, his statutory and administrative powers were transferred to states' control (for state matters), and to the High Commissioner for federal matters; meanwhile the State Councils were strengthened by broadening the basis of representation through the addition of further Chinese, European and Indian unofficial members.

The effect of the new arrangement on the states was remarkable. The increased responsibilities of the State Councils helped to deal with the problem of local administration and at the same time stimulated initiative for the development of the idea of self-government. Concern for the welfare of the rural population, which was neglected under the old arrangements of the Treaty of Federation 1895, now increased. Although the British government established State Legislative and Executive Councils, their members were appointed rather than popularly elected (similar to the Executive Council and Legislative Council at federal level), and these councils were never given power to be more than advisory bodies to the government. These new arrangements continued until World War II broke out.

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[10] No progress was made under the Financial Devolution Scheme (the Poutney Financial Scheme) to return financial autonomy to the states. The Financial Devolution Scheme failed to vest the State Councils with any real financial authority since the Federal Council exercised ultimate financial control over states' expenditure. The Scheme failed because the Federal Council wished to ensure the financial stability of the FMS 'since the existing State Council members almost entirely lacked experience in handling financial matters' (Yeo, 1982: 305).

Meanwhile, outside the FMS, the British attempted to expand their sphere of influence to other states: Johor, Kedah, Perlis, Kelantan and Terengganu, which were administratively isolated from the rest of the Malay states, known as the Unfederated Malay States (UMS). However, all of these states (Perlis, Kedah, Kelantan, Terengganu and Johor) were under separate administration, unlike the Federated Malay States (FMS). The British interest in these states was prompted partly by a wish to prevent further penetration by Siam (Thailand) and to suppress piracy, which threatened British interests. All these states (except Johor) were under Siam's protection[11] until 1909, when an Anglo-Siamese treaty was signed, by which Siam transferred the protection, right and suzerainty of these states to Britain. Subsequently, a series of treaties[12] were signed between the British government and the respective Sultans of these states, by which British advisers were appointed to each state.

As for Johor, a British adviser was accepted only in 1914, although British influence had been established by a Treaty of 1885 in which the Sultan of Johor ceded the control of the state's foreign affairs to the British. However, in 1914 an Agreement was concluded with the Sultan of Johor under which a British officer was appointed as General Adviser (Braddell, 1931) and hence, with this agreement, all Malay states were now under the British influence. Although the UMS accepted British advisers, 'each of these five states operated more or less independently of the others: they worked together only when they sensed an impending assault from Kuala Lumpur on their semi-autonomous status' (Bedlington, 1978: 34) and as such 'the UMS retained greater autonomy, a more traditional political system and less British intervention' (Means, 1976: 42). Even today, the former UMS states still keep their own state service, different from the former FMS states (Shafruddin, 1987; Zakaria Ahmad, 1987a). These Malay states' political division

[11] Siam's influence on these states was implicitly acknowledged by the British through the Anglo-Siamese Treaty 1826 (see Bedlington, 1978). The British decision to make advances to the states of northern Malaya was partly prompted by the Entente Cordiale with France in 1904, as a result of which the British no longer feared a France counter-move in or against Siam. See Milne and Mauzy (1980).

[12] The treaty with Kelantan and Terengganu was signed in 1910, Kedah in 1923 and Perlis in 1930.

continued until World War II broke out, when the Japanese evicted the British and occupied all the Malay states (1942-1945).

3.3 The federal form of government: The failure of the Malayan Union and the second attempt at federal creation

The Japanese occupation of Malaya planted the seeds of nationalism among the Malays, especially among the young generation and inspired a new political movement aimed at gaining independence. This was also partly influenced by the independence movement in other parts of the Southeast Asia region, especially in Indonesia. [13] 'The Japanese conquest of Malaya failed in disgrace. But by fatally wounding the British imperial lion, it had shown the people of Malaya a vision of self-determination, self-government, and independence from all outside tutelage, whether British or Japanese' (Simandjuntak, 1969: 14). After the Japanese withdrawal from Malaya in 1945, the British returned to Malaya to fill the power vacuum in the administration of the Malay states. Due to a fear that the communists would control Malaya,[14] the British Military Administration (BMA) was immediately installed as a temporary administration until a proper form of civilian government could be established. As the BMA was only an interim measure, the Colonial Office planned for a future Malaya by integrating all the Malay states (FMS, UMS and Straits Settlements) 'under one centralised and unified government' (Macdonald, 1948: 6) as a step towards self-government. According to this plan, the Malay Sultans were required to transfer their powers to the British Crown. Eventually, through the British representative – Sir Harold MacMichael[15]– the 'consent' of Malay Rulers was obtained

[13] The Japanese occupation in Malaya lasted for only three and half years, from 1942 to 1945, until the Japanese surrendered to the Allied Forces. See Percival (1949) and Kratoska (1995) for an account of the Japanese occupation in Malaya.

[14] The communist movement in Malaya during and after the Japanese occupation was represented by the Malaya Communist Party (MCP) which gained support primarily from the Chinese through the Chinese-led guerilla organization MPAJA (Malayan People's Anti-Japanese Army). See Oong Hak Ching (2000) for discussion on the communist movement in Malaya after the Japanese occupation.

[15] See MacMichael, (1946).

through the 1945 agreement.[16] In this agreement, the Malay Rulers surrendered their powers to His Majesty, as stipulated in the agreement: 'His Highness the Sultan agrees that His Majesty shall have full power and jurisdiction within the states'.[17] This clause is significant, as it became the central theme of the Malayan Union created in 1946.

However, the British attempt to integrate the Malay states gave rise to strong opposition[18] from Malay nationalists, which grew rapidly after the British Parliament accepted the proposal to form the Malayan Union in early 1946. Strong Malay opposition stemmed first from the fact that the powers of the Malay Rulers would be lost in the larger body of the union within which the states were to be merged (and subsequently the individuality and identity of states would be lost), and secondly, due to the citizenship issue, in which under the proposed Malayan Union, citizenship was open to all inhabitants in Malaya by reason of birth or by naturalisation (for those who had resided for ten out of fifteen years preceding 15 February 1942). The citizenship issue effectively created conflicts between communities, as Malays feared they would lose *ketuanan* ('sovereignty') to other ethnic groups in their own motherland because non-Malays would out-number the Malays (Macdonald, 1948: 7).[19]

During British colonial period, a large number of immigrants from China and India were brought in to Malaya to work in the tin mines and rubber plantations. This situation created a plural society in Malaya and in the long term caused socio-economic and political fears to grow among Malays over non-Malay political dominance, as the number of foreign labourers far outstripped that of the Malay population. As Macdonald (1948)

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[16] See Malaya (1945). Agreement with Johor was signed on 20th October, Selangor on 24th October, Pahang on 2nd November, Negeri Sembilan on 14th November, Perak on 22nd November, Kedah on 2nd December, Perlis on 4th December, Kelantan on 17th December and Terengganu on 21st December 1945.

[17] See Malaya (1945) Clause 1.

[18] By March 1946, the anti Malayan Union reached its peak. For the first time all Malay organisations gathered in Kuala Lumpur to attend the Pan-Malayan Malay Congress, primarily to plan for more coordinated opposition against the Malayan Union. Among other proposals of this congress was the formation of the United Malays National Organisation (UMNO). See Amoroso (1998). Finally UMNO was born on 11th May 1946. Further detailed discussion on the history of UMNO can be found in Ahmad Fawzi (1992).

[19] Malcolm Macdonald was a Governor-General of the British in Southeast Asia.

notes, the Malays were concerned that the non-Malays were temporary immigrants whose first loyalty continued to be to their own countries.[20] Ratnam (1967) concurs with this statement when he says that 'it is sufficient to say that most Chinese and Indians who came to Malaya during the first three decades of the twentieth century...were little more than "birds of passage", who left once they had made their money' (Ratnam, 1967: 6). The loyalty of Chinese and Indians towards Malaya was dubious, which prompted Malay resistance over the equal citizenship status proposed by the Malayan Union. According to Oong,

> 'the Malayan Union proposals...were favourable and beneficial to many of the Chinese. However, the proposals had not aroused sufficient interest among the Chinese. Some supported the principle of equality for all citizens but were sceptical about choosing to become Malayan Union citizens, as they were still proud to maintain their status as Chinese nationals' (Oong, 2000: 105).[21]

At the same time, the Sultans claimed that they had not been consulted on the idea of Union and were not given enough time to study the proposal. Furthermore, the Sultans were under threat of being replaced by rulers more loyal to the British government (as some Sultans during the Japanese occupation, for one reason or another, were accused of collaborating with Japanese), leaving the Sultans with no choice but to sign the treaty.[22] With this treaty, the powers of the Malay Rulers came to an end: their powers were conferred on the British government, leaving the Sultans with matters relating only to Islamic affairs and cultures. Thus, with the Union, the Malay Rulers and the Malays felt very deprived. Although there were State Councils, they could only make laws on Islamic affairs or any subjects assigned by the Union upon approval of the Governor General. A Statement by Rees-William in the House of Commons described the feeling of Malays and British ex-Malayan Civil Servants towards the colonial Malayan Union project -

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[20] In 1947, the total population of Malaya was 4.908 million, of which Malays comprised 49.8%, Chinese 38.4%, Indian 10.0% and others (mainly European) 1.8%. See Table 1.1 of Chapter 1.

[21] Further discussion on the Chinese reaction towards the Malayan Union can be found in Oong (2000), especially Chapter 4.

[22] Indeed, the Malay Rulers were forced to agree to the terms and conditions of the Malayan Union. The British used 'shotgun signature' (Milne, 1967: 29) to obtain the signature of the Malay Sultans.

'there was no consultation; there was no investigation; there was no Royal Commission; there was no parliamentary mission'.[23]

Despite strong objections towards the Malayan Union from Malay nationalists, on 1st April 1946 the Malayan Union was inaugurated. Thus, the union comprising the former FMS, UMS, and Straits Settlements states of Penang and Malacca became a reality, the first time that all eleven Malay states had been brought together under one administration. Singapore remained a separate Crown Colony,[24] 'since it was considered that it required separate treatment in view of the fact it was considered to be a centre of entrepot trade with economic and social interests distinct from those of mainland Malaya' (Hickling, 1960: 7). But this decision was not to 'preclude or prejudice in any way the fusion of Singapore and the Malayan Union in a wider Union at a later date should it be considered that such a course were desirable'.[25] Although the Union was thus officially established, Malay opposition continued. Macdonald (1948: 7) describes the situation as 'tense and dangerous and, indeed, might easily have led to acts of bloodshed' especially towards the middle of 1946.

With continued strong Malay opposition towards the Malayan Union, headed by the United Malays National Organisation (UMNO), the Malayan Union was finally abolished in 1948 and replaced by the Federation of Malaya. Thus the unitary form of government in Malaya was attempted through the Malayan Union experiment but failed due to the strong opposition of Malays on the ground of the citizenship arrangement, as well as the fear of losing the Malay Rulers' powers to the British. Clearly, the Federation of Malaya of 1948 and 1957 was not established to accommodate states' socio-economic diversity.

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[23] Rees-Williams' (Lord Ogmore) statements in the British House of Commons, cited from Simandjuntak (1969: 44). Rees-Williams was among ex-Malayan Civil Servants (together with Gammans, Winstedt, Swettenham) who opposed the idea of Malayan Union.

[24] Due to British economic interest in Singapore, coupled with the predominantly Chinese population which gave racial imbalance against Malays in the Malay states, the British decided to exclude Singapore from the proposed Malayan Union. Singapore received internal self-rule in 1959.

[25] Malaya (1946b: 3).

As the interest of the people and states was towards future political survival rather than defending states' interest in the new Union, it is not surprising if the financial arrangements between the centre and all state governments did not attract much attention from states. As a result, the form of early federation in Malaysia was symmetrical in character.

3.3.1 The first stage of federation: The Federation of Malaya (1948)

The Federation of Malaya was formed on 1st February 1948 following the signing of the Federation of Malaya Agreement, 1948[26] between the British government and the Malay Rulers of the nine states of the former FMS and UMS together with two Straits Settlements – Penang and Malacca. The Federation of Malaya Agreement 1948 contained provisions similar to the Malayan Union treaty of 1946, but it was significant to the Malays because it protected their future through the citizenship policy and recognised the individuality of the states. In practice, however, the Federation of Malaya Agreement 1948 reflected the overall theme of the establishment of the federation, that is, the establishment of 'a strong central government'[27] and less attention was paid to the second theme, that 'the individuality of each of the Malay States and of the Settlements should be clearly expressed and maintained'.[28]

This agreement is of great importance in the history of federalism in Malaysia because the present federal system evolved from it. With this agreement, a truly federal system of government became a reality after the first federal idea in 1895 and the Malayan Union in 1946. According to Hickling (1960: 10), this agreement was in fact 'a formal federal constitution'. However, the Federation of Malaya 1948 did not guarantee the autonomy of the states, as the federal government had complete legislative powers, except in

[26] See Malaya (1948).
[27] See Malaya (1946a) and Malaya (1947).
[28] See Malaya (1957a), Chapter II, page 7.

matters related to Islam and Malay customs. Although a formal constitution had yet to be established, the agreement spelled out most of the division of powers and functions between the federal (under federal list) and state governments (under state list). However, there was still some dissatisfaction over financial arrangements.[29] Although there was a sharing of powers between the federal and state governments, most of the powers were vested in the federal authority. The federal government had both legislative and executive responsibility over states' subjects, if the federal government felt it necessary. Therefore, what emerged from the Federal Agreement 1948 was a heavily centralized federation which was almost unitary in character with strong centripetal forces. As shall be seen later in the chapter, the Federation of Malaysia 1963 (and its predecessor the independent Federation of Malaya 1957) evolved from the arrangement set out in the Federation of Malaya Agreement 1948.

Unlike the former FMS, the 1948 Federal Agreement recognised the formation of federal government, comprising the Federal Executive Council and the Federal Legislative Council. However the power of the federal government was concentrated in the hands of the High Commissioner,[30] who was not politically responsible to the people but to the Secretary of State for the Colonies in London. He was given full executive authority for the running of the federal government, aided by a Federal Executive Council over which he presided. Although the High Commissioner was required to consult the council on all matters involving the exercise of his power (except where the public interest would sustain material prejudice or matters that were less important or too urgent), the High Commissioner could make the ultimate decision alone and did not have to give any reason for his decisions. The High Commissioner also appointed all the members of the

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[29] States' resentment over the problems of financial arrangements between the federal and state governments as provided in the Federal Agreement was prompted by the formation of a special committee to revive this arrangement. See further discussion on this issue in Section 3.5.1.2 of this chapter.

[30] See Malaya (1948), Part III.

Executive Council, which comprised official (Chief Secretary, Attorney General and Financial Secretary) and unofficial members.

The High Commissioner also presided over the Legislative Council which comprised 76 appointed members: fifteen ex officio members, namely, the High Commissioner (as a presiding officer), the Chief Secretary, the Attorney General, the Financial Secretary, the nine presidents of State Councils, and two representatives of the Straits Settlement Councils; eleven official members appointed by the High Commissioner; and fifty unofficial members that represented various communities and economic interests. Looking at the composition of both the Executive and Legislative Councils, the responsibility for the administration of the government rested entirely with the ex officio and official members who were appointed by the High Commissioner and, as such, it was not surprising if they were bound to act in accordance with the High Commissioner's directives. Looking at the composition of the Legislative Council, clearly state governments were not sufficiently represented (only eleven representatives out of seventy-six) to safeguard their interest in accordance with the federal spirit.

3.3.2 The Federation of Malaya (1957)

The successful creation of the Federation of Malaya 1948 inspired the movement towards self-government and subsequently Malayan independence from the British. Towards this end, for the first time in 1951, the members system[31] was introduced in the Legislative Council in order to give more political responsibility to the Malayans, in preparation for complete self-government. This was in line with the aim of the Federal Agreement, that 'progress should be made toward eventual self-government, and...as soon as circumstances and local conditions will permit, legislation should be introduced for the

[31] The members system was proposed in April 1950 and subsequently approved by the Legislative Council in January 1951 and came into effect in March 1951. See Council Paper No. 49/1950, Federation of Malaya.

election of members to the several legislatures to be established pursuant to this Agreement.'[32]

Subsequently in 1955, for the first time, members of the Legislative Council were elected. The Alliance coalition party[33] won a landslide victory, taking 51 out of 52 seats contested for the Legislative Council. Tunku Abdul Rahman, the party president of the United Malay National Organisation (UMNO) and the leader of the Alliance coalition party was appointed as Chief Minister and subsequently formed a cabinet. In 1956, a Constitutional Conference was held in London, whereby a decision was made that self-government and independence within the Commonwealth should be granted to Malaya by August 1957. Subsequently, a Constitutional Commission was formed to draw up a draft constitution.[34] With the 'strong central government' theme, the federal structure displayed extremely unitary characteristics. Indeed, the Federation of Malaya 1957 is best regarded as a unitary system with federal elements. The Federation of Malaya, according to Carnell (1961: 58) 'was the outcome of the British system of ruling through the Sultans of protected Malay states, and response to the problems posed by the survival of nine monarchies. In 1946 the mystique of monarchy was so strong among local British officials and Malaya nationalists as to rule out any possibility of the formal apparatus of a unitary state'.

It is also noteworthy that no Malayan was invited to be a member of the Constitutional Commission. Even the prospective members of the federation were not directly invited to determine their rights, interests and future in the federation, as most elements of the

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[32] See Malaya (1948), page 2.

[33] The Alliance party (Parti Perikatan) was formed in 1955 consisting UMNO, MCA and MIC.

[34] This Commission consisted of Lord Reid (Lord of Appeal in Ordinary) as Chairman, Sir Ivor Jennings (Master of Trinity Hall, Cambridge), Sir William McKell (a former Governor-General of Australia), Mr. B. Malik (a former Chief Justice of the Allahabad High Court, India) and Justice Abdul Hamid of the Pakistan High Court. The Commission worked according to the following terms of reference (a) the establishment of a strong central government with some autonomy in the states, (b) safeguarding the position and prestige of the Rulers, (c) providing for a constitutional head of state, (d) creating a common nationality, and (d) safeguarding the special position of the Malays and the legitimate interests of other communities. See Malaya (1957c), page: 6.

constitution were imposed by the British (as indicated in the terms of reference) in consultation with the Alliance coalition party, rather than openly negotiated by all prospective members of the federation. In other words, the state governments were not directly involved in the drawing up of the Constitution. As a result, the Constitution was not the result of an agreement of the member states but predominantly reflected the Alliance political elites' communal bargaining. As stated in Chapter 2, Wheare (1953) argues that a federation is established by a few previously independent states; however, his argument is not convincing in the case of the Federation of Malaya 1948, or the new Federation of Malaya 1957, as the states were not yet independent and hence were subject to the British terms of reference in designing the form and kind of the future constitution for their colonised states, based on the prevailing situation at the time of federating. Hence, the states were powerless (legally and constitutionally) to fight their interest during the formation of the federation. The Malayan inhabitants were invited only 'to comment and to accept' the draft of the Federal Constitution prepared by the Constitutional Commission.

The Reid Commission Report, which contains the draft constitution for an independent Malaya,[35] was largely derived from the Federation of Malaya Agreement of 1948. However, significant modifications were made especially with regard to federal citizenship, Malays' special privilege, Malay as a national language, education and the position of Islam as the official religion of the federation. The Reid Commission Constitutional Report was finally accepted by the British government after it had 'undergone changes both of substance and of form'[36] with regard to citizenship, Malay privileges, the position of Malay Rulers and religious matters. This was largely aimed at accommodating multiethnic diversity in the quest for unity within a larger body of

[35] The framers of the Federal Constitution drew on the constitutional experience of a number of other countries. However, it closely followed the Indian Constitution. 'Both directly and derivatively, the Constitutions of Great Britain and the United States have influenced that of Malaysia' (Groves: 1964: 22).

[36] For fuller discussion see Malaya (1957a), Malaya (1957b), and Malaya (1957c).

association. Finally, the Federation of Malaya gained independence on 31st August 1957 and the new Constitution came into force,[37] thereby ending the division of powers / functions between the federal and state governments under the Federation of Malay 1948.

3.3.3 The second stage of federation: The Federation of Malaysia (1963)

After independence in 1957 and the successful operation of the first stage of federalism, an attempt was made in the early sixties to recast the idea of a larger federation by including Singapore, Sabah (formerly North Borneo), Sarawak and Brunei to form the Federation of Malaysia. The idea of the Federation of Malaysia already existed long before Malaya became independent in 1957 (Macdonald, 1948), but was renewed in 1961 by Tunku Abdul Rahman, then the first Prime Minister of Malaya, who envisaged that Singapore, Brunei, Sabah and Sarawak should be merged together in one larger union. [38]

These states, however, had different political, economic, social and racial backgrounds, and were not closely related to the original members of the Federation of Malaya 1948. What these states had in common was that they were not yet independent, that is, they were still under British protection. Singapore had been a British Crown Colony since 1826, and Brunei had been a British protectorate since 1888, while North Borneo (Sabah) and Sarawak, had been British protectorates since 1946.[39] In 1962, an enquiry was conducted to solicit the opinion of the people in Sabah and Sarawak, as to whether or not

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[37] The financial provision in the Constitution, however, only came into force on 1st January 1958 since the government fiscal year ended on 31 December.

[38] See Tunku Abdul Rahman 'An address given to the foreign correspondents association of the South-East Asia on 27th May 1961'. See Malaysia (1963c).

[39] The status of Sabah (then North Borneo) and Sarawak was quite different. Until the Second World War, Sarawak belonged to Rajah Charles Brooke or the White Rajah (the Brooke family) who governed Sarawak for almost fifty years, while Sabah was administered by a British trading company (the East India Company) from 1761 when the Company concluded a treaty with the Sultan of Sulu in return for protection from Spanish encroachment. However, after the Second World War, the Colonial Office took over responsibility for both territories. For further discussion on the early history of Sabah and Sarawak, see Bedlington (1978).

they were in favour of joining Malaysia. The findings of the Commission indicated that the people of both North Borneo and Sarawak favoured the formation of Malaysia.[40]

Among these states, Singapore was more economically advanced, wealthy and developed than the states of Sabah and Sarawak. The main ethnic components of Singapore's population were similar to those of Malaya – Malay, Chinese and Indian, but, unlike Malaya, Singapore was overwhelmingly Chinese, and due to the small size of its ethnic communities, racial conflicts were not such a serious issue as in Malaya. However, the inclusion of Singapore into the Federation of Malaya was viewed by Malayan political leaders with scepticism, for fear of Chinese political dominance, as the number of Chinese would exceed the Malay population. Malaya and Singapore are geographically linked and historically both had experienced British control and influence for a long time. Singapore's economy to a large extent depended on the Malayan hinterland. On the other hand, Sabah and Sarawak are geographically separated from peninsular Malaysia by the South China Sea (see map of Malaysia). Hence, it was doubtful whether federalism could survive over such a distance. Both states had been taken over as British colonies in 1946. The population composition of both states was less clear, unlike the neat plural divide of Peninsular Malaya and Singapore. In Sabah and Sarawak, the critical lines of cleavage were firstly, between the non-Muslim and Muslim indigenous communities and secondly, between the indigenous and non-indigenous communities. However, on a positive note, the inclusion of Sabah and Sarawak into the Federation of Malaya would balance out the number of Chinese. As for Brunei, it was also a Malay state, which had been a British protectorate since 1888, but was economically wealthy due to oil production.

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[40] See Malaya (1962b). A Commission under the chairmanship of Lord Cobbold visited North Borneo and Sarawak between February and April 1962. This Committee comprised representatives from the British government (8), the Malayan government (20) the North Borneo government (18) and the Sarawak government (29). The Commission was unanimously agreed that a Federation of Malaysia was in the best interests of North Borneo and Sarawak and that constitutional arrangement should be made.

The Malaysia proposal received mixed reactions, in particular from the Philippines and Indonesia. The Philippines had renewed its claim over Sabah[41] as part of their suzerainty, while Indonesia claimed that people of North Borneo (Sabah) and Sarawak were not given enough opportunity to determine their future. Indonesia eventually launched military confrontation against Malaya.[42] Despite those threats, the Federation of Malaysia was finally inaugurated on 16th September 1963 to include Sabah, Sarawak and Singapore. The original Federal Constitution 1957 was amended to accommodate the new members in the Federation of Malaysia. With the establishment of Malaysia, a proper federal system of government was created, in which the constituent units, that is, Sabah, Sarawak and Singapore (while within the Federation of Malaysia (1963-1965)) were more autonomous than their counterparts in peninsular Malaysia, which were almost unitary in character.

3.4 The structure of government

The inauguration of the 1957 Federal Constitution on 31st August 1957 marked the beginning of a bicameral parliamentary system in Malaya. The Federal Constitution clearly divided the authority of the federal government into legislative, judicial and executive[43] as well as the division of powers[44] between the federal and state governments. However, as will be seen later in this section, the design of the federal system in Malaysia has made the federal government superior to the states, especially with regard to constitutional amendments.

3.4.1 The legislative branch

The Parliament of Malaysia is a federal legislature modelled on the British Parliament, which is responsible for federal laws. The parliament comprises the Houses of

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[41] See Malaysia (1963c).
[42] See Means (1963).
[43] The judicial branch will not be discussed here. See Abdul Aziz Bari (2003), Lee (1995) and Hickling (1991) for discussion on the judicial system in Malaysia.
[44] See Section 3.5 of this chapter.

Representatives[45] (Lower House or *Dewan Rakyat*) and the Senate (the Upper House or *Dewan Negara*). Thus, the Federation of Malaysia is a bicameral parliament. The *Yang di-Pertuan Agong* or the King heads the Parliament, and as such is the supreme head of the Federation of Malaysia.[46] In the exercise of his functions, under the Federal Constitution or federal law, the Yang di-Pertuan Agong shall act in accordance with the advice of the cabinet or of a minister acting under the general authority of the cabinet.[47] Nevertheless, the Yang di-Pertuan Agong may act on his discretion[48] on the following matters: the appointment of a Prime Minister; the withholding of consent to a request for the dissolution of Parliament; and the requisition of a meeting of the Conference of Rulers concerned solely with the privilege, position, honours and the dignities of Their Royal Highnesses, and any action at such a meeting.

Article 44 of the Federal Constitution stipulates that: 'The legislative authority of the Federation shall be vested in a Parliament, which shall consist of the Yang di-Pertuan Agong and the two Majlis (Houses of Parliament) to be known as *Dewan Negara* (Senate) and *Dewan Rakyat* (House of Representatives)'. The Dewan Rakyat is a democratic chamber that has 219 members (as at the 11th Parliamentary Session) who are elected representatives of the people from their respective states.[49] Elections are held at least once every five years. The last election was held in March 2004 and the next

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[45] The House of Representatives is a successor to the Federal Council formed in 1909 and is a legislative body for the Federated Malay States (FMS). See discussion on the FMS in Section 3.2 of this chapter.

[46] See Article 32 and Article 38 of the Federal Constitution. The Yang di-Pertuan Agong shall be elected by the Conference of Rulers; the Conference of Rulers comprises all the state Rulers and its prime duty is to elect the Yang di-Pertuan Agong and his deputy. However, the Governors (Yang di-Pertua Negeri) that Rule the non-Sultanate states assume no role in the election at the conference. The Conference must be consulted on the appointment of judges, the Attorney General, the Election Commission and the Public Services Commission. Concurrence must also be obtained from the Conference of Rulers on matters relating to the alteration of state boundaries, the extension to the federation as a whole, Muslim religious affairs, amendments to the constitution, the special position of the Malays and natives of Sabah and Sarawak and also the rights, prerogatives and privileges of the Rulers themselves. Thus this body acted like a 'third chamber' in the Malayan (and Malaysian) legislature structure, whereby certain matters (Islamic Affairs, Malay privileges, and alteration of state boundaries) require the concurrence of the Conference of Rulers.

[47] See Article 40(1) of the Federal Constitution.

[48] See Article 40(2) of the Federal Constitution.

[49] See Article 46 of the Federal Constitution.

election is not due until 2008. Thus far, eleven general elections have been conducted since independence in 1957.[50]

Table: 3.1
State Representation in *Dewan Rakyat*

States	Representatives		Population (2000) ('000)	Size of state (Sq. KM)
	1999	2004		
Perlis	3	3	204	795
Kedah	15	15	1,650	9,425
Penang	11	13	1,313	1,031
Perak	23	24	2,051	21,005
Selangor	17	22	4,189	7,960
Negeri Sembilan	7	8	860	6,644
Malacca	5	6	636	1,652
Johor	20	26	2,741	18,987
Pahang	11	14	1,289	35,965
Terengganu	8	8	899	12,955
Kelantan	14	14	1,313	15,024
Sabah	20	25	2,603	73,619
Sarawak	28	28	2,072	124,450
Kuala Lumpur*	10	11	1,379	243
Labuan*	1	1	76	92
Putrajaya*	-	1	na	na
Total	193	219	23,275	329,847

Note * : Kuala Lumpur, Labuan and Putrajaya are Federal Territory, not state.
Source: Malaysian Parliament, Election Commission, and Department of Statistics, Malaysia.

Initially, before Malaysia was established, the first parliament of 1959 had 104 members which increased to 159 in 1964 following the formation of Malaysia on 16th September 1963. However, the number was reduced to 144 in 1974 following the departure of Singapore from the Federation of Malaysia in 1965. The number continued to expand until it reached 219 at the last general election (21st March 2004), including 13 members from the Federal Territory; Kuala Lumpur (11), Labuan (1) and newly formed Federal Territory of Putrajaya (1). The present distribution of the representatives is shown in Table 3.1. At first glance it shows that states' representation in the Dewan Rakyat is based on the size of population rather than the size of the states. In practice, however, it is a result of hard political bargaining (Rachagan, 1987).

[50] The first general election for the independent members of the Federation of Malaya was held in 1959. See Part VIII (Elections) of the Federal Constitution for the conduct of elections in Malaysia.

Each elected member of the House represents a political party. As such, their allegiance is to the political party they represent and not really to the state where they obtained the parliamentary seat. This can cause serious problems if a state is led by a different party from the centre, as experienced by Kelantan, Terengganu and Sabah. As such, the members of the House are not truly able to defend the states' interest if they belong to a different party.[51] This is reflected in the way the members of the House vote on bills, and on other matters in the House, where party discipline is very strict. All members of parliament act in parliament according to the policy of the party. In other words, they must argue or debate on certain issues according to the wishes of the party to which they belong; otherwise disciplinary action can be taken against them by the party concerned.[52] Although this practice is quite common in some other parliamentary systems, the Malaysian system is relatively 'worse as freedom of expression, including the press, virtually does not exist' (Abdul Aziz Bari, 2003: 94). Further, Abdul Aziz Bari commented,

> 'In this country, parliamentarians seem to have given importance and priority to the survival of the party rather than to make government answerable to its actions and inactions. On the government side parliament is used to further political ambition rather than to further the interests of the constituencies' (Abdul Aziz Bari, 2003: 94).

On the other hand, the Senate or Dewan Negara has 69 members[53] of whom 40 members are nominated by the Yang di-Pertuan Agong, 26 members are elected by State Legislative Assemblies, (two members from each state), two members representing the Federal Territory of Kuala Lumpur and one member representing the Federal Territory of Labuan. Currently, only 62 members are appointed: 24 from the State Legislative

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[51] See Chapter 6 for the discussion on the political system and the effect on federal-state relations.

[52] For instance, in June 1996, Sabah Gerakan's pro-tem committee chairman Kong Hong Ming was expelled from the party for not supporting the Sabah BN sponsored Sabah Forestry Enactment (Amendment) Bill, aimed at reducing the administrative power of the Chief Minister. In the same year, another Sabah BN assemblymen Jahid Jahim was also expelled for voting against the State Government's Bill to amend the Forest Enactment in the State Legislative Assembly. On 22nd November 2002, Abdullah Badawi, the Deputy Prime Minister and Deputy BN chairman, said two Penang assemblymen faced possible expulsion from the BN for refusing to vote against a motion tabled by an opposition member to postpone the construction of proposed RM1.02 billion Penang Outer Ring Road at the State Legislative Assembly.

[53] See Article 45 (1) of the Federal Constitution.

Assemblies and 38 by the King (see Table 3.2). However, the number is subject to change: the number of members to be elected for each state can be increased to three, provided they are elected by the direct vote of the electors of that state; and the number of members to be appointed can be reduced or abolished altogether.[54]

Table: 3.2
State Representation in Dewan Negara (Senate)[1]
(Total 62 members)

Indirectly elected from the State Legislative Assembly*		Appointed by the King	
From:		From:	
Perlis	2	UMNO	18
Kedah	0	MCA	2
Penang	2	MIC	4
Perak	2	SNAP	1
Selangor	2	PPP	1
Negeri Sembilan	2	SAPP	1
Malacca	2	AKAR	1
Johor	2	SUPP	1
Pahang	2	Minority	6
Terengganu	2	Kuala Lumpur**	2
Kelantan	2	Labuan**	1
Sabah	2		
Sarawak	2		
Total	24	Total	38

Note:
[1] Position as at the 10th Parliamentary Session
* All elected members from states are from UMNO except 6 from MCA, 4 from PAS, 2 from PBB, one from GRM and one UPKO. All these parties are component of Barisan Nasional, except PAS
**Kuala Lumpur and Labuan are Federal Territory, not state.
Source: Malaysian Parliament and Election Commission, Malaysia.

Senators hold office for three years but they are not affected by any dissolution of Parliament. They are not allowed to hold office for more than two terms, either consecutively or otherwise. Appointments made by the Yang di-Pertuan Agong are based on the recommendation of the Prime Minister. These members are selected from citizens of the Federation aged not less than thirty years old[55] and shall be persons who 'have rendered distinguished public service or have achieved distinction in the professions, commerce, industry, agriculture, cultural activities or social service or are representative

[54] See Article 45 (4) of the Federal Constitution
[55] See Article 47(a) of the Federal Constitution

of racial minorities or capable of representing the interest of aborigines.'[56] As the selection of Senators is influenced by the Prime Minister, most of them are affiliated to the ruling party, or at least politically neutral (see Table 3.2). As can be seen, Senators appointed by the Yang di-Pertuan Agong are largely members of the BN coalition parties, especially from the United Malay National Organisation (UMNO), Malaysian Chinese Association (MCA) and Malaysian Indian Congress (MIC). Some Senators are individuals who were defeated in the general election but selected due to their 'distinguished' contribution / achievement within the party. Thus, the Senate is nothing more then a club of exiled politicians (Milne, 1967). By and large, they are no more than 'political nominees' or a result of the 'patronage system' of the ruling party. According to the report by the National Democratic Institute (NDI), 'In Malaysia, the weakness of the second house was manifested in its ability to oversee the executive. Oversight functions are not discouraged by the rule, but by the ruling party, which defines politics as a derivative of consensuses' (NDI, 1996: 5). Thus, the role of the senate as a guardian of states' interest in the federation was seriously undermined as, in practice, senators work not according to the states they seek to represent, but according to the party to which they belong (NDI, 1996; Nik Abdul Rashid, 1979). However this practice is not only confined to Malaysia but occurs in most federal countries.[57]

While the federal parliament adopted a bicameral legislature, at the state level there is a unicameral legislature called the State Legislative Assembly or *Dewan Undangan Negeri.* As for the Federal Parliament, members of a State Legislative Assembly face elections at least once in every five years. The Federal Constitution stipulates that each State Legislative Assembly shall consist of a given number of elected members and the number shall be the same as the number of federal parliamentary constituencies or a

[56] See Article 45 (2) of the Federal Constitution

[57] The practices of some federal countries with regard to the appointment of senators are as follows: by direct election (the US, Switzerland and Australia), by indirect election by state legislative (Malaysia (for 26 members) and India), by federal appointment (Canada and Malaysia for another 43 members). For further discussion see Watts (1999a) page 92-95.

multiple of the number of federal parliamentary constituencies.[58] The states' cabinet ministers, called the Executive Council or Exco, are headed by the Menteri Besar (Chief Minister), and are responsible to the State Legislative Assembly. The powers of the State Legislative Assembly are limited to the subjects under the State Lists or Concurrent List.

3.4.2 The executive branch

The executive branch of the government is responsible to the Parliament. Though vested in the Yang di-Pertuan Agong, the executive authority (the power to govern) is actually exercised by the Cabinet of Ministers, which is headed by the Prime Minister.[59] Hence, the cabinet is the highest policy-making body in the country and responsible to the Yang di-Pertuan Agong. Article 43 of the Constitution states that the members of the cabinet (ministers) are appointed from among Members of Parliament by the Yang di-Pertuan Agong on the advice of the Prime Minister, and are collectively responsible for all cabinet decisions. The Prime Minister has always been appointed from the Barisan Nasional (the National Front – a coalition of parties) and in particular from the UMNO, the dominant party in the Barisan Nasional.[60]

3.4.3 Federal bias: Debate about federal supremacy

Consistent with the concept of federalism, there is a division of powers between the federal and state governments.[61] However the power of the federal government is paramount, especially with regard to constitutional amendments. Investigation of the articles in the Federal Constitution shows that the federal government, through the Parliament, could encroach into the legislative jurisdiction of the state governments for certain reasons. Thus, it is doubtful whether the second theme of the establishment of the federation, 'states and settlements enjoying a measure of autonomy', was really

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[58] See Article 117 and Thirteen Schedule of the Federal Constitution
[59] See Article 39 of the Federal Constitution
[60] See Chapter 6 for discussion on the Malaysian political system.
[61] See Section 3.5 of this chapter.

embedded in the constitution. In the federal system, the two levels of government are unlikely to dictate each other's decisions or encroach into their competencies, but they do seek to affect them through the process of influence, persuasion and bargaining; the fundamental consideration for the federal ethos. Circumstances in which, in Malaysia, the federal government is allowed to encroach on state competencies, which make federal government supreme, are as follows:

First, for the consistency of law, the federal parliament can override a state law if the state law is inconsistent with federal law. Article 75 of the Federal Constitution stipulated that 'If any state law is inconsistent with a federal law, the federal law shall prevail and the state law shall, to the extent of the inconsistency, be void'. This article is of paramount importance in the event of a conflict between state and federal government, especially with regard to matters in the Concurrent List (such as social welfare, public health and veterinary services). With this article, the federal government may interfere in state legislation on any matter. This is an unwarranted violation of the federal principle, as states become subordinate to the federal government.

Second, for the purpose of uniformity, the federal government may also encroach into states' competencies (as enumerated in the State List), by virtue of Article 76(1) of the Federal Constitution in which parliament can pass a law for any of the following purposes: (a) for the purpose of implementing any treaty, agreement or convention between the federation and any country, or any decision of an international organisation of which the federation is a member - except regarding Islamic law, Malay customs or any matters of native law or custom in the states of Sabah and Sarawak, (b) for the purpose of promoting the uniformity of laws of two or more states, and (c) if requested by the Legislative Assembly of any states. The position of the federal government was further enhanced by Article 76(4) of the Federal Constitution which provides that the parliament may 'for the purpose only of ensuring uniformity of law and policy, make

laws with respect to land tenure, the relations of landlord and tenant, registration of titles and deeds relating to land, transfer of land, mortgages, leases and charges in respect of land, easements and other rights and interests in land, compulsory acquisition of land, rating and valuation of land, and local government.' With this article, the federal principle will be seriously undermined if the federal government wishes to trespass on any matters of state competence. However, the states of Sabah and Sarawak are not bound by this provision (Article 95D).[62] The states of Sabah and Sarawak have special status regarding policies concerning land and local government,[63] as is stipulated in Article 95E(2): these states 'shall not be required to follow the policy formulated by the National Land Council or by the National Council for Local Government'. However, with regard to the National Land Council (NLC) the concurrence of the Yang di-Pertua Negeri is required and the concurrence of the state Legislative Assembly is needed with regard to the National Council for Local Government (NCLG).

Third, for the national development purposes, the Federal Constitution also invests the federal government with the power to undertake national development policy on a nationwide basis (Article 92). With this provision, the power of the state legislatures is further abridged and state autonomy further diminished. For instance, the federal government can acquire state land on the pretext of national development purposes / national interest. Under the Federal Constitution, land falls under the State List. However Article 83 (to be read together with Article 92(1)) gives the central government the right to acquire state land for national development and projects in the name of national interest without the concurrence of the respective state legislatures. The establishment of the national councils under the Constitution, namely, the NFC, NLC and NCLG can advise on matters of national developments, to facilitate centre-state coordination and

[62] Article 76(1)(b) and 76(4) should be read with Article 95D which give special position to the states of Sabah and Sarawak as compared with their counterparts in peninsular Malaysia.
[63] See Article 95E(2) of the Federal Constitution

reduce potential conflicts. However, these councils are not impartial as the members are appointed by the centre. Virtually, states could only enjoy the spirit of these articles by the will of the centre. This would cause political tensions between the centre and state, especially in the case of a state led by an opposition party because it is possible that the federal government might exercise Articles 83 and 92(1) on the pretext of the national interest. To ensure states' interests are protected, therefore, before the federal government can initiate any development / investment within state competence, proper examination by an expert and impartial body must be concluded.

Fourth, for the purpose of public order and emergency, the Federal Constitution confers on the federal government the power to declare an emergency for the sake of maintaining security and public order in the federation. In the event of a serious threat to the security or public order, Articles 149 and 150 of the Federal Constitution empower the Yang di-Pertuan Agong to proclaim a state of emergency if he is satisfied that the federation or any of its parts are threatened and to extend the effect of this declaration to any matter within the legislative authority of a state. The most significant provision is Article 150(8), by which the action of the Federal Government in regard to a proclamation of emergency 'shall be final and conclusive and shall not be challenged or called in question in any court and any ground' and 'no court shall have jurisdiction to entertain or determine any application, question or proceeding, in whatever form, on any ground' (Article 150(8)(a)). During the emergency, the executive authority of the federal government is 'extended to any matter within the legislative authority of a state and to the giving of directions to the government of a state or to any officer or authority thereof' (Article 150(4)). Apart from this, the Parliament may 'make laws with respects to any matters' (Article 150(4) except 'any matter of Islamic law or the custom of the Malays, or with respect to any matter of native law or customs in the state of Sabah or Sarawak' (Article 150(6A). Indeed, the role of the federal government during an emergency is similar to

that of a unitary government and cannot be challenged. The danger of this article is the 'possibility of abuse of power' by the federal government to meet its own political interest and to safeguard its political supremacy. For instance, in 1977 the federal government suspended the operation of the state government of Kelantan and declared a state of emergency following a political crisis that paralysed the PAS-led government (Shafruddin, 1987). Another example is the proclamation of emergency in Sarawak in 1966 to deal with the constitutional crisis following the appointment of the Chief Minister (Lee, 1995).

Fifth, power of the states with regard to constitutional amendment is extremely limited as the Constitution is silent on the role of the states in the amendment process apart from the states of Sabah and Sarawak[64] (Article 161E). Consequently, the states (except Sabah and Sarawak) do not have a veto to protect themselves against any undesirable constitutional amendments. The Constitution may be amended by 'the federal law' (Article 159) through the following means: by acts which require a simple majority; or by acts which require a two-thirds majority in each House of Parliament: or by acts which need the consent of the Conference of Rulers as well as the support of a two thirds majority in each House of Parliament; or by acts requiring a two-thirds majority in each House of Parliament and also the concurrence of the Yang di-Pertua Negeri of the state concerned; or by an ordinance promulgated by the Yang di-Pertuan Agong during an emergency, as stipulated in Article 150(2B) of the Federal Constitution. This is another asymmetrical characteristic of the Malaysian federation, in which states receive different treatment within the federation. Thus, looking at the constitutional amendment process, Malaysia is 'non-federal' as state approval is not required to make amendment successful. Simandjuntak commented that,

[64] This is the result of political bargaining during the federation process when finally both states were able to secure a number of safeguards. See Malaya (1962a).

> 'the very character of the federal government demands some form of participation of the unit governments in the alteration of the supreme law of the land. *[However]* Malaya's *[Malaysia]* decision to leave this important task entirely in the hands of the central government amounts to a denial of the fact that the constitution is a contractual agreement between the states and the federation' (Simandjuntak, 1969: 287) [Emphasis added].

With regard to constitutional amendments, two observations can be made. First, the role of the states in the constitutional amendment process is insignificant, and as a result most of the constitutional amendments have been made in favour of the federal government. This is because the federal government interpreted and reinterpreted the Constitution in its own favour. Second, the role of states in the constitutional amendment process is not symmetrical; only the states of Sabah and Sarawak enjoy some degree of safeguard against unwelcome constitutional amendment. The only symmetry is in respect of matters relating to the Malay language (Article 152), Malay special rights (Article 153) and the special position of the Rulers (Article 38), over which the federal government does not have complete control. Article 159(5) of the Federal Constitution stipulates that laws on these subjects cannot be passed without the consent of the conference of Rulers. However, for the states of Sabah and Sarawak, a two-thirds majority in the legislative chamber and the concurrence of the Yang di-Pertua Negeri are required (Article 161E(2)) in relation to any amendment with regard to the rights of citizenship, the jurisdiction of the High Court of Sabah and Sarawak and the appointment, removal and suspension of judges, the legislative competence of state legislatures, the religion and language of the state and the special treatment of the native tribes, and the allocation of seats in the House of Representatives. Article 161E(4) also requires the approval of the government concerned for any legislation regulating immigration into both the states of Sabah and Sarawak.

3.5 The design of intergovernmental fiscal relations and its changing faces

The 'design' of intergovernmental fiscal relations in Malaysia is very closely related to the design of the federal system. It evolved gradually from the first idea of a federal

system in the late nineteenth century to a proper form of federal government in 1948-1957 and subsequently with the establishment of the Federation of Malaysia in 1963. In fact, it is difficult to separate the design of fiscal arrangements from the political developments leading to the formation of the federation. Thus, it is not surprising that the design of intergovernmental fiscal relations has been very much influenced and shaped by political developments in Malaysia, as discussed earlier in this chapter. The analysis of the design of intergovernmental fiscal relations in Malaya / Malaysian fiscal federalism will therefore be studied in three phases: first, during the pre-independence of the Federation of Malaya (1948-1957), second, the period of post-independence of the Federation of Malaya (1957-1963), and third, during the Federation of Malaysia (since 1963).

3.5.1 Financial arrangements during pre-independence of the Federation of Malaya (1948-1957)

The financial arrangements between the federal and state governments during the creation of the Federation of Malaya 1948 and also during the independent Federation of Malaya 1957 were not deliberately discussed compared with other aspects, especially social and political aspects, most notably language, religion, citizenship, Malays' right and the position of Malay Rulers. 'In fact at the time of federating the states showed little or no interest in economic or financial matters' (Holzhausen, 1974: 113). Investigation of records of public opinion on constitutional proposals for the Federation of Malaya 1948 indicate the lack of interest shown by states with regard to financial arrangements between the two levels of government. The Constitutional Proposals report revealed that there was no serious discussion of federal-state financial matters.[65] This situation reflected the desire of the British authority to create a strong central government for the Federation of Malaya; consequently, the fiscal arrangements did not really reflect the

[65] See Malaya (1946a), Malaya (1947), Malaya (1957c), Malaya (1962a), and Malaya (1963b).

desire of the states to have more independent fiscal power. There was no financial committee to study the federal-states financial arrangements of the Federation of Malaya in 1948. Only the Financial Secretary was responsible to answer any financial issues put forward by the public to the Working Committee.[66] With regard to revenue assignment, as the record indicates, only two issues were raised, namely, excise duties and the treatment of financial surpluses.[67] This indicates that the working committee, the state representatives as well as the public at large (including the political parties) did not have a serious interest in federal-state financial matters.

Similarly, with regard to expenditure, there was no objection from the states to the division of responsibilities. The division of expenditure functions were made after the revenue assignment was determined.[68] This is against the basic tenet of fiscal federalism and public finance, which requires expenditure to be determined in advance of revenue assignment so that the assigned functions match with revenue sources (Ter-Minassian, 1997).[69] Hence, based on this principle, expenditure functions should first be determined and then revenue sources assigned appropriately. Doing so would minimise the non-correspondence (right taxes for right expenditures) between expenditures and resources. However, in the design of Malaysian fiscal federalism, the opposite was the case. The upshot was that, during the course of the fiscal year, the states experience financial difficulties that require fiscal adjustment. However, the proposal was accepted by the states without much objection by all parties involved. Indeed, from the outset, the Constitutional framers had realised that this kind of financial arrangements would cause

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[66] The members of the Working Committee were representing the Malayan Union Government (Mr. A.T Newboult (Chief Secretary), Mr. K.K O'Connor (Attorney General), Mr. W.D. Godsall (Financial Secretary), Dr. W. Linehan and Mr. A. Williams, representing the Malay Rulers - Raja Kamaralzaman Raja Mansur (Perak), Dato Hamzah Abdullah (Selangor), Haji Muhammad Sheriff Osman (Kedah) and Dato Nik Ahmed Kamil Mahmud (Kelantan)), and representing UMNO (Dato Onn Jaafar and Dato Abdul Rahman Muhammad Yasin). See Malaya (1946a).

[67] See Malaya (1946a), Chapter IV: Finance and Budgets (Paragraph 40) page 13.

[68] See Malaya (1946a), Chapter IV: Finance and Budgets (Paragraph 41) page 13.

[69] See also Section 3.5.1.1 of this chapter.

financial hardship to the state governments. Therefore the Working Committee suggested that federal block grants should be extended to the states. [70]

Likewise, the Consultative Committee received neither suggestions nor objections regarding the financial arrangements between the federal and state governments. It seems that all matters concerning the financial provisions in Part XI of the Federal Agreement, were not in the interests of the state governments, as is evident from the Consultative Committee report. [71] Investigation of the content of all letters, memoranda and oral presentations put forward to the Consultative Committee shows that the public as well as the respective states were only interested in five main issues: citizenship of the new Federation of Malaya, representation (in the Federal Legislative Council and Federal Executive Council), language, education and Malay privileges. As a result of this and the lack of interest in economics and finance, the financial arrangements were not properly designed, which resulted in states losing fiscal independence.

However, unlike the Malayan Union of 1946, the financial arrangements between the Federal and state governments under the Federation of Malaya Agreement 1948 were made explicit. In the preamble of the Federation of Malaya Agreement 1948 it was proclaimed that the major purpose of the agreement was to form a federation 'with strong central government'. Executive powers were divided between federal and states

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[70] See Malaya (1946a), Chapter IV: Finance and Budgets (paragraph 43: Page 14).

[71] See Malaya (1947). The Consultative Committee was tasked to solicit public opinion on Constitutional Proposals for Malaya under the following terms of reference:

c. To invite the opinion of all interested individuals, communities and groups in Malaya on the Constitutional Proposals which have been published as a result of the consultation between the government and Malay representatives;
d. To hold such public or private sessions as may be necessary to give the fullest opportunity of expressing their views, whether orally or in writing, in accordance with the undertaking given by His Majesty's Governments:
e. To collate the views so expressed and to report their substance to the Governor of the Malayan Union for consideration in the Advisory Council with such and recommendations as the Committee may see fit.

The Committee received a total of 81 letters, memoranda and oral presentation and also four communications. Of the 81 letters and memoranda, 31 were from individuals, 5 from groups, and 45 from Associations. Some of these memoranda are from associations which are supported by a number of affiliated associations.

government in order to give weight to the second objective of the agreement, that 'the individuality of each of the Malay States and of the Settlements should be clearly expressed and maintained'.[72] However, the 'strong central government' theme of the agreement gave the federal government extensive powers of control over states' budgets and finances. Among other things, states were required to submit their revenue and expenditure estimates to the federal government and to obtain prior federal approval before introducing new heads of expenditure or certain new items of expenditure in the annual budget estimates.[73]

Furthermore, the High Commissioner had full power to make orders, binding upon the state governments, to enforce these provisions of the agreement. The states' annual budget estimates were also indirectly subjected to the approval of the Federal Legislature by the requirement that their budget estimates be revised if the amount applied for was less than the amount of allocation approved by the Federal Legislature. As will be discussed later, this caused annual wrangling in order to finalise states' budgets before they could be presented in the respective states councils. The Agreement further provided that 'any balance of revenue in excess of expenditure in any Malay State or Settlement at the end of a financial year shall accrue to the federal government' (Article 122). With this clause, the federal government had complete control over the state governments' finance.

3.5.1.1 Assignment of revenue and expenditure

For the first time, proper fiscal arrangements were outlined in the Constitution when the Federation of Malaya was formed in 1948. The financial powers and responsibilities of the federal and state governments were regulated by the Federal Agreement. The Third Schedule of the Agreement defined sources of revenue to the states governments. These included certain excise duties; revenue from lands, mines and forests; licences, fees and

[72] See Malaya (1948).
[73] See Malaya (1948), Section 114.

charges for goods and services supplied or rendered by state departments (for example the water supply); revenues of local authorities (other than municipalities); and profits distributed by the Currency Commission (see Table 3.3). All revenues not specifically allocated to the states governments belonged to the federal government. These included the main sources of revenue: import and export duties and income tax (introduced for the first time in 1948). Hence, the federal government had strong revenue-raising powers as the most lucrative sources of revenue were assigned to the centre. There was considerable debate about whether excise and sales tax should be assigned to the federal or state governments, but the Financial Secretary considered that the imposition of different taxes on articles sold throughout Malaya would be unwise.[74] The Agreement also stipulated that only the federal government was empowered to borrow.

On the expenditure side, under the Federal Agreement, education, medical, health, drainage, irrigation and new village services were assigned to the state governments. Land, agriculture, forestry and social services were also assigned to the state governments. The heads of expenditure to be met from states' revenue were set out in Part II of the Fourth Schedule of the Federal Agreement. The policy-making power which the states had, coupled with the system of lump sum grants, gave the state governments considerable power in determining levels of expenditure. However, as states were not fully 'responsible' for finding sources to finance their expenditure due to their limited revenue-raising power, states found it difficult to finance growing public services needs without depending on the federal government for funds. Furthermore, states also were not given borrowing power. The result of this fiscal arrangement was that state revenue could not match state expenditure and hence provision was made in the Federal Agreement so that this deficit could be met from allocations of federal funds in the form of lump sum grants. As a result, federal grants formed nearly two-thirds of total revenue

[74] See Malaya (1946a), Chapter 1V 'Finance and Budgets' page 13.

of states. In 1950, for instance, 55% of state revenue was in the form of federal grants (International Bank for Reconstruction and Development (IBRD), 1955). The detailed assignment of revenue and expenditure was contained in the Part X1 of the Third Schedule and Part 11 of the Fourth Schedule of the Federation of Malaya Agreement 1948 (Article 112), respectively, as shown in Table 3.3.

Based on the above fiscal arrangements, the state revenue showed little growth potential (such as land based revenue sources) while state expenditure showed high growth potential, in particular, expenditure on education and medical / health services. Indeed, the Agreement recognised the possibilities that the states' expenditure would exceed their revenue. Thus, in most financial years, the states' revenue sources were insufficient to meet total expenditure. The only source of financing available was through federal grants. The Federal Agreement provided for unconditional block grants (lump sum federal grants) to be made by the federal government to finance state expenditure. However, the Agreement was silent on this matter: it neither specified the amount of grants to be received by the state governments nor prescribed the method by which these grants were to be determined. More often than not, the amount of grants distributed to states for the current financial year was largely a result of annual political wrangling. In other words, these grants were apportioned on the basis of rule of thumb, rather than on stable, transparent and agreed principles. In practice, the amounts of grants received by the states are dependent upon the amount of grants received in the preceding year, but the federal government's financial performance weighed heavily in determining the total amount of grants. Thus, the design of the grants system did not follow the 'theory of fiscal federalism' which suggests that grants should be stable, set according to transparent formulae and announced in advance.[75]

[75] See Section 2.3.3 of Chapter 2.

Table 3.3

Assignment of Expenditure Functions and Revenue to State Governments under the Federation of Malaya, 1948

Expenditure Assignment (Fourth Schedule Part II	Revenue Assignment (Third Schedule Part XI)
Political pensions and compassionate allowances	Revenue from toddy shop
Ruler and Chiefs	Revenue from lands, mines, and forests
Agriculture (State and Settlement services)	Revenue from licences other than those connected with mechanically propelled vehicles, electrical installations and registration of business
Clerical Services (State and Settlement Posts)	Entertainment duty
District and Land Offices and Registrars of Titles	Fees in courts other than federal courts
Drainage and irrigation (Staff and Works in States and Settlements)	Fees and receipts in respect of specific services rendered by Departments of state or settlements governments
Education (State and Settlement services)	Revenue of town boards, town councils, rural boards, local councils and similar local authorities, other than municipalities established under any Municipalities Ordinance those town boards, town councils, rural boards, local council, and similar local authorities which have power under any written law to retain their revenues and to control the spending thereof
Fire Brigades	Receipts in respects of water supplies including water rates
Forests (State and Settlement services)	Rents on state and settlement property
Game	Interest on state and settlement balances
Government Gardens and Plantations	Receipts from land sales and sales of state or settlement property
Judicial (Subordinate Courts)	Fines and forfeitures in courts other than federal courts
Marine	Share in the Malaya and British Borneo Currency Surplus Fund
	Receipts in respect of any education rate imposed under any written law, to the extent to which such rate, if expressed as a percentage of the value of any property as calculated in accordance with the provisions of such written law, exceeds a rate of 2% per annum
Medical and health (State and Settlement services)	
Mines (State and Settlement services)	
Miscellaneous	
Public Works (Staff and Works in State and Settlement on State and Settlement services)	
Purchase of land for State and Settlement purposes	
Town Boards	
State and Settlement Treasuries	
Veterinary (State and Settlement services)	
Menteri Besar and State Secretaries; Settlement Secretariats	
Religious affairs and Courts	
Any other department constituted to be a State and Settlement Department	

Source: The Federation of Malaya Agreement, 1948

Based on the expenditure and revenue assignment, as well as federal transfers to states, it was impossible for states to prepare their budget estimates until they knew exactly how much they would receive from federal grants. One way to overcome this problem was to

hold meetings at an official level with representatives of the state governments to decide an acceptable amount of grant before estimates were submitted to the Federal Finance Committee so that agreement could be reached on the amount of grant required by state governments and, subsequently, budgets could be planned by both levels of government. Only then did states submit their annual budget estimates to the Federal Finance Committee for further consideration and approval. If any supplementary allocation (additional financing requirement out of those budgeted) was required during the course of the year, an application could be submitted to the Council even if the Finance Committee did not recommend that they should be granted. However, if state governments required small additional funds, Section 115 (2)(c) of the Federal Agreement provided for this without having to request additional allocation of funds from the federal government.

From the foregoing discussion, it is obvious that the Federation of Malaya Agreement 1948 did not provide for financial autonomy of the states, because in exchange for federal grants, the federal government was given extensive powers of control over states' budgets. State governments' annual budgets had to be submitted to the federal government for approval before they could be presented to their respective Councils of State for approval. The extensive control of states' financial matters were also shown by the requirement that any financial surplus incurred in the financial year must revert to the federal government. This provision led to fiscal imprudence, as the state governments attempted to use up all available funds each year.

The design of the financial arrangements in Malaya therefore did not follow the federal spirit discussed in Chapter 2. States had little bargaining power, being more concerned with the future of Malays' political interests. Furthermore, the Malay states during the

federating process were not independent, they were still under British colonial rule.[76] According to Cornell (1961: 59), 'only free people can really debate the issue of federation on its merits'. As shall be discussed shortly, this arrangement created strong resentment among states, especially when their revenue was far from sufficient to finance the constitutional obligations assigned to them. When Malaya gained independence in 1957, the financial arrangements was slightly improved following greater demand for more fiscal power resulting from the Raja Uda Committee Report (1955) and the IBRD Report (1955). As a result, the fiscal arrangements for independent Malaya in 1957 were more satisfactory than the financial arrangements of the Federation of Malaya in 1948.

3.5.1.2 Weakness of the pre-independence financial arrangements

Looking at the division of functions as set out in the Federal Agreement 1948, it can be seen that the system of financial relationships had many disadvantages and was unsatisfactory to both levels of government, especially to the state governments. The problem emerged when the state governments, which had no power to recourse to financing, had no control over their level of expenditures. This was because the states, which had executive authority and policy-making powers to determine the expenditure, were not fully 'responsible' for finding sources of revenue to finance the expenditure. At the same time the federal government, which had exclusive power over sources of financing, set the policy on the level and priority of services to be undertaken by states, notably in education and, medical and health services. The fallout of this arrangement is that state revenue could not meet expenditure needs in any fiscal year and consequently conflict emerged. Although the arrangements were made to finance these expenditures through federal grants, the design of the grants system did not prescribe the formulae by which grants were to be determined and distributed.

[76] See also Fernando (2002) especially Chapter 3.

Several weaknesses were further noticed arising from this arrangement. First, the assignment of revenue and expenditure caused a wide fiscal gap (expenditure higher than resources available). However, from the states' point of view, a wider fiscal gap meant a stronger bargaining position for states to get a larger share of federal grants. Furthermore, due to the requirement that revenue surpluses be returned to the federal government, the state governments tended to use up their unspent balances at the end of each financial year on unnecessary projects. Such an arrangement certainly did not encourage financial prudence or efficient spending.

Second, the grants system caused states to be financially complacent as it made them financially dependent on grants from the federal government. Thus, there was no incentive for states to exploit their own sources of revenue, as both politically and economically it was easier and more rewarding to concentrate their efforts on attempting to obtain a larger share of federal grants rather than on concentrating their efforts to improve tax collection to strengthen their own revenue performance. This is evident from the fact that about 55% of state revenue was contributed by federal grants and there were no changes in the state tax rate between 1948 and 1954. At the same time, arrears in revenue collection also increased.[77]

Third, the federal government faced difficulties in controlling state expenditure although federal transfers constituted about 55% of state revenues. Due to states' over-dependence on the federal government for funds, there should have been a greater degree of control over the direction of state expenditure financed by the federal grants. However, as the grants were unconditional block grants, the federal government had little control over the way grants were spent by the state. As such, the grants system discourages careful spending of scarce resources within the public sector. The lump sum grants also did not

[77] See the IBRD (1955), especially page 162-166.

foster any sense of financial responsibility on the part of state governments. Moreover, because of the uncertainty of the future level of grants to be received, the system made it difficult for the states to formulate long-term development programmes. This is because the amount of the federal grant to be received by states each year would only be known after budget estimates had been approved. The same process would apply for the subsequent years. However, there was no guarantee that the same amount of grant would continue to be received in each fiscal year. Therefore, it was impossible for the states to embark on long-term projects, as long-term development planning requires a continuous flow of financial resources over a period of time. Furthermore, the conflict between federal interest (such as for economic services, a joint federal – states responsibility) and state interest (such as for community services, a state responsibility) made development planning more difficult and, more often than not, decisions were the result of acrimonious political bargaining rather than made on national economic grounds.

3.5.2 Financial arrangements for the independence Federation of Malaya (1957)

The 1954 financial revision was only in operation until the end of 1957, when the Federation of Malaya Constitution, 1957 for an independent Malaya came into effect, replacing the Federation of Malaya Agreement of 1948. There was no new set of financial arrangements for the independence Federation of Malaya 1957. Instead, the provisions governing federal-state financial relations for the independence of the Federation of Malaya in 1957, as set out in the Federal Constitution, was taken in every respect from the Federal Agreement 1948. During the period of 1948 – 1954, federal control over state finances was very extensive. During that period the revenue of the state consisted mainly of ad hoc allocations from the federal government, especially federal grants.[78] Moreover, any financial surpluses recorded in the current financial year had to be surrendered to the federal government. Due to strong state resentment over the

[78] See IBRD (1955).

financial arrangements of 1948, a committee was set up in 1955, known as the Raja Uda Committee, to study the existing fiscal arrangements and finally to make recommendations on the new revenue allocation and expenditure to states.[79] Although the Committee found that the existing arrangements had not proved satisfactory, the Committee failed to recommend new sources of revenue that accrued directly to states as of right so that states would not be subject to any action on the part of the federal government. The states had little incentive to take prudent fiscal management, since they had no guaranteed assurance as to how much grant they could expect in future years and their deficits had to be met by the federal government each year. There was disagreement about the way in which the deficits of the states were to be dealt with. If this deficit was continuously financed by the federal transfers, the state governments would have no incentives to explore their revenue potential and to spend wisely. It was, furthermore, difficult for states to plan ahead without a firm assurance of their financial resources in the coming budget.

Accordingly, the Committee endeavoured to evolve a grant, which would not be subject to the annual wrangle for funds from the federal government. Subsequently, the Committee suggested a new set of financial arrangements which gave more grants and allocation to states. These were: (i) capitation grant; (ii) allocation of petrol import duty; (iii) grants in respect of education, medical and drainage and irrigation services, and in the case of less developed states; (iv) development grants; and (v) special transitional grants. The recommendations of the committee were embodied in Part 111 of the Fifth

[79] See Malaya (1955). The Committee was composed of D.C. Watherston (Chief Secretary), A.D. Farrell (Acting Attorney-General), E.Himsworth (Financial Secretary), Raja Uda Raja Muhammad (Selangor Chief Minister), Dato Panglima Bukit Gantang (Perak Chief Minister) Kamaruddin Haji Idris (Terengganu Chief Minister), Shamsuddin Nain (Negeri Sembilan Chief Minister), Abdul Razak Dato Hussain (Acting Pahang Chief Minister), Nik Daud bin Nik Mat (State Secretary of Kelantan), Abdullah Sahat (State Secretary of Perlis), Ahmad Perang (State Financial Officer of Johor) and Mohamed Khir Haji Jaafar (State Financial Officer of Kedah) Other members were Nik Ahmad Kamil Nik Mahmood (Member of Local Government, Housing and Town Planning), H.S.Lee (Member for Transport), Ismail Dato Abdul Rahman (Member for Natural Resources) V.M.N Menon (Member for Posts and Telecommunications), Tunku Abdul Rahman Ibni Abdul Hamid Halim Shah, Yong Sjook Lin, Lim Chong Eu and Ee Yew Kim.

Schedule to the Federation of Malaya Agreement, 1948 and came into force on 1st January 1956. However, the recommendations could not be implemented because at the same time the new constitution was being drafted for the independent Malaya.

Following the British decision to grant independence to Malaya, a Constitutional Commission was formed [80] and its report was published on 21st February 1957. A Working Party[81] was then formed to study the report put forwards by the Constitutional Commission (known as the Reid Report).[82] Among other matters, the Constitutional Commission Report reconsidered the federal – state fiscal arrangements of the Federation of Malaya 1948. In commenting on the 1948 financial arrangements, the Constitutional Commission Report recognised the fact that 'they are not based on any consistent principle'.[83] For instance, capitation grants (introduced for the first time by the Raja Uda Committee in 1955) were calculated based on the number of persons over the age of nineteen in the states, based on the 1947 census. Further, the Constitutional Commission Report commented: 'we do not know why no account was taken of children ... the amount of grant per head is determined each year by the Federation after consultation with states and no principles are laid down for its determination. The states hoped for a grant for 1956 of RM16 per head but the grant was fixed at RM12 per head'.[84]

The Constitutional Commission Report also commented on how grants based on petrol import duty were designed and implemented in the first place. Initially, this grant was designed to help the state to maintain states' roads, as road maintenance was too costly to

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[80] See Section 3.3.2 of this chapter

[81] The Working Party comprises: the High Commissioner, four representatives of Their Highness the Rulers, four representatives of the Government of the Federation, the Chief Secretary, and the Attorney General. See Malaya (1957a);, see also Fernando (2002) for further discussion on the Working Party's role in the making of the Independence Constitution, 1957.

[82] The most important change introduced by the Working Party on the Reid Commission's report was that states would be entitled to receive grants and other sources of revenue as of right. The grants and other sources of revenue allocated to states in this way were capitation grants, state road grants, and the proceeds from certain taxes and other sources of revenue specified in Part III of the Tenth Schedule in the Constitution. In addition the states were to receive under Article 110(3) of the Constitution, not less than 10% of the export duty on tin produced in the states.

[83] See Malaya (1957c), paragraph 129.

[84] See Malaya (1957c), paragraph 132.

be financed by state governments alone, due to their limited revenue. As a result, it was decided that the amount of petrol sold in each state would be the basis for this grant. This was because 'the amount of petrol sold in a state was supposed to bear some relation to the mileage of roads in the state.'[85] However, the Report found that 'there is no close relation between the cost to the state of maintaining its roads and the amount of petrol sold in the state.'[86] As an alternative, a new form of grant called the State Road Grant was introduced with the aim of helping state governments to maintain state roads.

Table 3.4
The Division of Powers and Responsibilities

Federal Government (List I)	State governments (List II and IIA)	Concurrent List (List III and IIIA)
External affairs	**List II Applicable to all state**	**List III Applicable to all state**
Defence	Islamic affairs	Social welfare
Internal security	Land matters	Scholarship
Civil and criminal law and procedure and administration of justice	Agriculture and forestry	Wild life and national park
Federal citizenship and naturalization	Local governments administrations	Veterinary services
Government machinery	Services of local character	Town and country planning
Finance	State work and water	Public health, sanitation and prevention of deceases
Trade and commerce and industry	Machinery of state governments	Drainage and irrigation
Shipping, navigation and fisheries	**List II A Supplement to Sabah and Sarawak**	Fire safety
Communications and transport	Native law and custom	Culture and sports
Federal works and power	Incorporation of authorities and other bodies	Housing
Survey, inquires and research	Ports and harbours (other than federal)	**List III A Supplement to Sabah and Sarawak**
Education	Railway (for Sabah)	Family law – marriage, divorce
Medicine and health		Adulteration of foodstuffs
Labour and social security		Shipping (under 15 tons)
Tourism		Electricity
		Agriculture and forestry
		Medicine and health
		Charities

Source: The Ninth Schedule of the Federal Constitution.

In all, the Constitutional Commission Report recognised the extensive federal control over states finance and that every year there were disputes (both economic and political)

[85] See Malaya (1957c), paragraph 132.
[86] See Malaya (1957c), paragraph 133.

between the federal and the state governments regarding to the amount of grants to be paid to the states. Thus, the Constitutional Commission Report recommended some improvement of the 1948 financial arrangements for the independence of Malaya 1957. The Ninth Schedule and Tenth Schedule of the Federal Constitution 1957 indicated the kind of fiscal federalism to be adopted in Malaysia. Both Schedules demarcated the line of responsibility between the federal and state governments. Under the Ninth Schedule, there were three lists: Lists I, II, and III (see Table 3.4). List I spelled out the responsibilities assigned to the federal governments. List II outlined the state governments' responsibilities and List III was the concurrent list, which contained the items which were joint responsibilities of the federal and state governments. The Tenth Schedule, on the other hand, outlined the grants and revenue assignment to the state governments. Parts I, Part II and Part IV of this Schedule were about the federal grants to state governments (capitation grant, state road grant, and special grants to states of Sabah and Sarawak, respectively), while Part III and Part V were exclusively about revenue assignment to state governments and additional sources of revenue assigned to states of Sabah and Sarawak, respectively. With the new financial arrangements, the states responsibilities were reduced but still did not eliminate state budgetary problems. As a result, grants were still an important feature of federal – state financial relations. There was also provision for a Statutory Reserve Fund (SRF) from which grants could be made for purposes of development and to meet current account deficits incurred by states.

To summarise, the financial arrangements for the Federation of Malaya 1957 were in fact only a slight improvement over the former financial arrangements stipulated in the Federal Agreement of 1948. Indeed, during the drafting of the Federal Agreement of 1948 and the Federal Constitution of 1957, the state governments demanded more revenue sources but were refused by the Working Party, as the Working Party was more comfortable on other non-financial issues, in particular, citizenship, Malay right, Malay

language and representation in the Legislative Council.[87] Consequently, the independent states' revenue remained limited, local in nature, and more difficult and expensive to administer and to collect than federal revenue, which was more productive and elastic. However, one of the striking features of the 1957 financial arrangement was its provision for setting up an intergovernmental fiscal institution to foster federal-state relations with regard to fiscal arrangements. This institution is called the National Finance Council (NFC), an advisory body to the federal and state governments. As briefly discussed in Chapter 1, the NFC was a high-level intergovernmental consultative body on financial matters aimed to ensure no open clashes between both levels of government. Matters specifically mentioned as requiring consideration of the NFC were revenue and grants to states, financial procedure and loans. However, this body was not impartial, as members of the NFC represented the political hierarchy and decisions made were not binding on the federal government.[88]

3.5.2.1 Expenditure assignment

The division of powers, functions and responsibilities (legislative and executive) between the federal and state governments was stipulated in the Ninth Schedule of the Federal Constitution, as shown in Table 3.4. Efficiency seems have been the guiding principle in the division of these functions. Chapter 2 demonstrated that, according to the principle of efficiency, functions of an international character and those concerning the nation as a whole, should fall under the jurisdiction of the federal government, while those of a more regional nature should normally fall under the competence of the states.[89] In this sense, the division of function between both levels of government did follow the efficiency principle as recommended by the theory of intergovernmental fiscal relations discussed in Chapter 2. Thus, functions of national and international interest fell within the purview of

[87] See Malaya (1947). See also Fernando (2002).
[88] See Chapter 7 for further discussion on the National Finance Council.
[89] See Section 2.3.1 of Chapter 2.

the federal government, while those of regional interest were left to state governments (see Table 3.4).

The Ninth Schedule stipulated that the federal government be responsible for the following areas: external affairs, defence, internal security, civil and criminal laws, citizenship, finance (currency, taxes, foreign exchange), education, health, trade and industry, communication, federal works, power / energy and social services. When the Constitutional Commission drafted the Constitution proposal, they realised that states would remain heavily dependent on grants unless the functional responsibilities of the two levels of government were rearranged. It considered that legislative and executive power should correspond. To achieve this objective, the commission recommended 'that educational, medical and health services should become federal subjects and, as a result, grants to the states for this services will cease, and expenditure on these services will no longer be made by the states'.[90] Hence, financial arrangements for the Federation of Malaya 1957 showed the transfer of education and medical and health services to federal responsibility.

The rearrangement of these functions into the Federal List was to ensure uniformity and efficiency in the provision of these services, which had previously been the cause of a large proportion of federal allocation to states and created much annual political wrangling. As the education, medical and health services became federal responsibilities, the state governments would be responsible only for matters related to Muslim laws, land, forestry and agriculture, local government, services of a local character (markets, cinemas), state public works and water supply, and the administrative machinery of state governments, leaving the states weaker than the former Federation of Malaya, 1948. However, both federal and state governments would have joint responsibilities in areas such as scholarships, town and country planning, protection of wildlife, drainage and

[90] See Malaya (1957c), paragraph 138.

irrigation, as indicated in the Concurrent List. However, the federal government had absolute power in matters concerning the subjects of the Concurrent List in that the federal government can overrule state governments (Article 74).

Looking at the division of functions, almost every significant function was assigned to the centre. The Constitution's financial provisions had indeed made the Federation of Malaya one of the strongest central governments from the financial point of view. To make the federal government further dominant, federal law could override state law in matters listed in the States List as well as the Concurrent List.[91] Thus, the federal government could encroach into states' legislation in matters such as land, agriculture and veterinary, local government and social welfare, on the pretext of the national interest and for the uniformity of policy throughout the federation.[92]

Consequently, Article 74 put further pressure on states' fiscal affairs, which could be twisted by strong central fiscal powers. Politically, however, it is important to the centre to remain in a position to direct states to comply with the federal order. In the final analysis, any state leaders that opposed the federal government could be put under severe financial pressure (Yusoff, 1998). However, despite strong centripetal forces, the states did not object to federal encroachment into their territorial function, for one reason: the same political party controlled the centre and the states (except after the 1999 election when two states – Kelantan and Terengganu – fell to the opposition).[93] Furthermore, the

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[91] See Article 74 of the Federal Constitution also Section 3.4.3 of this Chapter

[92] This is especially evident in the case of land matters, which are under the state . However, the federal authority, through the National Land Council (see Article 91 of the Federal Constitution), is responsible for formulating a common policy for the sake of coordination. A similar trend is also evident in the case of local government, for which the Federal Government formulated and coordinated a policy through the National Council for Local Government (see Article 95A of the Federal Constitution). The National Land Code also provides Federal Government with the power to acquire state land for public purposes. Other matters such as agriculture and forestry have also become federal matters. The privatisation policy of the Federal Government also causes states to lose their control over subjects that constitutionally belong to the states, as is evident in the case of water supply and sewerage. The water crisis in the mid 1990s indicated that a more organised and coordinated policy was required to manage water services, which led the way to further centralisation of this resource. This is shown in the establishment of the National Water Council, a committee formed under the auspices of the Federal Works ministry, to be responsible for managing water resources, which fall under the State List.

[93] See Chapter 6 for the discussion of the political party and its impact on centre-states relations.

states lacked the competence to undertake and manage their functions, due to revenue constraints. This was the result of the historical background when the Federation of Malaya was formed in 1948, whereby states were only interested in Malay political survival (for fear of non-Malay political dominance) rather than striving for states' interest in economic and financial matters in the federation.[94]

3.5.2.2 Revenue assignment

Under the Federal Constitution of 1957, state governments still retained their independent sources of revenue as it appeared in the Federation of Malaya Agreement 1948.[95] Investigation of the records and documents shows that an attempt was made by the states during the drafting of the 1957 Constitution for an independent Malaya to obtain more revenue sources in which taxing powers should follow the legislative list and, further, the states should receive, as of right, 25% of customs import duties and excise.[96] However, it was opposed by the Alliance Working Party and, instead, the Alliance Working Party proposed more grants to be given to the states. As a result, the Constitutional Commission opposed any extension of state tax powers on the ground that such a move would 'be wasteful in causing duplication of staff and would hamper the conduct of business on a national scale and retard the development of unity of the nation'.[97]

Based on this argument, the Constitutional Commission found it essential to assign to the federal government adequate financial powers commensurate with their role to undertake nationwide fiscal policy, notably stabilisation, allocation and redistribution functions. From the economic point of view, this arrangement was not construed as a violation of the principle of efficiency, since nationwide interest requires a nationwide policy, such as fiscal policy, which is better handled at the centre. Clearly, the division of revenue

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[94] See Section 3.3 for the discussion on the formation of the Federation of Malaya 1948.
[95] The Raja Uda Committee 1955 did not recommend new revenue sources for the states, as no other sources of revenue were suitable to be assigned to states. See Section 3.5.3 of this chapter.
[96] See also Fernando (2002).
[97] See Malaya (1957c), paragraph 139.

sources between the two levels of government was guided by efficiency considerations. Moreover, the arrangement ensured efficiency in tax administration, uniformity in the tax legislation, and avoidance of duplication and overlapping of functions. However, the financial arrangements of the independent Federation of Malaya 1957 caused over-dependence of state governments on federal funds, which was politically unwise considering the nature of the political system in Malaysia.

Table 3.5
Revenue Assignment to State Governments

	Sources of Revenue
1	Revenue from toddy shop
2	Revenue from lands, mines an d forest
3	Revenue from licences other than those connected with mechanically propelled vehicles, electrical installations and registration of businesses
4	Entertainment duties
5	Fees in courts other than federal courts
6	Fees and receipts in respects of specific services rendered by departments of the state governments
7	Revenue of town boards, town councils, rural boards, local councils and similar local authorities other than: - municipalities established under any Municipal Ordinance; - those town boards, town councils, rural boards, local councils and similar local authorities which have power under written law to retain their revenue and control the spending thereof.
8	Receipts in respect of water supplies, including water rates
9	Rents on state property
10	Interest on state balances
11	Receipts from land sales and sales of state property
12	Fine and forfeitures in courts other than federal courts
13	Zakat, fitrah and Baitulmal and similar Islamic religious revenue
14	Treasure trove

Source: Part III of the Tenth Schedule of the Federal Constitution

Part III of the Tenth Schedule of the Federal Constitution specified sources of revenue allocated to the states. These are proceeds from taxes, fees and other sources of revenues, as long as they were levied or raised within the state (see Table 3.5). However by virtue of Article 110(2), the Parliament could from time to time by law substitute the states sources of revenue specified in Part III of the Tenth Schedule with any other sources of revenue, except revenue from lands, rents on state property, interest on state balances, receipts from land sales and sales of property and revenue from Islamic religious (Zakat).[98] In addition, the states were to receive, under Article 110(3) of the Constitution, not less than 10% of the export duty on tin produced in the states. The Commission

[98] Thus far, unfortunately, none of the provisions of this article have been implemented to strengthen the states' revenue sources, despite the states' attempt to get more revenue through the NFC. See further discussion on this matter in Chapter 7 of this thesis.

considered that the federal government could best collect export duties but states should have a share of export duty on tin, as tin mining involved the permanent removal of valuable assets from a state. This is in line with the principle of derivation, which suggests part of the proceeds from the export duty on tin and other minerals should be given back to the producing states. Further, the allocation, by giving a state a direct financial interest in the production of tin, would provide an incentive to promote the development of tin mining. However, most of the sources of revenue assigned to states were still less productive, difficult to administer, trivial and non-elastic to economic growth, as can be seen from Table 3.5.

Sources of revenue other than those listed in Table 3.5 belonged to the federal government. Clearly the federal government had substantive and exclusive control over the most lucrative, elastic and productive sources of revenue, namely, direct tax (income tax, company tax) and indirect tax (sales tax, custom and excise duties), whereas state governments were left with the less productive and less lucrative revenue sources. Clearly, these sources of revenue did not make much difference from the revenue arrangement of the former Federation of Malaya 1948 (see Table 3.3). Although most taxes were centrally collected, the state governments still benefited from the proceeds by virtue of federal transfers. Nevertheless, the federal transfers were not properly designed, as will be demonstrated in the following section and also in Chapter 4, in the sense that they were not intended to negate the non-correspondence problems facing state governments' finance amid persistent states' financial difficulties. With extensive federal revenue sources, undoubtedly the federal spending powers are paramount. The strong federal spending powers were further enhanced by the Federal Constitution[99] and the National Finance Council[100] which empower the federal government to extend it jurisdiction over states' functions and the states are under obligation to the centre. As

[99] See Federal Constitution: Article 74(1), Article 75, Article 76(1), Article 76A, Article 80, Article 82 (a), Article 83, Article 85, Article 86, Article 94, and Article 109(3).
[100] See Federal Constitution: Article 108 (4)(e)

Article 81 states, 'The executive authority of every state shall be so exercised: (a) as to ensure compliance with any federal law applying to that state; and (b) as not to impede or prejudice the exercise of the executive authority of the federation.'

3.5.2.3 Fiscal adjustment: Federal grants and transfers

Fiscal adjustment, apart from revenue and expenditure assignment, is a crucial part in the design of federal-states fiscal relations, intended to undo any non-correspondence between revenue and expenditure arising from inappropriate revenue assignment compared with their functions. Federal transfers, as a means of fiscal adjustment, thus seek to reallocate revenue from the federal funds to state government so as to achieve the maximum satisfaction of all levels of government without undermining the financial stability of the federal government. Politically, fiscal adjustment is necessary to ensure that the benefits to small and poor constituent units are sufficient to maintain their interest in federation. As discussed above, the Constitutional Commission did not favour assigning additional sources of revenue to the state governments. Hence, for the national economic interest, the most lucrative and elastic revenue sources and taxing powers were assigned to the federal government, giving the federal government strong revenue raising powers. Therefore, the transfer of funds from federal to state level is necessary to ensure that unity in diversity is achieved. The Federal Constitution provided financial assistance to the state governments in the form of various federal transfers. Basically, federal transfers can be classified into five broad categories.[101] First, the constitutional grants – those grants stated in the Article 109 of the Federal Constitution, that is, Capitation Grants (Article 109(1)(a)) intended to enable state governments to meet differences between revenue and recurring expenditure, State Road Grant (109(1)(b)) to assist state to maintain state road and two grants provided under the State Reserve Fund, a grant to help states having deficit in their current account, and grants to raise the level of

[101] See Chapter 4 and Chapter 5 for a detailed analysis of the grants system in Malaysia.

economic development in the states. Second, the revenue / tax sharing arrangement – those taxes shared by the federal and state governments based on the derivative principle, that is, the origin of revenue / tax collection. These include export duties on commodity (tin, iron and other mineral), as stated in Article 110 (3) of the Federal Constitution. States that produce these minerals for export are entitled to 10% of the proceeds. Another form of revenue sharing assignment is Revenue Growth Grants, which state that if there is an increase in the federal government revenue, state governments are entitled to a portion, based on a certain formula. Third, special payments, for compensation and grants to local governments. Fourth, administrative payments designed to help the state government to finance operating expenditure. There are two types of payment under this category, 50:50 grants as stated in the Article 82 for maintenance of function under concurrent list (see List III of the Ninth Schedule of the Federal Constitution) and 5% grants for Federal Government projects in states. Fifth, other forms of transfers / payments – these include the federal government sponsored projects in states through various government agencies.

However, out of these transfers, only Capitation Grants, State Road Grant and grants provided under the State Reserve Fund were considered as actual forms of fiscal adjustment to remedy fiscal imbalances arising from the division revenue and expenditure functions provided for by the Federal Constitution. As a result, the states would continue to depend on the federal grants to finance their budgetary operation and the disbursement of grants was always subject to political strife, considering the centralising nature of political system in Malaysia, as experienced by states led by the opposition party. In Canada and Germany, the constitution specifically mentions the form and purpose of federal transfer to be employed, by equalisation, designed to equalise financial differences confronted by the state governments. In Canada, for instance, Section 36 (2) of the 1982 Constitution Act says, 'Parliament and the Government of

Canada are committed to principle of making equalisation payments *to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation'* [Emphasis added]. In Malaysia, a similar provision is also set out in the Constitution; however, it is only applicable with regard to grant reviews for Sabah and Sarawak (but not applicable to the eleven states in the peninsula), as stated in Article 112D(2),

> 'Any review under this Article shall take into account the financial position of the federal government, as well as the needs of the states or state concerned, but (subject to that) shall endeavour *to ensure that the state revenue is adequate to meet the cost of state services as they exist at the time of the review, with such provision for their expansion as appears reasonable*' [Emphasis added].

The theory of intergovernmental transfers [102] suggests that if assignment of revenue does not conform to the assignment of expenditure function, transfers from the higher level of government are essential to meet any financial imbalance and at the same time can promote redistribution of wealth, as well as incentives for states to delve into their own potential revenue sources. In addition, as the problem of financial imbalance grows over time, fiscal adjustments should provide a degree of flexibility and adaptability to accommodate those changes.

3.5.2.4 Borrowing powers

In the financial arrangements for the Federation of Malaya 1948,[103] borrowing power was granted only to the Federal Government. However, as a further step towards fiscal autonomy, provision was made for states to contract loans. The Constitutional Commission Report 1957[104] suggested that borrowing by state governments should be allowed as long as they did not 'compete against each other' and that states borrowing should be 'last in the queue', due to limited funds. However, the Report recognised that in future, states' borrowing would be necessary and 'in view of the degree of future autonomy which we recommend for the states, there ought in addition to be more general

[102] See Section 2.3.3 of Chapter 2
[103] See Malaya (1948), Section 115.
[104] See Malaya (1957c), paragraph 146-147.

provisions authorising states to contract loan'. The Report also suggested that 'the federal government would raise all loans, but only after considering the needs of the states as well as those of the federation as whole'. The recommendations of the Constitutional Commission were embodied in the Federal Constitution, which confers the federal government with absolute control over state governments' borrowing. States can only borrow from banks for a period of one year or less, provided prior approval is first obtained from the federal government. However, for borrowing for more than one year, states can only borrow from the Federal Government. Article 111(2) of the Federal Constitution says:

> 'A state shall not borrow except under the authority of state law, and state law shall not authorise a state to borrow except from the Federation or, for a period not exceeding five years, from a bank or other financial source approved for that purpose by the federal government, and subject to such conditions as may be specified by the federal government'.

However, when the states of Sabah and Sarawak joined the Federation of Malaya in 1963, the special arrangement with regard to borrowing was extended to Sabah and Sarawak. For the states of Sabah and Sarawak, borrowing within the state under the state law is allowed as specified in Article 112B of the Federal Constitution. According to Article 112B, 'clause (2) of Article 111 shall not restrict the power of Sabah or Sarawak to borrow under the authority of state law within the state, if the borrowing has the approval of the Central Bank for the time being of the Federation'. As can be seen from both articles (Article 111(2) and Article 112(B), there are two different treatments with regard to borrowing powers between states in peninsular Malaysia and the states of Sabah and Sarawak, whereby the latter have more autonomy compared with the former.

3.5.3 Financial arrangements for the Federation of Malaysia (1963)

When the Federation of Malaysia was formed in 1963, the states of Sabah, Sarawak and Singapore demanded more bargaining power[105] especially with regard to financial

[105] The special committee was established to study intergovernmental relations; one for states of Sabah and Sarawak and another one for Singapore. See Malaya (1962a) for financial arrangements for Sabah and

arrangements, which led to these states enjoying more fiscal autonomy than their counterparts in peninsular Malaysia. 'Their wider powers and greater resources are largely the result of the special conditions prevailing at the time of their joining Malaysia and the fact that their socio-economic and financial interests were more strongly represented at that time' (Holzhausen, 1974: 128). This is because the new member states (Sabah, Sarawak and Singapore) realised the deficiencies of the existing financial arrangements of the Federation of Malaya and its consequences for states' fiscal autonomy. As a result, new provision was added in the 1957 Federal Constitution to accommodate the financial requirement of the new members of the federation.[106] The financial arrangements for Sabah and Sarawak was based on the 'Malaysia Report of the Intergovernmental Committee 1962'.[107] This Committee was set up following Lord Cobbold's Report in 1962 which recommended the establishment of an intergovernmental committee to work out future constitutional arrangements, including safeguards for the special interests of North Borneo and Sarawak: 'religious freedom, education, representation in the Federal Parliament, the position of the indigenous races, control of immigration, citizenship and the state constitution'.[108] The composition of this committee[109] truly reflected the states' rights, expectations and their future in the federation,[110] unlike the eleven states in the Federation of Malaya (1948/1957) which did not have a bargaining position in the drafting of the Federal Constitution of 1957.[111] This

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Sarawak. For financial arrangements with Singapore, see Malaya (1963c). However, no such committee was established to study the intergovernmental fiscal relations when the Federation of Malaya 1948 was formed. The eleven states members of the Federation of Malaya 1948 were considered as a single entity rather than as separate states.

[106]Financial arrangements for Singapore will not be discussed. The thesis will only focus on financial arrangements for Sabah and for Sarawak.

[107] See Malaya (1962a), Paragraph 24, page 13-20.

[108] See Malaya (1962a), page 1.

[109]Lord Lansdowne, the Minister of State for Colonial Affairs was appointed as the Chairman of the Committee and Tun Abdul Razak, the Deputy Prime Minister of the Federation of Malaya, was appointed as the Deputy Chairman. Five sub-Committees were then set up: the Constitutional Sub-Committee, the Fiscal Sub-Committee, the Legal and Judicial Sub-Committee, and the Public Service Sub-Committee. See Malaya (1962a).

[110] See list of Twenty Points put forward by Sabah during the negotiation. The full list is attached in Appendix (iii).

[111] See Fernando (2002) for an account of the discussion of the making of the Federal Constitution.

bargaining power is essential to make membership of the federation worthwhile and encourage new states subsequently to remain in the federation (May, 1969).

The difference between the financial arrangements for the Federation of Malaysia 1963 and those for the Federation of Malaya 1957 lies in the special arrangements with regard to Sabah and Sarawak through the addition of Part IV and Part V into the Tenth Schedule (see Table 3.6). But the financial arrangements for members of states in the peninsula remained unchanged from those in the 1957 Federal Constitution. The unequal levels of economic development and endowments of natural resources of Sabah and Sarawak prompted these states to seek special financial treatment and greater fiscal powers as a precondition for entry into the federation. Thus, the most striking feature of the financial arrangements for the Federation of Malaysia 1963 was the special financial arrangements for Sabah and Sarawak, which both enjoy more fiscal autonomy than their counterparts in the peninsula (see Table 3.4, 3.5 and Table 3.6).

Table 3.6
Grants and Revenue Assignment

Part I	Part II	Part III	Part IV	Part V
Capitation Grant	State Road Grant	Sources of Revenue Assigned to states	Special Grants to Sabah and Sarawak	Additional Sources of Revenue to Sabah and Sarawak
Article 109	Article 109	Article 110	Article 112C	Article 112D
Capitation grants to be given to all states based on the number of population.	State road grants to be given to all states for road maintenance purposes.	This provision is applicable to all states. However Sabah and Sarawak received additional revenue sources (see Part V)	This provision only applicable to states of Sabah and Sarawak. Sabah and Sarawak will also receive grants as in Part I and Part II.	This provision only applicable to states of Sabah and Sarawak on top of sources of revenue in Part III.

Source: Tenth Schedule of the Federal Constitution

Additional revenue allocations were given to Sabah and Sarawak to enable these states to develop to a level comparable with their counterparts in peninsular Malaysia (Article 112D of the Federal Constitution). In the case of Sabah, the Federal Government undertook to pay Sabah's public debt. The reason was that on joining Malaysia, Sabah's development projects were financed by loans from the British government, thus the liability for repaying the loans fell upon the federal government. Both Sabah and

Sarawak also received proportionate amounts for social welfare purposes, and since Sabah retained jurisdiction over medical and health, it received a special allocation from the proceeds of customs revenue. As for Sarawak, the Federal Government provided special assistance (annual balancing grant and escalating grant) to enable it to upgrade its services.

The assignment of expenditure and revenue to the states of Sabah and Sarawak is more favourable, reflecting their strong bargaining position when entering the Federation. As for expenditure, apart those functions listed in the List II, the states of Sabah and Sarawak have additional expenditure responsibilities as stated in List IIA, that of native law and custom, the powers to incorporate of authorities and other bodies, responsibility for ports, harbours and railways (see Table 3.4). In line with these extra responsibilities, additional revenue sources were assigned to these states. Apart from the sources of revenue listed in Part III, which is applicable to all states, the states of Sabah and Sarawak enjoy additional revenue sources as stipulated in Part V of the Tenth Schedule (see Table 3.6). These include: import duty and excise duty on petroleum products; export duty on timber and other forest produce; export duty on mineral up to 10% ad valorem. For the state of Sabah only, as long as medicine and health remains under the Concurrent List, the state of Sabah will receive 30% of all customs revenue (other than import duty and excise duty on petroleum products, export duty on timber and other forest produce, and export duty on mineral); fees and licences of road vehicles[112]; fees from registration of vehicles; state sales taxes; and fees and dues from ports and harbours (other than federal ports and harbours).

Apart from the joint functions listed in List III, the states of Sabah and Sarawak have additional functions incorporated into the Concurrent List as stipulated in List IIIA (see Table 3.4; column 3), that is, family law (marriage and divorce), adulteration of

[112] However, in 1974 this function was taken over by the federal government for the sake of uniformity.

foodstuffs, shipping (under 15 tons), maritime and estuarine fishing and fisheries, electricity, agriculture and forestry, medicine and health (except Sabah until 1970) and charity. As for medicine and health, the list was extended to include List 14 (a to d) of the Ninth Schedule of the Federal Constitution, covering hospitals, clinics and dispensaries; the medical profession; maternity and child welfare; lepers and leper institutions; lunacy and mental deficiency, including places for reception and treatment; poison and dangerous drugs; and intoxicating drugs and liquors; and manufacture and sale of drugs. These functions fall under the Federal List but have been extended to Sabah and Sarawak.

The special financial treatment for Sabah and Sarawak also extended to the right to receive more grants from the federal government, as stipulated in the Article 112C and 112D of the Federal Constitution. The underdeveloped nature of these states merited special grants from the federal government.[113] For Sarawak, the annual balancing grant and escalating grant were given to finance the state's deficit, representing the difference between revenue and its expenditure during the fiscal year. This grant was payable annually until the review in 1968 took place. Moreover, an escalating grant was made to the state to cover the annual increase in the current cost of state services. The purpose behind this grant was to enable Sarawak to develop its departments which, compared with their counterparts in peninsular Malaysia, were relatively less developed. The amount of the grant payable was fixed in advance, and the rate was based on the expenditure growth between 1959-1962. The amount of grant payable for the next five years after 1968 was subject to review between the federal and state governments.

Sabah, on the other hand, did not receive any of these special grants. However, the state was given a special grant of 'an amount equal in each year to two-fifth of the amount by which the net revenue derived by the Federation from Sabah exceeds the net revenue

[113] See Part IV of Tenth Schedule of the Federal Constitution. See also Malaya (1962a), Section 24 on 'Financial Provision'.

which would have been so derived in the year 1963 if the Malaysia Act had been in operation in that year as in the year 1964 and the net revenue for the 1963 were calculated without regard to any alteration of any tax or fee made on or after Malaysia Day.'[114] Of particular importance is that in any revision of grants, the states of Sabah and Sarawak were not subjected to Article 108 (4) in that these states did not have to consult the National Finance Council.[115] Furthermore, as discussed above, the states of Sabah and Sarawak have more borrowing powers; they may borrow domestically under the authority of the state law, provided prior approval is obtained from the Central Bank. This exceptional power to borrow is not enjoyed by the states in peninsular Malaysia.

On the whole, the financial arrangements for the Federation of Malaysia in 1963, especially with regard to new members in the federation, are regarded as more than generous. Most of the principles of federal finance, such as efficiency, derivation, national interest and needs, have been incorporated in the system of revenue allocation for these states; in particular, consideration has been given to the underdeveloped nature of these states so that they merited special treatment. The voice of these states during the federating process was properly heard and translated into a concrete agreement, the Malaysia Act 1963. It can be observed that revenues given to the states in peninsular Malaysia were also allocated to the new member states; however, additional revenue sources enjoyed by the new member states were not extended to older members of the federation. Similar arrangements can be observed for expenditure assignment, as well as the grants system. Thus, looking at the fiscal arrangements, the Federation of Malaysia is undoubtedly an asymmetrical federation.

3.6 Conclusion

The questions posed at the outset of this chapter concerned the application of the theory of fiscal federalism to the design of Malaysian fiscal federalism. From the foregoing

[114] See Part IV, Section 2(1), Tenth Schedule of the Federal Constitution.
[115] See Chapter 7

discussion, it appears that the design of intergovernmental fiscal relations evolved gradually from the first federal idea in the late 19th century. It was seen that the first federal idea in Malaysia was not formed according to the federal principle, as there was no proper division of power and representation. Although a Federal Council was established, it did not function appropriately. The proper form of federal government was only created when the Malayan Union was abolished and replaced by the Federation of Malaya. The theme of the new federation was 'the establishment of a strong central government'. This theme was reflected in the Federal Agreement, which meant the centralisation of function at the centre. The result is a highly centralised federation as it exists today. The division of power between the federal government and eleven state governments consisted of three lists, namely the Federal List, the State List and the Concurrent List. However, the residual powers are exclusively federal.

The strong central power was notably reflected in a financial arrangement, as the kinds of functions assigned to the states were of secondary importance and the type of revenue sources assigned to states also limited, unproductive and difficult to manage and to collect. Even in the Concurrent List, the authority of the federal government was extensive, as the Parliament could make laws in areas of states' competence. To make the states' position worse, the Parliament could override any law made by the state legislature. Thus, the position of states in the Federation of Malaya was subordinate to the federal government, which is against the federal principle. This kind of arrangements is prone to political malpractice, especially if a state is ruled by a party different from that of the centre.[116]

However, when the Federation of Malaya was expanded, with the joining of Sabah and Sarawak with the Federation of Malaya to form the Federation of Malaysia in 1963, the position of the new member states was much better: they enjoyed more fiscal autonomy

[116] See Chapter 6 for the discussion on the Malaysian politics and fiscal federalism.

and the federal government could not encroach on those states' subjects without the concurrence of their respective Rulers or the State Legislative Assembly. This is because the new states had strong political bargaining power before entering the federation. In contrast, the eleven states in peninsular Malaysia, the original members of the Federation of Malaysia, had no strong bargaining power as these states were still under British colonial rule. Malaysian federalism did not evolve in the way it did in, say, the United States, Canada or Australia. It was a top down process of superimposing a strong central government theme on the existing states by the British colonial authority and later, after independence, continued by the federal government. Furthermore, the motive for adopting a federal structure in Malaya was primarily a communal and political one, notably the desire of the Malays to preserve their political supremacy over non-Malays, especially the Chinese. 'In fact, the lack of interest of the Malay states in economic and financial matters resulted in a predominance of the federal government which is almost tantamount to the control exercised by the government of a unitary country' (Holzhausen, 1974: 176).

From the examination of the design of intergovernmental fiscal arrangements, it is evident that the fiscal arrangement in Malaysian fiscal federalism was not properly designed according to the principle of federalism or the theory of fiscal federalism. However, some elements in the Malaysian fiscal federalism do conform to the theory of fiscal federalism, namely, the efficiency principle in the division of power / function. In other words, those powers / functions that have benefit accrued throughout the federation are assigned to the centre, while those localised in nature are assigned to the state governments. Those functions that are important for macroeconomic purposes - stabilisation, allocation and redistribution - are assigned to the centre to ensure macroeconomic stability. Similarly, the division of revenue does not infringe the principle of efficiency and equity, in the sense that for the purpose of efficiency, taxes

that have nationwide effect, such as corporate tax and income tax, are best collected by the centre, which, at the same time can promote economic incentives. Nonetheless, there are some inconsistencies with the efficiency principle, where localised taxes such as property taxes, consumption taxes, excise taxes and vehicle taxes, are assigned to the centre. This has led to over centralisation of revenue sources resulting in financial difficulties for states, as evident in horizontal and vertical imbalances. The independent states' revenue remains limited, local in nature, more difficult and expensive to administer and to collect than federal revenues, which are more productive, lucrative and elastic. In other words, the federal government has complete fiscal power to determine the direction of the public sector, leaving state governments with matters of secondary importance. The result of this arrangement is that the centre has more revenue sources, coupled with exclusive borrowing powers, while states have more financial problems. Consequently, transfers of funds from the federal to state governments are necessary to purge states' financial difficulties and to maintain their interest in the federation. Alas, federal transfers were not properly designed to negate the state's financial non-correspondence. The next two chapters will show how the problem of fiscal imbalance was addressed by the federal government (Chapter 4) and what are the determinants used in the making of federal transfers to states (Chapter 5). In the light of centralising nature of the political system, it will be seen to what extent the federal spirit is followed in overcoming states' financial difficulties and how political hegemony actually influences the grant system.

Chapter 4

Fiscal Imbalances and Adjustment Measures

4.1 Introduction

In Chapter 3, the design of fiscal federalism in Malaysia was discussed and the division of power between the federal and state governments was also examined, in particular what powers belong to the federal government and what powers belong to the states. The bottom line of our discussion demonstrates that the powers of the federal government, both executive and legislative, are enormous as compared to the states. In this chapter, the problem of fiscal imbalances resulting from the inappropriate design of intergovernmental fiscal arrangements and how the federal government undertook the correctional measures to alleviate the problem will be discussed. From this analysis, it will be learnt whether adjustment measures were taken on the basis of financial / economic expediency, federal consciousness, or merely based on political viability.

4.2 Analysis of fiscal imbalances

As discussed in the foregoing chapters, the fundamental issue in intergovernmental fiscal relations in most federations is the question of fiscal imbalance arising from the constitutional division of powers. In Malaysia, the problem of fiscal imbalance originated from the fact that states' constitutional obligations are higher than their capacity to raise revenue.[1] The limited revenue raising capacity of the state governments was the result of the division of taxation between the federal and state governments in which the former exclusively controls taxation powers. Two main issues have arisen as a result of this arrangement: first, the problem of 'vertical imbalance' between the federal and state governments due to the difficulties of states' revenue-raising powers as compared with the federal government; and, second, the problem of horizontal imbalance among the

[1] See Abdul Rahim, 2000; Wilson, 1995; Noh, 1991; Ariff, 1991; Holzhausen, 1974. These writers also found that the problem of fiscal imbalance was due to limited revenue raising powers on the part of state governments.

state governments arising from differences in their fiscal capacities due to differences in the cost of fulfilling responsibilities and differences in their natural endowments. For this reason, fiscal adjustment by the federal government, which possesses exclusive taxation powers, is necessary to provide adequate financial resources for the state governments to discharge their constitutional obligations. The extent of fiscal imbalances between the federal and state governments (vertical imbalance) as well as among the states (horizontal imbalance) needs to be assessed before the necessary fiscal adjustments can be made to remedy the imbalances. However, before discussing in further detail the fiscal imbalances in Malaysia's fiscal federalism and its remedial measures, the root cause of the problem will be discussed, so that an accurate analysis of the fiscal adjustment undertaken by the federal government can be made. It will then be possible to analyse the shortcomings of the overall design of fiscal adjustment, and to draw some conclusions about the federal government's commitment to overcome the financial difficulties of the state governments.

4.2.1 The root cause of fiscal imbalances

The root cause of fiscal imbalance, that is, non-correspondence between revenue and expenditure, can be traced back to the time when the Federal Constitution was drafted. In doing so, the division of functions and resources (taxation) that were enumerated and entrenched in the Constitution will be revisited. From investigation conducted in Chapter 3, it was observed that the framers of the Federal Constitution at the time of federating were not in a position to assign adequate revenue sources to the state governments that would match their needs in order to discharge the constitutional functions assigned to them. Consequently, fiscal adjustment (federal transfers) has always been of key importance to remedy fiscal imbalances in Malaysia. In order to trace the root cause of the problem of fiscal imbalance, analysis of both revenue and expenditure assignments and performance will be made.

4.2.1.1 Revenue side analysis

The economic functions of government are basically three, namely, stabilisation, allocation and distribution (Musgrave and Musgrave, 1976). The federal government has capacity, powers and resources to carry out these functions efficiently as a result of the centralisation of the most productive sources of revenue. The design of intergovernmental fiscal relations (assignment of fiscal function), as discussed in Chapter 3, is such that the Malaysian federation is heavily centralised, leaving the state governments to play a secondary role, that is, as the federal government's agent (principle – agent relationship), complementing federal programmes and maintaining public facilities. This can be seen in the way taxation and expenditure functions[2] were assigned by the Federal Constitution to each level of government. The most productive, buoyant and elastic tax sources, namely income tax (individual and company tax) and import and exercise duties, belong to the federal government, as can be seen from Table 4.3, whereas the states are left with unproductive taxes, which by and large are difficult to administer and collect (see Table 4.4). The federal government arguments is that the centralisation of revenue at the centre could conceivably eliminate the accumulation and concentration of wealth in one particular state and thereby reduce economic disparities between states, thus promoting a regional economic balance. However, this vindication is weak to justify the centralisation of fiscal power, as fiscal imbalance has persisted since the creation of the federation.[3] As a result of the centralisation of the most productive sources of revenue, the federal government revenue has grown remarkably[4] compared to that of state governments, as seen in Table 4.1 and Table 4.2 (This trend can also be seen from Figure 4.1.). In 1970, the federal government collected 79.1% of the total federal and state government revenue and increased to 86.3% in 2000, while the state

[2] See Chapter 3.
[3] See Ariff (1991) and MOEF (1993)
[4] As discussed in Chapter 2, most of states' revenue sources, such as land-based taxes, are not GDP elastic.

governments collected 20.9% in 1970, and further declined to 13.7% in 2000. This indicates the extent of vertical fiscal imbalance.

Table 4.1
Federal and State Governments' Revenue: A Comparison
(RM million)

Year	Federal Government		State Governments		
	Revenue[1]	% Change	Revenue[2]	% Change	% (iv) of (ii)
(i)	(ii)	(iii)	(iv)	(v)	(vi)
1970	2,400		636		26.5
1975	5,117	113.2	1,152	81.1	22.5
1980	13,926	172.2	2,996	160.1	21.5
1985	21,115	51.6	4,172	39.3	19.6
1990	29,521	39.8	6,634	59.0	22.5
1995	50,954	72.6	7,809	17.7	15.3
2000	61,864	15.2	9,796	25.4	15.8

Note: [1] Include all sources of revenue (tax, non-tax, and non-revenue receipts)
[2] Consolidated state governments revenue, includes grants received from the federal government
Source: Public Account Report and state governments' financial report: various issues.

Table 4.2
Federal and State Governments'
Revenue and Expenditure Comparison

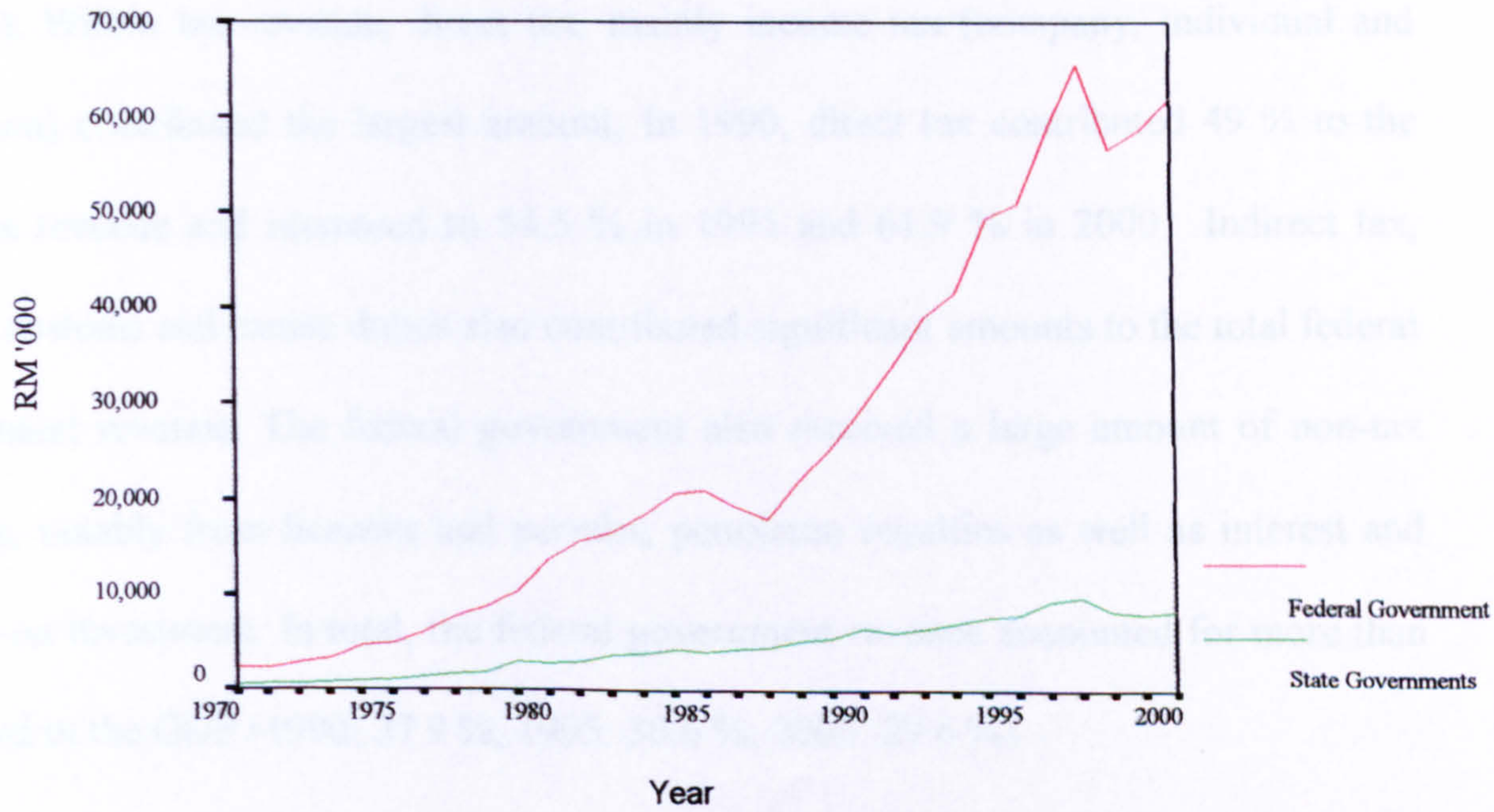
	Total revenue (% of total)		Total expenditure (% of total)	
	Federal	State	Federal	State
1970	79.1	20.9	80.6	19.4
1975	81.6	18.4	81.4	18.6
1980	82.3	17.7	83.9	16.1
1985	83.5	16.5	84.0	16.0
1990	81.7	18.3	82.6	17.4
1995	86.7	13.3	86.5	13.5
2000	86.3	13.7	88.8	11.2

Source: Calculated based on data from Economic Report, Ministry of Finance (various issues)

In 1970, the federal government revenue amounted to RM 2,400 million; it increased to RM 13,926 million in 1980 and subsequently to RM 29,521 million in 1990. In 2000, the federal government revenue amounted to RM 61,864 million. In terms of cumulative percentage change from 1971 to 2000, the federal government revenue recorded a strong growth of 17.6 %. The significant increase of the federal government revenue was due to its great advantages in revenue collection, due to the assignment of the most productive and elastic sources of revenue to the federal government (see Table 4.3 for details of the federal government revenue composition) coupled with an efficient tax collection system.

On the other hand, over the same period (1971 to 2000), the consolidated revenue of the thirteen state governments increased by 13.2 %. In 1970, the state governments' revenue, including federal transfers, amounted to RM 636 million or 26.5 % of the total federal government revenue and increased to RM 9,796 million in 2000 or 15.8 % of the total federal government revenue (see column (vi) of Table 4.1). Clearly, the state governments revenue as a percentage of the federal government revenue is reducing gradually, reflecting difficulties on the part of the state governments in raising revenue, even during periods of remarkable economic growth, let alone during economic recession. In 2000, for instance, the elasticity of the federal government revenue to GDP was 1.0 while the states' own sources of revenue had elasticity to GDP of only 0.02. This phenomenon causes the problem of vertical imbalance between the federal and state governments, where on the one hand the federal government has strong revenue raising capacity and on the other hand the state governments have limited and less productive sources of revenue (see Table 4.3 for details of the state governments' revenue composition). This problem is further exacerbated by the poor tax collection machinery on the part of the state governments.

Figure 4.1
Federal and State Governments Revenue



Source: SPSS

Table 4.3
Components of Federal Government Revenue
(RM million)

Components	1990	% share	1995	% share	2000	% share
Tax revenue	21,244	72.0	41,671	81.8	47,173	76.3
Direct tax	10,402	35.2	22,699	44.5	29,156	47.1
Companies income tax	4,497	15.2	11,707	23.0	13,905	22.5
Petroleum income tax	2,644	9.0	2,185	4.3	6,010	9.7
Individual income tax	2,506	8.5	6,203	12.2	7,015	11.3
Stamp duties	645	2.2	2,192	4.3	1,799	2.9
Others	110	0.4	412	0.8	428	0.7
Indirect tax	10,842	36.7	18,972	37.2	18,017	29.1
Export duties	1,970	6.7	853	1.7	1,032	1.7
Import duties	3,420	11.6	5,622	11.0	3,599	5.8
Excise duties	2,266	7.7	5,280	10.4	3,803	6.1
Sales tax	2,442	8.3	4,869	9.6	5,968	9.6
Service tax	121	0.4	1,016	2.0	1,701	2.7
Others	623	2.1	1,332	2.6	1,914	3.1
Non-tax revenue	6,946	23.5	8,469	16.6	14,093	22.8
Licences and permits	1,255	4.3	2,516	4.9	3,785	6.1
Petroleum royalties	627	2.1	710	1.4	1,763	2.8
Interest and returns on investment	4,613	15.6	4,381	8.6	7,383	11.9
Others	451	1.5	862	1.7	1,161	1.9
Non-revenue receipts	1,331	4.5	814	1.6	599	1.0
Total Revenue	29,521		50,954		61,864	
% GDP	27.9		30.6		29.6	

Source: Economic Report, Ministry of Finance (various issues).

Table 4.3 clearly shows that sources of the federal government revenue are enormous, and that more than 70 % comes from tax revenue (1990: 72 %, 1995: 81.8 % and 2000: 76.3 %). Within tax revenue, direct tax, mainly income tax (company, individual and petroleum) contributed the largest amount. In 1990, direct tax contributed 49 % to the total tax revenue and increased to 54.5 % in 1995 and 61.9 % in 2000. Indirect tax, mainly customs and excise duties also contributed significant amounts to the total federal government revenue. The federal government also received a large amount of non-tax revenue, notably from licences and permits, petroleum royalties as well as interest and returns on investment. In total, the federal government revenue accounted for more than one third of the GDP (1990: 27.9 %; 1995: 30.6 %; 2000: 29.6 %).

Table 4.4
Components of Consolidated State Government Revenue[1]
(RM million)

Components	1990	% share	1995	% share	2000	% share
Tax revenue	865	13.1	1,434	18.4	1,159	11.8
Direct tax	801	12.1	694	8.9	1,002	10.2
Land-based tax	580	8.7	687	8.8	972	9.9
Others	221	3.3	6	0.1	30	0.3
Indirect tax	64	1.0	741	9.5	157	1.6
Entertainment tax	24	0.4	35	0.4	31	0.3
Others	40	0.6	706	9.0	126	1.3
Non-tax revenue	4,155	62.6	4,564	58.4	5,312	54.2
License, permit and fees	103	1.6	188	2.4	233	2.4
Royalties	2,156	32.5	2,254	28.9	2,469	25.2
Fees	254	3.8	223	2.9	165	1.7
Sales of assets / land premium	413	6.2	954	12.2	1,634	16.7
Interest and return from investment	729	11.0	552	7.1	582	5.9
Others	500	7.5	394	5.0	229	2.3
Non-revenue receipts	1,614	24.3	1,811	23.2	3,325	33.9
Total Revenue	6,634		7,809		9,796	
% GDP	6.3		7.4		4.7	

Note: [1] Data for 1995 and 2000 are unadjusted – include trust funds, receipt from the Development Fund and Water Supply Fund
Source: State governments' financial statement (various years).

On the other hand, the consolidated state governments' revenue accounted for only 6.3 % of the GDP in 1990: 7.4 % in 1995: and 4.7 % in 2000, due mainly to the limited revenue base, comprising tax revenue and non-tax revenue. Tax revenue is made up of direct tax, mainly generated from land-based taxes and indirect tax (mainly from entertainment tax), while non-tax revenue comprises assorted licences, fees, royalties payments and returns on investment. As can be seen from Table 4.4, the state governments' revenue largely came from non-tax revenue, which accounted for 62.6 % of the total states revenue in 1990, 58.4 % in 1995 and 54.2 % in 2000. Non-tax revenue was largely generated from land premium and royalties payments from petroleum and forestry. However, royalties payments are exclusively enjoyed only by the producing states, that is, Terengganu, Pahang, Sabah and Sarawak. For Terengganu, before the decision by the federal government to desist petroleum royalties payments, petroleum royalties made up 63 % of Terengganu's total own sources of revenue in 1995. For Sabah and Sarawak, which

continue to enjoy petroleum royalties, revenue from this source contributed almost 4.8 % and 10.6 % of their total own sources of revenue in 1995, respectively. As for royalties from forestry, Sabah, Sarawak and Pahang are the largest recipients of this source of revenue, which made up 34.9 %, 40.9 % and 13.5 % of the total own sources of revenue, respectively, in 1995.

Tax revenue, on the other hand, contributed only 13.1 % of the total states revenue in 1990, 18.4 % in 1995 and 11.8 % in 2000. Within tax revenue, direct tax collection contributed the largest proportion of the total state governments' revenue: 12.1 % in 1990, 8.9 % in 1995, and 10.2 % in 2000. Direct tax was mainly generated from land-based tax, which accounted for 8.7 % of the total tax revenue in 1990, 8.8 % in 1995, and 9.9 % in 2000. Collection from indirect tax, mainly made up of entertainment tax was relatively insignificant. Moreover, not all state governments enjoyed entertainment tax, as in the case of less developed states of Kelantan, Terengganu, Perlis and Kedah.

From this survey, it is acknowledged that revenue assignments were heavily centralised (see Table 4.2). Revenue sources of the federal government, as provided in the Federal Constitution, are enormous, while the state governments' revenue sources are limited and benefit little from the GDP growth. The state governments' own sources of revenue comprise mainly tax revenue (land based taxes) and non-tax revenue (fees and licences), accounting for 75.7 %, 76.8 %, and 66 % of the total revenue in 1990, 1995 and 2000, respectively, while the remainder consist of federal transfers and federal reimbursement. However, analysis at the individual state level discloses the reverse position, in which federal transfers make up more than 70 % of their total revenue (notably for the states of Kelantan, Terengganu, Perlis, Kedah and Malacca). Within tax revenue, revenue from land-based taxation was significant (see Table 4.4). Hence, it is likely that those states (especially Perlis and Malacca) with a limited land-base will find it much harder to raise revenue and, hence, find it difficult to finance their expenditures. Thus, the state

governments have to turn on federal transfers to finance their deficits. On the other hand, those states with enormous natural endowments, notably petroleum and timber (Terengganu – oil, Sabah – oil and timber, Sarawak – oil and timber, and Pahang – timber) have a comparatively strong revenue base.

4.2.1.2 Expenditure side analysis

In terms of expenditure, most functions were also centralised even functions that are localised in nature, such as local policing and fire services. This indicates the degree of centralisation and states' fiscal autonomy in Malaysia (see Table 4.2). Besides, the tendency toward centripetal forces in most of the federal government policies also strong to the present day, as can be seen from the privatisation policies adopted by the federal government since 1983.[5] For the sake of efficiency, functions that are constitutionally assigned to the states have now been privatised, such as water supply, sewerage and refuse disposal, through the federal government privatisation policies.[6] Apart from privatisation policies, centripetal forces are also strong through federal sponsored projects in the states, such as in land-related development projects. Indeed, the importance of the state fiscal functions has declined gradually, leaving the states with functions of secondary importance, such as maintenance of federal projects. Shafruddin described the centralisation of powers and functions, saying that 'crucially the centre's political leaders believe that they are the custodians of the national interest' (Shafruddin, 1988: 25). Thus, it is difficult to gauge whether Malaysia is an authentic federation; instead, perhaps it can

[5] The latest trend in most federal countries is towards centrifugal forces following the decentralisation policies. See Birds and Vailancourt (1998).

[6] The privatisation programme is part of the federal government policy of private sector driven economy. Under this programme, government departments, corporations, or entities, which are viable but poorly managed, will be privatised, either through Built-Operate-Transfer, Bill and Transfer, or Sale of Share/Equity. As the management (and supervisory role) of the privatised entities are undertaken by the federal government, indirectly, this programme is a kind of centralisation instrument to usurp state functions. In the final analysis, state governments are losing its authority to federal government over those privatised state functions, as can be seen in case of sewerages and refuse collections. Today, water and water related services which fall under states' competence, are also in the process of centralisation through the National Water Council.

be best described as a unitary state with institutional scaffolding of a federal structure. The growing trend of centralisation of the state functions resulted in states losing their 'autonomy', and hence, becoming subordinated to the centre. According to Hadenan (1985: 196) 'the success of development planning in Malaysia can be attributed to the fact that state governments remain subordinate and dependent on federal authority over the years'. This underlines the minimal role of the state governments in the federation.

As a result of the centralisation of expenditure functions, the share of the federal government expenditure to the GDP, as an indicator of the leverage of the public sector in steering the economy towards its desired fiscal objective, was considerably large, as can be seen from Table 4.5. In contrast, the state governments' expenditures were relatively small. This clearly indicates the limited extent of the state governments' role in the specific public sector as well as in the general mainstream economy.

Table 4.5
Federal and State Governments' Expenditure[1]: A Comparison

Annual average	Public sector[2] Expenditure (RM million)	Federal Government Expenditure			State Governments Expenditure			
		(RM million)	% GDP	% (ii) of (i)	(RM million)	% GDP	% (v) of (i)	% (v) of (ii)
	(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)	(viii)
1981-1985	34,134	24,561	35.3	72.0	3,308	4.8	9.7	13.5
1986-1990	40,684	24,311	25.9	59.8	5,487	5.9	13.5	22.6
1991-1995	66,109	36,279	20.7	54.9	6,612	3.8	10.0	18.2
1996-2000	96,120	54,221	18.8	56.4	8,415	2.9	8.8	15.5

Note: [1]Data from consolidated public sector account.
[2] Comprises Operating and development expenditure of the federal government, state governments, local governments, statutory bodies and non-financial public enterprises (NFPEs)
Source: Public Account Report and state governments' financial report: various issues.

Table 4.5 shows that the federal government's participation in the economy was significant. Based upon its annual average share to the GDP, the share of the federal government expenditure in 1981-1985 was conspicuous at 35.3 % of the GDP. However, following the federal government's policy of a private sector driven economy and privatisation policy in the mid 1980s, as well as financial constraints facing the federal

government as a result of the global economic slowdown during the mid-1980s and the 1997 financial crisis, the share of the federal government expenditure to GDP declined to 25.9 % during 1986-1990, and further declined to 20.7% and 18.8% during 1991-1995 and 1996-2000, respectively.

Although the share to the GDP is declining, the federal government expenditure in the public sector remains significant; it accounted for more than 50 % of the total public sector expenditure between 1980-2000. For the period 1980-1985, for instance, the average total share of the federal government expenditure to the total public sector expenditure was extremely high at 72 % (see Table 4.5), due to increased demand on public infrastructure, especially transportation and other public services (education and health), and housing. The high share of the federal government was also due to the fiscal expansionary policy needed for economic recovery following the mid-1980s global economic recession. However, as economic recovery was under way, the federal government expenditure as a percentage of the total public sector expenditure declined: from 72 % during the period 1980-1985 to 59.8 % and 54.9 % for the period 1986-1990 and 1991-1995, respectively. Nevertheless, federal government expenditure increased again during 1996-2000 following the severe financial crisis that hit the Malaysian economy in mid-1997. As the federal government adopted a fiscal expansionary policy to expedite the economic recovery, its share of expenditure to the total public sector expenditure increased to 56.4 %, during 1996 to 2000. As such, deficit budgeting by the federal government was purposely planned to meet a specific objective, especially as a counter cyclical measure in response to the economic downturn.

On the other hand, as clearly seen from Table 4.5, the total share of the state governments' expenditure to GDP is small: constituting only 4.8 % of the GDP during 1981-1985 or 9.7 % of the total public sector expenditure. This share was by no means sufficient to have a significant influence on the economy. Unlike the federal government,

the state governments' expenditure is required to meet a minimum standard of public services at the state level. Its share to the GDP further declined to only 2.9 % of the GDP or 8.8 % of the total public sector expenditure during 1996-2000. This clearly indicates the limited extent of the state governments' role in the economy. The relatively small share of the state governments' expenditure to the GDP rules out any significant stabilisation function of the state governments and, hence, state governments' expenditures had no capacity to support the federal government fiscal policy. In most of the year, the state government expenditure recorded only around 10% of the total public sector expenditure as compared to the federal government, which recorded more than 50% of the total public sector expenditure (see Table 4.6).

Table 4.6
Public Sector Revenue and Expenditure[1]
(RM million)[2]

	1995	1997	1999	2000
Revenue	62,272 (100)	81,528 (100)	70,323 (100)	73,785 (100)
Federal Government	50,954 (81.8)	65,736 (80.6)	58,675 (83.4)	62,228 (84.3)
State Government	6,799 (10.9)	8,389 (10.3)	6,166 (8.8)	7,369 (10.0)
Local Government	2,294 (3.6)	4,193 (5.2)	2,762 (3.9)	2,819 (3.8)
Statutory bodies	2,225 (3.7)	3,210 (3.9)	2,720 (3.9)	1,369 (1.9)
Expenditure	71,195 (100)	91,876 (100)	102,646 (100)	119,919 (100)
Federal Government	41,764 (58.7)	51,407 (56.0)	57,242 (55.8)	67,692 (56.4)
State Government	7,398 (10.4)	8,770 (9.5)	8,027 (7.8)	10,745 (9.0)
Local Government	2,865 (4.0)	4,442 (4.8)	3,835 (3.7)	3,604(3.0)
Statutory bodies	5,538 (7.8)	5,916 (6.4)	7,290 (7.1)	8,936 (7.5)
NFPEs[3]	13,630 (19.1)	21,341 (23.3)	26,252 (25.6)	28,942 (24.1)

Note: [1] Consolidated public sector account (exclude intergovernmental transfers and trust funds)
[2] Figure in parentheses is percentage of total.
[3] Non-Financial Public Enterprises
Source: Economic Report, Ministry of Finance (various issues)

The federal government commitment to undertake the distribution function on a nationwide basis (to uplift the socio-economic status such as through poverty eradication programmes) contributed to a high percentage of federal expenditure, as it has exclusive control over fiscal policies, as taxation and expenditure are centralised (see Table 4.2). Therefore, federal controls over the major taxes are justified primarily to ensure a more

equitable distribution of wealth amongst the states. It is for this reason that the main taxing powers were assigned to the federal government with anticipation that in return the federal government could perform the distribution / redistribution function.

Table 4.7
State Governments' Development Expenditure
(% of total state expenditure)

State	1990	1995	2000
Perlis	32.0	41.1	43.2
Kedah	44.3	75.4	45.2
Penang	32.3	36.5	48.5
Perak	33.2	50.4	29.6
Selangor	82.7	44.1	42.9
Negeri Sembilan	36.2	42.2	61.7
Malacca	54.9	35.4	34.1
Johor	26.5	30.7	33.2
Pahang	41.1	43.2	41.9
Terengganu	38.8	44.0	31.5
Kelantan	35.5	28.6	23.3
Sabah	38.4	36.7	23.3
Sarawak	64.6	68.8	74.1

Source: Financial Statement (respective state governments)

Table 4.7 shows the percentage of the development expenditure of the individual states in relation to the total expenditure. In general, depending upon the stage of development, the state governments individually spent from around 23 % to 62 % of their total expenditure for development purposes in 2000, with the exception of Sarawak, which spent more than 74 % of their total expenditure for development purposes. The state governments' development expenditures were mainly aimed at providing a range of public services that would help to raise the minimum standard of living. These include expenditure on agriculture and rural development (including drainage and irrigation), public utilities, transport, housing and trade and industry, which are regarded as complementing the federal government's efforts in providing such services. Given the insufficient resources at their disposal, there is a doubt about the states' comparative advantage in delivering these social and welfare services that suit the diverse preferences and needs of local residents, which would be their expected role in view of their greater proximity to the residents. According to Oates (1972), the provision of public services

that has localised benefit should be performed by lower tiers of government, with sufficient resources assigned to them. However, this is not the case for Malaysian fiscal federalism, as public services that have localised benefit, such as fire services and local policing, are assigned to the centre to fit the strong central government theme.

Table 4.8
Federal Government Financial Position
(RM million)

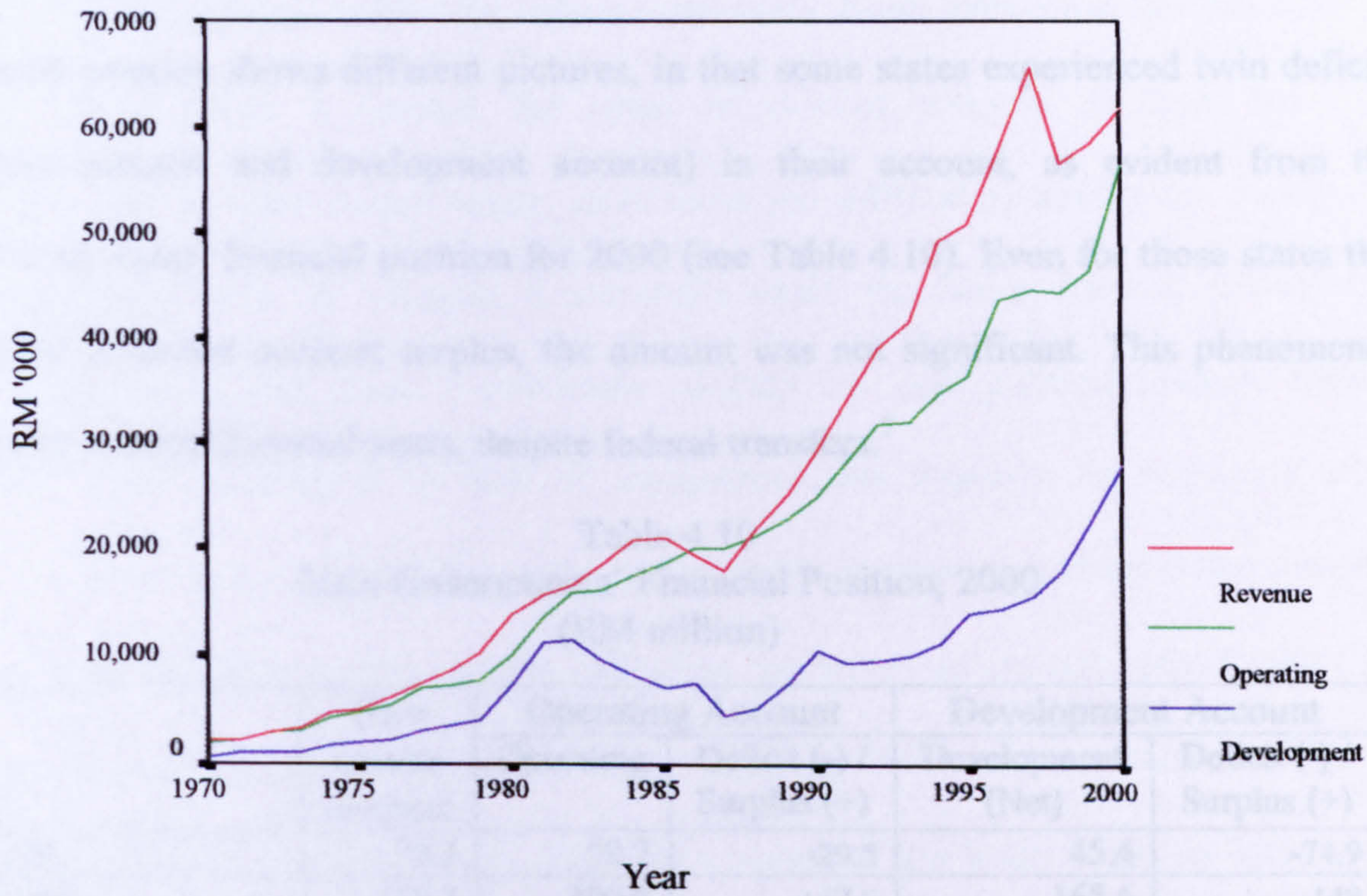
	1970	1975	1980	1985	1990	1995	2000
Revenue	2,400	5,117	13,926	21,115	29,521	50,954	61,864
Tax sources	1,840	4,256	12,160	16,700	21,244	41,671	47,173
Direct tax[1]	*685*	*1,990*	*5,495*	*9,259*	*10,402*	*22,699*	*29,156*
Indirect tax[2]	*1,155*	*2,266*	*6,665*	*7,441*	*10,842*	*18,972*	*18,017*
Non-tax sources[3]	529	792	1,675	3,975	6,946	8,469	14,093
Others	31	265	306	440	1,331	814	599
Operating expenditure	2,163	4,900	10,292	18,766	25,026	36,573	56,547
Current account	237	217	3,634	2,349	4,495	14,381	5,317
Gross Development expenditure	725	2,151	7,470	7,142	10,689	14,051	27,942
Less loan recoveries	13	33	132	386	2,757	1,531	2,910
Net development expenditures	712	2,118	7,338	6,756	7,932	12,520	25,032
Overall balance[4]	-475	-1,901	-3,704	-4,407	-3,437	1,861	-19,750

Note: [1] Includes income tax (individual, company and petroleum) and stamp duties
[2] Includes import, export and excise duties, sales tax, service tax
[3] Includes licences and permits, petroleum royalties, interest and returns on investment.
[4] + indicates surplus position and – indicates deficit position
Source: Economic Report, Ministry of Finance (various issues)

Table 4.8 shows the financial position of the federal government. It shows that the federal government recorded financial deficits in most years. This trend can also be clearly seen from Figure 4.2. However, most of the deficits that occurred, as discussed above, were primarily due to planned deficit budgeting following a fiscal expansionary programme for stabilisation, allocation and distribution purposes, in response to prevailing economic difficulties or to meet specific development objectives. To undertake this function, apart from its productive revenue sources, the federal government has been assigned borrowing powers by the Constitution to resort to domestic and external borrowing to finance the budgetary deficits. On the other hand, the state governments' financial deficits were merely due to scarcity of resources (due to limited revenue raising powers) to finance

their constitutionally assigned functions, to meet the expenditure required to provide a minimum standard of public services at the state level.

Figure 4.2
Federal Government Revenue and Expenditure



Source: SPSS

Table 4.9
Consolidated State Governments' Financial Position
(RM million)

	1970	1975	1980	1985	1990	1995	2000
Revenue	636	1,152	2,996	4,172	6,718	8,261	9,796
Own source	461	812	2,445	3,157	5,204	6,799	8,235
Grants and reimbursement	175	340	551	1,015	1,514	1,462	1,620
Operating expenditure	443	994	1,997	2,722	4,268	4,167	5,253
Current account	193	158	999	1,450	2,450	4,094	4,602
Development expenditure[1]	250	607	1,395	2,142	3,057	4,003	5,348
Less loan recoveries	-	-	-	-	399	531	265
Net development expenditures	250	607	1,395	2,142	2,658	3,472	5,083
Overall balance[2]	-57	-449	-396	-692	-208	622	-481

Note: [1] Comprises the Development Fund and Water Supply Fund
[2] + indicates surplus position and – indicates deficit position
Source: Financial Statements (respective state governments/various years).

The fiscal gap, that is, the difference between the states' own sources of revenue and their need for resources expressed in terms of total expenditure, was large, averaging 33.5 % in 1970. In 1980, the total gap was 27.9 %, and it increased to 29 % in 1990. In 2000, the

fiscal gap was further widened to 32.2 %. Table 4.9 displays the consolidated financial position of the state governments for the selected years. It clearly shows that the constitutional assignment of taxes and divisions of functions has resulted in persistent overall deficits in the state governments' finance. However, analysis of individual states' financial position shows different pictures, in that some states experienced twin deficits (current account and development account) in their account, as evident from the individual states' financial position for 2000 (see Table 4.10). Even for those states that recorded a current account surplus, the amount was not significant. This phenomenon persisted in most financial years, despite federal transfers.[7]

Table 4.10
State Governments' Financial Position, 2000
(RM million)

	Own source revenue	Operating Account		Development Account	
		Operating	Deficit (-) / Surplus (+)	Development (Net)	Deficit (-) / Surplus (+)
Perlis	30.2	59.7	-29.5	45.4	-74.9
Kedah	218.2	200.6	+17.6	165.6	-148
Penang	171.9	163.2	+8.7	153.5	-144.8
Perak	339.8	279.5	+60.3	117.5	-57.2
Selangor	1,348.7	1,022.3	+326.4	768.7	-442.3
Negeri Sembilan	170.6	131.8	+38.8	212.4	-173.6
Malacca	112.1	79.0	+33.1	40.9	-7.8
Johor	305.3	432.1	-126.8	214.7	-341.5
Pahang	321.1	310.5	+10.6	223.6	-213
Terengganu	578.9	419.9	+159.0	193.4	-34.4
Kelantan	132.2	161.0	-28.8	48.8	-77.6
Sabah	1,197.6	1,095.3	+102.3	332.4	-230.1
Sarawak	3,307.9	898.5	+2,409.4	2,565.7	-156.3

Source: Ministry of Finance and state financial statements

The above analysis of the financial position of both levels of government shows two contrasting views: first, the federal government deficits were planned, as the federal government has access to borrowing and unlimited sources of revenue, and second, the state governments' deficits were due to non-correspondence between revenue and expenditure required for provision of a minimum standard of state public services. Unlike

[7] See also analysis by Wilson (1996), Ariff (1991), and Abdullah (1978)

those of the federal government, states sources of revenue are limited and furthermore they have no access to other sources of financing (except borrowing from the federal government).[8]

In conclusion, the reasons behind the state governments' fiscal imbalances are that states' revenue-raising power is limited, the types of sources assigned to them are not productive, and to make things worse, most taxes are difficult to administer. Revenue from land-based taxes, for example, is extremely small; the rate is low and difficult to adjust and levying such taxes is politically harmful for local political leaders. These problems were exacerbated by lack of competence and expertise in managing and collecting these taxes, causing the state governments' revenue to remain undeveloped. According to Abdullah (1978), the tax collection machinery in the state governments is not well developed compared to the federal government, which is better staffed and has a more efficient tax collection system. Abdullah's comment still holds today, as up to now no institution has been established to provide training for the state governments' staff in matters relating to land tax administration and collection. As a result, the states' financial deficit has become a long-term phenomenon in the Malaysian federation. Efforts to remedy this problem therefore require measures for solving long-term problems in line with the spirit of federalism - not the ad hoc measures as in place today. On the other hand, the federal government's main tax collection machineries, that is, the Inland Revenue and Custom and Excise Department, are well staffed and developed. The corporatisation of the Department of Inland Revenue in 1993 and the establishment of its own training institute were geared towards improving efficiency in tax administration and collection. Similarly, the Custom and Excise Department has its own training institute to provide training for its staff in order to increase efficiency in tax collection.

[8] See Chapter 3 for discussion on state governments' borrowing.

4.2.2 Vertical imbalance

Vertical imbalance is not a strange phenomenon in federal countries; indeed it is 'an inescapable phenomenon in a federation' (Ariff, 1991: 207). In Malaysia, as discussed above, the problem of vertical imbalance or fiscal gap occurred between the two levels of government, that is 'between the federal government and state governments taken as a whole' (Holzhausen, 1974: 70), due to the fact that the most productive, dynamic and flexible tax sources are centralised at the federal level, leaving the state governments with limited and less productive sources of revenue. As a consequence, there appeared a mismatch between strong centre revenue-raising power and growing state governments' spending but limited sources of finance. This is the result of constitutional arrangements at the time of federating. Furthermore, the state governments' revenue sources do not have a strong link to the major economic activities, as compared with the federal government revenue. Consequently, the state governments benefited little from economic growth. Hence, the issue is to what extent the state governments are able to finance their expenditures, given their limited revenue sources, increasing public needs and escalating costs of provision and maintenance of public services. In light of these drawbacks, fiscal adjustment is inevitable so that the state governments will have enough resources to finance the functions constitutionally assigned to them. The vertical imbalance can be gauged in terms of the percentage of the states' own source revenue over total expenditure (see Table 4.11). This will indicate the extent of the fiscal gap between the states' own source revenue and their expenditure needs.

Table 4.11 shows the extent of vertical imbalance between 1980-2000, as measured by the fiscal gap. The largest fiscal gap was recorded in 1983, that is, 44.8% of the total own source revenue (as own source revenue could only finance 55.2% of the total expenditure), and the smallest gap was in 1996, that is 12.3% of the total own source revenue (as own source revenue could finance up to 87.7% of total expenditures) (see

column (vi) and (vii) of Table 4.11). On average, total consolidated own source revenue only represent 73.6% of the total states' revenue. The highest share of own source revenue was in 1996, that is, 84.2% and the lowest share was 71.4% recorded in 1986. This indicates the financial capability of the state governments taken as a whole to finance the functions / expenditures (both operating and development expenditure) assigned to them. Thus, federal transfers are of paramount importance to fill this gap in return for giving their tax powers to the centre at the time of federating. This is a 'political contract' that should be honoured by any federal government.

Table 4.11
State Governments: Vertical Imbalance
(RM million)

	Total revenue[1]	Own source revenue[2]	Total expenditure[3]	% (iii) of (ii)	% (iii) of (iv)	(%) Financing Gap (-) (before transfer)	(%) Financing Gap (-) (After transfer)
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii)	(viii)
1980	2,996	2,445	3,392	81.6	72.1	-27.9	-11.7
1981	3,125	2,489	4,454	79.6	55.9	-44.1	-29.8
1982	3,907	3,064	4,651	78.4	65.9	-34.1	-16.0
1983	4,025	2,997	5,426	74.5	55.2	-44.8	-25.8
1984	4,506	3,279	5,153	72.8	63.6	-36.4	-12.6
1985	4,172	3,157	4,864	75.7	64.9	-35.1	-14.2
1986	4,428	3,162	4,771	71.4	66.3	-33.7	-7.2
1987	4,702	3,680	4,500	78.3	81.8	-18.2	+4.5
1988	5,350	4,307	5,850	80.5	73.6	-26.4	-8.5
1989	5,630	4,346	6,216	77.2	69.9	-30.1	-9.4
1990	6,718	5,204	7,325	77.5	71.0	-29.0	-8.3
1991	6,236	4,859	7,799	77.9	62.3	-37.7	-20.0
1992	6,695	5,403	7,308	80.7	73.9	-26.1	-8.4
1993	7,361	5,994	7,309	81.4	82.0	-18.0	+0.7
1994	7,964	6,449	7,704	81.0	83.7	-16.3	+3.4
1995	8,261	6,799	8,170	82.3	83.2	-16.8	+1.1
1996	9,526	8,006	9,131	84.0	87.7	-12.3	+4.3
1997	9,968	8,389	9,688	84.2	86.6	-13.4	+2.9
1998	8,591	6,838	9,411	79.6	72.7	-27.3	-8.7
1999	8,228	6,421	8,856	78.0	72.5	-27.5	-7.1
2000	9,796	8, 235	10,336	84.1	79.7	-20.3	-5.2

Note: [1] Own source revenue plus federal transfers and federal reimbursement
[2] Includes tax and non-tax revenue (minus federal transfers)
[3] Includes operating and development expenditure
Source: Financial statements (respective state governments): (adjusted taking into account intergovernmental transfers and various trust funds)

However, in most years, federal transfers are still far from enough to fill the fiscal gap (see also Wilson (1995) and Wilson (1996)). As can be seen from Table 4.11 above, between 1980-2000, on average, the total state revenue (own sources of revenue plus

federal transfers) could finance up to 92.9% of total expenditures. In other words, even with transfers, the state governments still need additional resources to fill this gap. This indicates that federal transfers failed to bring financial relief to the state governments. Surprisingly, in some years, total state revenue was more than enough to finance expenditure, while in others, states' expenditures were under-financed (see column (viii) of Table 4.11). As a consequence, in some years states expenditures were over-financed. This may be attributable to better state government revenue performance, as during these years national GDP growth was higher (1993: 9.9%, 1994: 9.2%, 1995: 9.8%, 1996: 10% and 1997: 7.3%), while at the same time the federal transfers remained significant. As a result, the state governments taken as a whole registered higher revenue than required to finance their expenditures.[9] While this is financially favourable for the states, as they could build up their reserves, on the other hand, this resulted in states' poor budget planning, due to difficulty in predicting the amounts of forthcoming grants. This is in line with the finding from the study made by Ariff (1991: 208) that 'the years of under-financing of state governments consolidated budget deficits are interspersed by years of over-financing, which permitted the state governments to build up their reserves'.[10] This demonstrates that there is no built-in mechanism in the design of federal transfers.

Nevertheless, analysis using consolidated states data fails to demonstrate the real problem of vertical imbalance. Hence, analysis using individual states data is required to examine the real picture of vertical imbalance. For instance, in 1990, the states of Penang, Selangor, Johor, Kelantan and Sarawak (which, except Kelantan, are the most developed states in the federation) recorded higher own source revenue than required to finance their expenditure needs (see Table 4.13) while less developed states remained under-financed. With federal transfers, these states had more than enough resources, and so

[9] This also may be due to intention of the respective states to embark on surplus budgeting after a long period in deficit budgeting. However, according to Treasury officials, the federal government policy is that state governments should undertake a balanced budget.

[10] The study by Ariff (1991) was made using data from 1965-1987.

were able to build-up their reserves. At the same time, these states also received loans from the federal government. Hence, according to Ariff (1991: 209) 'it would appear that the basis of grants allocation collectively does not yield a distribution pattern'. Wilson (1995: 4) confirms that 'there is less direct attention to...equity in per capita revenue across states although some grants partly address this issue'. This finding suggests that the practice of fiscal adjustment did not contain a built-in mechanism to suit the changing revenue and expenditure pattern of the state governments. An earlier study by Holzhausen (1974)[11] suggests that the problem of vertical imbalance requires immediate remedial action by the federal government to iron out the persistent problem of non-correspondence. This argument appears sound, as the problem of non-correspondence was a serious matter during the early years of the federation, which generated federal-states conflicts.[12] However, as remedial measures were taken by the federal government in the course of time, the problem of vertical imbalance became less severe. Hence, the prevailing problem of intergovernmental fiscal relations at the present time is more related to the issue of remedying horizontal imbalance rather than vertical imbalance.

4.2.3 Horizontal imbalance

Horizontal imbalance occurs due to 'interstate disparity in the revenue raising capacity of state governments and consequently to the differences in the ability of states to fulfil their constitutional obligations' (Ariff, 1991: 209). Based on this argument, the extent of horizontal imbalance can be measured using the revenue performance of each of the states compared with their financing requirement. As discussed earlier, not all states have the same level of economic development, due to differences in their resources (natural resources, notably petroleum, tin ore, iron and timber). Some states which are well endowed with productive natural resources are more developed and prosperous, while

[11] In the analysis, Holzhausen (1974: 128-133) used data from 1964-65, that is, after the establishment of the Federation of Malaysia.

[12] For instance, see Chapter 3 for discussion of the weaknesses of financial arrangements for the Federation of Malaya 1948.

others are less developed due to scarcity of resources. This is because well-endowed states can collect higher revenues, due to their broader revenue base, while those states with limited resources find it difficult to raise their revenue at the margin. In other words, some states have a comparative advantage because they have access to revenue sources from favourable endowment of natural resources that others do not.

Table 4.12
State Governments' GDP and Own Sources of Revenue

States	Average annual GDP Growth (%)				States Own Sources of Revenue (RM million)		
	1971-1980	1981-1990	1991-1999	1971-1999	1990	1995	2000
Perlis	n.a	5.0	6.7	5.8	12.1	25.2	30.2
Kedah	5.2	4.8	7.7	5.8	138.2	151.6	218.2
Penang	10.7	4.5	6.9	7.4	106.6	160.9	171.9
Perak	2.4	4.0	6.1	4.1	179.2	254.3	339.8
Selangor	2.8	7.4	7.0	5.7	423	1002.3	1,348.7
Negeri Sembilan	4.5	6.8	7.0	6.1	106.3	191.5	170.6
Malacca	7.0	5.7	7.2	6.6	42.0	132.1	112.1
Johor	6.9	7.7	7.5	7.2	785.9	287.8	305.3
Pahang	7.4	5.5	6.1	6.4	153.8	318.3	321.1
Terengganu	14.8	9.6	7.1	10.6	438.1	548.7	578.9
Kelantan	7.3	5.7	4.9	6.0	92.1	133.4	132.2
Sabah	10.1	6.9	4.1	7.1	1370.8	1505.5	1,197.6
Sarawak	7.9	7.0	5.6	6.9	1355.9	2087.4	3,307.9

Note: na = not available as GDP for Perlis only available beginning 1980
Source: Malaysia Five Year Plan (various issues) and Ministry of Finance Economic Report.

As can be seen from Table 4.12, despite recorded strong GDP growth, states such as Terengganu, Kelantan, Kedah, Perlis, Negeri Sembilan and Malacca, collected low own sources of revenue. This is because, as noted above, states' own sources of revenue have no direct relation to the national GDP and, hence, did not benefit from a higher GDP growth. This is noticeable as in the case of Terengganu. Although, it registered a higher GDP growth (1971-1999: average 10.6%) the state government revenue remained low, as higher GDP was largely contributed by the petroleum industry, which did not significantly generate revenue to the state government (except for petroleum royalties) but to the federal government through centralised income tax, petroleum tax and company tax collection. Thus, higher GDP growth does not bring higher revenue to the

state governments. As such, the states own sources of revenue have little growth potential as compared with the federal government revenue. Furthermore, those states that have ample natural resources (although nowadays natural resources such as tin ore and iron are no longer produced), such as the states of Selangor, Johor, and Perak, have become industrialised and subsequently their revenue sources are more broad based. For instance, the value of property and land premium in these states is higher and they contribute significantly to their revenue compared with non-industrialised states. Moreover, states like Sabah and Sarawak enjoy special privileges in custom and excise duties, as these sources of revenue belong to the states under the Constitution. On the other hand, those states without natural resources, such as states of Kedah, Perlis, and Kelantan, are less developed and continue to be left behind, as most of their economic activities are agriculture-based, which by and large still under developed. Thus, it is not surprising if these states have a limited revenue-base and subsequently find it difficult to raise revenue.

Table 4.13 highlights the fiscal gap for each of the thirteen states. It is evident that revenue differs between states. Some states have more revenue than is required to finance their expenditures. In 1990, for instance, most states, except Johor, had more expenditures than revenue, as their own source revenue was not enough to finance their expenditure. In 1995, only state of Perak had more own source revenue than their expenditure needs. Even with federal transfers, most states remained find it difficult to finance their expenditure, as federal transfers still unable to fill up the revenue-expenditure gap. As discussed above, this disparity was attributable to their differences in revenue-raising capacity due to favourable endowment of natural resources (petroleum, timber and other mineral), which provide guaranteed revenue inflow to the states (in the form of royalties or tax-sharing).

Table 4.13
Horizontal Imbalance: Fiscal Gap
(RM million)

State	Total revenue[1]		Own source revenue		Total expenditure[2]		% of own source revenue to total expenditure		% of total revenue to total expenditure	
	1990	1995	1990	1995	1990	1995	1990	1995	1990	1995
Perlis	60.9	70.9	12.1	25.2	61.7	97.4	19.6	25.9	98.7	72.8
Kedah	233.9	269.9	138.2	151.6	262.0	343.1	52.7	44.2	89.3	78.7
Penang	144.1	212.0	106.6	160.9	125.9	215.9	84.7	74.5	114.5	98.2
Perak	261.5	385.0	179.2	254.3	286.8	232.3	62.5	109.5	91.2	165.7
Selangor	826.4	1173.8	423.0	1002.3	486.8	1,169.5	86.9	85.7	169.8	100.4
Negeri Sembilan	141.2	242.6	106.3	191.5	154.4	288.6	68.8	66.4	91.5	84.1
Malacca	79.3	169.4	42.0	132.1	93.7	145.5	44.8	90.8	84.6	116.4
Johor	851.5	394.0	785.9	287.8	597.1	335.2	131.6	85.9	142.6	117.5
Pahang	206.4	398.8	153.8	318.3	289.9	469.1	53.1	67.9	71.2	85.0
Terengganu	478.5	627.4	438.1	548.7	524.1	676.7	83.6	81.1	91.3	92.7
Kelantan	177.2	214.7	92.1	133.4	153.5	209.2	60.0	63.8	115.4	102.6
Sabah	1526.2	1719.3	1370.8	1505.5	2,082.5	1,667.9	65.8	90.3	73.3	113.1
Sarawak	1453.7	2224.5	1355.9	2087.4	2,206.6	2,319.6	61.4	90.0	118.6	95.9

Note: [1] Own source revenue plus federal transfer and federal reimbursement
[2] Include gross operating expenditure, gross development expenditure and loan recoveries
Source: Financial statements (respective state governments).

On the basis of Table 4.14, it is clearly shown that revenue per capita before transfers in 1995 differed widely between the state governments: between 37.1% and 305% of the average own source revenue per capita. Even after transfers, the differences in revenue per capita were still large, that is, between 45.2% and 268.4%.[13] The state of Sabah, with 268.4% of the average revenue per capita after transfer, had over four times as much per capita spent by the states of Johor, Pahang, Kelantan, Penang or Perak. The table also demonstrates that states with higher revenue per capita before transfers continued to receive high per capita transfers. This is evident as in the case of Sabah, Sarawak, Terengganu and Selangor (except Terengganu, these states are among the most developed states) with higher revenue per capita (before transfers), had per capita transfers of more than 80% of the national average. Thus, it can be concluded that, first, revenue per capita (before and after transfers) differs widely among states, and second, higher per capita

[13] This result is also confirmed by an earlier study made by Wilson and Sulaiman using 1992 data. They found that revenue per capita varied from 30% to 326% of national average (see Wilson and Sulaiman, 1996: 153)

states received high transfers per capita, and vice versa. In the short term, this situation caused differences in the ability of states to fulfil the constitutional obligations assigned to them. In the long run, these differences cause problems of both equity and efficiency. Although efforts have been taken to rationalise the differences, 'lack of success in reducing inequality has been the case since independence' (Shafruddin, 1987:94).

Table 4.14
State Governments' Revenue Per Capita, 1995

	Revenue per capita After transfers		Revenue per capita Before transfers		Federal transfers Per capita	
	RM	% of average	RM	% of average	RM	% of average
Perlis	567.2	121.1	344.9	88.8	222.3	277.9
Kedah	261.2	55.8	181.6	46.8	79.6	99.3
Penang	220.9	47.2	178.0	45.9	42.9	53.5
Perak	243.4	52.0	181.7	46.8	61.7	76.9
Selangor	505.8	108.0	441.4	113.7	64.5	80.4
Negeri Sembilan	377.6	80.6	311.9	80.3	65.7	81.9
Malacca	359.7	76.8	294.8	75.9	64.9	80.9
Johor	211.6	45.2	166.7	42.9	44.9	56.0
Pahang	213.8	45.6	144.1	37.1	69.7	86.9
Terengganu	787.7	168.2	699.4	180.2	87.7	109.4
Kelantan	219.4	46.8	159.1	41.0	60.3	75.2
Sabah	864.4	184.5	759.3	195.6	105.1	131.0
Sarawak	1,257.1	268.4	1,184.1	305.0	73.0	91.0
Average	468.4		388.2		80.2	

Source: Calculated from data collected from the Economic Report, Ministry of Finance.

The existing fiscal adjustment has done little to remedy large differences in per capita state revenues, perhaps because the federal government has allocated a substantial amount for the federal sponsored projects in states through annual budgetary allocation. This partly explains why the federal transfers are not large when compared to the total federal government revenue, that is, about 2.6% of total federal government revenue in 1995. Therefore, federal transfers were not designed to alleviate revenue per capita disparity between states. From the standpoint of federal equity, this is unjust, as it makes states 'survive' at the mercy of the centre, which could lead to serious economic and political wrangling especially for those states ruled by a political party at odds with the BN.

The foregoing analysis of fiscal imbalance (vertical and horizontal) confirms that the problem of vertical imbalance or fiscal gap, that is, the difference between the states' own sources of revenue and their financing requirements for expenditure, existed following unfavourable assignment of revenue sources to the state governments. The average amounts of fiscal gap were as much as 25% of the financial needs, expressed in total expenditure terms. This suggests that the average amount of transfers from the federal government should at least be enough to fill this gap. On the other hand, horizontal imbalance resulting from huge tax differences among the states brings about considerable difference in the fiscal performance of the states, which causes different levels of economic and social development among them. These differences were largely due to their different aggregate tax capacities and mainly originated from differences in the level of industrialization and exploitable natural resources, especially revenue derived from forest and mining (including petroleum and gas). States that have experienced high industrialization (formerly tin / iron producing states – Selangor, Perak, Johor and Pahang) have a broader revenue base compared to less industrialised states, which continue to depend on land-based taxes, as their main own sources of revenue. As a result, horizontal imbalance gives rise to the complex question of equity, which requires interstate fiscal adjustments by the federal government, such as through fiscal equalisation programme. Regional disparities in the federation should not be allowed to persist because of their corrosive effects on the socio-economic development and political implications on the federation.

4.3 Fiscal adjustments: An analysis

The aim of fiscal adjustment is primarily to ensure that state governments have sufficient resources to finance their assigned functions under the Constitution and, secondly, to equalise interstate fiscal disparities following significant differences in the states' fiscal capacity. As discussed in Chapter 2 the literature of fiscal federalism shows various types

and purposes of grants designed to remedy fiscal imbalance. The most common practice available to effect intergovernmental fiscal adjustments is through the combination of tax /revenue sharing and federal grants (Ter-Minassian, 1997). In Malaysia, as in other federal countries, the mechanism for fiscal adjustment was made through a combination of tax-sharing arrangements and various types of conditional and unconditional grants depending on the objective of the grants. However, the implementation of fiscal adjustment in Malaysian fiscal federalism has not specified whether the purpose was to remedy vertical imbalance or horizontal imbalance. As can be seen, most of the transfers were made to remedy vertical imbalance, that is, non-correspondence between revenue and expenditure, although some of the transfers also seem to be attempts to rectify horizontal disparities. Perhaps it is the authority's belief that once vertical imbalances are addressed that, this will by itself reduce horizontal imbalance. As noted in Chapter 3, federal transfers can be grouped into five categories: first, the constitutional grants - comprising the Capitation Grant, the State Road Grant, and grants under the State Reserve Fund; second, revenue / tax sharing arrangements – comprising the Revenue Growth Grant and revenue sharing from export duties on commodity (tin, iron and other mineral); third, special payments – comprising payments for compensation, and grants to local governments; fourth, administrative payments – these payments are designed to help state governments to finance their operating expenditure; and finally, other forms of transfers / payments – these include federal government-sponsored projects in states through various government agencies. Apart from these transfers, there is a fund called the Contingency Fund created under Article 103 and 109(5) to provide advance payments to the states to meet urgent and unforeseen needs which are not budgeted for under annual budgetary allocation. However, this fund is not regarded as a fiscal adjustment instrument, as it is only intended to provide advances to the states should they require

funds urgently for unforeseen needs (expanses due to natural disaster such as floods) and, as such, the states are required to pay them back.

These are the instruments of fiscal adjustment used by the federal government to remedy fiscal imbalances arising from the design of intergovernmental fiscal arrangements in Malaysia. However, as will be discussed shortly, not all of these grants are real transfers as defined by the theory of intergovernmental transfers discussed in Chapter 2.

4.3.1 Constitutional Grants

4.3.1.1 Capitation Grants

This is an outright unconditional grant provided by the federal government under Article 109(1)(a) of the Federal Constitution to all state governments based on the number of population in each state. This is the only unconditional lump-sump grant for fiscal adjustment. As such the state governments are free[14] to spend this grant but it is mostly to be spent on operating expenditure in the current financial year.

The formula for deriving this grant is equitable in the sense that the amount of grant is equated with the number of people residing in a particular state, on a sliding scale. If the number of people residing in a rich state is high, than the amount received is large, and vice versa. Before 1976 this grant was based on the last population census, as follows:

On the first 50,000	- $15 per person
On the next 20,000	- $10 per person
On Balance	- $ 4 per person

The Federal Constitution provides that Parliament may vary the rate of the Capitation Grants from time to time by law. However, only the federal government can make proposals to make changes in the rate of the Capitation Grants, with prior consultation of the National Finance Council. As stated in Article 109 (2), the rate of this grant can be

[14] Although it is unconditional, the state governments are subjected to current financial procedure and auditing. This is to ensure that the state governments do not misuse the grant. See Article 106 of the Federal Constitution.

revised upward or downward from time to time with the approval of Parliament. However, if downward revision is made, the changed rate will be not less than 90 % of the amount paid in the previous year. This provision was primarily designed to give an assurance of a source of revenue as a guaranteed minimum payment to the states, to enable them to plan their expenditure and probably also to prevent the federal government from making drastic cuts. In line with this Article, this grant has undergone a series of revisions to take into account the latest population estimates of the states. Thus the rate was revised in 1976 to be as follows:[15]

On the 1st 100,000 people	- RM20.0 per person
On the next 150,000	- RM10.0 per person
On the next 250,000	- RM6.0 per person
On balance	- RM3.0 per person

Again in 1992, the rate was revised as follows:[16]

On the 1st 50,000 people	- RM60.0 per person
On the next 500,000	- RM8.50 per person
On the next 500,000	- RM 9.0 per person
On balance	- RM 9.50 per person

In 2001, the rate was again revised, taking into account consumer and producer prices indexes. The new rate is as follows:

On the 1st 100,000 people	- RM72.0 per person
On the next 500,000	- RM10.20 per person
On the next 500,000	- RM 10.80 per person
On balance	- RM 11.40 per person

As can be seen, the Capitation Grant is made on a population basis and is on a sliding scale, intended to favour the less populous states. This may be due to the assumption that a less populated state would not have sufficient taxpayers to support its current expenditure commitments. Thus, the Capitation Grant was designed partly to fulfil the objective of financing public services in low-revenue and less populated states. This grant is paid in two payments: in January and June each year.

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[15] Capitation Grant Act, 1977
[16] Capitation Grant Act, 1993

Table 4.15
Capitation Grants[1]
(RM million)

	1980	1985	1990	1995	2000
Perlis	2.2 (2.9)	2.6 (3.0)	2.8 (3.2)	4.3 (2.2)	4.5 (2.0)
Kedah	6.4 (8.4)	7.1 (8.1)	7.4 (8.3)	15.6 (7.9)	17.5 (7.6)
Penang	5.8 (7.7)	6.7 (7.6)	7.0 (7.8)	12.9 (6.5)	14.0 (6.1)
Perak	8.2 (10.8)	9.3 (10.6)	9.7 (10.8)	21.1 (10.7)	22.8 (10.0)
Selangor	8.4 (11.1)	9.0 (10.2)	10.0 (11.2)	27.2 (13.7)	32.3 (14.1)
Negeri Sembilan	4.9 (6.4)	5.4 (6.1)	0.5 (0.6)	9.2 (4.6)	10.0 (4.4)
Malacca	4.4 (5.8)	5.0 (5.7)	5.1 (5.7)	7.3 (3.7)	7.9 (3.4)
Johor	7.3 (9.7)	9.0 (10.3)	9.7 (10.9)	23.8 (12.0)	27.9 (12.2)
Pahang	5.0 (6.6)	6.5 (7.4)	7.3 (8.1)	12.6 (6.4)	14.2 (6.2)
Terengganu	5.8 (7.7)	5.4 (6.2)	5.8 (6.5)	10.2 (5.2)	11.5 (5.0)
Kelantan	5.6 (7.3)	6.6 (7.5)	7.0 (7.9)	14.0 (7.1)	16.4 (7.2)
Sabah	5.5 (7.2)	7.2 (8.2)	8.1 (9.1)	20.9 (10.5)	28.3 (12.4)
Sarawak	6.4 (8.5)	8.0 (9.1)	8.8 (9.9)	19.3 (9.7)	21.6 (9.4)
Total	75.9 (100)	87.6 (100)	89.2 (100)	198.4 (100)	228.8 (100)
% of total transfers	20.6	9.9	7.2	15.2	14.1

Note: [1] Figures in parenthesis represent share to total
Source: Budget Division, Ministry of Finance, and state financial statement.

Table 4.15 shows the distribution of the Capitation Grants paid to state governments. In 1980, the total Capitation Grants paid to the state governments amounted to RM75.9 million and then increased to RM87.6 million, RM89.2 million, RM198.4 million and RM228.8 million in 1985, 1990, 1995 and 2000, respectively. For some states, the Capitation Grant contributed more than 10% of the total states' own sources of revenue (1990: Perlis (23%), and Malacca (12%)). Although the amount paid to the states in absolute terms increased, its share to the total federal government transfers is low and getting smaller (1990: 20.6%; 1985: 9.9%, 1990: 7.2%: 1995: 15.2%; and 2000: 14.1%) (see Table 4.15), despite an increase in total population. Annoyingly, the disbursement of this grant to the states that are not politically affiliated with the centre (Kelantan and Terengganu) was always belated. Until the end of December 2003, for instance, the state of Terengganu still did not receive the second payment of this grant despite strong reminder from the state.[17]

[17] Information obtained from the Chief Minister of Terengganu statement in *Harakah*, See http://www.harakahdaily.net/article.php?sid=5265, accessed on 1 January 2004.

However, the Capitation Grant has not really been able to bring about states' financial improvement, for either remedial of vertical or horizontal imbalance, mainly due to the fact that the states differ considerably in their level of economic development, their natural resources, population density, per capita income, level of public services, and regional price levels. As discussed above, the Capitation Grant fails to take into account the states' actual 'need' for financial assistance, as it is not sufficient to link transfers merely with the population. Thus, grants based on population alone are insufficient to determine the financial need of the states. As shall be discussed shortly, other types of grants are also ad hoc in nature, such as grants from the State Reserve Fund. Rightfully, differences in the level of development, geographical differences, divergences in the urban/rural distribution of the populations, should be taken into account as well. For this grant to be effective as a main instrument for fiscal adjustment, firstly, all these differences may be reflected using per capita income as a main basis of calculation to determine the entitlement of each state. Secondly, the Capitation Grant should be able to act as a balancing grant and, as such, the basis for the Capitation Grants should be more broad-based, taking into account the revenue needs of the states, as well as other socio-economic indicators of the states.

4.3.1.2 State Road Grant

The State Road Grant is another type of statutory grant. A state road is defined under the Federal Constitution as 'any public road other than a federal road, and other road other than a federal road to which the public has access'.[18] This grant was introduced to replace the pre-independence 'petrol duty grant'[19] as recommended by the Reid Commission, since the sale of petroleum is not related to the maintenance of state roads. As the name suggests, this grant is conditional, in that it can only be used for road maintenance

[18] See Part II (5) of Tenth Schedule of the Federal Constitution.

[19] This grant was used before independence 1957 in the Federation of Malaya. Under this grant, states were entitled to 30% of the federal proceeds from the import duty on petrol, in proportion to the tax collected from each state, based on derivation basis. As a result, the richer states get more than poorer states.

purposes, where 'the maintenance of states roads means the preservation, upkeep, and restoration of states roads, roadside furniture, bridges, viaducts or culverts forming part thereof or connected therewith as nearly as possible in their original condition as constructed or as subsequently improved'.[20] The purpose of the grant was specified in detail in the Constitution and this means states are not allowed to use any part of it for any other purpose. To some extent, this grant is a type of reimbursement of what the state governments have spent on maintaining the state roads, and it is not intended to serve as a financial adjustment purpose.

The mechanism for computing the grant is based on the average cost of maintaining standard and sub-standard roads in each state. This is a fair measure, as local factors are taken into consideration. For this purpose, a committee of officials has been established to determine the average cost of maintaining state roads in each state, including roads in municipal areas. The committee will then submit the estimated average cost of road maintenance to the National Finance Council for approval and to be used as a rate suitable for the State Road Grant. Before 1981, the amount of grant was obtained by multiplying the average cost of road maintenance (national average) per mile by the total length of state roads registered in the last two financial years. As will be discussed shortly, this method of calculation caused annual wrangling between the federal and state governments. Hence, after 1981, this formula was amended so that the amount of road grant is obtained by multiplying average cost of maintenance of state roads (state average) per mile by the total length of state roads registered in the last financial year. With this amendment, abnormal factors such as maintenance of roads due to road damage by flood during the monsoon season, especially in states prone to flooding, such as Kelantan, Pahang, Johor and Terengganu, are now taken into consideration. Table 4.16

[20] See Part II (3)(a) of Tenth Schedule of the Federal Constitution

shows the distribution of the State Road Grant. Since 1991, this grant has been paid monthly.

Table 4.16
State Road Grants[1]
(RM million)

	1980	1985	1990	1995	2000
Perlis	1.200 (1.3)	2.203 (1.3)	3.832 (1.1)	4.533 (1.0)	5.450 (0.8)
Kedah	7.698 (8.2)	13.489 (8.0)	27.257 (7.5)	29.127 (6.2)	43.736 (6.5)
Penang	4.080 (4.3)	7.827 (4.7)	16.939(4.6)	18.514 (3.9)	22.536 (3.4)
Perak	10.544 (11.2)	17.268(10.3)	34.172(9.3)	46.748(9.9)	57.648(8.6)
Selangor	9.184(9.8)	16.260 (9.7)	64.120(17.5)	80.232(17.0)	106.332 (15.9)
Negeri Sembilan	4.788 (5.1)	7.286 (4.3)	16.879(4.6)	13.684(2.9)	26.247(3.9)
Malacca	2.893(3.1)	5.062 (3.0)	12.628(3.5)	12.607(2.7)	17.063(2.6)
Johor	8.103 (8.6)	13.487 (8.0)	26.265(7.2)	37.474(8.0)	61.018(9.1)
Pahang	5.304 (5.6)	6.482 (5.9)	19.452(5.3)	30.221(6.4)	45.713(6.8)
Terengganu	4.085 (4.3)	7.187 (4.3)	13.553(3.7)	28.546(6.1)	39.115(5.9)
Kelantan	3.213 (3.4)	5.700 (3.4)	13.324(3.6)	12.385(2.6)	22.560(3.4)
Sabah	19.561 (20.8)	37.734 (22.5)	85.013(23.2)	108.854(23.1)	138.503(20.7)
Sarawak	13.457 (14.3)	24.380 (14.5)	32.560(8.9)	48.082(10.2)	82.551(12.4)
Total	94.112 (100)	167.807(100)	365.994 (100)	471.008(100)	668.473(100)

Note: [1] Figures in parenthesis represent share to total
Source: Budget Division, Ministry of Finance, and state financial statement

The distribution of this grant has always been an issue, due to delay in payment, as a result of difficulty in obtaining the actual mileage data. As a result, some states receive more than their actual entitlement while others receive less. In most cases, the adjustment process takes a long time after receiving a complaint from the Auditor General Office. In 1981, all thirteen states were overpaid, by a total of RM106 million, due to changes in the basic state road average, and the National Finance Council only rectified the matter in 1996. In order to recover this amount, the federal government made an adjustment through deduction of grants received in 1997-1999. From 1977 to 1985, the state of Sarawak was underpaid by a total of RM33 million and the federal government only paid these arrears in three payments from 1997 to 1999. Investigation of the documents shows that this problem emerged as a result of the method of payment employed. Before the confirmation of the states' entitlement, the states received provisional grant and actual grants were only be paid when actual state road mileage was finalised. However, the determination of the actual state road mileage was always an issue, as the mileage claims

by the states were differed from the mileage shown in federal records and there was also double counting of certain roads. As a result, overpayment and underpayment are inevitable and rectification of this problem is time consuming, typically taking more than five years to solve. This makes states' budgetary planning difficult.

4.3.1.3 State Reserve Fund

The State Reserve Fund is in fact an extension of the repealed Special Development Grants[21] introduced in 1956. This fund was established under Article 109(6) of the Federal Constitution. This Article says 'the Federation may from time to time, after consultation with the National Finance Council, make grants out of the State Reserve Fund to any state for the purpose of development or generally to supplement its revenue'. The objective of the State Reserve Fund is to assist states, which run into financial difficulties due to limited revenue raising capacity and increase in annual budget. Hence, prior to 1983, the State Reserve Fund was used only to assist state governments that faced deficits in the operating accounts. However, after 1983, this fund was extended to finance[22] state development projects. Thus, this fund is now used for two purposes; first, grants to help states having deficits in their operating account, and second, grants to help states uplift the level of economic development, infrastructure and standard of living (see below). Beginning in 2001, the total amount of grant allocated for this fund was increased to RM211.1 million, of which RM170 million is allocated for grants based on the level of economic development, infrastructure and standard of living and the remainder is allocated to help alleviate deficits in their operating account. Table 4.17 shows the disbursement of the grants provided for under the State Reserve Fund.

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[21] Special Development Grants was first introduced in 1956 following the recommendation of the Raja Uda Committee on the proposed new financial arrangements for the Federation of Malaya 1948. See section 3.5.1.3 of Chapter 3 for discussion on this grant.

[22] See the minutes of the National Finance Council meeting on 12 Mac 1983.

Table 4.17
State Reserve Funds[1]
(RM million)

	1980		1985		1990		1995		2000	
	a	b	a	b	a	b	a	b	a	b
Perlis	2.3 (17.0)	-	-	6.8 (7.4)	11.5 (42.3)	12.4 (12.6)	-	13.6 (10.9)	-	16.3 (9.6)
Kedah	-	-	-	12.7 (13.9)	9.0 (33.0)	15.0 (15.2)	-	22.0 (17.7)	-	22.0 (13.0)
Penang	-	-	-	4.8 (5.2)	-	4.8 (4.9)	-	0.000 (0.00)	-	8.7 (5.1)
Perak	-	-	-	6.2 (6.8)	-	5.4 (5.5)	-	13.8 (11.1)	-	13.8 (8.1)
Selangor	-	-	-	1.0 (1.1)	-	0.8 (0.8)	-	5.2 (4.2)	-	6.1 (3.6)
Negeri Sembilan	-	-	-	3.6 (3.9)	-	3.6 (3.7)	-	7.0 (5.7)	-	7.0 (4.1)
Malacca	-	-	-	6.3 (6.8)	-	6.3 (6.4)	-	0.000 (0.00)	-	9.8 (5.8)
Johor	-	-	-	4.5 (4.9)	-	4.5 (4.5)	-	10.6 (8.5)	-	10.6 (6.2)
Pahang	-	-	-	4.4 (4.9)	-	4.5 (4.5)	-	9.6 (7.7)	-	9.6 (5.6)
Terengganu	-	-	-	4.7 (5.1)	-	4.7 (4.7)	-	9.3 (7.5)	-	9.3 (5.5)
Kelantan	11.4 (83.0)	-	-	19.1 (20.8)	6.7 (24.7)	19.1 (19.4)	13.6 (100.0)	2.3 (1.9)	-	26.0 (15.3)
Sabah	-	-	-	6.5 (7.1)	-	6.5 (6.6)	-	13.2 (10.6)	-	13.2 (7.8)
Sarawak	-	-	-	11.0 (12.0)	-	11.0 (11.2)	-	17.6 (14.2)	-	17.6 (10.3)
Total	13.7 (100.0)	-	-	91.5 (100.0)	27.2 (100.0)	98.4 (100.0)	13.6 (100.0)	124.2 (100.0)	-	170.0 (100.0)

Note: [1] Figures in parenthesis represent share to total
[a] Grant for states having deficit in its operating account
[b] Grant based on the level of economic development, infrastructure and standard of living
Source: Calculated from state governments financial statements and Federal Treasury allocation budget (various years).

i. Grants for States having deficit in their operating account.

This grant is in the form of conditional grants, which is designed to assist states having difficulties in financing their operating expenditure. Thus, the proceeds are used to cover shortfalls in the operating expenditure. However, this grant is only available after investigation on the state governments' accounts is made by a committee of the National Finance Council. This committee comprises a representative from the Federal Treasury, representatives from two states that do not have financial difficulties and a representative from the Accountant General Office. The committee was given the task to scrutinize the

claimant state governments from their receipts and payments made.[23] The deficit is then determined by obtaining the difference between total receipts and payments made. To determine the amount of grants, this deficit needs to be adjusted, taking into account revenue arrears and advance payments received from the State Contingency Fund. The receipts side, includes all receipts from the ordinary revenue sources, revenue from the Water Supply Fund, and all federal transfers for operating purposes, but excludes all receipts from the federal government loan, receipts from part two of the Revenue Growth Grant (based on the numbers of population – see below), receipts from the State Reserve Fund and loan repayments received from the Water Supply Fund. The payments side includes all amounts spent on operating and capital expenditure from the revenue account, less amounts transferred to the Development Fund and other Trust Fund, all loans received and investment made from the revenue account, loan repayment, and federal reimbursement. In practice, the payment of this grant can only be made two years after the end of the financial year, that is, after investigation by the committee established by the National Finance Council is completed.

Clearly, this grant was merely an attempt to overcome temporary imbalances in the accounts of applicant states and was not intended to provide a permanent source of income to the state governments. In other words, this grant is made on an ad hoc basis, to assist states having temporary difficulties in meeting their current expenditures. As such, it cannot be regarded as an instrument of fiscal adjustment. Furthermore, due to the long process involved before the claimant states could receive payment, it is difficult for the state governments to carry out budgetary planning. This grant is indeed a kind of federal reimbursement, especially if the claimant state governments have to finance their current deficits through advance payment from the State Contingency Fund.

[23] This information was obtained during interview with officials from the Budget Division, Treasury.

ii. Grants based on the level of economic development, infrastructure and standard of living.

This is also a form of conditional grant in that it is given to the states only for approved development projects. From the outset, this grant was aimed at bringing about higher socio-economic development of the states. This grant was first introduced in 1983 and given to those states that had a low level of economic development, so that they would be financially capable to undertake development projects, in line with the government policy of balanced regional socio-economic development. [24] An initial annual allocation of RM100 million was provided for this grant. [25] Subsequently, in 1993, the annual allocation of this grant was increased by RM70 million, to become RM170 million.[26]

This grant has the feature of an equalisation grant in the sense that only less developed states are entitled to this grant. The rationale behind this grant is to assist the state governments, particularly those states that are less developed, to implement development projects to enable them to achieve a faster rate of growth. As such, the less developed states received significant amounts of this grant (see column 'b' of Table 4.17). A total of seventeen indicators are used to allocate these funds among state governments. These include, among others, the level of economic development, the development of infrastructure (water and electricity supply, roads) and other socio-economic indicators (level of poverty, rate of illiteracy, rate of infant mortality, and ratio of doctors to population). Projects that are eligible for this grant includes: roads and bridges other than projects financed by the Ministry of Rural Development or by the existing federal government allocations, water supply and rural electricity other than projects financed by the Ministry of Rural Development or by the existing federal government allocations, agriculture projects (flood mitigation, agriculture centre), building (mosques and

[24] Regional balance economic growth is one of the government long-term plans to eliminate economic disparity. See the Outline Perspective Plan 1 (OPP1) and Outline Perspective Plan 2 (OPP2).
[25] See minutes of the National Finance Council Meeting on 12 Mac 1983.
[26] See minutes of the National Finance Council Meeting on 27 February 1993.

religious schools), and local government projects other than those financed by the allocation of the Ministry of Housing and Local Government.

The federal government will ensure that this grant is not duplicated with other grants. As such, guidelines are imposed on development projects [27]carried out by the state governments to qualify for this grant. However, before allocation can be made to the respective state governments, an application has to be made to the Treasury (Ministry of Finance). A special committee composed of officials from the Treasury, Economic Planning Unit and Implementation and Coordination Unit (Prime Minister's Department), and Ministry of Rural Development will then study the viability of the projects. Only projects approved by this Committee are entitled to a grant.

4.3.2 Revenue / tax sharing arrangements

4.3.2.1 Revenue Growth Grant

This grant is a combination of conditional grant and unconditional grants, which are given to the state governments on the principle of revenue sharing between the federal and state governments. This grant was first introduced in 1977 by virtue of the *Revenue Growth Grants Act (1977)*. This act stipulated the purpose of this grants, that is,

> 'The grants made to state under section 4 shall be utilised to generally supplement its revenue and the grants made to a state under section 4A shall be utilised for any or all of the following specific development purposes: water supply, public housing, industrial estate development, minor works and such other developments as may be determined from time to time by the National Finance Council established under Article 108 of the Federal Constitution'.

The Revenue Growth Grant is given to the state governments only if there is an increase in the federal government revenue. As such, no payment has been made in 1987, 1988 and 1999, as there was no increase in the federal government revenues. As a large portion of the federal government revenue is from tax sources, this grant is very much dependent on federal tax revenue collection. The rationale for introduction of this grant was because

[27] See minutes of the National Finance Council Meeting on 27 February 1993.

the federal government benefits most from investments undertaken by the states, but in return the states may have no way of capturing significant return from their investment, such as investments on the development of industrial zone and national park. Investment in these projects greatly advantages the federal government, as revenue derived from such investments belongs to the federal government in the form of company tax, income tax, service tax and sales tax. However, this grant does not guarantee a stable flow of income to the states, as it depends on increases in the federal government revenue. As such, a grant dependent on the share of federal taxes collected in each state would be preferable. Amounts of grants distributed are shown in Table 4.18.

When this grant was first introduced, the maximum allocation made by the federal government was RM 50 million per year. It increased to RM 100 million per year in 1980 and subsequently to RM 150 million per year in 1990,[28] to be distributed to all state governments. The formula is as follows:

i. The first RM 25 million is equally distributed to all state governments.

ii. The next RM 25 million is distributed based on the states population, as follows:

On the first 500,000 people	= 2 shares/person
On the following 500,000 people	=1 share/person
On balance	= ½ share/person

Thus the allotment of each state will be:

$$\frac{\text{State share}}{\text{Total share}} \times \text{RM 25 million}$$

iii. The remaining of RM 100 million will be shared based on per capita GDP of each state in comparison to the national per capita GDP. States that registered lower per capita GDP than the national per capita GDP will be eligible for this grant.

[28] See minute of the National Finance Council Meeting on 12 Mac 1983.

Table 4.18
Revenue Growth Grants[1]
(RM million)

	1980	1985	1990	1995	2000
Perlis	2.323 (4.6)	8.187 (5.4)	15.844 (10.6)	17.868 (11.9)	16.590 (11.1)
Kedah	4.298 (8.6)	27.490 (18.3)	28.675 (19.1)	20.195 (13.5)	17.169 (11.4)
Penang	3.998 (8.0)	4.021 (2.7)	3.885 (2.6)	3.803 (2.5)	3.744 (2.5)
Perak	4.848 (9.7)	9.608 (6.4)	13.490 (9.0)	12.669 (8.4)	9.976 (6.7)
Selangor	4.348 (8.7)	4.389 (2.9)	4.536 (3.0)	4.695 (3.1)	4.748 (3.2)
Negeri Sembilan	3.498 (7.0)	3.413 (2.3)	7.933 (5.3)	9.797 (6.5)	7.019 (4.7)
Malacca	3.248 (6.5)	11.503 (7.7)	10.654 (7.1)	6.794(4.5)	4.139 (2.8)
Johor	4.598 (9.2)	5.662 (3.8)	8.813 (5.9)	6.535 (4.4)	4.898 (3.3)
Pahang	3.573 (7.1)	3.798 (2.5)	13.282 (8.9)	12.633 (8.4)	12.115 (8.1)
Terengganu	3.248 (6.5)	4.377 (2.9)	3.485 (2.6)	3.560 (2.4)	3.591 (2.4)
Kelantan	3.873 (7.7)	33.209 (22.1)	27.340 (18.3)	20.195 (13.5)	31.134 (20.8)
Sabah	3.798 (7.6)	9.180 (6.1)	4.119 (2.7)	17.968 (12.0)	22.680 (15.1)
Sarawak	4.348 (8.7)	25.516 (17.0)	7.946 (5.3)	13.084 (8.7)	12.196 (8.1)
Total	50.00 (100.0)	150.353 (100.0)	150.00 (100.0)	150.00 (100.0)	150.00 (100.0)

Note: [1] Figures in parenthesis represent share to total
Source: Budget Division, Ministry of Finance, and state financial statement

As can be seen from Table 4.18, the states of Perlis, Kelantan, Kedah and Terengganu, which are less developed compared to the rest of the members of the federation, received the bulk of the grant. This is because the formula for calculating the eligibility of each state takes into consideration not only the population but also the per capita GDP of the states. Therefore, by taking the per capita GDP into consideration, this grant is more equitable than the Capitation Grant because the poorer states, in particular Perlis, Kedah and Kelantan, received more grant than rich states (see Table 4.18). The state of Perlis, which has the lowest income, received RM17.9 million or 12% of the total Revenue Growth Grant in 1995. Indeed the Revenue Growth Grant 'is a reaction to the general issue of whether states properly share in the benefits of development expenditure' (Wilson, 1995: 3). It enables the states to undertake development expenditure from which they have no way of capturing any return. Before the implementation of this grant, states argued that they had no incentive and could not afford to undertake infrastructure investments, because of their narrow tax revenue base. However, this grant has strings attached, in that the first RM50 million can only be used for operating purposes, while the remaining RM150 million that go to the states with below average GDP per capita can only be used for approved development projects (namely water supply, public

housing, industrial estate development, minor works and such other development) as may be determined from time to time by the National Finance Council. Furthermore, the amount of grants received by the states is not stable, in that states only receive a grant when there is an increase in the federal government revenue, which constantly fluctuates, which makes state planning more difficult.

4.3.2.2 Export duty of tin ore

Under the Article 110(3) of the Federal Constitution, the states that produce tin ore are entitled to receive 10% of the total tax on export of tin ore. This is a form of tax sharing based on derivation. However, this payment has not been made since 1986, due to cessation of tin mining operations following depletion of deposits. Alas, no new arrangement has been made to replace revenue losses from this source of revenue.

Table 4.19
Export Duty of Tin Ore[1]
(RM million)

	1980	1985	1986[2]
Perlis	0.078 (0.15)	0.006 (0.18)	0.008 (0.22)
Kedah	0.377 (0.72)	0.020 (0.61)	0.022 (0.59)
Penang	-	-	-
Perak	30.815 (58.71)	2.008 (61.6)	2.121 (57.29)
Selangor	17.415 (33.18)	0.907 (27.8)	1.189 (32.12)
Negeri Sembilan	0.355 (0.68)	0.020 (0.61)	0.028 (0.76)
Malacca	0.244 (0.46)	0.003 (0.09)	0.001 (0.03)
Johor	0.771 (1.47)	0.074 (2.27)	0.092 (2.49)
Pahang	2.039 (3.88)	0.179 (5.49)	0.201 (5.43)
Terengganu	0.394 (0.75)	0.041 (1.26)	0.040 (1.08)
Kelantan	-	-	-
Sabah	-	-	-
Sarawak	-	-	-
Total	52.487(100.0)	3.258 (100.0)	3.702 (100.0)

Note: [1] Figures in parenthesis represent share to total
[2] The last year this payments was made was in 1986 due to depleted in tin deposit
Source: Budget Division, Ministry of Finance, and state financial statement

4.3.2.3 Export duty on iron ore

This is another form of tax sharing arrangement based on derivation. The payment under this arrangement is made to the states producing iron ore, by virtue of the *Assignment of revenue (Export Duty on Iron Ore) Act, 1962*, which stipulates that 10% of revenue from export duty from iron ore is to be assigned to the respective states producing the ore.

Only Johor, Kedah, and Perak are entitled to this payment but the amount received was minimal, as the output of the tin ore was low. Since 1987, no payment has been made, as no iron ore was produced by the states.

4.3.3 Special payments

4.3.3.1 Payment to Sabah and Sarawak

This grant is given to the states of Sabah and Sarawak under Articles 112C (1) (a) (see Part IV of Tenth Schedule) and to Selangor (see below) through a special agreement. However the purpose of the payment is different between the states of Sabah and Sarawak, and Selangor. For Sabah and Sarawak, the objective of this grant is to enable these two newer states in the federation to upgrade their services to be on a par with the other states in Peninsular Malaysia. Under this arrangement, Sarawak received RM5.8 million each year from 1964-1968[29] and an escalating grant[30] amounting to RM3.5 million (1964), RM11.5 (1965), RM16 million (1966), and RM21 million (1967). However this grant was revised in 1969, after which the amount received by Sarawak was RM12 million (1969), RM12.9 million (1970), RM13.9 million (1971), RM14.9 million (1972), and RM16 million (1973). Since 1973 up to now, no revision has been made; as a result, the amount received has been fixed at RM16 million.

On the other hand, Sabah had received a grant of an amount of two fifths of the amount by which net revenue received by the federal government from Sabah exceeds the net revenue received by the federal government from Sabah in 1963.[31] Based on this formula, Sabah received RM5 million (1965), RM8.2 million (1966), RM13.3 million (1967), and RM11 million (1968). However after 1 January 1969, the amount of this grant was revised as follows: RM20 million (1969), RM21.5 million (1970), RM23.1 million (1971), RM24.8 million (1972), and RM26.7 million (1973).

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[29] See Section 1 (i) Part IV of the Tenth Schedule.
[30] See Section 1(2) Part IV of the Tenth Schedule.
[31] See Subsection 1 of Section 2 of Part IV of the Tenth Schedule

This grant may be changed or substituted, with the consent of both the federal and state governments concerned. However the federal government is not required to consult the National Finance Council[32] as in the case of variations of the Capitation Grant, and any agreement to this effect is made binding by assent of the *Yang Di pertuan Agong*. In other words, the federal government cannot make changes unilaterally without consulting the state governments concerned and hence there appeared a form of negotiation for the financial betterment of these states. Article 112D of the Federal Constitution provides detailed procedures to be followed to alter the conditions of the above grants, as experienced in the case of the abolition of import duty and excise duty on petroleum products,[33] which were constitutionally assigned to the states of Sabah and Sarawak.

4.3.3.2 Payment to Selangor

A special grant to Selangor is made in perpetuity as a form of compensation for the loss of revenue to the state of Selangor following the formation in 1972 of the Federal Territory of Kuala Lumpur, the capital city of Malaysia, which was once territory belonging to the state of Selangor. The amount of the grants agreed upon is RM18.3 million, which is equivalent to the revenue collected by the Selangor from the Federal Territory in 1974.

4.3.4 Administrative payments

4.3.4.1 Payment for the administration of functions under the concurrent list

Based on Article 82 of the Federal Constitution, the National Finance Council has agreed to finance 50% of the cost for administration of functions under the concurrent list: social welfare, veterinary services and drainage and irrigation, beginning in 1987.[34] In other words, the state governments are only required to finance the remaining 50% of the cost

[32] See Article 112D(7) of the Federal Constitution.
[33] See Chapter 7
[34] See minutes of National Finance Council meeting on 18 February 1987.

of the administration of these functions (see column 'a' of Table 4.20). This payment was made to reduce the financial burden on the state governments in the administration of functions specified under the concurrent list of the Federal Constitution.[35] However, only three out of the nine functions in the concurrent list are eligible for this payment, that is, social welfare, veterinary services and drainage and irrigation. This is because most of the functions other than social welfare, veterinary services and drainage and irrigation have been taken over by the federal government. This is further evidence of growing centripetal forces in the Malaysian Federation.

Table 4.20
Administrative payments[1]
(RM million)

	1980		1985		1990		1995		2000	
	a	b	a	b	a	b	a	b	a	b
Perlis	0.80 (8.1)	-	-	-	-	2.24 (1.8)	2.01 (4.4)	3.42 (2.1)	5.60 (7.4)	4.12 (2.3)
Kedah	0.05 (0.5)	-	7.48 (48.7)	-	0.98 (4.5)	6.36 (5.2)	2.60 (5.7)	8.58 (5.4)	2.30 (3.0)	9.19 (5.1)
Penang	0.78 (7.9)	-	0.66 (4.3)	-	0.30 (1.4)	4.48 (3.7)	3.63 (8.0)	5.45 (3.4)	2.77 (3.6)	5.80 (3.2)
Perak	2.37 (23.9)	-	-	-	1.06 (5.0)	16.97 (14.0)	6.73 (14.8)	20.21 (12.7)	9.58 (12.6)	23.10 (12.8)
Selangor	2.63 (26.5)	-	0.40 (2.6)	-	0.64 (3.0)	11.35 (9.3)	6.90 (15.1)	16.28 (10.2)	5.91 (7.8)	21.57 (11.9)
Negeri Sembilan	0.06 (0.6)	-	0.32 (2.1)	-	1.52 (7.0)	3.58 (2.9)	5.03 (11.0)	4.59 (2.9)	4.67 (6.1)	5.32 (2.9)
Malacca	0.44 (4.5)	-	-	-	0.08 (0.4)	2.32 (1.9)	2.67 (5.9)	2.95 (1.9)	1.07 (1.4)	2.67 (1.5)
Johor	1.00 (10.1)	-	1.63 (10.6)	-	0.87 (4.0)	14.01 (11.5)	4.24 (9.3)	18.15 (11.4)	6.53 (8.6)	20.79 (11.5)
Pahang	-	-	-	-	1.91 (8.8)	5.26 (4.3)	2.96 (6.5)	8.33 (5.2)	1.69 (2.2)	7.92 (4.4)
Terengganu	0.92 (9.3)	-	0.57 (3.7)	-	0.66 (3.1)	11.72 (9.6)	2.81 (6.2)	16.51 (10.4)	7.71 (10.1)	17.93 (9.9)
Kelantan	0.86 (8.7)	-	-	-	3.85 (17.8)	6.46 (5.3)	3.24 (7.1)	8.38 (5.3)	4.59 (6.0)	9.59 (5.3)
Sabah	-	-	-	-	3.94 (18.2)	21.03 (17.3)	2.76 (6.1)	23.42 (14.7)	10.32 (13.6)	27.84 (15.4)
Sarawak	-	-	4.32 (28.1)	-	5.80 (26.8)	15.73 (12.9)	-	23.07 (14.5)	13.25 (17.4)	25.16 (13.9)
Total	9.92 (100.0)	-	15.34 (100.0)	-	21.63 (100.0)	121.49 (100.0)	45.57 (100.0)	159.32 (100.0)	76.00 (100.0)	181.00 (100.0)

Note: [1] Figures in parenthesis represent share to total
[a] Payment for the administration of functions under the concurrent list
[b] Service charges for federal projects
Source: Calculated from state governments financial statements and Federal Treasury budget allocation (various years).

[35] See List Three of the Ninth Schedule of the Federal Constitution. See also section 3.5.2 of Chapter 3.

4.3.4.2 Service charges for federal projects

Under Article 80(5) of the Federal Constitution, the federal government is obliged to make payment to the state governments for any federal projects implemented in the states. This Article says, 'subject to any provisions of federal or state law, arrangements may be made between the Federation and a state for the performance of any functions by the authorities of the one on behalf of the authorities of the other and as such arrangements may provide for the making of payments in respects of any costs incurred under the arrangements'. In 1978, the National Finance Council decided that the state governments could claim a payment called 'service charges' for the implementation of federal projects in the states.[36] The payment is made based on the states' staff involvement in the projects. If the total staff of the state governments where the project is being implemented is 50% or more, then the state concerned is entitle to receive an amount equivalent to 5% of the total cost of the project. However, if the state staff involvement is less then 50%, the state can only claim from the federal government an amount equivalent to 2.5% of the total cost of the project. Column 'b' of Table 4.20 shows the disbursement of this payment to states. It clearly demonstrates that more advanced states received a significant portion of these payments. This indicates that projects were allocated to the more developed states rather than to the less developed states. However, payment is made only after the states' accounts have been audited by the Auditor General. If the state submits its accounts to the Auditor General late, then payment will be delayed sometimes up to two years.

4.3.5 Other type of transfers and financial assistance to states

Apart from the transfers discussed above, the federal government also provides annual allocations to the states through the Ministry of Rural Development and from the Prime

[36] See the minutes of the National Finance Council meeting on 28 January 1978.

Minister's Department. However, these allocations cannot be considered as real grants, but rather as federally sponsored projects. Among the projects under this category are construction of village roads, water and electricity supply in rural areas, village improvement projects and the provision of infrastructure for trade and industry. Looking at the nature of the federal sponsored projects, they seem to be intended to achieve balanced regional development and, subsequently, to eliminate horizontal imbalance among the state governments. However, they are not intended to finance projects / investments planned by the state governments under their annual budget. These projects should be carried out by the respective state governments, as they are closest to the local citizen. Moreover, these projects are trivial and not cost effective for the federal agency to undertake on the nationwide basis. In most cases, the selection and the place of the projects to be implemented is based on the political viability. [37]

Another government agency that is given some role in regional development is the Implementation Coordination Unit (ICU) of the Prime Minister's Department. This agency is given a yearly allocation for small projects (other than projects carried out by the Ministry of Rural Development) such as the construction and repair of stalls for small businesses throughout the country, particularly in the less developed areas. The purpose is to raise standards of living, especially for those who fall under the poverty line.

Federal sponsored projects are also carried out by the federal government through regional development agencies, especially projects involving land development and new townships in specific areas (construction of roads, water and electricity supply and other basic amenities). The main purpose is to improve the income and standard of living of the people in general. Among these agencies are the Federal Land Development Authority

[37] Some federal sponsored projects are intended to serve for the survival of the centre political leader, especially if the selection and location of the projects involves political consideration in order to rally political support.

(FELDA), Federal Land Consolidation and Rehabilitation (FELCRA), Pahang Tenggara Development Board (TENGGARA), Johor Tenggara Development Board (KEJORA), Central Terengganu Development Board (KETENGGAH), South Kelantan Development Board (KESEDAR), Smallholders' Rubber Industries Development Authority (RISDA), Kedah Regional Development Authority (KEDA), Penang Regional Development Authority (PERDA), and Jengka Regional Development Authority (JENGKA).

From the foregoing discussion, the implementation of fiscal adjustment revealed two main weaknesses:

1. Total federal transfers are very small as compared with total federal government revenue and not all grants are real grants intended to balance out state governments' accounts. Between 1980-2000, the average federal transfers were only 3.6% of the total federal government revenue. In 1980, total federal transfers amounted to RM369 million or 2.7% of the total federal government revenue, and increased to RM881 million in 1985, equivalent to 4.2% of the total federal government revenue. In 1990, total transfers amounted to RM1,237 million or 4.2% of the total federal government revenue and increased to RM1,302 million in 1995 or 2.6% of the total federal government revenue. This trend shows very little change, as evident from the amount of transfers disbursed in 2000, amounting to RM1,434 million or 2.6% of the total federal government revenue (see Table 4.21).

As displayed in Table 4.21, federal transfers comprise various types, which are designed to meet different purposes. However, according to the definition of fiscal adjustment, as discussed in Chapter 2, not all of these transfers are considered as a real fiscal adjustment measures. Out of these transfers, only the Capitation Grant, the State Road Grant, the Revenue Growth Grant and the two grants from the State Reserve Fund, that is, the grant to assist states having current account deficits and grant based on the level of economic

development, are considered as a real fiscal adjustment instrument. Two other grants are in the form of revenue sharing, that is, export of tin ore and export of iron ore. However, no further payment is made due to cessation of the production. Hence, total transfers to the states are even smaller if taking into account only real grants as defined under the theory of fiscal federalism.

Table 4.21
Types and Amounts of Federal Transfers to State Governments
(RM Million)

	Capitation Grants	Road Grants	Revenue Growth Grants	Grant based on State revenue	50:50	5%	Special transfers[1]	Others[2]	Total	% of total Federal Government revenue
1980	75.9	94.1	50.0	-	-	6.9	61.0	81.3	369.2	2.7
1981	82.4	90.5	92.3	-	-	6.9	61.0	41.7	374.8	2.4
1982	81.6	271.4	97.7	-	-	19.3	353.5	40.8	864.3	5.2
1983	82.2	148.9	128.8	77.7	-	25.3	353.5	48.6	865.0	4.6
1984	86.2	167.8	145.2	122.3	-	80.8	353.5	48.0	1003.8	4.8
1985	87.6	167.8	150.3	91.5	-	15.4	353.5	14.4	880.5	4.2
1986	89.1	414.5	146.8	94.8	-	6.3	353.5	30.6	1,135.6	5.8
1987	89.1	214.0	-	95.6	100.5	9.2	353.5	22.5	884.4	4.9
1988	90.0	260.3	-	99.1	102.7	13.9	353.5	13.9	933.4	4.2
1989	94.7	250.2	150.2	99.7	109.1	12.1	353.5	55.9	1,125.4	4.5
1990	89.2	366.0	150.0	98.4	121.5	21.6	353.5	36.7	1,236.9	2.5
1991	95.5	357.9	147.1	108.3	125.4	34.4	358.9	56.9	1,284.4	3.8
1992	95.5	387.0	150.0	97.3	167.6	36.4	61.0	64.4	1,059.2	2.7
1993	180.1	390.7	150.0	163.5	161.5	41.9	61.0	80.8	1,229.5	2.9
1994	192.6	441.5	150.0	165.8	153.0	51.0	61.0	81.4	1,296.3	2.6
1995	198.4	471.0	150.0	124.2	159.3	45.6	61.0	93.7	1,303.2	2.6
1996	196.9	488.9	138.0	174.7	143.7	47.7	61.0	83.6	1,334.5	2.3
1997	212.8	549.3	150.0	151.6	180.5	48.1	61.0	82.2	1,435.5	2.2
1998	216.1	687.8	150.0	165.1	205.9	65.6	61.0	82.2	1,633.7	3.0
1999	214.9	660.8	-	165.9	189.6	61.0	61.0	80.2	1,433.4	3.0
2000	228.8	668.5	150.0	170.0	181.0	76.0	61.0	84.6	1,619.9	2.6

Note: [1]Only to Selangor (compensation for Federal Territory = RM18.3 million, annually), Sabah and Sarawak (compensation for joining federation, Sabah = RM 40.1 million and Sarawak = RM 16 million, annually)
[2] Include transfers from State Reserve Fund, commodity export grants (tin, iron and other minerals)
Source: Budget Division, Ministry of Finance, and state financial statement.

In 1990, for instance, the total amount of these grants were only RM731 million or 59.1% of all total transfers and payments (RM1,237 million) accorded to the states by the federal government, equivalent to 2.5% of the total federal government revenue (see Table 4.21 and Table 4.22). This is because some federal transfers are made up of compensation by the federal to state governments (as in the case of payments to Selangor, Sabah and Sarawak) and administrative payment due to shared responsibility (for federal

projects in states and payments for joint responsibility functions under the concurrent list). Thus, federal transfers do not really attempt to solve the financial imbalances faced by the state governments. This problem was further exacerbated by the political considerations in disbursement of grants and federal projects to the states. The disbursement of grants, notably to the states ruled by the opposition party, was carried out on the basis of political viability in that the federal funds would not be forthcoming in the normal way if the states were politically worlds apart from the centre. Therefore, this practice disadvantages states that are not politically affiliated with the centre.

Table 4.22
Intergovernmental Fiscal Adjustments –
Amounts Received by State Governments in 1990 (RM Million)

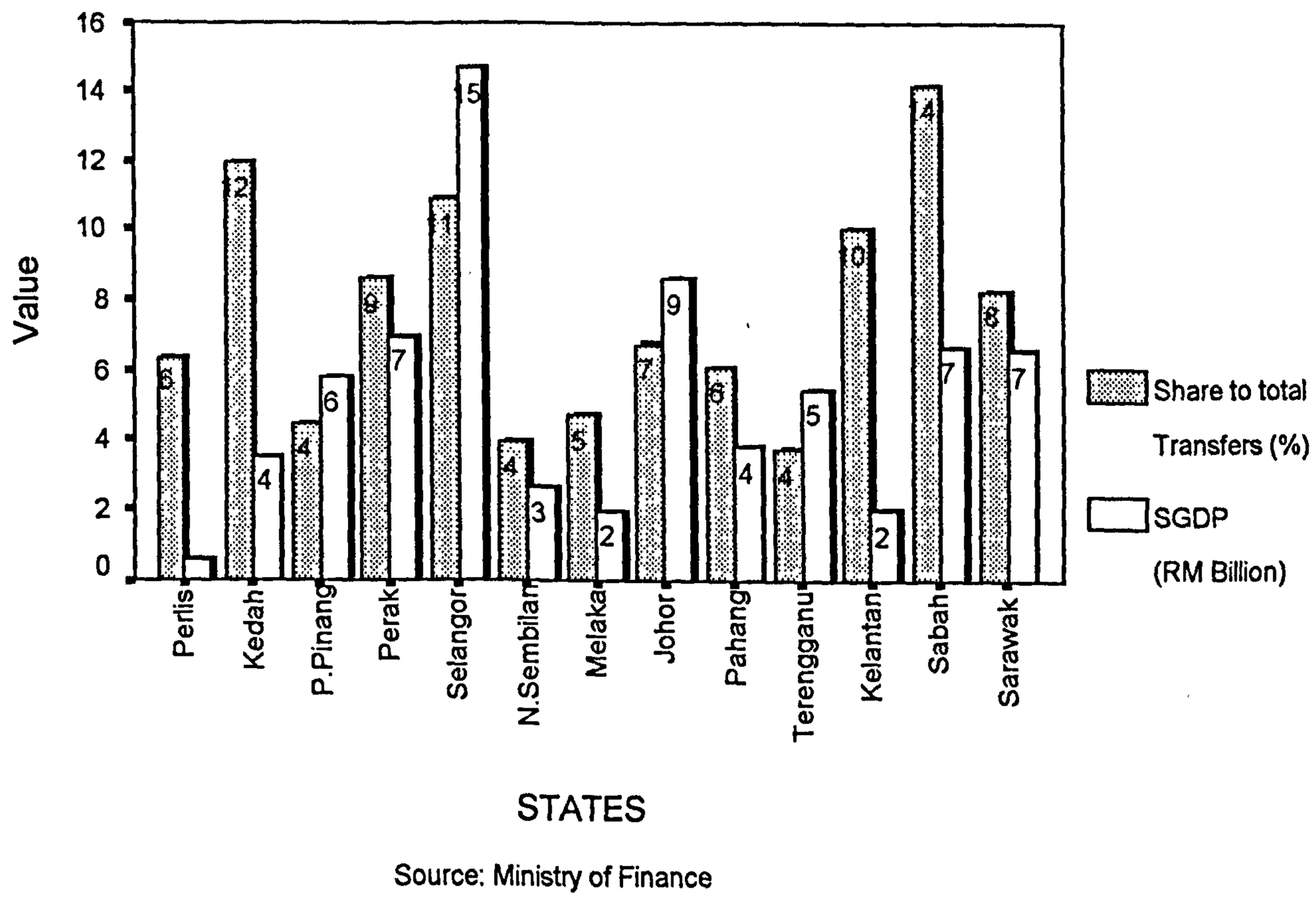
States	Constitutional Grant		State Reserve Fund		Revenue/tax sharing			Total	
	CG	RG	CAD	LEG	RGG	TXG	IXG		Share (%)
Perlis	2.8	3.8	11.5	12.4	15.8	-	-	46.5	6.4
Kedah	7.4	27.3	9.0	15.0	28.7	-	-	87.3	11.9
Penang	6.9	17.0	-	4.8	3.9	-	-	32.5	4.5
Perak	9.7	34.2	-	5.4	13.5	-	-	62.7	8.6
Selangor	10.0	64.1	-	0.8	4.5	-	-	79.5	10.9
Negeri Sembilan	0.5	16.9	-	3.6	7.9	-	-	28.9	4.0
Malacca	5.1	12.6	-	6.3	10.4	-	-	34.6	4.7
Johor	9.7	26.3	-	4.5	8.8	-	-	49.3	6.7
Pahang	7.3	9.5	-	4.5	13.3	-	-	44.4	6.1
Terengganu	5.8	13.6	-	4.7	3.5	-	-	27.5	3.8
Kelantan	7.0	13.3	6.7	19.1	27.3	-	-	73.5	10.1
Sabah	8.1	85.0	-	6.5	4.2	-	-	103.8	14.2
Sarawak	8.8	32.6	-	11.0	8.0	-	-	60.3	8.3
Total	89.2	366.0	27.2	98.4	150.0	-	-	730.9	100.0

Note: CG = Capitation Grants; RG = Road Grants; CAD = Current Account Deficits; LEG = Level of Economic Grants; RGG = Revenue Growth Grants; TXG = Export of Tin Ore; IXG = Export of Iron Ore
Source: Budget Division, Ministry of Finance, and state financial statement.

2. The practice of federal transfers does not bring equalizing effects to all state governments, as states with higher GDP receive higher federal grants than lower GDP states. Figure 4.3 shows that states with higher GDP continue to receive higher federal grants than lower GDP states. In 1990, for instance, seven higher GDP states, namely, Selangor, Perak, Johor, Penang, Sabah, Sarawak and Terengganu received higher federal

transfers, compared with lower GDP states, namely, Perlis, Malacca, Negeri Sembilan, Kelantan, Kedah and Pahang. Thus, the current practice of federal transfers does not constitute a mechanism that irons out fiscal imbalances among the states. This finding suggests that richer states continue to enjoy higher federal transfers, which in the long term may cause detrimental effects on the regional economic development. The fall out is that the rich states become richer and poor states become poorer. Consequently, this phenomenon induces a high degree of mobility of resources (labour and capital) to the richer states.[38] To make matters worse, there was lack of political will to undertake transfer reform that would have an equalising effect on all state governments in the federation despite flexibility provided by the Federal Constitution.

Figure 4.3
Transfers to State Governments, 1990



Source: Ministry of Finance

[38] This phenomenon will cause socio-economic problems (housing, crime, urban poverty) in the richer states such as Selangor, Johor and Penang. This, in turn, requires the Federal Government involvement to overcome urban problems and, as a result, more federal allocation needs to be channelled to these states. This situation creates somewhat of a cycle, i.e. richer states continue getting federal allocation due to this problem and further attract internal migration. As a result, poorer states remain poor.

The above weaknesses further exacerbated by the ineffective role of the National Finance Council (NFC) as an institution of intergovernmental fiscal relations to make fiscal adjustments, as the decisions made by the Council are indirectly politically influenced. This is not surprising, as the members of the Council are largely from the ruling party and therefore it is difficult for the NFC to be impartial. We will discuss in greater detail the deficiency of the NFC in Chapter 7 of the thesis. To be effective, this Council should be impartial to ensure equity, consistency and continuity working of the whole system of fiscal federalism. In this case, the Finance Commission of India and the Commonwealth Grant Commission of Australia are two good examples of institutions of intergovernmental fiscal relations that work better than the NFC in Malaysia. This is because the members of these institutions are appointed from among professionals familiar with the various aspects of intergovernmental fiscal relations. As a result, political influence on decisions is minimised.

4.4 Conclusion

This comprehensive survey demonstrates severe shortcomings in the design of intergovernmental fiscal relations in Malaysia, as hypothesised in this research, in particular due to the division of functions and revenue assignments, which clearly favour the federal government. The upshot of this general deficiency is persistent fiscal imbalance. The assignment of favourable revenue sources to the federal government, coupled with its exclusive access to sources of borrowing (domestic and external) are justifiable from the point of view of economic considerations; for stabilisation, allocation and distribution functions. However, the state governments were assigned less productive sources in conformity with the constitutional functions accorded to them. With limited sources of revenue and borrowing powers, the state governments face financial constraints in attempts to finance their functions. This situation has resulted in long-term fiscal imbalance, both vertical and horizontal, due to non-correspondence between

revenues collected and the responsibilities to be performed. Fiscal imbalances require fiscal adjustment, whether through federal transfers or reassignment of taxes.

Although fiscal adjustments were undertaken, the design of fiscal adjustments made to remedy this problem is not effective in bringing financial relief to the state governments and hence has failed to have a equalising effect. Furthermore, total federal transfers are too small as compared to total federal government revenue, not all grants are real grants intended to overcome disparities between expenditure and revenue, and annoyingly the disbursements of grants were also delayed due to political unlikeness. To make matters worse, the grants system does not have a built in mechanism to respond to any economic changes. Hence, in the final analysis, the 'have' states receive higher amounts of grants than 'have not' states, and higher GDP states receive higher grants. In the long term, if this trend continues, rich states will get richer, while poor ones get poorer. However, the most affected are those states ruled by the opposition party, as they are not supporting their 'master' at the federal level. This is a subtle and systematic way of winning the political competition. For this reason, the development of an effective transfers system to strengthen states' fiscal position is desirable. Moreover, the role of the National Finance Council as an institution to foster intergovernmental fiscal relations is less effective, as by and large, the decisions are indirectly politically influenced, they are not binding on the federal government. Finally, only the federal government can initiate changes on fiscal matters concerning states' finance, as the federal government is the 'care taker' of the state governments. Clearly, the state governments are subordinated by the action of the federal government.

Fiscal adjustment, which includes both the adjustment of horizontal and vertical imbalances, was mostly effected by means of grants and tax-sharing arrangements. However, most grants are made conditionally, to enable the federal government to

exercise control over the extent and quality of state services and over state development expenditures. While conditional grants are desirable in the interest of nation-wide uniformity and equality, as well as to ensure that the federal government's financial responsibility is adhered to as far as possible, they could be used by the centre to put political pressure on states that are ruled by a different political party from the centre. Furthermore, conditional grants limit the financial freedom of the state governments to spend resources according to local preferences. This practice of intergovernmental transfers makes state governments supplicants for financial assistance from the federal government. As such, this type of fiscal adjustment can be best described as a 'carrot and stick' system, which bears the risk of political malpractice. In the next chapter, the determinants of federal transfers to states and their significance to the state governments finance will be analysed.

Chapter 5

Fiscal Adjustment: Determinants of Federal Transfer and Their Significance for State Governments Finance

5.1 Introduction

Fiscal adjustment is the cornerstone in the design of intergovernmental fiscal arrangements to accommodate the mismatch between revenue and expenditure. It is the manifestation of inappropriate or uneven assignment of revenue sources between levels of government. However, fiscal adjustment in Malaysia's fiscal federalism was not designed to negate states' fiscal deficiencies resulting from such assignment of functions. Analyses on the theory of fiscal adjustment, and the design and practice of fiscal adjustment in Malaysia in the previous chapters, reveal that the most practical way to remedy fiscal imbalances is through intergovernmental transfers, notably through grants from the federal to state governments. While this approach to fiscal adjustment is financially pivotal to meet national economic objectives, politically, since the federal government could attach any condition to the receipt of such grants, they are potentially a way of exerting political elements to strengthen the hegemony of the centre (see Chapter 6). This is one of the reasons why the federal government in the past was reluctant to assign some degree of financial autonomy to the states, in guise of efficiency and equity considerations.

Analysis of fiscal adjustment in Chapter 4 revealed that the amount of federal transfers to the states was too small as compared to the total federal government revenue, and the 'have' states have continuously received higher grants than the 'have not' states. Hence, the practice of federal transfers has actually failed to bring about an equalising effect. A question can now be asked: what are the determining factors in the making of these transfers? Having discussed the problem of fiscal imbalances and the importance of

financial adjustment to remedy fiscal imbalances in the preceding chapters, in this chapter, the focus of analysis will be: first, the determinants of federal transfers, and second, the significance of federal transfers to the state governments' finance. The aim of this analysis is to examine whether or not significant factors such as the revenues and expenditures of both federal and state governments, national Gross Domestic Product (GDP), size of population and political factors have any significant impact on the making of the grants system.

5.2 Theoretical framework

The literature suggests that fiscal imbalances faced by the constituent government need to be remedied by way of federal transfers. Considerable research using regression analysis has been conducted to examine the effect of intergovernmental transfers on fiscal decisions at the lower levels of government (Pommerehne (1977), Gramlich (1977), Grossman (1994), Rao and Singh (2000), Dasgupta, Dhillon and Duta (2001), and Khemani (2002)). These analyses explore the significance of variable federal revenue, federal expenditure, gross national product, population, states' revenue and expenditure in making grants to states.

The main conclusion from these investigations is that transfers have a strong influence on both the level and composition of spending by recipient governments, which further highlights the importance of the design of intergovernmental transfers to the lower level of government. These analyses also revealed that matching grants promote spending better than non-matching grants, consistent with the positive theory of grant, which anticipates that grants could stimulate more spending. These empirical findings suggest the importance of intergovernmental grants in determining the level and mix of public goods and services that could be delivered by lower levels of government. Interestingly, the studies by Rao and Singh (2000), Dasgupta, Dhillon and Duta (2001), and Khemani

(2002) used the variable of different political parties at the federal and state levels in India, to examine whether or not political affiliation influences the grant system and stimulate states' spending. Their analyses show that transfers to states were to some extent influenced by states' political affiliation with the centre, with states closely affiliated to the centre receiving more grants. According to Grossman (1994), based on his study using the United States data, grants are assumed to rally support for ruling political party and other interest groups, and therefore political affiliation has contributed to an increase in amounts of grants to states. A study by Rogers and Rogers (2000) on the trend of states expenditure in the United States also indicates that political competition has an effect on the size of expenditure by states, in that states that politically affiliated with the centre registered higher expenditures.

In the case of Malaysia, federal transfers depend on several factors. The most significant factor is the federal government revenue. This is because the federal government has been assigned lucrative revenue sources, while the states' independent sources of revenue are limited, not productive and difficult to collect and administer. Hence, the federal government finds it easier to raise revenue than the state governments. In this situation, transfer of funds to the states in the form of grants is inevitable. Although most transfers are constitutionally enumerated, it was found neither objective nor formula of grants are spelled out. Instead, grants are determined by the federal government through the National Finance Council. In theory, federal transfers should depend on the federal government finance, in particular, their revenue performance and expenditure pattern. Apart from this, the states' fiscal needs are also a significant variable in determining the amounts of federal transfers. GDP is another variable that affects federal transfers to the states. This means that when GDP is high, states' economic activities should correspondingly be high; thus, states would require more financial assistance, as their revenue-raising power is limited. Another variable that influences the decision on the

amounts of transfers is the size of the states population. Growing population means increasing government expenditures. This is evident as can be seen from increasing demand for public goods and services, resulting in high financial requirement (Chapter 4). As states' financial capacity is limited, population factors should be taken into account in the design of the transfers system.

Based on this framework, the following propositions were developed to be verified using multiple regression model.

i. As the federal government has been assigned exclusive revenue sources, higher federal revenue should be extended to the states in the form of grants.

ii. Federal transfers should take into consideration the difficulties of the states in raising revenue, growing fiscal needs, increasing population, and the state's overall financial position, as a fiscal gap continues to exist, even with federal transfers.

iii. The growth in GDP does not influence the decisions in making transfers to the states.

iv. The disbursements of federal transfers to the states are subject to the states' political affiliation with the centre. If the states' ruling party is not affiliated with the centre, the grants will not come in the normal way.

5.3 The Model

The model used in the analysis is based on the *ordinary least squares* (OLS) regression model (see Gujarati, 1995). This model explains that the relationship between dependent and independent variables should be linear. The OLS regression is an appropriate statistical technique used to explain the movements of one variable (the dependent variable) as a function of movements of a set of other variables (independent variables). Gujarati, a prominent econometrician, asserts 'the method of least squares has some very

attractive statistical properties that have made it one of the most very attractive statistical regression analysis' (Gujarati, 1995: 52) and regression is 'one of the most widely used techniques in the analysis of data' to explain the relationship of variables (Bryman and Cramer, 1997: 190). The OLS regression model is also an accepted technique for regression analysis of time series data (Gujarati, 1995: 23). However, as this investigation is particularly concerned with the relationship of variables, the use of the OLS regression model in this analysis is not intended for predicting or forecasting what should be the amount of grant to be received by the state governments.

The basis of the OLS regression model is expressed in the following regression equation:

$$Y = \alpha + \beta X \qquad [i]$$

where Y is the dependent variable and X is the independent variable or explanatory variable. α and β are parameters of the model. α is the *intercept* and represents geometrically the value of Y where the regression line crosses the horizontal Y axis. In other words, α represents the value of Y when the independent variable X is equal to zero or is assumed to be held constant, or in the absence of an independent variable X. β, on the other hand, is a *slope of coefficient*. This slope means that the rate of change in values of the independent variable X (explanatory) affects values of the dependent variable Y.

For the OLS regression model to be valid and significant in examining the relationship between variables, the relationship between the dependent variable and independent variables should be linear. In other words, the OLS model requires a causal relationship between the dependent variable and independent variables. This presupposition is significant to see whether or not the model is useful and reliable. Linearity can be seen from the value of R (correlation coefficient) derived from the multiple regression. R measures the proportion or percentage of the total relationship of dependent variable explained by the regression model. However, in practice, the value R^2 (coefficient of

determination) is a more meaningful property of multiple regression to gauge the extent of the relationship between the dependent variable and a set of independent variables (Gujarati, 1995: 5; Berry and Feldman, 1985: 10; Bryman and Cramer, 1997: 172-173). The value of R^2 lies between 0 and 1. If the value of R^2 is positive and close to one, it indicates that the variables (dependent and independent) are positively related, that is, when one variable increases the other variable increases in the same direction and *vice versa*. On the other hand, if $R^2 = 0$, the model does not explain any of the variation in Y and hence the regression model is not reliable (Gujarati, 1995; Bryman and Cramer, 1997). In other words, the closeness of R^2 to one indicates how well the data used in the regression actually fit the regression line and hence indicates the degree of relationship between dependent and independent variables. However, the significance of the model also depends on the standardised regression coefficient beta (β).

In carrying out the investigation to examine the relationship between dependent variable and a set of independent variables, a multiple regression equation was developed based on the simple regression equation [i]. Using multiple regression, all independent variables are entered into the model at once. By doing so, it is possible to determine how strong are the relationships of each of independent variables regressed jointly, and subsequently help us to analyse which of the independent variables are more significant. Based on the theoretical framework discussed above, two models (Model 1 and Model 2) have been used for this purpose.

In Model 1, the assumption is that federal transfer to the state governments is a function of the federal government revenue, expenditure, states' own sources of revenue, states' expenditure, states' financial position, gross domestic product, size of population, and states' political affiliation with the centre. This function can be summarised in the following equation:

$$\ln Tf_{t-2} = \alpha + \beta_1 \ln X_{1t} + \beta_2 \ln X_{2t} + \beta_3 \ln X_{3t} + \beta_4 \ln X_{4t} +$$

$$\beta_5 \ln X_{5t} + \beta_6 \ln X_{6t} + \beta_7 X_{7t} + \beta_8 X_{8t} \quad ..... \quad [ii]$$

Where:

$\ln Tf_{t-2}$ = log federal transfers – two years lagged effect

$\ln X_{1t}$ = log federal government revenue (FGREV) (from all sources of revenue – tax revenue, non-tax revenue and non-revenue receipts, classification used by the Ministry of Finance, Malaysia)

$\ln X_{2t}$ = log federal government expenditure (FGEXP) (operating expenditure and development expenditure combined)

$\ln X_{3t}$ = log state government own source revenue (STREV)

$\ln X_{4t}$ = log state government expenditure (STEXP)

$\ln X_{5t}$ = log GDP (current)

$\ln X_{6t}$ = log population (POPVAR)

X_{7t} = Dummy variables of state governments financial position (STFINPOS) (0 = deficit / 1 = surplus)

X_{8t} = Dummy variable of political affiliation variables (POLVAR) (0 = non-affiliated / 1 = affiliated)

This model will be used to test the propositions developed in this study (see above) to examine the determinants of federal transfers. The dependent variable of this model is federal transfer (with two years lagged effect), as the disbursement of grants is subject to changing indicators, which normally take almost two years to be audited and implemented, such as two types of grants under the State Reserve Fund (Grants for states having deficit in their operating account, and Grants based on the level of economic development), State Road Grant, Revenue Growth Grant, and Service Charges for federal projects in states. Therefore, transfers that are supposed to be received in the current fiscal year, actually arrive two years later. In other words, the amount of transfers received by the states in the current fiscal year actually takes into account changing indicators and events that occurred in the last two financial years. The two years lag

effect is due to the time taken to internalise the changing indicators used in the design of grants, as well as the long auditing process involved (see Chapter 4).

For independent variables, a set of eight variables were selected, that is, the federal government revenue, federal government expenditure, state governments' revenue, state governments' expenditure, national GDP, population, dummy states' financial position, and dummy variable of political affiliation.[1] The data for these variables (except the dummy variable of political party) were obtained from secondary sources (see below). The dummy variable of political affiliation was selected due to the fact that the federal-state fiscal operations, in particular federal transfers, are influenced by the political operation of the federation. Dummy variables are variables that take values of either 0 or 1, and are used to indicate the presence or absence of one or more qualitative characteristics. In other words, dummy variables quantify or measure qualitative variables that are not measurable but their presence in the model is considered as significant, such as states' financial position (deficit or surplus) and the political variable (affiliation or non-affiliation). The use of dummy variables enables other independent variables, that is, non-metric qualitative data, to be transformed into metric quantitative data in the regression. The coefficient of a dummy variable in a regression equation shows the average effect on the dependent variable when the dummy variable assumes the value 1. In sum, the regression equation [ii] hypothesised that federal transfers to the state governments (Tf) are a function of federal government revenue (X_1), federal government expenditure (X_2), state governments' own source of revenue (X_3), state governments expenditure (X_4), national GDP (X_5), size of population (X_6), state governments' financial position (X_7), and political variables (X_8). To meet to the purpose of this analysis, the degree of linear dependence of federal transfers (Tf) on eight

[1] The purpose of taking the political dummy variable is to investigate whether or not the federal government transfers to state governments are associated with political affiliation. See Rao and Singh (2000), and Khemani (2002) for discussion on the significance of the dummy of political affiliation variable in the determination of federal transfers.

federal transfers that can be explained by linear dependence upon those eight independent variables operating jointly.

For Model 2, the assumption is that the ability of the state governments to take up the constitutionally assigned functions is subject to the states' own sources of revenue and transfers from the federal government. The aim is to examine the significance of federal transfers to the state governments' finance. For this purpose, the state governments' expenditure was used as a dependent variable while the independent variables were state governments' own sources of revenue (X_1), and federal transfers / grants (X_2), as shown in equation [iii].

$$\ln Y_t = \alpha + \beta_1 \ln X_{1t} + \beta_2 \ln X_{2t} \qquad [\text{ iii }]$$

Where:

$\ln Y_t$ = log state government expenditure (STEXP)
$\ln X_{1t}$ = log state government own source revenue (STREV)
$\ln X_{2t}$ = log federal government transfers (FGTF)

5.4 The Data

The data used in the regression analysis are based on the time series secondary data, which were obtained from the various government official documents and publications, namely, the Ministry of Finance's Economic Report, the State Financial Statements, the Five-Year Malaysian Plans and the Department of Statistics. These data were collected to cover the 31-year period of Malaysia's economic planning (1970 to 2000).[2] The year 1970 is significant because the New Economic Policy (NEP) was implemented in that year following the 1969 racial crisis, which was the turning point in the direction of Malaysia's socio-economic policy. Using 31 years observation would help to analyse the

[2] Malaysian economic planning is implemented through five-year plans, that is, First Malaysian Plan (1966-1970), Second Malaysian Plan (1971-1975), Third Malaysian Plan (1976-1980), Fourth Malaysian Plan (1981-1985), Fifth Malaysian Plan (1986-1990), Sixth Malaysian Plan (1991-1995), and Seven Malaysian Plan (1996-2000). From 2001 to 2005, the economic is progressing under the Eighth Malaysian Plan.

year following the 1969 racial crisis, which was the turning point in the direction of Malaysia's socio-economic policy. Using 31 years observation would help to analyse the actual pattern of the subject under study. The data on the federal government finance, that is, revenue, expenditure and federal transfers to the state government, were compiled from the Ministry of Finance's Annual Economic Report and the Accountant General Office. The data on gross domestic product (GDP) were also compiled from the Ministry of Finance's Annual Economic Report, while data on population were obtained from population census of the Department of Statistics, Malaysia. The state government data, namely, revenue, expenditure and financial position, were compiled from the individual state government financial statements and then transformed into consolidated form (See Appendix vi and Appendix vii).

5.5 The results

5.5.1 Model 1: The determinants of federal transfers

The application of multiple regression analysis in Model 1 aimed at examining the main determinants of federal transfers to the states using the four propositions mentioned in section 5.2. Thus, the focus of the regression was to evaluate the strength of the dependence of federal transfers upon independent variables. The prerequisite conditions for this regression to be significant are that the relationship between dependent and set of independent variables should be linear and the value of R^2 should be significantly different from zero. The result from this regression shows that the value of R^2 is 0.986, which suggests that the variation in federal transfers was totally explained by the set of independent variables used in the regression jointly. Expressed differently, the value of R^2 in this model indicates that the independent variables used in this model are valid, in that the relationship between dependent variable and independent variables is linear and the data used are normally distributed (see Figure 5.1 and Figure 5.2). As such, the result from this model is statistically significant and reliable in investigating the relationships

between dependent variable and independent variables. Furthermore, the analysis of variance (ANOVA), which tests whether the two variables (dependent variable and a set of independent variables) have a linear relationship, indicates that the data used fits the model. The ANOVA result as presented in Table 5.1 shows that the F value is high and significant. Hence, the model is highly significant, indicating a linear relationship between the dependent and independent variables.

Table 5.1

Analysis of Variance (ANOVA) Table[a]

Model 1	Sum of Squares	df	Mean Square	F	Sig.[b]
Regression	2.862	8	0.358	170.639	.000
Residual	0.042	20	0.002		
Total	2.903	28			

a Dependent Variable: log fgrnlag2

b Predictors: (Constant), natural log SGEXP, dummy state fin position, dummy political affiliation, natural log POP, natural log FGEXP, natural log SGREV, natural log FGREV, natural log GDP

Source: SPSS output

Figure 5.1

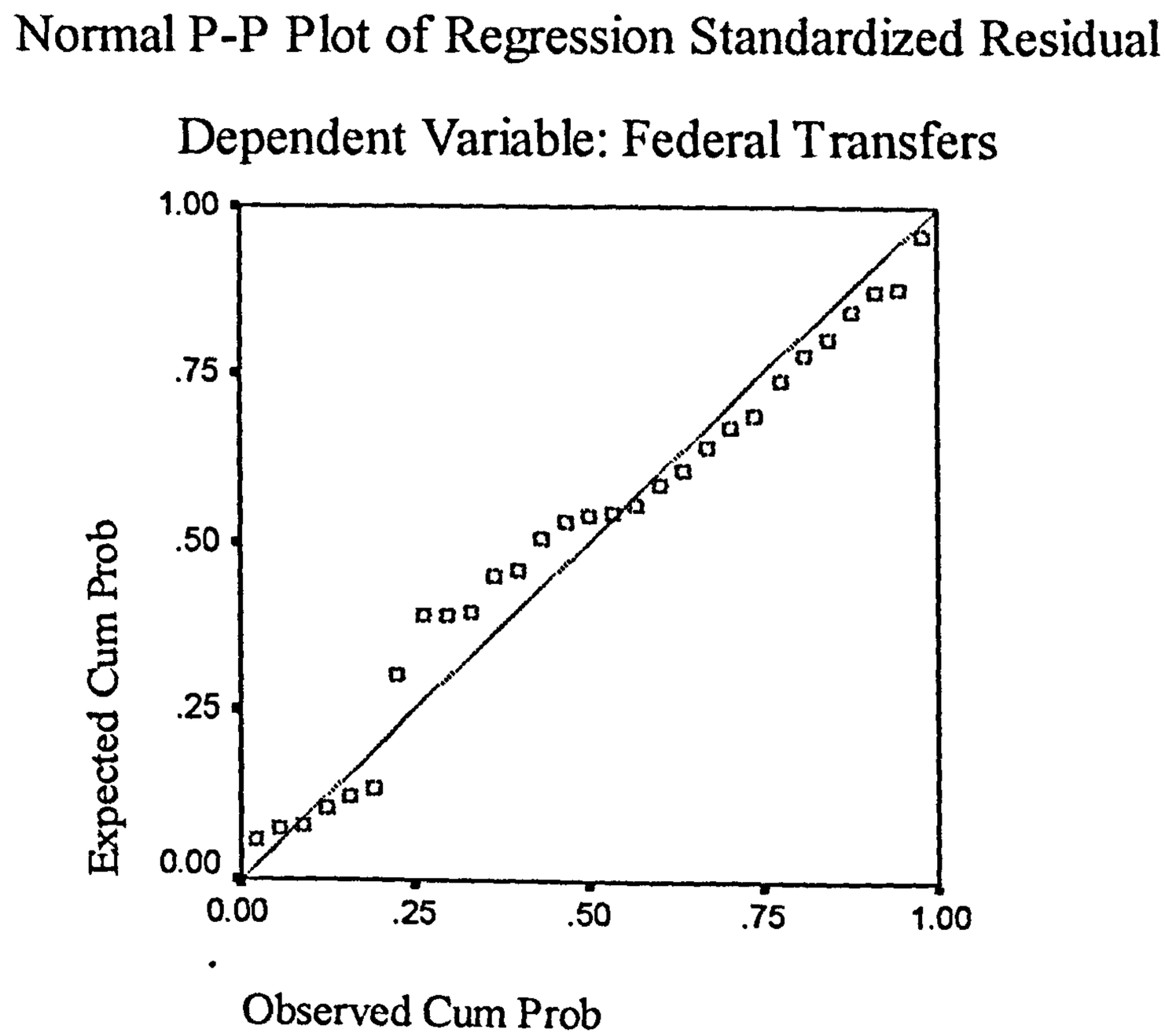
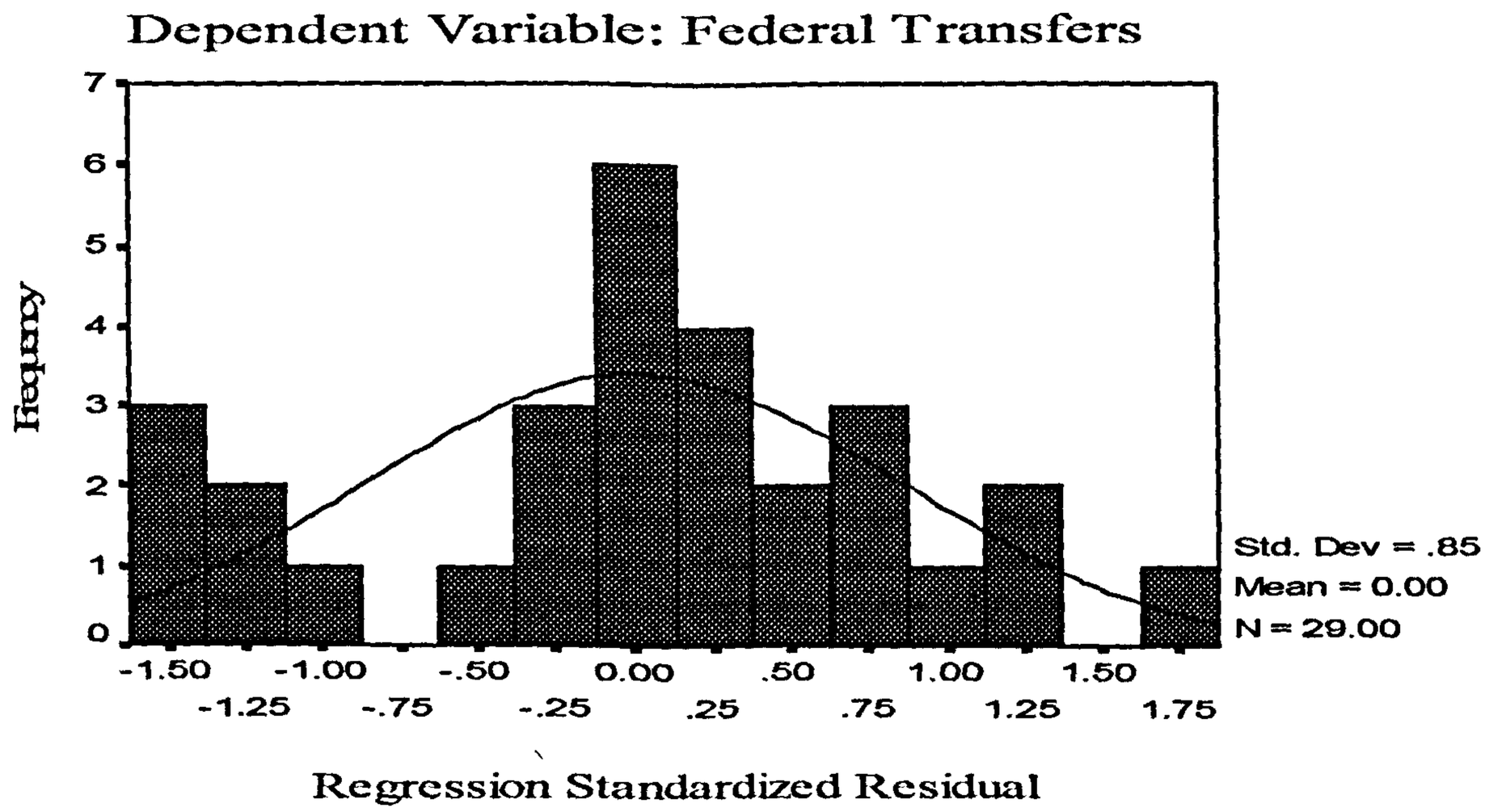


Figure 5.2

Histogram



The result of the regression Model 1 using regression equation [ii] is presented as follows:

Table 5.2

Result of Model 1

(*t* statistic in parenthesis)

Variable		Coefficient
$lnTf_{t-2}$	Federal transfers (lag 2)	1.166 (3.959)
lnX_{1t}	Federal government revenue (FGREV)	0.488 (1.001)
lnX_{2t}	Federal government expenditure (FGEXP)	0.304 (1.175)
lnX_{3t}	State government own source revenue (STREV)	0.709 (2.844)
lnX_{4t}	State government expenditure (STEXP)	-0.665 (-2.440)
lnX_{5t}	GDP	-0.569 (-1.116)
lnX_{6t}	Population (POPVAR)	0.330 (0.967)
X_{7t}	Dummy variables of state governments financial position (STFINPOS)	-0.070 (-1.923)
X_{8t}	Dummy variable of political affiliation variables (POLVAR)	-0.458 (-6.620)

$R^2 = 0.986$ DW= 2.32

This result shows that the intercept (α) is 1.166, which means that if all independent variables are held constant, that is, assuming no influence by all independent variables, the total federal transfers to the state governments amount to 1.166. However, the presence of independent variables has different effects on federal transfers. Now, the effect of each independent variable on federal transfers will be examined, to see whether it could substantiate the propositions. Since all independent variables used in regression were measured in the same units (using natural log, except for the dummy variables), it is therefore able to determine the relative importance of each independent variable by looking at the standardised regression coefficient beta (β) of each independent variable in equation [iii].

1. *As the federal government has been assigned exclusive revenue sources, higher federal revenue should be extended to the states in the form of grants.*

This proposition is logical, due to the fact that the Federal Constitution assigned unlimited and productive revenue sources to the federal government (Chapter 3). As such, if considering the federal spirit in the design of transfers, then a 'considerable' amount of grants (based on needs) should be extended to the states as part of political contract in the federation. However, as evident in this regression, the regression coefficient of the federal government revenue (FGREV=X_1) did not strongly support the above proposition. The regression coefficient of FGREV is 0.488. However, the value of the *t* statistic is low, 1.001. In other words, theoretically, with every unit increase in the total federal government revenue, federal transfers would increase by only 0.49 units. Virtually, the variable FGREV is not a key determinant of federal transfers. This is evident, as the federal government did not consider their revenue performance as a main consideration in giving out grants to the states, as the average of the federal transfers received by the state governments over the period 1970-2000 was only 4% of the total federal government revenue (see Table 4.20 and earlier observation discussed in Chapter 4). Hence, in terms of policy decision-making, the design of federal transfers should

consider the growth of the federal government revenue although some transfers, such as, the Revenue Growth Grant, have taken into account the federal government revenue performance (see Chapter 4). Similarly, the regression coefficient of the federal government expenditure (FGEXP=X_2) has a low value, that is, 0.304, with an accompanying *t* statistic of 1.175. Statistically, this result suggests that the variable FGEXP also does not significantly influence the decision-making on federal transfers to the state governments.

2. *Federal transfers should take into consideration the difficulties of the states in raising revenue, growing fiscal needs, increasing population, and the state's overall financial position, as a fiscal gap continues to exist, even with federal transfers.*

This proposition suggests that federal transfers to the states should be able to close up the revenue-expenditure gap that results from the division of power and revenue assignment between the federal and state governments, growing expenditure, increasing population, and the overall state financial position. A proof of this proposition can be seen from the variables of the state governments' own source of revenue (STREV=X_3), the state governments' expenditure (STEXP=X_4), population (POPVAR=X_6), and the states' financial position (STFINPOS=X_7) used in the regression.

The regression coefficient of the state governments' own source of revenue (STREV=X_3) is 0.709 with an accompanying *t* statistic of 2.884. Statistically, this result implies that if the state governments' revenue increases by one unit, the total federal transfers to the states would increase by 0.709. Although this result may suggest that any increases in the state governments revenue will be followed by the substantial increase in federal transfers, but it still not help the states to ease difficulties to finance the expenditures, especially in times of economic downturn. This is because federal transfers increase in line with increases in the states' own sources of revenue. This demonstrates that there is no built-in mechanism in the design of federal transfers. Looking at the difficulty of the

states to raise revenue, there should be an inverse relationship between the two variables. In other words, when the states' own sources of revenue decline (due to the difficulty states have in raising revenue), federal transfers should be increased to counterweight the states' revenue-expenditures gap. This is why the current practice of federal transfers fails to eliminate financial discrepancies between the states, as a fiscal gap remains occurs even with federal transfers.

To make matter worse, there is also statistical evidence that the federal transfers did not take into account the states fiscal needs. The regression coefficient of the state governments' expenditure (STEXP=X_4) does not support the proposition that federal transfers actually take into consideration states' fiscal needs. The regression coefficient for the state governments' expenditure is -0.665 and statistically reliable as the *t* statistic is higher, at -2.440, which is significant at the 95% level of confidence. This shows that for every increase in the state governments' expenditure, the amount of federal transfers to the states is reduced significantly by 0.665. The inverse relationship between the state governments expenditure and federal transfers shows that the design of federal transfers does not consider the fiscal or financial needs of the state governments to finance their expenditure (see Table 4.11 of Chapter 4). Theoretically, when the states' fiscal needs increase, federal transfers should also increase correspondingly. Thus, in terms of policy implications, the federal government should look at the size of the state governments' expenditure in the design of federal transfers, recognising the fact that the state governments' revenue-raising powers are limited.

The variable states' financial position (STFINPOS=X_7) is also inversely related to federal transfers, as the regression coefficient for STFINPOS is - 0.070 (with a *t* statistic of 1.923). This finding tells us that there is statistical evidence that the design of federal transfers as a whole does not consider the states' overall financial position. This is in line

with the finding discussed in Chapter 4, which indicates that the existing grants system does not consider the states' overall financial position (except in the case of grant from the State Reserve Fund which was designed to help states having current account deficits). Hence, the overall design of transfers does not attempt to negate revenue-expenditure mismatch. Perhaps the main reason for this is that the federal government is determined to undertake nationwide development in all states in line with its role of 'care taker' of the states.

The regression coefficient of variable population (POPVAR=X_6) also does not strongly support the above proposition. Increasing population should significantly contribute to higher grants to the states. Theoretically, increasing population means growing state expenditures for public services. However, the impact of the variable population (POPVAR=X_6) is not statistically significant. This means with every increase in the size of population, the amounts of transfers increase but only slightly, as shown by the low regression coefficient of this variable (β = 0.330). This result implies that the variable population does not significantly influence the amount of transfers, as shown in the case of the Capitation Grant, and grant based on level of economic development provided under the State Reserve Fund (see Chapter 4).

3. *The growth in GDP does not influence the decisions in making transfers to the states*

It is noticeable that the states' expenditure pattern does not correspond to the national GDP. As discussed in Chapter 4, during periods of high national economic growth, the states' expenditure recorded lower growth as compared to the federal government's expenditure. One reason is that the federal government, with its extensive revenue sources, was responsible for most fiscal policy, especially the stabilisation function, while the states with limited revenue sources found it difficult to respond immediately to economic growth without relying on the federal government for funds. In other words,

whether the national GDP growth is higher or lower does not significantly stimulate the states to embark on higher investment projects. This is because the state governments' expenditures are mainly for the maintenance of public facilities. As such, it is not surprising that the state governments' finance, collectively, does not benefit much from growth in GDP. From the federal government point of view, therefore, there is no reason why federal transfers should be increased (when there is an increase in national GDP) since the state governments' expenditure bears little relationship with GDP. As a result, the state governments' own sources of revenue are not elastic to GDP growth compared to those of the federal government revenue. This is because the state governments' revenues mainly comprise land-based taxes and non-tax revenue (mainly royalties payment), which do not correspond to the growth in GDP (see discussion on the state government revenue in Chapter 4).

As expected, the regression coefficient of the variable Gross Domestic Product (GDP=X_5) is negative (β = - 0.569). Statistically this coefficient suggests that if GDP increases, the amount of federal transfers declines. Therefore, this result supports the above proposition that the growth in national GDP does not influence the decisions in making transfers to the states, as the coefficient of variable GDP is inversely related to the federal transfers. This means the GDP growth does not much contribute to the federal transfers, although some transfers take into account the variable GDP as one of the indicators in the design of grants, such as the grant based on level of economic development provided under the State Reserve Fund. Indeed, this finding supports the arguments that the state governments in Malaysia are not assigned or expected to undertake fiscal policy, as the spending behaviour of the state governments is not influenced by national GDP. However, the reliability of this coefficient is dubious, as the accompanying *t* statistic is not significant (-1.116). In terms of policy-making, consideration should be given to the importance of this variable in the design of transfers

4. *The disbursements of federal transfers to the states are subject to the states' political affiliation with the centre. If the states ruling party is not politically affiliated with the centre, the grants will not come in the normal way.*

Initial analysis shows that the states' political affiliation with the centre political party determines the posture of the federal-state fiscal relations and therefore significantly influences the working of fiscal federalism. From empirical analyses in this chapter, it proves that the above proposition is statistically convincing. In other words, if states are not affiliated with the federal level politics, the conduct of fiscal federalism is difficult. The regression coefficient of the dummy variable of political affiliation (POLVAR) is significant ($\beta = -0.458$) with a high value of the *t* statistics (6.620), and significant at the 99% level of confidence. This result suggests that federal transfers (and wider aspects of fiscal federalism) are influenced by the degree of political affiliation of the states with the federal level politics. This is notably evident as the disbursements of federal transfers are not forthcoming smoothly to the states led by a political party different from that of the centre. This finding also supports the study by Yusoff (1998), which revealed that the federal government in some instances control the disbursement of transfers, especially in the states led by the opposition party. Although this result seem akin to other empirical findings obtained in other federations, in particular the US and India,[3] however, their case is not as bad as Malaysia's, in the sense that grants are not used to coerce and undermine the states' existence. This is due to strong federal and democratic culture in these states, which is an important element for federalism to flourish.

5.5.2 Model 2: The significance of federal transfers

The result of Model 2 suggests that, statistically, there is a significant relationship between the dependent variable (state governments' expenditure) and independent variables (state government's own sources of revenue, and federal transfers). This result also indicates that the relationship between the dependent variable and independent

[3] For instance, for India, see Dasgupta, Dhillon and Duta (2001), and for the US see Grossman (1994).

variables (state government's own sources of revenue, and federal transfers). This result also indicates that the relationship between the dependent variable and independent variables is linear, as the values of F statistics and R^2 are high: 839.3 and 0.984 respectively. The data used are normally distributed as depicted in Figure 5.3 and Figure 5.4.

Figure 5.3

Normal P-P Plot of Regression Standardized Residual

Dependent Variable: State Government Expenditure

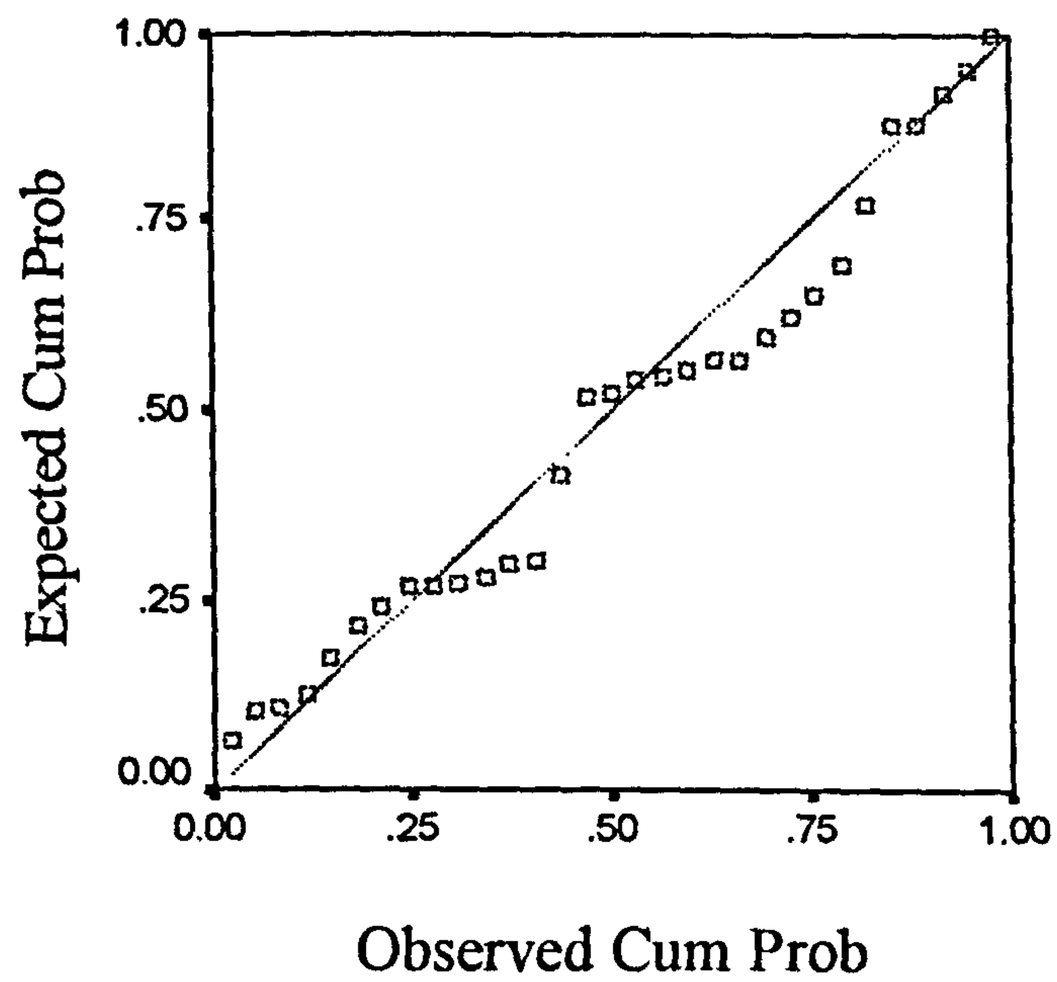
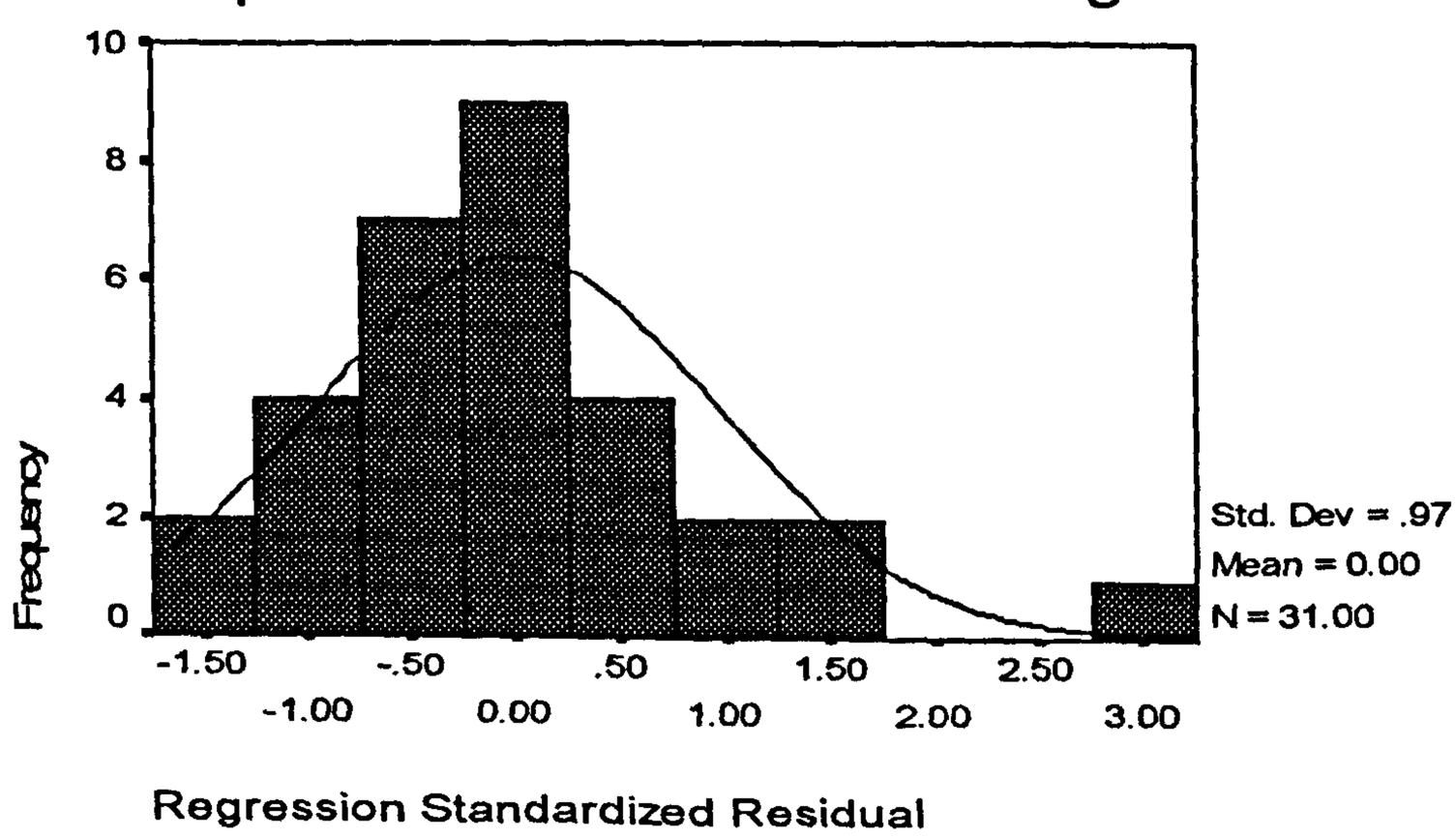


Figure 5.4



The result of the multiple regressions in Model 2, using regression equation [iii], can be summarised as follows:

$$Y_t = 0.602 + 0.864X_{x1} + 0.132X_{x2} \quad \text{.....} \quad [iv]$$
$$(3.140)\ (9.263)\ \ (1.415)$$
$$R^2 = 0.984;\ \text{Adjusted } R^2 = 0.982$$
$$F = 839.3;\ F\ Sig. = 0.00$$
$$DW = 1.465$$

This result indicates that the intercept (α) is 0.602, meaning that if all independent variables (states' own source of revenue and federal transfers) are held constant, the consolidated state governments' expenditure amounts to 0.602, with a significant *t* statistic (3.140). However, the independent variables (state governments' own sources of revenue and federal transfers), gave different values of coefficient beta (β) to the regression equation.

For the state governments' revenue (X_1), the regression coefficients indicate a positive relationship with the state expenditure and states own sources of revenue, as indicated by the standardised coefficient beta (β) at 0.864. This means that every increase in the state governments' own sources of revenue could stimulate an extra 0.864 units to the state governments' expenditure. Note that the *t* value for this variable is also significant at 9.263, significant at the 95% level of confidence. This implies that the state governments' expenditure, taken as a whole, is significantly dependent on their revenue performance to finance their expenditure.

On the other hand, the federal government transfers (X_2), has a coefficient of 0.132. Theoretically, every one unit increase in the federal transfers would result in an increase of 0.132 units in the state governments' expenditure. However, the correlation between federal transfers and the states expenditure is not significant at the 95% level of confidence, as the value of the *t* statistic is low (1.415). This shows that the state governments do not significantly benefit from federal transfers. This result also suggests

that there was no 'flypaper effect' from the federal transfers to states. According to the theory concerning the effect of grants, the flypaper effect is present when the grant received by the state 'sticks where it hits'.[4] Theoretically, the flypaper effect suggests that grants should not only contribute to the increase in public spending but more importantly, grants should increase private income. This is because, with the federal grants, the states will reduce taxes imposed on its citizens to finance the expenditure needs, and as a result, private income should increase (as burden to pay taxes reduces). However, all empirical studies on the flypaper effect found in the literature show a consistent finding that grants boost public spending more than an equivalent increase in private income (Knight, 2000). Nevertheless, in the case of Malaysia's grants system, the flypaper effect is not present, due to the fact that the amount of grants is too small for the flypaper effect to take place, let alone to have an effect on private income. This is because the states have limited taxing power except in regard to taxes on land-based economic activities (see Chapter 3 and Chapter 4). Thus, in terms of policy implications, federal transfers should be strengthened to ensure that the state governments are able to discharge their constitutional functions effectively. However, thus far, the grants received by the state government only represent a very small proportion of the federal government revenue, on average about 4% of the federal government revenue between 1970-1999, which is considered too small for the state governments, compared with the rate of increase in the federal government revenue during the same period. Although some types of grant were revised during this period (see discussion on types of grants in Chapter 4), much still needs to be done, especially due to the increase in the cost of provision and maintenance of public services and the rapid increase in the state expenditures as a result of growing urbanisation.[5]

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[4] See, for instance, Gramlich (1977); Oates (1994); Hines and Thaler (1995); and Bailey and Connolly (1998) for further discussion on the flypaper effect.

[5] See also MOFER (1992).

To summarise, the finding from Model 2 strongly suggests that the state governments' own sources of revenue and federal transfers have significant effects on the state governments' expenditure. However, the effect of federal transfers is less significant, as the amount of transfers is small. As such, the hypothesis that the state governments' expenditure is dependent on the state governments' revenue and federal government transfers (grants) cannot be rejected. Therefore, this result suggests a policy consideration for fiscal adjustment, in that reassignment of revenue resources needs to be considered in the future, since the state governments' expenditure is growing, as reflected in the increases in total expenditure as compared with their revenue. If measures are not taken to improve current revenue assignment, the state governments will continue to depend on the federal government for grants to finance most of their expenditures. This will seriously affect the federal government's budgetary position. However, as will be discussed in Chapter 7, reassignment of revenue sources is not possible at the present time, as the centre is reluctant to reassign / decentralise its taxing power, on the grounds that the federal government is committed to taking charge of the national economic development. Alternatively, restructuring the present transfers system is necessary to improve the state governments' financial position.

5.6 Conclusion

Fiscal imbalance requires remedy from the federal government, as most productive resources and revenue raising power are centralised. Thus, federal transfers are important sources of finance for the states to undo any fiscal discrepancies. Analysis of the federal and states' revenue in Chapter 4 indicates that the state governments' capability to undertake their constitutionally assigned functions is very strongly dependent on their own sources of revenue and transfers from the federal government. As the states' own sources of revenue are limited, federal transfers are essential. However, as evident, federal transfers are ineffective in bringing about fiscal equalising effects, and the

amounts of transfers are relatively small as compared to the amounts of revenue collected by the federal government.

The foregoing empirical analyses support the proposition that the federal government having strong revenue-raising power should extend more funds to the states in the form of grants or expenditures. Regression analysis on the significance of federal transfers to the state governments' finance also supports the hypothesis that there is a strong relationship between the state governments' expenditure and state governments' own sources of revenue and federal transfers. As such, the reassignment of revenue sources and design of federal transfers should take into consideration the difficulties of the states in raising revenue, their growing fiscal needs, increasing population, and the state overall financial position, as a fiscal gap continues to exist even with federal transfers. At the same time, transfer system should takes into account the growth of national GDP, so that the states could participate in the mainstream economic development. By doing so, the states' revenue could benefit from GDP growth. More importantly, the disbursements of federal transfers should not be subject to the states political affiliation with the centre, as this would undermine the states' fiscal autonomy and the federal spirit. Based on this finding, the influence of political system on the working of fiscal federalism will be investigated in depth in Chapter 6 of the thesis.

Although the federal government revenue performance is important in making decision on transfers, the amount of transfers is still far too low despite significant increases in the federal government revenue collection. Furthermore, as discussed in Chapter 4, federal transfers are not intended to eliminate financial non-correspondence or the states' fiscal discrepancies. Besides, not all transfers are made on stable formulae and there is no built-in corrective mechanism in the design of federal transfers, to keep pace with changing economic conditions. As Rao and Singh suggested, 'a formula of intergovernmental

transfers should be equitable, simple, transparent, and perceived to be objective' (Rao and Singh, 2000: 11). Thus, the federal government should look into this problem in order to strengthen the state governments' finance.

In light of those shortcomings, the federal government should have the courage to revise the existing transfers system and the assignment of revenue sources (tax and non-tax sources) to the state governments, insofar as there are no counter-effects on the stabilisation function of the federal government fiscal policy. Ideally, the review of the existing transfer system should devise a system of transfers that could encourage the states to explore their revenue potential, promote better public expenditure management, eliminate financial non-correspondence, and more importantly, it is pivotal to have built-in corrective mechanism in the design of grants system to respond to any economics circumstances. The reassignment of revenue requires strong political will, due to the centralised nature of the Malaysian politics. The reassignment of revenue would not only reduce economic disparities between the states resulting from the state governments' scarce resources, but more importantly, it would ensure that federalism is preserved and continues to flourish.

Chapter 6
Fiscal Federalism and the Political System: The Maintenance of the Single Party System

6.1 Introduction

Federalism is dynamic, in the sense that it is continuously changing to accommodate new challenges due to political development and social change, and growing socio-economic needs such as the demand for better public services. Therefore, federal-state relations, especially fiscal arrangements, are not static, due to the influence of various interlocking socio-economic and political factors (Simeon, 2001; Chapman, 1993; Watts, 1999a). As the articles in the Constitution are the result of political bargaining at the time of federating, they only reflect a degree of satisfaction between all members of the federation at that point in time. However, this degree of satisfaction cannot be sustained in the long-term, as new sources of changes emerge as the federation evolves. Thus, the initial arrangement that is embedded in the Constitution may not be working satisfactorily after a period of time and therefore flexibility and adjustment to accommodate new developments in the federation are required to produce another new arrangement to satisfy all members in the federation and foster amicable federal-state relations aimed at preserving the federation. Chapter 3 provides an analysis of how Malaysian fiscal federalism was designed and what functions are assigned to which level of government. It clearly showed that the Constitution allocated more substantial powers to the federal than the state governments, consistent with the underlying theme of the federal creation of a 'strong central government'. Hence one of the most important questions is to what extent the federal government, having substantive power, is willing to accommodate new developments in the federation to reinforce the legitimacy and stability of the federation, as it occurred in other federations, such as in Germany (Jeffery, 2003a; Jeffery 2003b), Canada (Vaillancourt and Rault, 2003; Shah, 1995; Banting, *et al.*, 1994), Australia (Nicholas, 2003), and India (Bhattacharyya, 2001; Rao

and Singh, 2000). Logically, another question that follows is: does the practice of fiscal federalism adhere strictly to what is enumerated in the Constitution? As Alain Gagnon argues, federalism is not there to resolve all conflicts but to manage them and 'the success of federal systems is not to be measured in terms of elimination of social conflicts but instead in their capacity to regulate and manage such conflicts' (Gagnon, 1993: 18). Initial observations reveal that the government of the day has no capacity to regulate and manage conflicts according to the federal spirit, for political reasons, which turn out to be the major impediment to the proper working of fiscal federalism in Malaysia. This is the central theme of this chapter. In the discussions on Malaysian politics that follow, the intention is not to denounce Malaysian politics, but rather to identify those points that affect the working of fiscal federalism.

6.2 Political system: The impact on federal – state relations and fiscal federalism

The conduct of fiscal federalism in Malaysia is strongly influenced by the political system. In Malaysia, political ramifications have significant implications for the conduct of federal-state relations. For this reason, the study of fiscal federalism requires an understanding of government and politics: the political and the party systems that have been adopted and adapted. The political system is the set of rules that governs the externalisation of political parties to the mass public, while the party system is a set of interactions among political parties (Stockton, 2001). Hence, the working of the political system and the party system is determined by the actions of political parties that operate within the encompassing structure of a political system that affects the whole spectrum of federal-state relations.

In Malaysia, both political system and party system are crucial to ensure that the federal spirit continues to flourish and to shape federal -state relations. However, the question is what type of political and party system is most suitable for the federal system of government. The answer depends on the cooperative relationship within their political

system and political understanding between the federal and states' political parties to preserve federalism, as well as the history, tradition and socio-economic framework of the particular federation. However, the most important aspect is the spirit of keeping the national interest, above the narrow political agenda of the parties. As will be seen shortly, state government-led opposition parties were not formally 'recognised' by the ruling party as their political operation could threaten the majority of the ruling party in parliament, and as a result, federal-state relations became strained. States should not be treated with contempt or as enemies, but as partners, regardless of which party rules the centre or the states. Thus, the survival of a federation is very much dependent on the ability of each political party to preserve and maintain the federal spirit within the federation. In short, political repugnance and political coercion are inappropriate for a federation, as any federation must be based on cooperation, participation and understanding between all levels of government.

As with most constitutions, the Malaysian Constitution is silent on the subject of political parties. The working of the Constitution can only be understood once knowledge of the political system and party politics is attained. The Federal Constitution only provides legal boundaries within which the constituent members in the federation work.[1] As noted above, federal-state relations are shaped by the political operations of the ruling party. Therefore, the best guarantee of cordial federal-state relations lies in its political operations and how conflicts which arise are solved (Watts, 1994; Gagnon, 1993). The division of powers and functions between the federal and the state governments as enumerated in the Constitution only provide a guideline to avoid possible clashes between the two levels of government. Chapman commented that 'reliance on a

[1] The Federal Constitution follows the pattern of the Indian Constitution in having three Lists: the Federal, State and Concurrent Lists (see the Ninth Schedule). Residual powers are given to states (see Article 7 of the Federal Constitution). These Lists are extremely comprehensive, with almost no room for clashes between the two levels of government. However, from these Lists, the Federal Government has far more powers than the states. Moreover, the Federal Government enjoys special benefits over the Concurrent List if clashes occur between the two levels of government (See Article 74 of the Federal Constitution). Indeed, the content of the Constitution provides for the supremacy of the Federal government.

constitutionally defined structure alone cannot ensure stability in a federations' (Chapman, 1993: 72). Indeed, federal-state relations are multidimensional, as they involve legal and constitutional as well as economic, social, political and cultural forces, over which the political system presides. As such, political parties and party systems are crucial in shaping federal- state relations.

The political system in Malaysia is characterised as: first, heavily based on communal cleavages, second, regionally (state) based, and third, dominated by the one party system. Almost all political parties in Malaysia reflect a communal bias. Milne (1967) noted that,

> 'because of the communal nature of politics in Malaya [and Malaysia] all parties face the dilemma. If they do not try to appeal to a particular community or communities, they will lose support to parties which do make this type of appeal. It would seem that non-communal parties cannot hope to survive, while communal parties might have some difficulty in winning a majority' (Milne, 1967: 87).

Due to this, consociational arrangements in the Malaysian political system are inevitable in that power-sharing between communally based political parties is entrenched.[2] In 1974, a grand coalition of communally based political parties was formed, known as the *Barisan Nasional* (the National Front (BN)), the forerunner of the Alliance Party formed in 1952. Although there are other political parties formed on a non-communal basis, their support was less widespread compared to that of parties formed on the basis of communal divides. This is because each communally based party is fighting for its respective community's interests in the federation and therefore does not seek support from other communities. The three major components of the BN are the United Malays National Organisation (UMNO), the Malaysian Chinese Association (MCA) and the Malaysian Indian Congress (MIC).[3] As the names indicate, all these parties appealing to

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[2] See Ismail (2003), Lijhpart (1977).

[3] UMNO was formed in 1946 by Onn Jaafar in Johor Bahru, primarily to organise Malay opposition to the Malayan Union. Malay political consciousness arose during the Japanese occupation of Malaya (1942-1943). 'Although the Japanese Occupation was destructive and brought about hardship and misery to the people, it did awaken the political consciousness among the people which stimulated some desire for national independence. It acted as a catalyst for the emergence and development of nationalism in Malaya, especially Malays whose nationalism later became the basis of nationalism' (Sabaruddin, 1978: 18). Further discussion on UMNO can be found in Ahmad Fawzi (1992). The Japanese occupation also witnessed the rising of Chinese and Indian politics, eventually resulting in the formation of the Malaysian

its own community - UMNO looking after the Malay interests, MCA for Chinese interests and MIC for Indian interests. Due to this reason, communal clashes will easily turn to political chaos. However, with the formation of the coalition party (the BN) communal interests are accommodated to minimise conflicts. But, even so, the coalition of communal parties is also not spared internal clashes of interest:

> 'the strains and stress inside the Alliance are considerable. Each of the two main partners, the UMNO and MCA in particular, has to meet the competition of parties appealing to its own community, while trying to keep in step with its component partners. This may result in pressures which tend to disrupt the component party' (Milne, 1967: 87).

In most cases, the clashes arose between UMNO and MCA, especially with regard to the issues of language, education and Malays' rights, as can be seen over the issue of a proposal to use English language for Science and Mathematics subjects in schools, about which some quarters in MCA remain sceptical. However, the BN has been able to accommodate this political difference without any serious political instability.[4] In this regard, Michael Leifer (1973: 176) argued,

> 'In the case of Malaysia, communal allegiance has dominated the character of the political system albeit in a context where no one race commands an absolute majority and where viable and effective government is possible only through some form of inter-communal accommodation. In such circumstances any political grouping which seeks through such accommodation, to command the middle-ground of politics is vulnerable to challenge from parties which rest on an exclusively communal base'.

The record of the BN as a coalition of communally based parties proves that the claim made by Michael Leifer is irrefutable. Since independence, the BN and its predecessor (the Alliance Party) have dominated the party system and have survived to the present day. According to Barraclough, 'one of the most significant characteristics of BN (and its predecessor the Alliance Party) has been their ability under the leadership of UMNO to maintain a high degree of cohesion between their component parties' (Barraclough: 1985: 33). As such, the BN has been able to maintain a majority in Parliament since 1957 and

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Chinese Association (MCA) and the Malaysian Indian Association (MIC). In 1955, the Alliance swept the first general election, winning 51 of the 52 elected seats in the still colonial, partially appointed legislature. The Alliance ministers then proceeded to negotiate the terms by which peaceful independence was secured from the British on 31st August 1957.

[4] See *Utusan Malaysia*, 23rd August 2002, 'Action against people turning English into a racial issue'.

has been able to bring the Malaysian economy up to its present level. In Malaysia, the parties' coalition does much good work and indeed buttresses political stability, shaping federal-state relations and the upholding the ability to maintain and preserve federalism and federation due to the domination of the BN led by UMNO. As such, the assurance of cordial federal-state relations is dependent on the quality and creativity of centre political leadership from UMNO, it being the largest component of the BN and the most influential in the government.

Apart from communal cleavage, the political parties in Malaysia are also characterised as regionally / state-based. However, some political parties extend beyond state boundaries, as demonstrated by UMNO, which established a branch in Sabah in February 1991. The move by UMNO to expand its wing to Sabah was primarily to capture the state of Sabah from the Parti Bersatu Sabah (PBS) after the PBS was expelled from the BN and became the opposition party. The PBS won Sabah in the 1985 state election and subsequently in the 1990 state elections.[5] The strong support for the PBS was based on race and religious issues, the ceding of Labuan Island to the federal government, Filipino illegal immigrants, and the restoration of Sabah's rights over 'twenty- points' (see Sabah twenty-points in Appendix iii).

The multi party coalition, as demonstrated by the BN, has developed as an effective mechanism for the accommodation of Malaysia's communally diverse political elite, and, since independence, has never lost power, at least at the national level.[6] As explained above, the amicable federal-state relations since independence are to some extent the outcome of political cohesion / congruence at federal and state levels, that is, the

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[5] Note that PBS is a state opposition party which successfully won Sabah from the Parti Berjaya, the Barisan Nasional (BN) component parties, in the 1985 state election. In 1986 PBS joined the BN. However PBS was in the BN only for a short while; it was expelled from the BN in 1990. In 1994 UMNO successfully won Sabah after defeating PBS. See Yusoff (1998) especially Chapter 5, Vejai (1998), Ongkili (1992), Puthucheary (1985).

[6] Except in the 1969 general election when Penang fell to the opposition party (Gerakan), Sabah (1985 and 1990), Kelantan (1959, 1990, 1995, 1999, 2004), and Terengganu (1999).

dominance of the BN led by UMNO. However, conflict between the BN and state governments led by opposition parties has arisen, as is evident with Gerakan in Penang (1959-1964) (Gerakan is now a member of the BN); PAS in Kelantan (1959-1978, 1990-present); PBS in Sabah (1985-1994) which was initially a member of the BN but withdrew from the coalition in the 1990 general election, resulting in strained and tense federal-state relations; and PAS in Terengganu (1999-2004). Although there are instances where conflicts emerged within the same political congruence, that is, between the federal and state governments, both controlled by UMNO,[7] conflicts within the same party are less severe and do not threaten federal-state relations as much as conflicts between different parties.

Another factor that contributes to cordial federal-state relations is the strong central government power 'bestowed' by the Constitution, which enables the federal government to dominate and control the states by various means of federal intervention in states' affairs. As noted above, the centralisation of executive power has enabled the centre to discipline state political leaders by various federal interventions (political, economic and financial) to keep the states tied to the centre. As noted by Chin (1997), there are three degrees of federal intervention – 'mild intervention' (with the federal government typically co-opting local leaders); 'mid-intervention' (with the federal authorities using a mixture of administrative pressures like the Internal Security Act (ISA)[8] and financial rewards to lure opposition politicians to the BN); and finally 'direct intervention', by the declaration of a state of emergency. Apart from these interventions, the use of the police

[7] For example, conflicts involving the UMNO dominated Pahang government and the UMNO dominated Federal government over the issue of the Endau-Rompin National Park, which finally witnessed the expulsion of the Pahang Menteri Besar. For further discussion on this issue, see Shafruddin (1987) especially Chapter 9.

[8] The Internal Security Act (ISA) was established in 1960 initially to enable detention without trial, for an indefinite time, of those involved in communist activities. However, with the end of the communist threat, the ISA was used to detain any 'elements' of threat to the public order (including politicians, and now terrorists in the war against terrorism since September 11th, 2001) if the Government feels that their action may cause a threat to national security (see Rais Yatim, 1994). At present, there is a strong movement in Malaysia pressing the government to abolish this Act (see www.abolishisa.com)

force[9] by the federal government in the name of 'public law and order', as well as federal bureaucrats in states,[10] also contributes to the ability of the ruling party to control states' political behaviour. Indeed, the whole structure of government administration is tailored and geared towards the continued maintenance of a 'strong central government'. All forms of federal intervention, coupled with the federal government's financial strength due to its exclusive control over revenue sources relative to state governments, are factors that give the federal government political advantages, enabling the centre to bring its political rivals to heel and subsequently maintain Malaysia's political stability. Yusoff (1998: 26) commented that:

> 'national leaders *[federal executive]* were basically unwilling to accept the fact that the State was under the control of a party which was not an integral part of the ruling *Barisan Nasional* coalition. They thus sometimes behaved in a manner going beyond the bounds of federal principles by using whatever powers they had at their disposal to undermine a state government'.

This political parochialism causes strains in federal-state relations, in particular in dealing with leaders of the opposition parties (Ongkili, 1992).

If the arguments developed above are correct, then the conflict between the federal Government and the government of Terengganu over petroleum royalties payments, as will be discussed in the following section, may be partly due to the manifestation of the BN's, (in particular UMNO's), fear of the possible spread of PAS influence. As a result, 'when a state was not viewed as being in line with the priorities of the federal leaders, clearly it risked becoming a target for financial sanction' (Yusoff, 1998: 233) and as such, 'states under the control of parties not in agreement with the priorities of the central leadership have tended to develop much slower than states remaining loyal to the central ruling coalition' (Yusoff, 1998: 19). Thus, the strained relations involving the federal government and the state of Terengganu over the issue of petroleum royalties are the

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[9] For a fuller discussion on the role of the Royal Malaysian Police in maintaining federal-states relations, see Zakaria Ahmad (1987b).

[10] See Shafruddin (1987) and Zakaria Ahmad (1987).

manifestation of the above two conflicting forces. This results in severe fiscal difficulties for states, a price to be paid for not obeying 'the master'. Thus, if the opposition parties are weak, they will become the target of federal political leaders' allegations that the opposition parties do not have credibility to rule or to bring wealth to the states concerned. Such assertions would easily influence the hearts and minds of the people.

As the largest component in the BN and most influential in the government, UMNO is of particular interest with regard to federal-state relations. According to Milne and Mauzy (1978: 217), 'one must look within the coalitions to find the key to the dominant party system: the key is UMNO'. Of particular importance, the Prime Minister is selected from UMNO, although it is not written in the Constitution that this must be the case. Traditionally, the Prime Minister was also the president of the BN, the overarching title of the coalition party. The power of the Prime Minister is such that the *Menteri Besar* or Chief Minister of each BN controlled state has to be approved by him. Barraclough (1988: 9) claims,

> 'The Prime Minister from the UMNO has considerable powers within the *Barisan Nasional*, that is, he may veto the candidate for election proposed by any constituent party, is empowered to allocate seats between the various parties, and retains the right to nominate the Chief Minister or Menteri Besar in any state controlled a component party'.

The influence of the centre on the states was further enhanced by the role of the Central Executive Committee of the BN in selecting 'suitable' candidates to stand for election for seats in the *Dewan Rakyat* (House of Representatives) as well as at the State Legislative Assemblies. The power of the Central Executive Council of the BN also extends to the removal of the Menteri Besar in a state led by a component party. This factor, coupled with the high concentration of financial resources held by the BN at the centre, has made the candidates, especially those with little personal resources, dependent on the contributions from headquarters. According to Milne and Ratnam (1965: 193), 'the parties in Malaysia are highly centralised in the sense that party discipline is strong...and

the selection of candidates *[to stand for election]* is subject to some central control'. As a result, communal allegiance is strong in the Malaysian political system. Thus, all Menteri Besar and Chief Ministers from the BN are selected from candidates who have a good track record in the party, so that they will not create unwelcome disturbances for the leadership. In other words, they must show undivided loyalty to the party and, as a reward, if they lose their seat in the election, they may still enter Parliament as appointed members of the Second Chamber (Senate). As a result, political cohesion is strong in Malaysia. Hence, the power of allocating seats and election finances enables the national leaders to administer a system of rewards and punishments, according to whether a politician toes the line or not. Indeed the 'carrot and stick' system may help a leader to identify candidates that are suitable for high rank in the government and reject those that may cause trouble to the party and government.

The tension in federal-state relations is always motivated by the severe party competition to control state governments, in particular between the ruling coalition party, BN, and opposition parties.[11] This has been evident in every general election, where the incumbent ruling party has exerted the utmost effort to capture all the states. There are advantages to party competition. Among other advantages, party competition ensures the preservation of a democratic system of government. However, in Malaysia, as a prominent scholar in the field of Malaysian politics asserted, 'democratic process were permitted only as long as they did not actually undermine the power of the ruling elite while they were quickly modified or abolished when elites interests were threatened' (Crouch, 1992: 21). As a consequence, federal political elites took whatever steps 'considered necessary to ensure its continued control of the government' (Crouch, 1992: 21), as seen in the case of the payment of petroleum royalties to the Terengganu

[11] Except in the case of Singapore which, when it was part of Malaysia, attempted to control the Federal Government, which was against UMNO policy, and finally resulted in Singapore being expelled from the Federation in 1965.

government. Therefore, party competition in Malaysia do not encourage a healthy political environment, because the incumbent ruling party uses 'unscrupulous'[12] means to overcome their opponents. This was evident during BN's attempt to win back Sabah from the PBS in the 1994 general election. With advanced election machinery at the national and state levels, as well as enormous funds and resources, BN easily overpowered PBS and recaptured Sabah (Chin, 1997). According to Kahin (1992) and Ongkili (1992), the strained relations between the federal government and Sabah during PBS's tenure (1985-1994) were due to the unwillingness of leaders at both levels of government to cooperate with one another. Thus, Sabah's state leaders sought to raise sensitive states' rights issues (see Sabah's Twenty Points in Appendix iii) in pursuit of their own political agendas, while the federal leaders were inclined to discriminate against state governments which were not willing to follow their dictates.

According to Shamsul AB (1996), Mohamed Mustafa (1998) and Vejai (1998), this scenario took place because different political agendas were being pursued by federal and state political elites.[13] In particular, federal political elites[14] promote the building of 'a nation state' *(negara bangsa)*, which is dedicated to the formation of a unitary state. Their view is that Malaysia should move towards one single state that is based on one

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[12]'Unscrupulous means' includes money politics, media control, uses of government machinery, provocation, and denying 'freedom to speak'. With regard to media control, an interview between A. Lin Neumann (Asia programme consultant of CPJ (Committee to Protect Journalist)) and Steven Gan (SG) a journalist from the *Malaysiakini*, conducted in Kuala Lumpur, Malaysia, in November 2000, said.

'CPJ: What's wrong with the Malaysian media? Why is it self-censored? I thought this was a democracy.

SG: The mainstream media is either completely or directly owned by political parties in Malaysia, so in that sense there is very little room for editors to go beyond, in terms of criticizing the governing political parties in Malaysia. In that sense, that is what is wrong with the mainstream media.'

(http://www.cpj.org/awards00/gan_interview.html, and http://www.malaysiakini.com)

Other critical observations on this matter, as well as the executive supremacy of the executive power, can be found, for instance, from Crouch (1996), Crouch (1992), Jomo (1996), Gomez and Jomo (1997), Gomez (1990), Gomez (1991) and Rais Yatim (1995).

[13] Based on a discussion of Malaysian Nation-of-Intent concepts in relation to federalism with Professor Sahmsul A.B, Director of the *Institute of the Malay World and Civilisation*, National University of Malaysia.

[14] Political elites, according to Lapalombara (1974: 468) are composed of 'those persons who occupy formal government positions, and who are endowed with official authority to make political decisions'. 'Persons' here refers to one particular group of politicians who run the government, enjoy governmental positions and take political decision. Political elites seek to remain in power so that they will continue to enjoy the privilege of being an elite.

culture, and one political belief. In other words, the whole idea of a unitary nation state promotes the renunciation of the constituent state government concept, and especially undermines states' rights which have been growing following escalating economic and political self-awareness. Thus, since independence, the Malaysian federation has witnessed a growing centripetal force aimed at strengthening federal political elites in pursuit of building a centralised nation state. Consequently, if the federal political agenda is challenged or under threat, the upshot is strained federal – state relations, in which all resources are directed to quell state opposition. This is evident in the federal- state relations with states controlled by the opposition party. For instance, when PBS won control in Sabah in 1984, the federal government launched open political confrontation with the Sabah government. Various instruments have been used to 'overthrow' the PBS government. These include open political and economic attacks on PBS's credibility in leading Sabah. Vejai (1998: 143) identified political attacks by the federal government aimed at weakening the credibility of states' political elites. The federal government has also attempted to stop foreign investment to Sabah on the grounds that Sabah's political situation is not stable. Federal political elites, in alliance with some state politicians sympathetic to Kuala Lumpur, also accuse the PBS government of corruption and claim the misuse of public funds. Even the Chief Minister (Pairin Kitingan) has been accused of corruption by awarding contracts to a company owned by one of his relatives. Court action taken against him rendered his appointment as a member of the State Legislative Assembly null and void. However, the judge did not give the maximum sentence to him, which enables Pairin to continue to hold his post as Chief Minister. As expected, this angered federal political elites and especially the Prime Minister (Dr. Mahathir Mohamad), who criticised the court's decision and consequently introduced UMNO into Sabah to quash PBS from Sabah politics. As a result, during PBS[15] government (1985-

[15] PBS was expelled from the BN in 1990 due to differences in their political goals. The federal political leaders claimed PBS to be Sabahans' champions by promoting its twenty-points. These federal political

1994), Sabah suffered political mayhem, which resulted in the state's financial difficulties. The federal government's intention was finally revealed by the Prime Minister, Dr. Mahathir Mohamad, in his speech to the people of Sabah during the Gaya Constituency by-election campaign on 11th October 2002. He revealed:

> 'Of course, we give more attention (now) to Sabah because while Sabah was under the opposition party (PBS) Sabah did not get fair treatment or enough allocation for development. We need to expedite development process in Sabah. Indeed, PBS had realised that being an opposition nothing can be done'.[16]

What this implies is that when political hegemony is challenged by states, the states concerned will face severe political and economic isolation. The upshot of this situation is a growing anti federal sentiment among Sabahans. With the power to control the media and use of other federal agencies, the federal political elites put further pressure on state governments. The same strategy has been used in other states controlled by opposition parties, in Kelantan and Terengganu. Conversely, states ruled by the same political party as the centre have a political advantage, due to cordial political relations with the federal leaders, which makes it relatively easy for them to obtain financial assistance. However, states ruled by the opposition find it difficult to get assistance from the centre. As Pang Teck Wai argues 'states (or state officials) which do not have good relations with the federal government (or federal officials) are likely to get less development funds' (Pang Teck Wai, 1992: 84-85). Hence, fiscal federalism only works well when 'the same political parties have formed the government at the centre as well as in all the state governments' (Abdullah, 1978: 322). In other words, there will be strained relations and misunderstanding between the federal and the states if different political parties rule at federal and state levels, which will affect the working of fiscal federalism. Indeed, political hegemony controls the state governments. For instance, the federal government exercises some control over disbursement of grants and decisions concerning loans to the

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elites views as a serious threat and challenge to the federal government, in that it promoted anti-federal sentiment among Sabahans. However, after failing to control Sabah, PBS rejoined the BN in January 2002.

[16] *Utusan Malaysia* 12th October 2002.

states, as the Federal Constitution gives no guidance on when to disburse grants to states. Hence, if a state challenge the federal political elites, the state concerned will not get the benefit of federal aid, because it refuses to abide by the centre's political agenda of promoting the nation state concept.

If the tension between parties runs high, especially when racial issues are involved, there is a threat to public order. In a plural society like Malaysia, almost every issue could turn into a racial one (Zakaria Ahmad, 1987b) which may be prejudicial to the national security interest. Consequently, under the rhetoric of public order and national unity, stern interventions from the centre are inevitable to ease the tension. In the past, the government intervened by conducting a national crackdown on the opposition party using popular acts - the Internal Security Act (ISA) – or, if the situation deteriorated, the government may exercise[17] its emergency power (Article 150 (1) which cannot be challenged in court (Article 150(8)). This may create political fear and a perception of oppression among the people and spawn the feeling of abhorrence towards the government. However, on a positive note, the action of the ruling coalition party can maintain political stability and, more importantly, maintain public law and order, since it is recognised that in a multi-racial community, political tension can lead to racial disharmony, which, if left unattended, could end in catastrophe, as experienced in the 13th May 1969 incident. Thus, one might question the authenticity of the government's ability to maintain 'political stability', whether on genuine grounds of public law and order or purely on the ground of political threats to the incumbent ruling party's ascendancy. This is what described by Chin (1997) as 'mid-intervention' and 'direct-intervention' in state affairs.

[17] For instance, in 1967, an emergency was declared in Sarawak following political tension between federal and state government over the issue of the appointment of Sarawak's Chief Minister (see Shafruddin, 1987). In 1978, an emergency was again declared in Kelantan over UNMO-PAS friction, which resulted in PAS's withdrawal from the coalition (see Muhammad Syukri, 1999). In 1987, a national crackdown on the opposition parties was carried out in Peninsular Malaysia to restore 'public order' using the ISA. For further discussion on the ISA, see Rais Yatim (1994). See also Zakaria Ahmad (1982, 1987a, 1987b) for the role of the police force in maintaining public order in Malaysia.

In summary, the working of fiscal federalism goes beyond matters of constitutional law. Although the function of each level of government is determined in the Constitution, the strength of federation and federalism is dependent upon the interactions of each level of government through institutional organisations, as well as the conduct of the political system and political parties; that is, to what extent they uphold the federal spirit and, most importantly, the Constitution. Hence, the nature of federal-state relations depends on which political party controls the federal and state governments. As Milne (1967) argues, 'the best guarantee of happy federal-state relations does not lie in any constitutional provisions but rather in the harmonising influence of memberships of the same party' (Milne, 1967: 79). Therefore, what actually protects states in Malaysia is not their constitutional status per se, but their political legitimacy through the political affiliation with the governing elites at the centre. Consequently, when studying fiscal federalism, it is important to look at the conduct of the political system and the party systems in a federation. These components, individually and in their interactions, affect the whole spectrum of federal-state relations.

With regard to Malaysian politics, there are three scenarios which affect the conduct of fiscal federalism: first, if the same political party controls the two levels of government, the working of fiscal federalism is relatively easy because there is no conflict of interest and less of an internal political power struggle. Any disputes over fiscal matters will be easily overcome within the party itself. In addition, if the socio-economic and cultural differences among the constituent governments in the federation are marginal and spread between members of the federation, politically insignificant, and financially dependent on the centre, it would be easier for both levels of government to reach an agreement. However, if this is the case, the tendency will be either (a) towards an expansion of central government policy-making, or (b) the spirit of national unity and co-operation

between units will be further enhanced. If the case (a) is prevalent, then there is a possibility of federal encroachment and intervention in the state competence, and states will be directed or subordinated to the centre. However, in most cases both forces (cases (a) and (b) above) are equally strong. This is where conflicts of interest between the federal and states, as well as between states, emerge, which needs a delicate balance of coalescing and conflicting forces (involving persuasion, influence, and bargaining process) between levels of government in the federation.

Second, if different political parties control the two levels of government, the rivalry and competition between government ruling parties at federal and state levels will significantly influence the conduct of fiscal federalism, which may undermine the effectiveness of fiscal federalism. In addition, if the socio-economic and cultural differences among the constituent governments in the federation are significant, and concentrated in one state, but are politically strong, the tendency will be towards severe party competition. This is another source of conflict of interest, which needs a delicate solution within the spirit of federalism.

The third scenario is single party dominance, as in the case of UMNO in the BN, which has control at both the federal and state levels. This enables the federal government to implement a development policy throughout the federation, whether or not within federal competence. Thus, the existence of a powerful federal government can be considered an advantage for planning and implementing socio-economic development throughout the federation. 'The success of development planning in Malaysia can be attributed to the fact that state governments remain subordinate and dependent on the federal authority over the years' (Hadenan, 1985: 196). Single party dominance thus enables the centre to determine and control almost every sphere of federal-state relations. However, if different political parties control the two levels of government, the rivalry and competition

between the ruling parties at the federal level and the opposition parties at the state level significantly influences the conduct of fiscal federalism.

Alas, the federal spirit in solving federal-state conflicts is not always present, but depends on whether or not the states are politically affiliated to the centre. The three forces above explain the nature of the political system and their impact on the conduct of fiscal federalism in Malaysia, as well as overall federal-state relations. Thus, clearly, the Constitution provides only a legal 'guideline' for federal-state relations; however, the working of this 'guideline' is subject to the above forces. As a result, party competition is in practice severe, and, more often than not, the result is political antagonism towards federal political elites and the ruling party. Political antagonism could endanger federation, as federation qua federation is established in a spirit of cooperation, participation and understanding between all levels of government. Finally, the study by Yusoff (1998) on relations between the federal government and Kelantan led the opposition party (PAS) to suggest the following conclusion:

> 'Firstly, the unwillingness of both parties to cooperate reflected primary competition for power at state level. The central government was reluctant to be cooperative for fear that this would simply bring advantages to the PAS in consolidating its position within Kelantan. Similarly, the state government was wary of cooperating with the central government for fear that its position in the state might be undermined by UMNO. Secondly, the reluctance of the central government to accept the people's right to choose a party other than the party that ruled at the centre (or a willing ally) was a reflection of an abiding insecurity of power at the centre- a fear that the seeds of autonomy vis-à-vis the centre, once sewn, might take root and produce a vigorous growth that would spread to other states. It is because of this basic unwillingness that the central government punished the rakyat of Kelantan by shifting federal funds away from the centre' (Yusoff, 1998: 234)

The undesirable aspect of the financial dependence of states on the centre is that it has been used to maintain one party rule in the country. Through this mechanism, coupled with the centralisation of fiscal powers, the federal political elites can make state opposition parties fall into line with the centre. One of the arguments in favour of having a federal as opposed to a unitary form of government is that it enables an opposition party to build up its base at state level and, eventually, to win national support. However, this

practice does not work in Malaysia, as the federal political elites will turn down any attempt by any state based political party to be the champion of a state. For instance, the BN has campaigned against opposition parties in states on the grounds that if an opposition party were to win control of the state governments, the people in the states would suffer, as federal allocations / projects would not be forthcoming.[18] Even if they were forthcoming, they would be concentrated in selected areas where the ruling power had a stronghold. This was the strategy used by the BN to remain in control. This was accompanied by promises of huge projects from the federal government in the event of a BN victory, as proved when the BN successfully removed PBS from power in Sabah in 1994. This argument was repeated during the campaigning for the general election in Kelantan in 1999 (the 10th general election), in an attempt to topple the PAS government. The new Prime Minister Abdullah Badawi also made similar promises in his campaign leading up to the 11th general election (held on 21st March 2004) to win back Terengganu from the PAS control, in which he said that 'the Barisan Nasional (BN), if returned to power in Terengganu, will bring about changes never seen before in the state'.[19] He gave further assurance to the people of Terengganu that Terengganu will become a developed and successful state if administered by the BN Government. Such assurances were also echoed by the Deputy Prime Minister Najib Razak to allure people of Kelantan to vote for the BN in the 11th general election when he said that 'I am hopeful the Kelantanese will make a firm decision as the time had come for the state to be in the mainstream of national development, [and] when the BN back in power the Federal Government would be in a better position to implement all development projects planned for Kelantan'.[20] The BN politicians also constantly remind the people of the difficulty which the central government has in cooperating with opposition state governments, and how this has

[18] Prior to the 1999 Sabah state election, the centre had made a further allocation of RM50 million to Sabah constituencies for developmental purposes. When the BN won the election, another RM230 million was channelled to Sabah in the form of soft loans (see Andaya and Andaya, 2001; Yusof, 1998).
[19] *Utusan Malaysia*, 19th March 2004, 'BN will bring changes never seen before in Terengganu – PM'.
[20] *Utusan Malaysia*, 19th March 2004, ' Give us the mandate to build a new Kelantan – Najib'.

retarded development in the state. The result was as expected. In the 11th general election, the PAS government in Terengganu was toppled by the BN, while in Kelantan, although PAS still maintain its power, its influence is diminishing.[21]

Another coercive practice is that the federal political elites recognise state governments led by opposition parties only on paper (as part of democratic process) but in practice do not really recognise them. From the outset (during the process of writing the independence Constitution of 1957), the Alliance Working Party (the forerunner of the BN) foresaw the practical difficulties if different parties controlled the federal and state governments, but there was no serious consideration given to figure out a kind of federal-state political structure that would be free from federal political manoeuvre (Fernando, 2002). This was evident when the federal government set up its own federal administration in states ruled by the opposition party while at the same time the states also ran their own administrations, as can be seen in the case of the Federal Development Department (FDD) in Kelantan and Sabah (Saharudin, 1998). Although it was stated that the aim of the FDD was to bring development to states, as a matter of fact it was designed to undermine any opposition's capability to rule or to bring development to states, and so to give political leverage to the governing ruling party. 'This is like having two governments running parallel in one state at one time', said the one opposition party member (PAS) on the FDD. Politically, the federal government's move to establish the FDD was intended to prove to the people that the opposition could not be trusted to bring development to the country. Indirectly, it implied failure to recognise the opposition government, which had been selected by the people through the democratic election process. To further deprive, those states led by the opposition were not invited to the

[21] In the 11th general election held on 21st March 2004, the BN won 28 out of the 32 Terengganu's State Legislative Assembly seats contested, and swept all parliamentary seats (eight). In Kelantan, the BN won 21 out of 45 State Legislative Assembly seats, and won eight parliamentary seats out of 14 seats contested.

Council of Chief Ministers' Meeting *(Majlis Mesyuarat Menteri Besar dan Ketua Menteri)* presided over by the Prime Minister. This Council meets on a regular basis to iron out any difficulties in federal-state matters regarding socio-economic, financial, and security issues. Thus, the Council has become the exclusive club of the ruling party, instead of an instrument of executive / cooperative federalism, to foster cordial federal-state relations to benefit the citizens.[22] This is another impediment towards genuine federal relationship in Malaysia federalism.

The rationale of having the FDD is to undertake and monitor development projects in states, with federal development allocations being channelled through this department, instead of to the state government, as is the normal practice. By so doing, the centre can plan, coordinate, supervise and evaluate federal development allocations 'wisely' in states led by the opposition parties. This causes a conflict of interest between federal and state governments, especially with regard to the selection of projects to be implemented, as some projects may be considered a priority (economically and politically) to the federal government, but not to the state. There could also be conflicts over the location of the project to be implemented. Undoubtedly the establishment of the FDD was aimed at undermining the opposition's capability to bring development to the states. If the federal government were really sincere about monitoring the states' fiscal affairs, Article 95 of the Federal Constitution, which empowers the federal officer to 'inspect any department or work of a state government', could have been exercised. By setting up the FDD

[22] In Canada, the First Minister's Conference (FMC) and the Annual Premiers' Conference (APC) are presided over by the Prime Minister and attended by all Provincial Premiers, regardless of political belief. They have become fully-fledged intergovernmental meetings. In Australia, the Council of Australian Government (COAG) is a primarily intergovernmental institution, chaired by the Prime Minister and its members include all State Premiers and Chief Ministers, as well as the President of the Australian Local Government Association. Apart from the COAG, there are other forums to strengthen federal-state relations, namely, the Treaties Council (with the same membership as the COAG), the Leaders' Forum (whose membership consists only of State Premiers and Territory Chief Ministers), and Ministerial Councils. In Germany, the Bundesrat plays a very significant role as a chamber of states to protect states' rights and to foster federal-Länder relations. Also, there are a number of councils and meetings to enhance cooperative federalism, such as 'the Conference of Ministers-President', and the Land-based parliamentary group of the Bundestag (see Meekison, 2002; Leonardy, 1999).

instead, the impression is given in the eyes of people that development is coming from the federal level, not the state government. By so doing, the governing ruling party is able to gain political leverage by winning the hearts and minds of the people through 'federally monitored development projects'. Thus, the establishment the FDD is a highly political aimed at maintaining the political power of the federal elites. This entire move is motivated by strong party competition in the pursuit of one party rule in the country, by the centre.

6.3 Petroleum royalties payments: A case study of party political competition

Much has been written about federal-state conflicts resulting from political party competition, prompted by the differences in federal and state political agendas.[23] All these studies prove that strained federal-state relations will tend to surface when federal political elites are threatened, which subsequently causes federal-state fiscal conflicts. The strained relations between the federal and Terengganu government over the issue of petroleum royalties is a manifestation of political party competition that results from clashes of interest between the federal and a state's political elites. Therefore this issue deserves special attention in this study, as it has ramifications for federal-state fiscal relations in general. At the same time it proves that fiscal federalism is a political process used to maintain federal political elites and single–party dominance in Malaysia in the quest for unity in diversity. This is because, to some extent, this issue has created problems in fiscal relations in the context of fiscal federalism in Malaysia. As said in Chapter 1, the federal government action to stop payment of petroleum royalties to Terengganu is a manifestation of severe party competition. In the following section, the legal and political arguments on this issue will show whether or not the decision made by the federal government is justifiable.

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[23] See Yusoff (1998); Vejai (1998); Rais (1997); Shafruddin (1987); Salleh Abbas (1978); Lai (1968), Milne (1967).

6.3.1 Political perspectives – is this political punishment of the opposition party?

The royalties payment tussle between the federal and Terengganu governments started when the newly installed Terengganu PAS-led government (after it won a landslide victory in the 1999 general election, sweeping 28 out of the 32 seats in the Terengganu's State Legislative Assembly) made a public announcement of the possibility of requesting the PETRONAS and federal government to increase the rate of petroleum royalties from the current 5% to around 20%. With the current rate of petroleum royalties, Terengganu would easily receive almost RM1 billion in 2000, following higher petroleum prices. For Terengganu, the petroleum royalties, which had been enjoyed for more than twenty years, contributed more than 50% of its total revenue. Since the first royalties payment in 1978, the total petroleum royalties payments received by Terengganu amounted to RM7 billion. Thus, the termination of the royalties payments had serious financial implications for the Terengganu PAS-led government. In this section, the decision to terminate the royalties payments will be discussed to see whether it was a *bona fide* or politically motivated. For simplicity, investigation of the federal government's point of view will be made first, followed by Terengganu's response then conclusions will be drawn on this issue by comparing the experience faced by the state of Sabah during the PBS-led government.

The initial response by the federal government to the PAS-led Terengganu government's proposal to request higher royalties payments was quite accommodating. The Prime Minister promised to review the whole structure of petroleum royalties payments. However, the promise turned into a political wrangle when the Prime Minister argued that the royalties payments made to Terengganu thus far had been a mistake. He said, 'I think this was a mistake because Terengganu was previously ruled by UMNO and we did not consider carefully the rights of the states in the peninsula to get royalties. As such, we believed that Terengganu was a poor state.'[24] He further asserted, 'We also thought then

[24] *The Star*, 30th June 2000

that our oil reserves were too small and that we would be paying Terengganu at the most RM 50 million in royalties. We were not that thorough. However, the royalties has now increased to RM 800 million and if the trend continues (oil price increases), we will be paying the state RM 1 billion in royalties in year 2000'.[25]

Following this statement, the former Terengganu Chief Minister (Wan Mokhtar Ahmad), who was defeated and his government toppled by the PAS government in the 1999 general election, and who had signed the royalties agreement between PETRONAS and state of Terengganu on 22nd March 1975, issued a statement saying that, 'it is not so much an agreement but more of an understanding based on the federal government's policy of compassion. Terengganu was very backward and this prompted the federal government to extend aid in the form of royalties on compassionate grounds'.[26] But more significant was his statement that 'furthermore, both the federal and state governments then were from the Barisan Nasional'. What this implies is that if different political parties rule at the federal and state levels, the states will be subject to various difficulties such as those experienced by Terengganu's PAS-led government.

In response to the former Terengganu Chief Minister, the President and Chief Executive of Petroleum Nasional (PETRONAS), Hassan Marican, revealed that the petroleum royalties payment to Terengganu was based on an agreement signed on 22nd March 1975 whereby 'for as long as oil and gas is produced, royalties will be paid to the state and the royalties amount, accrued or due is RM810 million, which is 5% of the value of oil and gas produced'.[27] Thus, the royalties payment to the Terengganu had a legal basis. The agreement entered between PETRONAS and the Terengganu government on 22nd March 1975 referred to 'the cash payment to be made by PETRONAS to the government in return for the ownership and the rights, powers, liberties and privileges vested as

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[25] *The New Straits Times*, 30th June 2000
[26] *Utusan Malaysia*, 28th June 2000
[27] *The Star*, 30th June 2000

aforesaid in respect of petroleum'. This agreement was to give effect to Section 4 of the Petroleum Development Act 1974.[28] Section 1(1) of the agreement proved Hassan's statement; it says that 'PETRONAS shall make to the government cash payment in the form of a yearly sum amounting to the equivalent of five percent of the value of the petroleum won and saved in Terengganu and sold by PETRONAS or its agents of contractors...' and section 3 says 'It is agreed and declared that the cash payment payable under this Agreement shall be payable only for so long petroleum is obtained ...'. His statement was a response to the allegation made by the former Terengganu Chief Minister that no agreement had been made with regard to petroleum royalties. Following this development, the Terengganu PAS government declassified confidential documents related to petroleum royalties to let the public know the actual position of the issue. Based on this agreement, PETRONAS was to pay the Terengganu government 5% of the total production of oil and gas in two instalments, the first on or before the first day of September, and the second on or before the first day of March of the following year.[29]

In September 2000, the Prime Minister made another statement saying that no such 'petroleum royalties payment' to the Terengganu government existed. What had been

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[28] See Appendix iv of the thesis

[29] The computation of petroleum royalties, as stated in the second agreement between PETRONAS and the Terengganu government entered on 16th September 1987, was as follows:

i) For payment of 1st half of nth year (paid in September)

$R = [0.05 \{(T^n)*(D^n)*(Pp)*(Xr)\}]$

where:

- R = royalties payments
- T^n = average production rate (barrel per day –bpd) in the 1st half of nth year
- D^n = number of days in the 1st half of nth year
- Pp = average petroleum price (in $US per barrel)
- Xr = exchange rate (USD/RM)

ii) For payment of 2nd half of $(n^{-1})^{th}$ year (paid in March of the following year)

$R = [0.05 \{(T^{n-1})*(D^{n-1})*(Pp)*(Xr)\}]$

where:

- R = royalties payments
- T^{n-1} = average production rate (barrel per day –bpd) in the 2nd half of $(n^{-1})^{th}$ year
- D^{n-1} = number of days in the 2nd half of $(n^{-1})^{th}$ year
- Pp = average petroleum price (in $US per barrel)
- Xr = exchange rate (USD/RM)

paid hitherto was a *'wang ihsan'* (compassionate payment), as Terengganu at that time (1975) was the poorest state and, more importantly, it was under the BN. There is a significant difference of interpretation between the terms 'compassionate payment' and 'royalties payment'; the former refers to a payment made solely at the discretion of the federal government, that is, it is not compulsory for it to be made if the federal government wishes not to do so; while the latter is a compulsory payment based on legal standing, which is the right of the state. With the Prime Minister's statement, the royalties payment was officially ended and replaced by a compassionate payment. The federal government argument for granting 'petroleum royalties payment' or 'compassionate payment' to Terengganu from 1978 to 1999 on the ground that Terengganu was the poorest state is arguable because Kelantan was the poorest at that time. The real reason was the fact that Terengganu at that time was under the BN and, therefore the federal government was more 'cooperative and concerned' with the well-being of the former BN-led Terengganu government. The federal government's argument for denying petroleum royalties payment is that, the oil was found offshore, and so the federal government claimed Terengganu had no right to it.

> 'Terengganu has no rights to such payments (petroleum royalties). All this while, what we gave Terengganu was based on compassion because it was once the poorest state in the country. It is true the payment was referred to as royalties, but in truth, Terengganu has no such rights because the oil comes from offshore and under the law of the country, everything that comes from offshore belongs to the federal government' (Dr. Mahathir Mohammed).[30]

Following the Prime Minister's statement, the de facto Law Minister, Rais Yatim, on 29th October 2000, declared that the agreement on the cash payment between PETRONAS and Terengganu entered on 22nd March 1975 was 'null and void'. He claimed that 'when one party revokes the agreement by not following the terms contained in it, it automatically causes the agreement to be invalid and ineffective'. Hence, the agreement was automatically nullified, as one side no longer observed any of the conditions

[30] *The Star*, 8th September 2000

mutually agreed upon. What is surprising in this statement is that the agreement was revoked by the federal government (the sole stakeholder in PETRONAS) and not by PETRONAS, which signed the agreement with the Terengganu government. According to Rais Yatim, the decision to revoke the agreement was based on the law, that is, the PDA 1974 and the Continental Shelf Act 1966, which stipulated that states (including Terengganu) were not eligible to receive a cash payment in respect of resources found outside three nautical miles from states' territorial waters. With the annulment of the agreement, the state of Terengganu now did not have a right even to royalties payments for oil and gas found onshore of Terengganu, although the original dispute was only regarding oil found offshore. However, there was no exchange of words regarding oil found onshore as, thus far, all oil fields had been found outside the three nautical miles limit. This move clearly amounted to a breach of contract. However, 'it is up to the Terengganu government to accept it as an official and final decision. The state government is free to take legal action if they are not satisfied with the decision' (Rais Yatim).[31] Rais Yatim further affirmed that the government decision was not politically motivated.

What is implied here is that when a different political party (opposition party or non-coalition party component) rules Terengganu (or any other state), federal-state relations becomes strained and 'uncompassionate'. The possibility of paying a high petroleum royalties to Terengganu's PAS government was viewed by the centre as politically dangerous, due to the possibility that 'PAS might use the royalties payment to finance political activity of PAS government which can further strengthen opposition influence in neighbouring states, which could possibly threaten the BN government', as admitted by the one ruling party member. Thus, the main concern of the UMNO leaders (the main component of the BN coalition) was that Terengganu might turn out to be the launch pad

[31] *The Star*, 30th September 2000

for a greater PAS role in national politics. As discussed above, UMNO and PAS are bitter rivals in their contest for the Malay mandate and this action revoking the petroleum royalties was a way to derail the opponent from success in mainstream politics. The amount of royalties to be received by Terengganu in 2000 would have been very large, in view of high oil prices, which led the federal government to decide to review its policy of giving petroleum royalties, for fear that the large amount of money to be received by the Terengganu PAS-led government would be used wrongly to finance PAS activities, and so to strengthen and subsequently further spread the PAS influence to other states, especially to Pahang and Kedah, which have strong PAS support. This clearly contradicted the spirit of Article 4 of the PDA.

In order to regulate the disbursement of 'compassionate payment', the federal Government, through the Ministry of Finance (MOF), formed a committee known as the *Jawatankuasa Peringkat Pusat* (the Federal Level Committee (FLC)) on 5th September 2000. The main function of the FLC is to manage and monitor the disbursement of 'compassionate payment' so that it would directly benefit the people of Terengganu. A statement issued by the MOF revealed that the motive for the establishment of the FLC was that 'the federal government is less confident in the PAS state government's ability to co-operate in assuring prosperity and welfare of the people of the state',[32] unlike the previous BN government, which had 'successfully transformed' Terengganu from the poorest state to a fairly developed state, through its development programmes.[33] Therefore, it was claimed, the FLC was needed to ensure prudent spending that could directly benefit the people of Terengganu. However, this move is against democratic practices, as the FLC is not backed by a mandate of the people of Terengganu, unlike the Terengganu government, which was formed by people who gave their mandate through the democratic process of election. Before this, cash payment received from PETRONAS

[32] *The Star*, 6th September 2000
[33] *The New Straits Times*, 6th September 2000.

was treated as state revenue. Hence, it went to the State Consolidated Revenue Account, money from which could be used to finance annual expenditures, once the State Annual Budget had been tabled and approved by the State Legislative Assembly. This is in line with the Federal Constitution and the Financial Procedure Act, 1957.

However with the termination of the royalties payment to Terengganu, the cash payment paid by PETRONAS is now credited to the federal government Consolidated Revenue Account, and so becomes federal government revenue instead of going to the state of Terengganu's Consolidated Revenue Account. Any cash payment to be used by the FLC will be drawn from this federal government Consolidated Revenue Account. Earlier, the federal government had announced that cash payment (to be paid to Terengganu) would be credited to a special Trust Fund under the MOF. However, when the 2001 Budget was tabled and approved by Parliament, 'cash payment' received from PETRONAS was not credited to the Trust Fund. Up to now, the amount of 'compassionate payment' supposed to be paid to the Terengganu government was far too low; only RM150 million has been disbursed through the FLC to finance various development programmes - town and rural roads, water and power supply, low-cost housing for fishermen and hardcore poor, loans for the purchase of fishing boats and related equipment, bursaries and schooling aid. The federal government's move to stop cash payment and replace it with 'compassionate payment' channelled through FLC has caused great discontent and resulted in much anti-federal feeling by the PAS-led Terengganu government and the people of Terengganu, as it is a form of federal interference in the state's fiscal affairs that severely affects the administration and implementation of development projects. Clearly, the establishment of the FLC was politically motivated, although this was denied by federal political elites, as they did concerning the formation of FDD in Kelantan.

Terengganu government's response to the federal government action of terminating payments of petroleum royalties was reflected in a press statement by Hadi Awang, the *Menteri Besar* (Chief Minister) of Terengganu. He bemoaned that

> 'the leadership of the central government is a leader who does not understand the concept of federalism, the basis of the existence of Malaysia, whereby the principle of respect between the constituent members in the Federation of Malaysia needs to be preserved, respected and maintained'.[34]

According to the Terengganu Executive Councillor, Tun Salleh Abbas, the former Lord President and a key person in the drafting of the Petroleum Development Act 1974, the federal government has no right whatsoever to deny petroleum royalties payment to the PAS-led Terengganu government.[35] He confirmed that the cash payment should be made to Terengganu, as well as to other states if oil is found in them. No question arose as to whether or not Terengganu was the poorest state at the time of the agreement. The treatment of states in the federation with regard to cash payment should be equal, in the eyes of the law. Nik Aziz, the Chief Minister of the PAS-led Kelantan government asserted that if the basis of the cash payment to Terengganu was because Terengganu was the poorest state, then Kelantan, which is poorer than Terengganu, should also be entitled to cash payments. Hence, he claimed that the federal government's move to stop cash payment to Terengganu is contrary to a legal contract and to the Federal Constitution. The channelling of cash payment through the federal authority, namely the FLC, formed by the federal government, is obviously counter to the principle of democratic government.

The Terengganu PAS-led government claimed that the former BN government spent money from petroleum royalties wastefully, as the state is still RM700 million in debt despite receiving RM7 billion in petroleum royalties since 1978. The former BN government spent money on unnecessary ventures such as the construction of high-rise

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[34] *The Chief Minister's Office, Terengganu, 2000.*

[35] This information was obtained from *Warta Darul Iman* (the Information Secretariat, Government of Terengganu), 8th October 2000.

buildings and investing in problem-ridden companies, in particular, in the controversial Perwaja Steel which incurred RM3.5 billion losses, and bailing out the now defunct steel company (Gunawan Iron and Steel). Therefore, the federal government should investigate the financial misconduct by the former BN government, rather than penalising the barely one-year-old PAS government.[36]

Disgruntled with the federal government move, the PAS-led Terengganu government finally filed a lawsuit on 8th March 2002, which reneged on agreements made on 22nd March 1975 and 16th September 1987, for a once-and-for-all solution. Terengganu named PETRONAS as the first defendant and the federal government second. In the lawsuit, the Terengganu government claimed that PETRONAS and the federal government's non-payment of petroleum royalties, totalling RM850 million, amounted to a breach of contract. The state insisted that the defendants honour the agreement.

> 'The suit against PETRONAS is to get it implement the agreement by paying petroleum royalties to the Terengganu government, while the suit against the federal government is for using its power to interfere in the implementation of the agreement'. 'We will also claim damages for loss suffered due to the interference (by the federal government) which resulted in projects and administration being affected' (Wan Abdul Mutalib Embong, Senior State Executive Councillor).[37]

In the first court hearing on technical issues in the Kuala Lumpur High Court on 19th February 2001, the court ordered PETRONAS and the federal government to deliver written submissions. Earlier in its defence, PETRONAS argued that it need not make any payment (since the September 2000 payment owing to Terengganu amounted RM850 million) on the grounds that oil was obtained outside the state's territorial waters. The federal government in its defence argued that all payments to Terengganu since 1978 were to be deemed as *wang ihsan* (compassionate payment) and not royalties payment as claimed by the Terengganu government. Counsel for the Terengganu state government, Tommy Thomas, said 'Despite its failure to make the said cash payments to the

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[36] *Warta Darul Iman*, (the Government of Terengganu Information Secretariat), 8th October 2000
[37] *Utusan Malaysia*, 8th January 2001

Terengganu state government, PETRONAS continued to make similar cash payments to other state governments and in particular to the state governments of Sabah and Sarawak'.[38] In other words, discriminatory action was practised by PETRONAS, by denying Terengganu cash payment for oil and gas harvested in Terengganu. The Terengganu counsel also claimed that the federal government, the stakeholder of PETRONAS, acted in bad faith when it directed PETRONAS to desist from making more payments to the PAS-led Terengganu government after the BN-led Terengganu government was defeated by PAS in the 1999 general election. As Counsel Tommy Thomas claims,

> 'The federal government, acting through the Prime Minister and members of the Cabinet, brought to bear the issue of party politics in the wake of the 1999 general elections results which saw the replacement of the BN government of Terengganu with that by members of a rival political party, PAS. The actions of the federal government and its agents and servants were oppressive, arbitrary or unconstitutional' (Counsel Tommy Thomas).[39]

On 29th August 2002, during a second court hearing, the High Court ruled that the Terengganu government should be given an opportunity to proceed with its suit against PETRONAS and the federal government for non-payment of petroleum royalties. Under the ruling, the plaintiff can now call its witnesses to give evidence before a trial judge. The issues to be determined include: first, whether Terengganu had any right under the law to petroleum obtained adjacent to the state's coast, subject to the enactment of the PDA 1974, and the execution of the agreement dated 22nd March 1975, between Terengganu and PETRONAS; second, whether the Terengganu government has any rights to petroleum obtained off its coast via the vesting instrument and the agreement dated 22nd March 1975; and third, whether the Terengganu government was entitled to payment in respect of petroleum obtained off its coast under Section 4 of the PDA 1974. However, as expected, the High Court decisions on the determination of preliminary legal issues in the oil royalties suit were unwelcome by the defendants, and subsequently

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[38] *Harakah*, 20th February 2000. 'Oil Royalties: Petronas acted double standards'.
[39] *Harakah*, 20th February 2000. 'Oil Royalties: Petronas acted double standards'.

both filed appeals against the decisions. On 26th July 2003, the Court of Appeal retained the judgment made by the High Court in the appeals brought by defendants.[40] However, on 29th August 2003, the Court of Appeal issued a new judgement that the High Court now would have to hear submissions from all parties before deciding if the case should be heard in full trial (as preferred by the Terengganu government) or could proceed by way of preliminary issues alone (that is, whether Terengganu had any right under the law over the petroleum obtained adjacent to the state's coast), as preferred by both defendants. However, until now no further hearing has occurred. Based on the latest development, that is, after the BN regain power from PAS, the new Chief Minister of Terengganu is likely to withdraw the legal suit put forward by the former PAS government.[41]

The conclusion drawn over termination of petroleum royalties payment to Terengganu, from a political viewpoint, is that it was clearly politically motivated, although this was denied by the federal government. From the outset, the federal political elite felt that their authority was being challenged and their popularity diminished when PAS won a landslide victory in Terengganu and Kelantan, especially after it suffered a decline in popularity in some states like Kedah and Pahang in the 1999 general election. Clearly, the PAS strength was increasing and federal political elites believed that this would bring political catastrophe to Malaysia if PAS influence were not curtailed. As an opposition government made wealthy by the large contribution received from petroleum royalties, Terengganu had become a threat to the federal political elites. Indeed, it was because the amount of petroleum royalties was so large that the federal government revised the policy of giving royalties, in fear that the large amount of money to be received by the PAS Terengganu government would be used wrongly to finance PAS activities, and spread PAS influence to other states.

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[40] *Utusan Malaysia*, 27th July 2003

[41] *Utusan Malaysia*, 31st March 2004, 'Oil royalties case: Comprehensive study to be carried out'

In short, the action of the federal government was intended to undermine the PAS-led administration. If this argument is correct, then the statement by Yusoff (1998: 233) that 'when a state was not viewed as being in line with the priorities of the federal leaders, clearly it risked becoming a target for financial sanction' is supported. This indicates that the decision to terminate the petroleum royalties payment had an element of political vindictiveness. Looking at the chronology of events leading to the decision to stop petroleum royalties, it is clearly evident that the decision was made amid strained political relationships between the UMNO and PAS after the1999 general election. This event was a huge blow to the UMNO, the largest component party in the BN. If the PAS influence was not curtailed early, it might cause a 'domino effect' in which all adjacent states would fall to the opposition party (or coalition of opposition parties – *Barisan Alternatif* (Alternative Front)).[42] If this happened, the incumbent ruling party would not be able to maintain a two-thirds majority in Parliament. Thus, it would be politically wise to cut PAS's source of finance, so that the domino effect would not take place. As expected, in the 11th general election held on 21st March 2004, the BN successfully toppled the PAS government in Terengganu with more than a two-thirds majority.

From the above discussion, there are at least five important issues that need to be observed and investigated. First, the denial of the petroleum royalties payment to Terengganu by the federal government was on the basis that 'oil comes from offshore and under the law of the country, everything that comes from offshore belongs to the federal government'. Second, the right of states in relation to oil found inland and offshore of the respective states, set out in the agreement for cash payment, has been annulled by the federal government. Both these issues can only be resolved by legal

[42] The Alternative Front (Barisan Alternatif – BA) was formed in 1999 by three major opposition parties – PAS (the Islamic based party), Parti Keadilan (formed to fight for justice for the former Deputy Prime Minister Anwar Ibrahim) and DAP (largely Chinese based opposition party). The aim of the BA was to challenge the BN in the 1999 general election.

interpretation of the Federal Constitution and related act. Third, why has there been no investigation initiated against the former BN-led Terengganu government on the allegation by PAS that petroleum royalties was spent wastefully on unnecessary ventures? Fourth, why did the federal government realise that the petroleum royalties payment to Terengganu should be stopped only after the BN had failed to retain its power in Terengganu, after 22 years in office? Fifth, would the federal government have continued to pay petroleum royalties or cash payment or compassionate payment to Terengganu if the BN had won the 1999 general election and will it do so after winning a landslide victory in the 11th general election? The answers to the last three questions relate to the fact that the former Terengganu government was politically affiliated to the centre, while the PAS is an opposition. Based on the Prime Minister's assurance, it is expected that huge petroleum moneys (in cash or in kind) will flow again to Terengganu after the BN regain power in Terengganu after the 11th general election. The Prime Minister assured, 'I wish to pledge that the federal government will help the Terengganu so that the state government will not face financial problems in ensuring the success of the development programmes'. [43]

Although the modus operandi on the decision to cease royalties payment seems to be politically motivated, the federal government claimed its decision has a strong legal standing. Hence, it is necessary to examine from a legal standpoint the question of states' rights to royalties in respect of petroleum discovered and obtained offshore and on the continental shelf, to see whether or not the federal government's claim to stop royalties payment has a legal basis.

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[43] *Utusan Malaysia*, 29th March 2004. 'Abdullah directs Terengganu to implement development agenda'. After regaining power in Terengganu, the BN government also announced it would continue construction of the second phase of the East Coast Highway from Kuantan, Pahang to Chendering, Terengganu, costing RM1.6 billion. This project was put on hold during the PAS time in government due to political strife. The new BN Chief Minister of Terengganu also announced that new airport will be built costing RM1 billion. (*Utusan Malaysia*, 8th April 2004).

6.3.2 What is the state's right? Legal perspectives

As the petroleum sector became increasingly important to the Malaysian economy, the federal government determined to review its petroleum policy and to consider the possibility of exercising greater centralised control over the petroleum industry (Adnan, 1978). It was not until 1964 that the Malaysian government began to realise the importance of proper regulation of the petroleum industry in Malaysia. The Malaysian government appointed Levy in 1964 to study and make recommendations on an appropriate future plan for effective development of the petroleum industry in Malaysia (Meng, 1984; Adnan, 1978). Of particular importance, Levy was assigned to recommend additional constitutional rights for the federal and state governments following new regulation of the petroleum industry.

Before Malaysia was formed in 1963, each state had its own legislation to regulate the petroleum industry. However, the Levy Report recommended harmonisation of petroleum legislation for proper future development of the petroleum industry in Malaysia. The Levy Report stated that, 'from an administrative point of view, and also from the point of view of an oil company engaged in exploration (or deciding whether or not to apply for exploration rights) in the various parts of Malaysia there would be considerable attractions in the simplicity of single hold petroleum agreement designed for universal application throughout Malaysia'.[44] This means that all aspects of petroleum legislation, including the right of states to receive royalties, would be reviewed and harmonised. It is vital therefore to focus on the right of the states to receive petroleum royalties based on historical and legal arguments, as this is an important issue that affects federal-state fiscal relations.[45]

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[44] Levy Report, Para 48, Page 32, cited from Meng (1984).

[45] Information contained in this section was partly obtained from discussion with the officials from Petronas on 14th April 2000 while I was working with the Ministry of Finance.

The initial arrangement over petroleum royalties before Malaysia was formed in 1963 was quite different between states in peninsular Malaysia and the states of Sabah and Sarawak. Petroleum royalties payment to states was closely related to the issue of the derivation of petroleum, that is, whether it was found onshore or offshore. A legal tussle emerged when petroleum was found offshore of the respective states, as there was no clear legal demarcation between onshore and offshore. There was a significant difference between interpretations of offshore between the states in peninsular Malaysia and Sabah and Sarawak. 'Offshore' is defined based on jurisdiction over the continental shelf. States in peninsular Malaysia did not have jurisdiction over the continental shelf, unlike the states of Sabah and Sarawak, as will be shown shortly. For states in peninsular Malaysia, the definition of state land, under Chapter 138 of the Land Code (1928), 'including the foreshore and bed of the sea within the territorial waters' of the respective state. However, the boundary of territorial waters was not precisely defined, but following customary international law, it was recognised as three nautical miles from the low water mark. Section 2 of the Interpretation and General Clauses Ordinance, 1948, defined territorial waters in relation to any territory as the inland waters of the territory and part of the sea adjacent to it. However, Ordinance No. 7, 1969, declares that the breadth of the territorial waters of Malaysia should be 12 nautical miles. Therefore, based on this legal interpretation, the rights of the peninsular states to the ownership over petroleum resources in states lands (defined to include the adjacent territorial waters) is extended to rights over the petroleum resources in the territorial waters only, not on the continental shelf. When the Federation of Malaya was formed in 1948, the right / jurisdiction over the continental shelf, including petroleum resources, was given solely to the federation.[46] The operative legislation governing the petroleum industry in Malaysia was the

[46] This argument is true as reflected in the Petroleum Mining Act 1966 and the Continental Shelf Act, 1966. These acts governed petroleum exploitation in the states of peninsular Malaysia until the Petroleum Development Act, 1974 was promulgated. However, these two acts were not made applicable to the states of Sabah and Sarawak.

Petroleum Mining Act, 1966 and the Continental Shelf Act, 1966. However, these acts were not extended to Sabah and Sarawak, since both states had their own separate legislation governing the exploitation of petroleum resources, not only onshore but also on the continental shelf. Taking a strict interpretation of the law, thus, it is legally sufficient to say that the states in peninsular Malaysia (including Terengganu), at least at that time, did not have any right over petroleum in the continental shelf, unlike the states of Sabah and Sarawak. In order to harmonise legislation governing the exploitation of petroleum resources, the Emergency (Essential Powers) Ordinance No. 10 (1969) (which was promulgated by the Yang di-Pertuan Agong on 7th November 1969 following the outbreak of a communal crisis on 13 May 1969 and subsequently by national emergency on 15 May 1969), amended the Continental Shelf Act, 1966 and the Petroleum Mining Act, 1966 on 8th November 1969 to include Sabah and Sarawak. To give effect to this amendment, the Emergency (Essential Powers) Ordinance No. 11 (1969) was instigated, which limited the territorial water of states (including Sabah and Sarawak) to three nautical miles from the low water mark. With the amendment of the Petroleum Mining Act, 1966 'all rights with respect to the exploration of the continental shelf and exploitation of its natural resources are hereby rested in Malaysia and shall be exercisable by the federal government'.[47]

However, the legal background over the right of the states of Sabah and Sarawak to petroleum found offshore / in the continental shelf is significantly different from that of their counterparts in peninsular Malaysia. The states of Sabah and Sarawak had a right over petroleum found offshore / in the continental shelf since before they joined the federation in 1963. It evolved from 1954, when the British parliament passed two Orders-in-Council, the Sarawak (Alternation of Boundaries) Orders-in-Council No. 839 of 1954, and the North Borneo (Alternation of Boundaries) Orders-in-Council No. 859 of 1954, to

[47] Section 3 of the Petroleum Mining Act (amended 8th November 1969).

define the boundaries of these states. Subsequent to this, another two Orders-in-Council were passed, the North Borneo Orders-in-Council No. 1960 of 1960 and the Sarawak Order-in-Council No. 402 of 1962, which altered and determined the boundaries between Sabah and Sarawak. With these Orders-in-Council, the boundaries of Sabah and Sarawak were extended to include not only the territorial seas but also the submarine area of the continental shelf adjacent to the two states. In 1956, the Sabah government amended its Land Ordinance (Chapter 68) to give effect to the North Borneo (Alternation of Boundaries) Orders-in-Council No. 859 of 1954 by including, inter alia, a provision enabling the state to grant licences or leases for oil exploration. In 1958, Sarawak enacted the Oil Mining Ordinance (Cap. 85), empowering the government to issue licences or leases for oil exploration in any land. Under the Sarawak Land Ordinance, land was defined to include the foreshore and submarine areas beneath Sarawak waters and also the areas of the continental shelf. Hence, these two states had legal claims and exercised sovereign rights over their respective continental shelves from the Order in Council Alternation of Boundaries for Sabah and Sarawak 1954.

However, as discussed above, no such Orders-in-Council were made to define the territorial waters or the submarine areas of the continental shelf for the states of Peninsular Malaysia. As such, the jurisdiction of states of peninsular Malaysia over petroleum found in their territorial waters is limited to three nautical miles from the low watermark, while the jurisdiction of the states of Sabah and Sarawak is not confined to the territorial waters but also includes the continental shelf. This implies that for Sabah and Sarawak, the right to petroleum royalties extends to the continental shelf, and even when they joined the federation, the right remained unchanged.

However, when the Continental Shelf Act, 1966 and the Petroleum Mining Act, 1966 were amended on 8th November 1969 and extended to both states of Sabah and Sarawak

in order to harmonise regulations governing the exploitation of petroleum industry, a legal battle emerged between the federal government and the states of Sabah and Sarawak. In particular, the states of Sabah and Sarawak were unhappy about the harmonisation of legislation on petroleum by which the states lost their rights over petroleum resources found on the continental shelf. The Sarawak government claimed that, by virtue of the Orders-in-Council, both Sarawak and Sabah had jurisdiction and rights not only over their territorial water but also over the continental shelf. They also claimed that these areas still belonged to the states, and hence the position remained unchanged, even when they joined the federation. The Sabah government was initially inclined to accept the federal government's views favouring harmonisation, but later followed Sarawak's stand.

In response to the Sarawak government's claim, the federal government stood by its view that, constitutionally, on entry into Malaysia, Sabah and Sarawak had lost jurisdiction over their continental shelf, which therefore passed into hands of the federal authorities. Following a legal tussle between the federal government and states of Sabah and Sarawak, a series of negotiations were held to resolve the constitutional and legal hurdles, but were suspended following a declaration of national emergency on 15th May 1969 in response to the outbreak of communal disorder on 13th May 1969.

Hence, before 1969, the rights of the states to exercise jurisdiction and claims of ownership to the petroleum resources in the offshore areas were not uniform: the states in peninsular Malaysia did not have a right over the continental shelf, in contrast to the states of Sabah and Sarawak that did. But after 1969, with the amendment of the Continental Shelf Act, 1966 and the Petroleum Mining Act, 1966, the previously distinct legislation governing petroleum exploitation for Malaysia was harmonised. This harmonisation of legislation brought about the desired uniformity of the legal status of

Malaysia's continental shelf (Moorthy, 1982). However, the Mining Ordinance of Sabah, the Oil Mining Ordinance of Sarawak and other state laws in force in Sabah and Sarawak continued, except in relation to the exploration, prospecting or mining for petroleum offshore, as it was handed over to the federal government through the Petroleum Mining Act 1966 (amended 1969).

In 1974 a further step to regulate the petroleum industry in Malaysia was made when Parliament passed the Petroleum Development Act (PDA), in which the management of the petroleum industry was conferred on the federal authority known as Petroleum Nasional or PETRONAS. Among other goals, PDA aimed at effective management in the development of the petroleum industry in Malaysia. Of particular importance is the fact that the PDA provided for payment to be made (PDA Section 4) to state governments based on the derivation principle, that is, when petroleum was found onshore and offshore of respective states, payment was to be made to compensate them for handing over ownership of petroleum resources to this newly formed federal authority. To give effect to this section, thirteen agreements were signed between PETRONAS and the state governments.[48]

As discussed above, the legal interpretation regarding offshore territories was still not resolved, notably with regard to claims by Sabah and Sarawak that their right of petroleum resources stretched over the continental shelf, unlike that of the states in peninsular Malaysia, following the proclamation of a national emergency in 1969. Hence, the Sabah and Sarawak governments challenged the action of the federal government to centralise / harmonise the ownership of petroleum resources through the PDA, 1974. As a result, a legal wrangle over petroleum re-emerged, which it was perceived could affect

[48] Agreements were signed between PETRONAS and thirteen state governments: Penang (14th March), Terengganu, (22nd March), Sarawak (27th March), Malacca (23rd April), Perlis (25th April), Kedah (26th April), Perak (26th April), Kelantan (9th May), Negeri Sembilan (12th June), Johor (24th June), Pahang (11th September 1975), Selangor (1st June), and Sabah (14th June 1976).

the solidarity of the infant Federation of Malaysia. This issue clearly caused serious tension between Sabah and Sarawak and Kuala Lumpur. According to Tun Salleh Abbas (the former Lord President / Attorney General), Sabah and Sarawak claimed sole ownership over the continental shelf on the grounds that they had enjoyed such a right before they joined the federation in 1963.[49] Based on this claim, in 1974 the government of Sarawak threatened to file a lawsuit against the federal government. This caused a fear among the federal political elites that Sabah and Sarawak would follow in the steps of Singapore. Indeed, this was construed as a second threat to the solidarity of the federation after the departure of Singapore in 1965. Tun Salleh Abbas described the situation at that time as 'tense and critical'. To solve the problem, the late Tun Abdul Razak (then the Prime Minister) directed Tun Ismail Ali (the former Governor of the Central Bank), Tengku Razaleigh Hamzah (the former Minister of Finance) and Tun Salleh Abbas (then the Attorney General) to find a political solution to the issue. Finally, both states accepted the political solution offered by the centre after they agreed to withdraw their total claim over the continental shelf but limited only to petroleum and subsequently; both states agreed to hand over it to PETRONAS. In return, PETRONAS agreed to make cash payments for oil found onshore and on the continental shelf of Sabah and Sarawak.

However, according to Tun Salleh Abbas, the word 'royalties' was not used at that time, as it was too sensitive to Sabah and Sarawak because they had just lost their rights to royalties to the federal government. Subsequently, the late Tun Abdul Razak agreed that cash payments should be made not only to Sabah and Sarawak but also to all states in the federation. This settlement became the basis of states' rights over petroleum found on the continental shelf. However, there was no agreement signed regarding this settlement; it was only de facto, not de jure. Therefore, the states in the federation did not have 'legal ownership' over the petroleum found on the continental shelf.

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[49] This information was obtained from the *Warta Darul Iman* (the Information Secretariat, Government of Terengganu), 8th October 2000.

6.3.3 The economic perspective

The literature on intergovernmental fiscal relations with regard to the division of natural resources in the federation suggests that, for reason of efficiency and equity, it would be wise to assign natural resources to the centre to achieve balanced development, as well as for allocation and redistributive purposes (Mc Kenzie, 2002; Tanzi, 2001; Mieszkowski, 1983). According to Mieszkowski,

> 'as natural resource endowments are very unevenly divided between states and are relatively immobile, provincial taxation of minerals will cause a misallocation of labour and capital within the federation if mobile factors migrate to the taxing states to obtain their share in mineral rents. The centralisation of mineral taxes will eliminate this problem' (Mieszkowski, 1983: 129).

However, McKenzie (2002) suggest that states should also be given a fair share of non-renewable resources extracted within states boundaries for compensation of revenue losses and for other externalities (such as environmental damage) to maintain harmony and cooperation within federation. There are many options to do this, such as through royalties payment, resource rent tax, or by allocating a certain share of the revenue derived from petroleum tax levied by the federal government, based on the derivation principle. The federal government's share would then be allocated to other states across the federation who were not endowed with natural resources, either through nationally provided public goods and services or federal transfers as part of redistribution programme (equalisation), or a combination of both. Hence, based strictly on economic efficiency and equity, petroleum royalties would be best managed by the federal government and, in return, distributed to the states.

However, in the case of Malaysia, petroleum royalties were given to states based on the derivation principle, that is, only producing states would receive any royalties. As discussed in Chapter 2, there is an inherent danger within the derivation principle (Bahl and Linn, 1994). Derivation could undermine the objective of distribution policy to overcome inequality, as there is a tendency to promote and exacerbate invidious interstate disparities - states are rewarded not on the basis of any superior productive or revenue

mobilization effort, but on the basis of the geographical advantage. This could undermine the national economy and the political integration of the federation. As a result, it is doubtful that nationwide redistributive and macroeconomic reforms can be implemented effectively. To resolve this problem, the practical alternative is to allocate the federal government's share of revenue from royalties and petroleum taxes to states across the federation under an equalisation programme or intergovernmental transfers based on a revenue pooling arrangement.[50]

Thus, based on a strict economic argument, the federal government's decision to stop petroleum royalties payments to a state supports the economic hypothesis that, for efficiency and equity considerations (redistribution objectives), petroleum royalties are best managed by the federal government. To avoid a severe development gap between well-endowed states and those less fortunate, revenue from natural endowments should be centralised and, in return, the federal government should undertake the redistribution of these revenues to all states. By doing so, it could avoid the well-endowed states becoming richer while less endowed states become or continue impoverished. Alas, since the centralisation of petroleum royalties, states are still experiencing financial difficulties, and hence, the centralisation of petroleum royalties remains dubious from the economic efficiency viewpoint. However, in the light of Malaysia's political and party system discussed above, the centralisation of petroleum resources would have given political leverage to the federal political elites in the struggle for power. Conceivably, this is why petroleum payments to the Terengganu government were stopped, while at the same time the states of Sabah and Sarawak continued to enjoy similar payments.

6.4 Conclusion

The foregoing discussion has unveiled the significance of the political and party systems in shaping the conduct of fiscal federalism in Malaysia. In particular, the working of

[50] See section 2.3.3 of Chapter 2

fiscal federalism depends on the extent of political cohesion at the federal and state levels. When political cohesion is strong at federal and state levels, federal-state fiscal relations will work well. Riker (1975) asserts that if the political system is over-centralised, any bargaining involving federal-state fiscal relations will favour the centre, and hence the fiscal structure will be more centralised.

The preceding analysis of Malaysian politics and the party system proves that the working of Malaysia's fiscal federalism depends not only on the Constitution but also in practice on their political operations, which determine the direction of federal-state fiscal relations, and makes federalism in Malaysia rigid. Consequently, fiscal federalism in Malaysia has undergone little change since 1957. More importantly, fiscal federalism has been used to maintain strong political cohesion for one reason, that is, to ensure that the incumbent ruling party remains in power by securing a two-thirds majority in parliament. Thus, the foregoing analysis substantiated the view that fiscal federalism is indeed a political process used to maintain single party dominance, as the federal political elites believe, as a stakeholder of states, that only one party rule at the centre and state levels (in this case the BN led by UMNO) can ensure unity in diversity and development and wealth to the people and the country. In other words, the BN believe that unity in diversity can be achieved only when all states are ruled by the same party that rules the centre; otherwise, there would be political disarray. This is because, if all political parties toe the line, party competition can be minimised, political criticism will be lessened and unity will be assured. Thus, it is not surprising that the federal political elites perceived the presence of opposition parties as a serious threat to national unity.

Political opposition is tolerated only to show that Malaysia is a liberal democracy in that party competition and citizen participation in the electoral processes are allowed.[51] In

[51] However, the democratic electoral process in Malaysia was fuelled with debate due to some irregularities brought about by inefficiency of the Election Commission: the institution which is supposed to act as an

these circumstances, the emergence of an opposition party needs to be defused and one way of doing it is through fiscal punishment, as has been observed in this case study of petroleum royalties payments and other federal-state conflicts in Sabah during the PBS government. Therefore, strengthening states' fiscal capacity is of key importance to ensure that federalism continues to flourish. This is the main thrust of the discussion of the next chapter, that is, to find ways to improve state governments' fiscal capacity in order to create propitious intergovernmental financial relations.

To summarise, the economic backwardness of the opposition-led state governments was partly caused by the 'cold-shoulder' fiscal treatment being practised by the federal government, following polarised party competition. Hence, the citizens, who are longing for development, are the ones who suffer from economic 'collateral damage' as a result of severe federal and states political competition. Liberal democratic theory suggests that fiscal federalism should not be used as a means of political revenge to undermine opposition parties. For the country to become well-developed by 2020, Malaysia requires a mature and self-confident political system that recognises the legitimacy of elected opposition parties and governments in the federation. Unfortunately, the practice of fiscal federalism in Malaysia makes state governments subordinate to and dependent upon the largesse of the centre. Although there are detrimental effects brought about by single party dominance, it has one major benefit, that is, it has helped to minimise and control communal conflict, which leads to political tensions and disintegration if left unchecked. This is because, for multi-racial society like Malaysia, sources of conflicts are numerous: religion, linguistics, economics and cultural. Any discontentment could easily turn into racial conflicts and subsequently political chaos.

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impartial regularity body. There are many explanations for this. One reason is that the Chairman of the Commission was appointed from the Civil Service whose members lean to the ruling party political elite, and, as a result of this 'closeness' to the ruling party, the Commission, to some extent, is discriminatory in its action (See Abdul Aziz Bari, 2003). This was evident, for instance, when the Commission failed to be fair to the opposition party about using mainstream media during the election campaign. The Commission should ensure a level playing field for the opposition in the electoral process

Chapter 7

Strengthening States' Fiscal Capacity: Minimising States' Fiscal Dependency

7.1 Introduction

In Chapters 4 and 5 the problem of fiscal imbalances and measures taken to remedy this problem was examined. Based on empirical investigation, it may be concluded that; first, the problem of fiscal imbalance, in particular vertical imbalance, is long-term in nature. Second, fiscal adjustment undertaken by the federal government was, by and large, insufficient to undo this imbalance. The amounts of federal transfers were too small compared to the federal government's revenue, particularly due to the fact that the most lucrative revenue sources were assigned to the centre. Third, the federal transfers were not intended to overcome the financial difficulties faced by the state governments. Holzhausen describes the weakness of fiscal adjustment as:

> 'The practice of fiscal adjustment as it operates in Malaysia deviates in another important respect from the ideal solution...the system of adjustment largely consists of conditional grants and allocations under tax-sharing arrangements, which are not related to the states' financial needs. Nor are the major unconditional adjustment grants geared to a device indicating the actual requirements of the states. (Holzhausen, 1974: 142).

Since it is acknowledged that the root cause of states' financial difficulties is their limited revenue potential, it would be apposite to reassign more independent revenue sources to states as well as to devise a proper grants system so that there is no necessity for the states to be so dependent on the federal government for funds. If this were done, the states would be able to kick-start their efforts to regenerate the state's economy and, subsequently, states' revenue could benefit from national GDP growth. As the Chief Minister of Kedah asserts,

> 'When Kedah is developed, this poor state, which has been dependent on the federal government for assistance for so long, would finally be able to take its position of pride in the country. Kedah does not want to rely on the federal government for help forever; we want to be independent economically and serve as a model to the rest of the country,'[1]

[1] Kedah Chief Minister, Syed Razak Syed Zain, *The New Straits Times*, 12th December 2002, *'Kedah Maju 2010: Achieving Developed States'*.

This vision could become a reality if adequate sources of revenue are made available to states so that the revenue can be strengthened. As discussed in Chapter 6, the articles in the Constitution only reflect a degree of satisfaction or 'balance' between states in the federation at the time of federating in 1948. Undoubtedly, in the long term this 'balance of arrangements' cannot be sustained, as other sources of imbalance would emerge following rapid socio-economic and political developments taking place in the federation. Thus, the original fiscal arrangements as set out in the Constitution are subject to change over time, otherwise the arrangements may not working satisfactorily. As acknowledged by Watts,

> '...due to changing values of revenue sources and cost of expenditure responsibilities over time, regular processes for the systematic review and adjustment of the financial equalisation arrangements are necessary. These recognise that the essence of federalism is not in static structures but in the dynamic processes of evolving intergovernmental relations responding to changing circumstances' (Watts, 2003b: 128).

Recognising the fact that states' sources of revenue are limited, it is unfair to leave states alone to find their own ways and means to increase their revenue raising power. In line with the spirit of federalism, therefore, the drawbacks of the existing financial arrangement resulting from the shortcoming of the design of fiscal federalism need to be reviewed to ensure states' interests are preserved. This seems practical, since there has been no significant change in the division of revenue sources and fiscal adjustment since 1957, except ad hoc measures taken to overcome a state's temporary financial difficulties (see Chapters 3 and 4). The following account of the need to strengthen state revenue raising power was drawn largely from interviews with fiscal practitioners at the Federal Treasury and selected state financial officers.[2] These expert opinions were obtained concerning three key issues: first, how to reassign revenue sources to state governments;

[2] My interviews with fiscal practitioners at both federal and states levels were on an informal basis. I also discussed issues with members from both the ruling and opposition parties to obtain a fair view on political issues concerning the federal-state fiscal relations. I have concealed the names of the fiscal practitioners and politicians involved, in accordance with a guarantee of anonymity given to the interviewees as a condition of their cooperation. Please refer to the separate reference attached to the thesis.

second, how to improve the current transfer system for better intergovernmental fiscal relations; and finally, how to revive the role of the National Finance Council (NFC) from acting only as an advisory body to the government to a more efficient role in promoting better intergovernmental fiscal relations.

7.2 Strengthening states' revenue raising powers

Principally, in order to strengthen a state government's finance, it is necessary to reassign more independent revenue sources to the state. As discussed in Chapters 3 and 4, the striking feature of public finance in Malaysia is the overwhelming share of revenue collected by the federal government. The Federal Constitution provides exclusive control of tax revenue (income taxes, imports and export duties and even taxes that are localised in nature, such as property taxes and road taxes) and non-tax revenue (such as licences, permits, and return on investments) to the centre. Such revenues in most federations are also available to the states.[3] By and large, the federal government's major sources of revenues are flexible and have strong growth potential. On the other hand, states' revenue sources, as stated in Part III of the Tenth Schedule of the Federal Constitution, are limited, unproductive, have less growth potential and are expensive to collect. Besides the limited and unproductive revenue sources assigned to the state governments, economic growth has not favoured the states as much as it has the federal government. For instance, GDP growth increases direct taxes (income tax and company tax) collected by the federal government. In sum, the federal government revenue is more elastic to GDP. In 2000, the revenue elasticity to GDP was 1.0 compared to only 0.02 for states' own source of revenue.[4] Moreover, federal policies (such as revision of salaries in the public sector), growing demand for public services following urbanisation, the rising cost of the provision of public services, as well as inflation, have contributed to the increase in state governments' expenditures, which could not be met by existing revenues. Although

[3] See Watts (1999a), Bird and Vaillancourt (1998), Ter-Minassian (1997), and Shah (1994).
[4] See Chapter 4 for analysis of the federal and state governments revenue.

revenue from municipal / town councils does not directly contribute to states' revenue, the less efficient and less developed municipal / town council is a fiscal liability to states whose financial position is already squeezed due to growing allocation for transfers.[5] Thus, state transfers to local authorities (local government) are another source of increase in state expenditure, as more and more urbanisation is taking place. The biggest proportion of states' tax revenues comes from land-based taxes, including mines and forests. Although non-tax revenue contributes the largest proportion to total consolidated states revenue, only a few states benefit, as non-tax revenue comes from royalties payments from petroleum and timber, which are not evenly distributed. Hence, most states continue to depend on land-based taxes as their most important source of revenue. However, revenue from land-based taxes is generally small, since the land is basically agricultural and underdeveloped, hence carrying a low premium. A fiscal practitioner in a state financial office, when interviewed, revealed that even revenue from land premiums is subject to political 'consideration'. For instance, a company being alienated of state land can make an appeal to lower the premium imposed and in most cases a reduction was given for political reasons – especially if the company is related to a strong supporter of the states' ruling party. At the same time, the states ruling party (UMNO) itself is involved in business, which has negative consequences for the states' ability to raise revenue and poses a threat to public governance.[6]

Looking at the lop-sided revenue assignment between federal and states, the fiscal practitioners suggested that it is appropriate that the existing arrangement should be revised in order to strengthen state governments' revenue and subsequently to alleviate, if not totally eliminate, the problem of fiscal imbalances. Thus, the fiscal practitioner

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[5] See Phang (1997) especially Chapter 7 for discussion on the financial issues facing local governments in Malaysia.

[6] See Shamsul A.B (1983), Jomo (1998), Gomez (1990), and Gomez and Jomo (1997) for fuller discussion on the nature of political patronage and political rewards for maintenance of political power of the governing ruling party.

suggested that drastic reforms should be made, aimed at redesigning a system of revenue allocation that can guarantee continuous and stable revenue inflow to the states, as states' financial difficulties are a long-term relentless problem. The limited financial resources of the state governments and their inadequate capacity to implement large socio-economic development projects, have led to greater federal government involvement in the development process 'on behalf' of the states. This causes states to continue to be subordinated and subservient to the centre, so that the nation state agenda promulgated by the centre will be achieved (Chapter 6). Although it is a good development policy from an economic standpoint, nevertheless, from the federalism point of view, it is a form of usurpation of the states' little remaining fiscal autonomy, which undermines the states' economic and political self- awareness.

Revision of the existing revenue arrangement would seem to be in line with the spirit of Article 110(4) of the Federal Constitution, which allows the federal government to transfer the proceeds of any tax or fee collected to the state governments, as well as to reassign responsibility for collecting any taxes, to states. Specifically, Article 110(4) of the Federal Constitution says:

> 'Parliament may by law:
> i. Assign to the States the whole or any portion of the proceeds of any tax or fee raised or levied by the Federation; and
> ii. Assign to the States the responsibilities of collecting for States purposes any tax or fee authorised by federal law'.

Article 110(2) also provides that 'Parliament may from time to time by law substitute for any source of revenue specified in section 1,3,4,5,6,7,8, 12, or 14 of Part III of the Tenth Schedule or for any source of revenue so substituted, another source of revenue of substantially equal value'. Based on these two articles, clearly there is flexibility in the assignment of revenue sources and considerable scope for amending the existing revenue receipts of the states. However, as the fiscal practitioner asserted, 'the federal government does not really exercise both articles amid financial difficulties faced by the states'. The

reason was due to 'limited revenue sources that could be reassigned to states'. In addition, whatever the provision says, the alteration to be made under Article 110(2) and Article 110 (4)(a) must be initiated by the federal government, after consultation with the NFC, before being proposed to parliament. This is where the spirit of executive federalism should play a vital role to initiate proposal regarding alteration of the existing revenue assignment, as states themselves have no direct say in these decisions. States can only express their concern through their representatives at the NFC. However, as will be discussed later, membership of the NFC merely reflects the political hierarchy, which more often than not prevents a 'free flow of discussion' and results in 'one way traffic'.

However, the states of Sabah and Sarawak enjoyed some degree of freedom in respect of alteration of the existing revenue assignment in the sense that the Constitution did not require these states to consult the NFC but any amendment 'shall be made by order of the Yang di-Pertuan Agong'. Article 112 D (5) says,

> 'If on the occasion of any review under this Article the Government of the Federation gives notice to the states or state concerned of their intention to vary any of the assignments of revenue under Part V of the Tenth Schedule (including any substituted or additional assignment made by virtue of this Clause), or to vary Clause (4) of Article 112C, the review shall take the variation into account, and provision shall be made by order of the Yang di-Pertuan Agong...'.

Clearly, the states of Sabah and Sarawak were given power to negotiate with the federal government in order to get more favourable terms in respect of their revenues, as in the case of the abolition of import and excise duty on petroleum products. On 1st January 2000 the federal government decided to abolish import and excise duties on petroleum products, which, under items 1 of Part V of the Tenth Schedule of the Federal Constitution, were assigned to the states of Sabah and Sarawak. This abolition was the federal government's commitment under the AFTA (ASEAN Free Trade Area) in which member countries are required to abolish any import and excise duties on petroleum products. As a result, Sabah and Sarawak lost their revenue from these sources. This is

another source of potential conflicts in federation, following the growing trend of globalisation.[7]

Following this development, the federal government decided to allow these states to impose sales tax on petroleum products at the equivalent rate, to compensate for the revenue lost due to abolition of import and excise duties on such products. As a result, the two states should not, in theory, lose revenue following the abolition of these duties from the independent state revenue list. However, the states claim that the revenue collected from sales tax is too little compared with the revenue collected from import and excise duties on petroleum products. Furthermore, sales tax is already under the States List in Sabah and Sarawak, so giving them sales tax is immaterial. In addition, to top up the differences, both states demanded that the federal government reassign road tax,[8] stamp duty and service tax. At the same time, both states requested that import duties and excise duties on petroleum should not be repealed from the State List on the ground that AFTA is situational, although administratively the states agreed with the centre's commitment to abolish import and excise duties on petroleum products. However, the federal government refused to fulfil this demand, on the ground that 'these taxes have belonged to the federal for such a long time'. As an interim measure, the federal government agreed to pay RM200 million to Sabah and Sarawak. Subsequently, both states agreed on a payment of RM200 million every year, on condition that there should be a five percent increment each year. However, the federal government rejected this idea and instead insisted that the payment is only a temporary measure. However until now, no firm decision has been taken, despite three rounds of negotiations between state and federal officers. This type of arrangement is obviously more satisfactory to these states

[7] There is considerable argument on the effects of globalisation on the federal political system especially when country commitment does not correspond with the division of power / function between federal and state governments. In more decentralised federations, globalisation increases states involvement in foreign affairs, which is a function of the federal government, especially in matters of international trade. See Klemen (2002), Singh and Srinivasan (2002), Fry (2000) and Fry (1999).

[8] This tax was previously assigned to Sabah and Sarawak until 1974, when it was taken over by the federal government for regularity purposes.

(Sabah and Sarawak), as it makes the states partners in the process of making decisions affecting states' interests.

The foregoing discussion shows that there is enough flexibility for rearrangement of revenue sources to be made to strengthen state governments' finance. The fiscal practitioners suggested that the states' financial capacities could be strengthened by giving more revenue sources to states, and this could be done by a combination of the following. First, based on the derivative principle. Tax revenue should be collected by the centre (for efficiency purposes) and returned to the states based on its origin, that is, from where taxes were collected (Ter-Minassian, 1997). Currently, the number of taxes which can be allocated to the states based on this principle are rather limited. As taxes cannot be left entirely to the discretion of the states, the states could share the yield of a centrally administered tax with the state government, based on the principle of derivation of origin. Based on this principle, some portion of the import duties can be allocated to the state where the entry point is located. This is justifiable, as extensive cargo movement leads to higher costs for road maintenance where the entry points / ports are located. Thus, it is fair that these costs be partially borne from a share of the import duties collected. However, there are critics who argue that there is an inherent danger in tax / revenue sharing based on the derivative principle (Bahl and Linn, 1994). This is because the derivative principle could have a counter-equalising effect and undermine the distributive objective of overcoming income inequality, as there is a tendency to promote and exacerbate invidious interstate disparities, rewarding states on the basis of geographical advantage not on the basis of any superior productive or revenue mobilisation effort. This could also undermine the national economic and political integration of the federation. As a result, it is doubtful whether reassignment of revenue sources based on the derivative principle is capable of achieving nationwide redistribution and effective macroeconomic reforms.

The second possibility is by a federal-state revenue sharing arrangement. Based on this arrangement, revenue could be shared on the basis of absolute amounts or percentages of a given tax yield, with no reference to the derivation principle. A tax that could be shared between states based on this principle is petroleum duty, as currently the benefit from petroleum is only enjoyed by the oil rich states of Terengganu (before it was stopped), Sabah and Sarawak in the form of royalties. By such a sharing arrangement, every state could enjoy the benefits of the petroleum industry. Alternatively, the federal government's portion of petroleum royalties and petroleum taxes could be used to finance an equalisation programme for those states not endowed with petroleum resources. This is justifiable, as the ten per cent of revenue from the export of tin ore and the ten per cent of revenue from the export of iron ore is no longer enjoyed by the states, due to depletion of these resources. The adjustments could be achieved based on a revenue pooling arrangement, such as the one implemented in Nigeria through the Distributable Pool Account (DPA), in which revenue was pooled and then shared among the states on the basis of equity, needs, national interest, financial comparability, population and interstate equality (Suberu, 2002). Another alternative that could be considered is a tax-sharing arrangement, whereby states could levy a certain percentage of the tax collected by the federal government, or be allowed to add their own percentage tax rate to the federally administered tax, such as on individual income tax and company tax, instead of receiving an allocation from a purely federal tax. Based on this arrangement, the collection of tax would be conducted by the federal government for efficiency purposes and subsequently the federal government would transfer revenue back to respective state governments on the agreed formulae. This suggestion is feasible, as state governments do not have an efficient machinery to collect these taxes themselves. The ten percent of export duties on minerals as provided for under Article 110(3A) of the Federal Constitution to the producing states is a form of tax sharing arrangement.

However, as there is currently no significant mineral production, none of the states enjoy revenue from this arrangement. As a result, it is appropriate to replace this source of revenue with other taxes with local characteristics such as income tax (individual and company) collected from the states. In other federations, such as the United States, states are allowed to levy some percentage of federally collected tax based on agreed formulae (Ter-Minassian, 1998; Shah, 1994).

The third method is by reassignment of federally controlled taxes to states as of right, based on the efficiency principle, so that states would be guaranteed a stable revenue inflow, unimpeded by political wrangling. Based on this principle, certain taxes that are localised in nature could be more efficiently managed and collected by states and hence are appropriately assigned to the states. This measure could strengthen states' revenue so that states will not be continuously dependent on federal funds. However, the number of taxes which could be reassigned to the states is rather limited, while some taxes cannot be left entirely to the discretion of the states, due to poor tax collection machinery at state level. Among revenue sources which could be reassigned to the state based on this principle are property tax, stamp duties, and road tax (tax on vehicles) as well as production and consumption taxes as such excise duties, sales and service taxes.[9] The reassignment of road tax to states has been suggested and discussed in NFC meetings. However, the federal government was not in favour of assigning this tax to states, on grounds of efficiency and uniformity. As land matters are the responsibility of the states, it is appropriate to reassign property tax to the states, as the property tax is largely land-based. Any taxes related to landed property, such as estate duty, real property gains tax and stamp duty on land transfers, are appropriately assigned to the states, with policy determined by the federal authority for uniformity purposes. The respective state governments could then determine their own tax rates, depending on prevailing local

[9] Under Article 96 of the Federal Constitution, only the federal government can impose income taxes.

economic preferences. Reassignment of property taxes to states could encourage healthy competition between state governments and could promote business activities, especially the development of the property market, as investors would compare the government services they received / expected to receive with the tax rate in determining the location of their properties. However, there would be a negative impact for less developed states, as they would be less attractive to investors. This could be overcome by reducing the tax rate. Furthermore, these taxes are localised in nature and as such the problem of tax evasion (by moving to other states) could be minimised. Consequently, this measure would promote efficiency in tax collection efforts and would encourage business in the states. Similarly, tax on vehicles, which is also localised, is better collected by the states concerned, as the data base regarding information on vehicles is available in every state.

A final alternative would be based on compensation for states' revenue losses. There are many federal projects in the states, for which states are required to alienate land and, as a result, states lose out in terms of land usage as well as revenue potential, as alienation of states land, especially in major towns and cities, does not correspondingly result in higher tax revenues from better land utilisation. The five percent administrative payment for federal projects implemented in states is made on the basis of the states' staff involvement in the projects, but is not intended to improve states' revenues (see Chapter 4). No compensation system has been designed for such revenue loss; such a system needs to be considered as a potential state revenue source. Currently, land used for federal projects (federal building and installation, forest reservations and national parks) in the states is exempt from land tax (fixed rent on land) to states or is paid at a fixed minimum rate, but only for those buildings that have a Certificate of Fitness (CF). Ironically, most of the federal buildings in the states, such as schools, do not have a CF, as in most cases building plans were not required to be submitted to local councils for approval; local councils therefore refuse to issue a CF. Even highways built under the

privatisation programme are not subject to land tax. As a result, states have lost both useable land and revenue potential. The only benefit that states get is the spill over effects from such projects. Another reason why compensation should be used as a basis for the assignment of new sources of revenue to the states is due to revenue lost following states' efforts to attract foreign direct investment (FDI), such as sending trade missions abroad and expenditure on related industrial sites. Abdullah affirmed,

> 'Although there have been substantial amounts of state governments development expenditure over the years, which originate from state initiatives or even federal government financing, the benefits of these development expenditure or investments have mainly accrued to the federal government in the form of income tax and export duties related to the output of these investments projects' (Abdullah, 1978: 312).

All these efforts should be compensated because states did not receive any lucrative revenue for their efforts. For instance, income tax and company tax from the operation of foreign direct investment (FDI) in states belongs to the federal government, although states receive some allocation for expenditure spent on the construction of an industrial zone. With a compensation system, states would not be deprived of revenues from federal activities in states.

In the recent controversial issue over timber logging in Kedah, the federal government argued that the action of Kedah in granting concessions to the logging company near the Pedu Dam reserve forest would cause adverse impact to the environment, especially to the water catchments area.[10] However, as Kedah is ruled by the same party as the centre, the matter was resolved amicably and in return the federal government is considering special payment to the Kedah government on the basis of 'potential revenue lost' from their projected profit from the logging activities. But this was not the case for Terengganu, when the opposition-led Terengganu government granted a logging concession near Kenyir Lake to the logging company. This concession was opposed by the federal government, ostensibly for fear of an environmental hazard. However, special

[10] *Utusan Malaysia* 19th May 2003: *'Hands off Pedu Dam reserve forest, says Cabinet'*.

payments were not considered as they had been in the case of Kedah. In a nutshell, these clashes of interest are indeed the manifestation of states being desperate for revenue while the federal government is concerned about the environmental implications.[11]

Although reassignment of independent revenue sources to states is inevitable, the federal officials interviewed noted that reassignment of revenue sources to the states may not be viewed as appropriate, as most taxes are under federal jurisdiction.[12] Thus, any demand to revise the existing arrangements would result in a long constitutional battle. Therefore, federal government views states' suggestion for reassignment of revenue sources with mistrust, as it would give more fiscal autonomy to the states, which would threaten the political supremacy of the centre. Indeed, there is no simple answer to the problem of revenue assignment in a federation. However, three important principles should be considered if revenue sources are to be reassigned to the states: first, the importance of the economic functions of government, that is, the stabilisation function (to avoid macroeconomic drawback), the distribution function (to avoid unnecessary inequity among states) and the allocation function (efficiency in the allocation of scarce resources) should not be undermined. Second, the federal spirit (cooperation, trust, partnership and respect) should be maintained; and third, the political aspect of federalism (political system and party politics) should be considered.

However, reassignment of taxes is only possible through the implementation of a fiscal decentralization process as practised in other federal countries.[13] According to Holzhausen, 'a change in the substance and composition of the tax subjects or other

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[11] A similar situation arose in Pahang over a logging concession in Endau-Rompin forest reserve, which resulted in the removal of the Pahang Menteri Besar (Chief Minister). See Shafruddin (1987), Chapter 9.

[12] Private interview with a government official who wants to remain anonymous. Please refer to separate reference attached to the thesis.

[13] See Bird and Vailaincourt (1998) for detailed discussion on the current practice of fiscal decentralisation. Ismail (1997) argues that fiscal decentralisation may not be suitable in Malaysia as Malaysia is a small country and citizens' were indifference. Abdul Rahim (2000) also shares the same opinion, that fiscal decentralisation may not be appropriate in Malaysia as the federal government is committed to undertake national development throughout the federation through the annual budgetary process.

assured sources of income of the states would be the most appropriate solution to any long-term imbalance in relation between the states' needs and resources' (Holzhausen, 1974: 158). Nevertheless, the federal government views reassignment of taxation to solve the long-term fiscal imbalance as impossible, since the most important taxes have been exclusively assigned to the centre under the Federal Constitution. Based on past experience, the federal government resists the reassignment option for economic (macroeconomic management) and political reasons (the desire to control political behaviour of the states). Investigation of government fiscal policy shows that the ability and willingness of the federal government to implement new arrangements (tax assignment) are not always present, especially if the new arrangements mean a loss of the powers of the centre.[14] Therefore, reassignment of revenue sources requires strong political will, given the nature of the political system. In the absence of political will, federal transfers continue to be used as the main method of fiscal adjustment in Malaysia because they can serve both economic and political purposes. Politically, federal transfers can act as a 'carrot' as well as a 'stick' by which the central political leader can put pressure on recalcitrant states' opposition leaders.[15] Realising the fact that fiscal adjustment can only be made through federal transfers, the federal government should improve the existing grants system.

7.3 Improving states' tax collection system

Reassignment of revenue sources is only possible if it is followed by improvements in the states' tax collection system in order to increase states' absorptive capacity as well tax effort. The ability to collect revenue is vital to increase the states' fiscal capacity. It has been noticed that the tax collection system differs from one state to another. There is no standardised mechanism and structure of tax collection. As a result, states' revenue from

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[14] For instance, in 1987 there was a demand by the states to reassign road tax and property tax to state governments as new sources of revenue but was turned down in the National Finance meeting.

[15] This was repeatedly done by delaying disbursement of grants to states, as experienced by Kelantan and Terengganu. See also discussion on this matter in section 4.3 of Chapter 4.

land tax collection is still below its potential. Therefore, state governments should explore the potential of land tax as a major source of revenue in future. State governments should improve the efficiency of land office administration and should take steps to ensure constant collection of land revenue and follow up arrears. The inefficiency of land administration has in fact been criticised by the Deputy Prime Minister, Abdullah Ahmad Badawi[16], who commented that, due to states' bureaucratic red tape, several land applications, for the issue of land titles and transfer of ownership have taken up to fifty years to be resolved.[17] This bureaucratic red tape caused states to lose their revenue potential from land premium, although land tax collection is the second major source of states' revenue.

Inefficiency has also been noticed in the collection of water charges. In Selangor and Kuala Lumpur, for instance, up to 30th September 2002, a total of RM230 million of water charges had not been collected, partly as a result of inefficiency in water management. As land and water are state matters, the respective states should take steps to modernise the management of these factors of production. Poor management skills would pave the way for federal interference in state fiscal affairs for the sake of efficiency. This was evident when the federal government in August 2003, through the formation of the National Water Council, decided to centralise water management away from the states, despite objections from the states led by the opposition. What will happen next is that, if a state fails to improve its tax collection system and, subsequently, its revenue performance, more and more functions will be usurped by the centre, and land management may be next on the list. Although land falls under the State List, the policy is a federal matter (through the National Land Council), and the amendment to the National Land Code 1965 enables the federal government to take over state land for

[16] On 1st November 2003, Abdullah Ahmad Badawi was 'appointed' as the fifth Malaysian Prime Minister when the longest serving Prime Minister Dr. Mahathir Mohamad voluntarily retired.
[17] *Berita Harian*, 10th December 2002.

federal purposes. It seems here that, as in the case of the NFC, the council becomes a strong instrument of power usurpation.

Through improvement in the tax collection system, states' tax efforts can be increased to reach their full potential. Therefore, long term planning of state taxes should be made to increase states' tax efforts. The fiscal practitioners were of the opinion that without proper tax planning, state governments will be forever dependent on the federal government for funds. However, they also believed that it is easier to put effort into getting federal funds through good political relations with the centre, rather than to put effort into exploring states' revenue potential, such as by improving the tax collection system. This implies that the current system has made states more complacent, and this is perilous for states' fiscal management.

7.4 Fiscal adjustment measures: Improving transfers system.

The downside risk of the application of an efficiency rationale in tax revenue assignment is a high degree of tax centralisation, due to the poor tax collection mechanism at state level and the mobility of factors of production across the states. Thus, from the point of view of efficiency, the federal government is likely to collect most of the productive revenue indefinitely, unless there is strong state protest against the centralisation of taxes. Subsequently, the issue of non-correspondence between revenue and expenditure of the state governments will continue to be a long-term problem. This poses the question of how serious the federal government is about intergovernmental fiscal adjustment. Since the fiscal imbalance in Malaysia is long-term in nature, the most appropriate approach to fiscal adjustment is to assure a steady inflow of income to the state governments, regardless of economic and political cost.

The significance of federal transfers is justifiable because the federal government has strong revenue-raising powers, compared to that of the states. The aim of fiscal adjustment is primarily to ensure that the state governments have sufficient resources to finance the functions allocated to them under the Constitution, given the non-correspondence in the distribution of responsibilities and sources of revenue between the federal and state governments; and secondly, to equalise interstate fiscal disparities following differences in the fiscal capacities. The literature suggests three methods to remedy these imbalances: first by federal transfers, second by reassignment of revenue, and third by changes in tax components (Holzhausen, 1974). However, economists suggest that the first method is more practical than reassignment of taxation to the state governments, as it is relatively less difficult to be administered and recognises the lack of efficiency in revenue collection machinery at the state level. Within federal transfers, grants and tax revenue sharing are the most practical ways to remedy both vertical and horizontal imbalances (Ter-Minassian, 1997). Grants could be either conditional or unconditional, depending on their purpose and on the type of imbalances to be remedied (see Chapter 2).

As discussed above, the problem of fiscal imbalance in Malaysian fiscal federalism is long-term in nature. One way to overcome long-term fiscal imbalance is to equate revenue and expenditure responsibilities. Any discrepancies (or fiscal gap), should they arise, should be balanced out by a proper grant / transfer based on fiscal needs and fiscal capacity. Fiscal needs would depend on such factors as the area, population, capacity to extend and socio-economic status such as production, employment, GDP, and incidence of poverty, health indicator and access to public amenities. On the other hand, fiscal capacity would depend not only on revenue collected but also on the ability to collect revenue. However, it is important that legitimate criteria be adopted to ensure a high

degree of transparency in the design and disbursement of the grants system. More importantly, grants should be stable, transparent and distributed on time.

As discussed in Chapter 4, the existing fiscal adjustment practices have several shortcomings. First, total federal transfers are very small compared with the total federal government revenue, and not all grants are real grants intended to balance state governments' accounts. Second, the instruments of federal transfer comprise various types, which were designed to meet different purposes and not all transfers are considered as real fiscal adjustments to eliminate revenue-expenditure mismatch. Third, the practice of federal transfers does have an equalising effect on all state governments, as states with a higher GDP continue to receive higher federal grants than lower GDP states. Furthermore, the grants do not have a built-in mechanism to respond to economic changes. Finally, fiscal adjustment, which includes both the adjustment of horizontal and vertical imbalances, has mostly been effected by conditional grants, mainly to enable the federal government to exercise control over the extent and quality of state services and state development expenditures.

Analysis of state and federal financial data indicates that state governments' capability to undertake their constitutionally assigned functions is very strongly dependent on their own sources of revenue and transfers from the federal government (see Chapter 4). This is supported by the findings from regression analysis conducted for this research, which supports the hypothesis that there is a correlation between state government expenditure and federal transfers (see Chapter 5). However, the result of regression analysis did not strongly support the hypothesis that federal government revenue is a key determinant of federal transfers to the states. This is evident, as the amount of transfers is still low compared to the size of federal government revenue. As such, the federal government should revise the existing transfers / grants systems.

Under the Federal Constitution, besides flexibility being provided for reassignment of revenue sources, there is also sufficient scope to revise the existing transfers system to state governments. Article 109 (3) and 109 (6) of the Federal Constitution provides enough flexibility for fiscal adjustment to be made by introducing new grants (through enactment of a specific law). Specifically, Article 109(3) says, 'Parliament may by law make grants for specific purpose to any of the states on such terms and conditions as may be provided by any such law', while Article 109 (6) provides further flexibility 'the federation may from time to time, after consultation with the National Finance Council, makes grants out of the State Reserve Fund to any state for the purposes of development or generally to supplement its revenue'. However, despite this flexibility, the state government remain 'voiceless' in the making of fiscal adjustment. This is because only the federal government can initiate the introduction of new grants, as stated in Article 108 (4)(a) and Article 108 (5), which gives power to the federal government to introduce new grants to states after consultation with the NFC. However, the efforts taken by the federal government thus far to bring about financial relief to the state governments remain unsatisfactory, inadequate and not intended to solve long-term problem of fiscal imbalance. Indeed, the federal government had realised the weakness of the existing transfers system, as stated in the Ministry of Finance's Economic Report:

> 'Over the years, grants given to the state governments were inadequate due to a number of factors. Firstly, the expenditure of the state governments has been increasing to cater for the expansion in services and development programmes. Secondly, the revenue from the states' own sources did not increase in line with the general growth of the economy. In some cases the revenue sources are in fact depleting. Thirdly, the structure of some federal grants does not have a built-in price adjustment factor and as such increase in cost and inflation have rendered the grants inadequate to meet their original purposes'(MOFER, 1992: 170).

On closer scrutiny, the major hurdle is the lack of political will on the part of the federal government to review the whole structure of transfers systems to solve the long-term problem of fiscal imbalance. However, the position of the states of Sabah and Sarawak is relatively more satisfactory, in that these states can demand a review of the grant received

from the federal government, to ensure the 'revenue is adequate to meet the cost' of provision of public services. This is clearly stated in Article 112D(2),

> 'Any review under this Article shall take into account the financial position of the federal government, as well as *the needs of the states* or state concerned, but subject to that shall endeavour *to ensure that the states revenue is adequate to meet the cost of state services* as they exist at the time of the review, with such provision for their expansion as appears reasonable'. [Emphasis added].

Hence, if any fundamental imbalance should eventually arise, there is always a likelihood of revising the amount of the special grants. This provision is not applicable to states in Peninsular Malaysia. However, despite this provision, revision of special grants takes a long time to be implemented. For instance, since the last revision of special grants (Article 112C and 112D, and Part IV of the Tenth Schedule of the Federal Constitution) in 1973, there have been no revisions made. [18]

The success of any system of fiscal adjustment also depends largely on the formulae chosen in the design and the distribution of grants. In determining the amount of transfers, the financial need of the state governments (based on income per capita, expenditure per capita, and state GDP per capita) should be the main criterion, apart from the financial capacity of the federal government, with a view to remedy both vertical and horizontal imbalances. In this case, the grants based on the level of economic development provided under the State Reserve Fund can be developed into a comprehensive fiscal equalisation system, as this grant takes into account some elements of the states' fiscal needs. The justification for an effective fiscal equalisation programme is that it will promote the concept of equal rights, equal treatment and federal spirit in response to citizens' changing needs and preferences. Without a fiscal equalisation programme, federal-state fiscal conflicts could have a corrosive effect on the federation's

[18] In 2000, the Federal Government agreed to revise the whole arrangement of Part IV of the Federal Constitution following the abolishment of Section 1 of Part V (import duty and excise duty on petroleum products). This is part of the Federal Government's commitment towards AFTA, which requires the member country to abolish import duty and excise duty on petroleum products. As a result, the states of Sabah and Sarawak lost their revenue derived from these sources. New arrangements have yet to be finalised.

political stability and cause economic distortion when capital moves in favour of richer and more prosperous states. In the final analysis, fiscal equalisation should be able to remedy the financial hardship of the state governments, and subsequently iron out any fiscal imbalance (horizontal and vertical). However, in the view of the fiscal practitioners, a fiscal equalisation programme would be too expensive to implement and would have constitutional implications. In the absence of a fiscal equalisation programme, fiscal adjustment through the existing transfers / grants system should be reviewed by an independent and impartial authority to remedy the states' financial difficulties and, more importantly, federal transfers should be made unconditional - at the disposal of the states to spend without any strings attached, and the amount of the transfers should be revised annually. As discussed in Chapter 4, some grants were designed only to overcome states' temporary financial difficulties, as in the case of grants to ease current account deficits provided for under the State Reserve Fund.

If a fiscal gap still persists, balancing grants with a built-in mechanism to correspond to economic fluctuation would be the best option, as they could automatically negate any revenue mismatch or non-correspondence. However, as also experienced by developed federations such as Canada and Germany, it is almost impossible to achieve the ideal situation of matching revenue with expenditure needs. Alternatively, a self-correcting mechanism with built-in flexibility (to avoid rigidity) for tax and grants arrangements would be the preferred option. At the same time, it would provide the best solution to changing economic and political conditions. Such a mechanism would automatically correct any revenue and expenditure discrepancies that may arise. It is essential, however, that the distribution of grants should be stable and transparent - not subject to political whim and fancy – regardless which political party rules the states. As the Treasury officials asserted when asked about the delay in disbursement of grants to states led by the opposition party, 'the Constitution only provides what grants are to be paid to states

but the disbursement is solely within federal jurisdiction – when to pay cannot be questioned'.[19] Thus, it is appropriate that grants should be given to the states as of right and not subject to the vagaries of the centre's political agenda. According to Watts, 'intergovernmental financial adjustments are therefore not simply technical adjustments but inevitably the result of political compromise' (Watts, 2002: 2). With regard to the practice of fiscal adjustment within Malaysian fiscal federalism, Holzhausen commented that 'only if the whole question of financial adjustment is isolated from politics and handled by an independent panel of experts, is it possible to arrive at a solution, which will really meet the needs of the states' (Holzhausen, 1974: 160). More importantly, whatever the design, the new grants system should not only be capable of eliminating revenue-expenditure mismatch, but also encourage local tax efforts.

7.5 Enhancing the role of the National Finance Council (NFC)

As was seen in Chapter 1, the existence of the NFC to foster intergovernmental fiscal relations in Malaysian fiscal federalism is vital. The financial provisions of the Constitution came into force on 1st January 1958 and hence the NFC legally came into effect. Unfortunately, the Council can only advise on matters of federal finance relating to states in Peninsular Malaysia. Hence, the current status of the Sabah and Sarawak in the NFC is merely as 'sitting-in' members only.

The NFC is a high level intergovernmental consultative body on financial matters as provided for in the Federal Constitution, to ensure that there are no open clashes in intergovernmental relations with regard to fiscal matters. Intergovernmental institutions like the NFC should become an effective intergovernmental negotiation body on finance to solve federal-state financial conflicts (Jeffery, 2003b). In the Constitutional Commission Report 1957, the Commission was directed to recommend 'machinery for

[19] Private interview with a government official who wants to remain anonymous. Please refer to separate reference attached to the thesis

consultation between the central government and the states and settlements on certain financial matters to be specified in the Constitution' (Para 149). Subsequently the Commission recommended a body through which both levels of government can consult each other on various matters in which the states as well as the federal government would be interested. The federal government should be free to bring forward any other questions which require consultation between the federal and state governments, and the states should be free to consult the Council on any financial matters.

> 'We recommend that this machinery should be purely consultative. We do not think that it would be right, or indeed practicable, to give any executive functions to the body which we recommend should be formed, or to allow its powers to affect or diminish the ultimate responsibilities of the federation and the states within their respective spheres' (Constitutional Commission Report 1957).

The spirit of this recommendation has been embodied in the Constitution as found in Article 108. Article 108 (4) and (5) of the Federal Constitution outlines the main function of the NFC as follows:

> '(4). It shall be the duty of the federal government to consult the National Finance Council in respect of:-
>
> a. the making of grants by the Federation to the states;
> b. the assignment to the states of the whole or any portion of the proceeds of any federal tax or fee;
> c. the annual loan requirements of the Federation and the states and the exercise by the Federation and the states of their borrowing powers;
> d. the making of loans to any of the states;
> e. the making of development plans in accordance with Article 92;
> f. the matters referred to in Items 7(f) and (g) of the Federal List;
> g. any proposal to introduce a Bill for such a law as is mentioned in Clause (2) Article 109 or Clause (3) or (3a) Article 110;
> h. any other matter in respect of which this Constitution or federal law makes provision for consultation with the National Finance Council.
>
> (5). The federal government may consult the National Finance Council in respect of any other matter, whether or not it involves questions of finance, and the government of a state may consult the said Council in respect of any matter which affects the financial position of that state'.

Clearly, the Federal Constitution provides ample room for negotiation and arbitration concerning federal – state fiscal matters, to be undertaken by the NFC: the making of grants, revenue assignment, the making of loans to the states, the making of development plans, and any other federal-state fiscal matters. However the questions are: to what

extent can the Council meet this role, given the composition of the Council, and, subsequently, how can better use be made of the NFC in the promotion of better intergovernmental fiscal relations? In practice, however, the role of the NFC is limited by political influence in its conduct, as the members of the NFC represent the political echelons of the governing ruling party. It is not an impartial body in which fair decisions affecting states' interest are made. As stipulated in the Article 108(1), the NFC consists of the Prime Minister, such other ministers as the Prime Minister may designate and one representative from each of the states appointed by the Ruler or Governor. The state representative in the Council is the *Menteri Besar* or Chief Minister of the state. The NFC is summoned to meet by the Prime Minister as often as he considers it necessary and whenever the representatives of three or more states demand a meeting to be held. However, it is compulsory to hold at least one meeting every year. At any meeting, another minister of the federation may represent the Prime Minister; if the Prime Minister is not present, the minister representing him presides over the meeting. In practice, the Deputy Prime Minister always presides over the meeting in the absence of the Prime Minister.

All Menteri Besar or Chief Ministers and members of the Council are from the ruling coalition party, except for those of Kelantan (from 1990 till now) and Terengganu (from 1999-2004), who are from the opposition party (PAS). Hickling commented on the composition of the NFC: 'The council is heavily in favour of the states: a fact perhaps likely to cause it to be viewed with a certain degree of suspicion by the federal government' (Hickling, 1960: 52). However this statement is grossly inaccurate, as numbers do not reflect actual states' strength in the Council because the Council decisions are not made by the number of votes.[20] In practice, there is no voting involved in making decisions; rather, decisions are taken by consensus, which means that the

[20] See also Lai (1968).

federal government and a majority of the states support the decision. As one fiscal practitioner said, 'Everything has been sorted out at the officers' level and therefore the NFC meeting is only to endorse decision made at the State Finance Officers meeting held prior to the NFC meeting'.[21] Therefore, the influence of the Federal Treasury on the working of the NFC is significant as the Treasury is the only authority responsible for the NFC. This is another reason that makes the NFC impartial. Saharudin also admitted, 'Although the Finance Council includes a representative from each of the states, its deliberation could be regarded merely as a formality, particularly because it is chaired by the Prime Minister who presides over the Cabinet' (Saharudin, 1998: 227). Indeed, the NFC is one council where numbers (thirteen representatives from states) do not constitute strength, as the position of the federal government in the NFC is stronger and more dominant than that of the states taken as whole. In the light of the powerful and decisive personality of the chairman of the NFC, that is, the Prime Minister or the Deputy Prime Minister, the states dare not dissent on most issues. As fiscal practitioners commented, 'Who would dare to argue with the Chairman?'[22] Hence, looking at this structure, federal politics that actually dominates the Council (Saharudin, 1998; Yusoff, 1998). Thus, decisions made by the NFC are politically determined according to the wish of the centre. In other words, the decisions of the NFC reflect the strong political cohesiveness of the ruling party both at the centre and at state levels. In this regard, the states of Sabah and Sarawak are in a better position, as they are not obliged to consult the NFC concerning the making of additional grants or reviewing existing grants.

Although there is flexibility for fiscal adjustment, the practice cannot be considered adequate from the point of view of the state governments. This is because only the federal government can initiate such changes affecting states' financial interest (Article

[21] Private interview with a government official who wants to remain anonymous. Please refer to separate reference attached to the thesis.

[22] Private interview with a government official who wants to remain anonymous. Please refer to separate reference attached to the thesis.

108(4)(a)), while the state governments can only express their view through their representatives (the Chief Ministers) on the NFC. However, if their representative comes from the opposition party, the states concerned cannot rally support for issues affecting their states. It is in effect as though they had no representatives in the Council, and hence the say of the federal government is overriding and final. The ability of the federal government to win over the state governments into agreeing on certain financial matters can be attributed to its political supremacy over the states. This is not surprising because, as mentioned above, all of the members of the NFC are Menteri Besar or Chief Ministers (from the State Legislative Assemblies), whose selection as candidates for election is made by the UMNO Central Executive Committee[23] (except for the opposition party) and whose appointment as a Menteri Besar is in the hands of the Prime Minister. As such, they are obliged to agree with the Chairman on most matters raised in the NFC. Thus, the federal government is always in a strong position to obtain the compliance of the state governments controlled by the ruling party (the Barisan Nasional in which UMNO is the main component) owing to the internal power structure of the party. Hence, the federal government in effect controls the NFC with little protest from its members because only two members belong to the opposition party (for period 1999-2004). This factor has led the federal government to assume a supervisory role over state finances (through the NFC). Although this is undoubtedly required to ensure 'prudent fiscal management' and to improve the degree of public governance, it was implemented to such an extent that it coerces state fiscal affairs, which make states weak and complacent. Indeed, it is a way of degrading the states' capability to undertake fiscal functions.[24]

The federal government is merely obliged to consider the recommendations of the Council, and its decision affecting federal government interest is final. This is clearly seen in the case of loan repayment by the state to the federal government, where the

[23] See Chapter 6 for discussion of the party system in Malaysia.
[24] See also Jomo and Wee (2002).

decision was made to deduct sums from grants to states in lieu of loan repayment.[25] The states cannot object, due to the 'political supremacy' of the federal government in the Council, as discussed above. In view of the practical problems with the NFC, it is timely to have an independent body so that proper review of federal-state financial relations can be made on a regular basis for the benefit of the both levels of government. According to Holzhausen,

> '...if politicians feel that federalism should, nevertheless, play a useful role...., a larger measure of responsible participation of the states in decisions vital to their independence would certainly be appropriate. In these circumstances there would then be a need for a review of the various aspects of federal/state financial relations in Malaysia' (Holzhausen, 1974:159)

Although it is not explicitly mentioned in the Constitution, in practice the federal government is not really obliged to follow the advice of the Council, if the decision made by the Council departs from the federal government's wishes. As such, the effectiveness of the NFC as an institution for overseeing intergovernmental fiscal relations is questionable. The fact that the NFC has merely an advisory function and cannot force the central government to accept its recommendations is contrary to its role as an institution for coordinating federal-state financial relations. Another factor, which also tends to weaken its significance, is its limited jurisdiction with regard to the financial relations between the federal government and the states of Sabah and Sarawak, as the states are not obliged to consult the NFC. As stated in Article 112D (7) of the Federal Constitution, the jurisdiction of the NFC does not extend to cover the interests of the states of Sabah and Sarawak in the matter of reviewing special grants to these States. On a positive note, this article actually gives a better position to the states of Sabah and Sarawak, as they can remain aloof from political wrangling, should the states become politically unaffiliated from the centre. However, as was seen in Chapter 6, this constitutional guarantee still

[25] The NFC 2000 meeting warned that the federal government could invoke Article 98 (2) of the Federal Constitution to reduce grants to states if states failed to make repayments of the loans taken from the federal government. In fact this has already been done. In 1995, payments for Road Grants to Kedah, Kelantan and Negeri Sembilan were reduced by the amount of defaulted payment (Kedah's grant was reduced by RM 3.3 million, Kelantan's by RM 6 million and Negeri Sembilan's by RM 4.6 million).

fails to safeguard the states from central intrusion, as the centre can use other means to pressure the states to toe the line, as in case of Sabah while under the PBS government (1985-1990). On a negative note, however, this article may induce the central political leader to put undue pressure on a state over its fiscal affairs. Nevertheless, with regard to possible future conflicts between the federal government and the states of Sabah and Sarawak on the subject of the special grants, Article 112D (6) of the Constitution provides for arbitration by an independent assessor. The recommendations of the assessor are binding on both governments concerned and shall be given effect as if they were the agreement, unlike recommendations of the NFC (for states in the Peninsula) which are not binding on the federal government.

Since the purpose of the establishment of the NFC is to provide room for negotiation on a wide array of federal-states fiscal relations, it may be desirable to revise the function as well as the structure of the NFC so that it can play a more effective coordinating role for the betterment of the intergovernmental fiscal relations. To achieve this aim, it is crucial for the NFC to be made impartial, in that the representation of the two levels of government on the Council should be based on the strength of their expert knowledge on the constitution, economics, federalism and fiscal federalism. In the case of the failure to make the NFC an impartial body, there should be an independent authority with executive function, comprising members from a wide array of expertise, not bound by political bias and empowered with broader supervisory functions, including the power to review a wide range of federal-state financial relations on a regular basis, especially with regard to the system of fiscal adjustment, in order to strengthen state governments' finance and, subsequently, to ensure continuous efficient working of the whole system of federal-states financial arrangements. More importantly, its recommendations, especially those concerning the intergovernmental financial adjustment, should be final and binding on the federal government.

7.6 Liberalising the borrowing power to states

Literature shows that hardly any government can undertake rapid socio-economic development without some kind of borrowing (Oates, 1972). Even in developed economies, borrowing is an integral part of the financing of public investments. The need for borrowing is a manifestation of inadequate resources to finance public investment. If the revenue falls short of expenditure or if the government decides to undertake a fiscal expansionary programme for which expenditure exceeds available resources, then the government will resort to domestic / external sources. Undoubtedly, public borrowing plays a significant role in the financing of development projects at both federal and state level. For state governments, the need for borrowing is also a sign of inadequate transfers from the higher level of government. As far as public finance is concerned, there are four issues that need to be considered. First, both levels of government should equally benefit from public borrowing. Second, if only the federal government has borrowing powers, to which states do not have access, the distribution of loans from the federal to states government should conform to the principle of equity. Third, if states have access to borrowing, the level of borrowing should be determined for the purpose of prudent debt management and for monetary policy purposes. Finally, borrowing from central bank should be avoided.

As discussed in Chapter 3, the federal government has exclusive powers to resort to borrowing, as well as absolute control over the borrowing needs of the states. Therefore, states should benefit from borrowing made by the federal government and the distribution of loans should conform to the principle of equity. There are two sources for states' borrowing. First, for loans of duration of more than one year, the states may borrow from the federal government. The terms and conditions of all loans are determined by the Treasury, and strict conditions are attached to the loan agreements between the federal government and the borrowing state. The terms and conditions under

which loans are made vary with the purpose of the loan. Borrowing can only be used to finance approved development projects, in particular for land development schemes, low-cost housing schemes, water supply, agriculture related projects and industrial estate schemes. This is one way in which the centre induces the states to conform to its policies, especially to deal with those states led by the opposition party. Borrowing conditions have often been the cause of friction between the federal and state governments.

Second, for loans of duration of one year or less, states may borrow from banks, but must first obtain the approval of the federal government. Nevertheless, borrowing from the banking system is limited, as the states' credit rating by and large is weak. Therefore, most of the borrowing contracted by states comprises loans from the federal government. For the states of Sabah and Sarawak, borrowing within the state is allowed under state law, provided the borrowing has the approval of the Central Bank. Table 7.1 shows the borrowing raised by states from the federal government for selected years.

Table 7.1
State Governments Borrowing from the Federal Government*
(RM million)

	1996		1997		1998	
	Gross Borrowing	Principal Repayment	Gross Borrowing	Principal Repayment	Gross Borrowing	Principal Repayment
Perlis	6.6	1.0	1.5	14.0	9.1	5.4
Kedah	133.9	61.6	116.5	84.0	76.4	30.8
Penang	21.4	14.4	35.1	0	95.7	18.9
Perak	8.7	22.4	17.7	21.3	15.7	14.9
Selangor	71.2	27.2	15.5	37.5	34.5	75.7
Negeri Sembilan	42.9	38.1	77.5	39.6	160.6	29.7
Melaka	24.9	36.0	83.4	13.0	59.0	27.0
Johor	14.1	96.6	52.7	39.4	29.9	32.8
Pahang	41.6	53.4	73.6	48.8	92.3	25.6
Terengganu	54.5	93.1	107.5	31.3	126.3	28.4
Kelantan	0	12.2	0	20.4	0	19.4
Sabah	22.1	7.6	14.3	0	121.4	7.8
Sarawak	74.2	15.1	75.2	41.5	130.4	74.3

Note: * This loan is largely to finance low cost housing projects, projects under State Development Corporation, and water supply projects.
Source: Ministry of Finance

With the federal government's power to allow or refuse loans for any purpose, borrowing power becomes another instrument of control over the direction of states' economic development. Of late, there is growing practice for the federal government to give loans

rather than grants to states. Nevertheless, this is annoying, as states' capacity to pay back loans is limited (see Table 7.2). States' fiscal practitioners argue that, since federal transfers are too small and not intended to negate fiscal discrepancies, states should be allowed to borrow within their financial capacity, to enable them to tap finance from the capital market especially through long-term bonds. This is because repayment of bonds could be spread over the generation and therefore minimise states' repayment burden. As such, bonds are preferred for financing long-term investment or development expenditures of which the benefit of the projects goes beyond the current generation. However, bonds should not be used to finance current expenditures because they place the burden of financing current benefits on future generations. If borrowing is allowed, some form of control is necessary but not to an extent that it coerces states' fiscal affairs because of political incompatibility. The rationale for controlling states borrowing is that uncontrolled borrowing by state governments would not be in the national interest, as excessive state borrowing would cause moral hazard, contingent liability and bail out, as well as cause a crowding out effect. While this is appropriate from the public finance and macroeconomic standpoints, the tight restriction on borrowing in Malaysia is a definite check on states' fiscal autonomy.

Table 7.2 shows that 'have not states' (Perlis, Kedah, Negeri Sembilan, Melaka, Pahang and Kelantan) are seriously in debt, as the share of debt to the state GDP is high (more than ten per cent) compared to the rest of the states. This also indicates the difficulty of these states to serve debts (loan repayment and interest payment), due to their limited revenue raising power. The states are unable not only to service the interest but also to pay the principal. Even principal repayments are not made on time. The outstanding interest payment would normally be capitalised, causing states' debt to grow larger. However, the way federal government responded to the states' failure to service the debt by reducing the amount of grant they received is rather annoying. In the final analysis,

this practice has a persistent chain of effects, whereby solving states' fiscal problem becomes more complicated, which causes moral hazard.

Table 7.2
State Governments Debt*
(RM million)

	1997			1998		
	State GDP	Debt	% Debt to GDP	State GDP	Debt	% Debt to GDP
Perlis	956.9	108.1	11.3	918.8	111.9	12.2
Kedah	7061.1	1,131.5	16.0	6724.6	1,158.9	17.2
Penang	11221.2	231.8	2.1	10612.8	308.6	2.9
Perak	12141.9	187.3	1.5	11652.0	188.2	1.6
Selangor	29778.6	1,119.1	3.8	27882.5	1,078.2	3.9
Negeri Sembilan	5045.6	714.1	14.2	4782.4	813.8	17.0
Melaka	3862.5	442.3	11.5	3660.8	474.3	13.0
Johor	17301.7	819.5	4.7	16361.8	813.3	5.0
Pahang	6612.6	640.4	9.7	6390.3	698.2	10.9
Terengganu	10288.2	644.0	6.3	10029.2	742.6	7.4
Kelantan	3175.5	624.4	19.7	3093.7	605.1	19.6
Sabah	9219.5	143.1	1.6	9155.9	258.8	2.8
Sarawak	11610.3	671.1	5.8	10712.2	728.3	6.8

Note *: Debt due to borrowing from the Federal Government
Source: Ministry of Finance and Economic Planning Unit, Prime Minister's Department

The appalling aspect of loan repayments by states is that they are capitalised on by the ruling party for political purposes, especially when default is by states led by the opposition party. According to the 1998 Auditor-General's Report, at the end of 1998, total unpaid loan arrears by Johor stood at RM229.78 million, Kedah at RM225.54, Sarawak state government at RM86.22 million, Kelantan at RM44.88 million, Pahang at RM44.88 million, Terengganu at RM27.34 million[26] and Sabah at RM24.53 million. Clearly, Kelantan and Terengganu do not head the list of loan arrears to the federal government; this position goes to the states of Johor and Kedah. However, due to the political cohesion of Johor and Kedah with the central political leadership, this is not an issue. For Kelantan and Terengganu, however, the scenario is different; they have been repeatedly accused by governing elites of being the major loan defaulters, because these

[26] For Terengganu, where PAS took over power from BN government in 1999, PAS 'inherited' more than RM700 million of debt to the federal government, despite payment of large sums in petroleum royalties. However, the new PAS government has been able to pay off loans according to the schedule. At the same time, PAS government demanded investigation into the malpractice of the former BN government, due to its aggressive involvement in doubtful businesses (*Warta*, 2000).

states are governed by the opposition party. Thus, the voters are induced to believe that opposition governments are less reliable in terms of repaying federal government loans.

The tight restriction on borrowing makes states dependent on the federal government for funds. Subsequently, it makes it difficult for them to undertake rapid socio-economic development and further sets a limit on their fiscal autonomy, since the final decisions as to which projects are to be accepted as loan commitments are federal. This has been a source of difficulty and in some circumstances annoyance for the state governments, particularly for states controlled by a party different from that controlling the federal government. There have been instances where politics was a basis for approving or rejecting loan applications by state governments, as in the case of a loan application made by the Kelantan government to finance the construction of a bridge over Sungai Kelantan to link Pasir Mas and Tumpat. Another example is financial assistance in terms of soft loans to Kelantan, amounting to RM600 million, to improve the existing water system. The former Second Finance Minister (Mustapa Mohamed) commented that the people of Kelantan still need federal government assistance; although it is governed by the opposition (since 1990), it will continue to receive its fair share of financial assistance as stipulated in the Constitution.[27] Subsequently, the loan was granted on 2nd April 1999. However, after the 10th general election (29th November 1999), in which the BN coalition failed to recapture Kelantan from the opposition, the federal government requested the Kelantan government to resubmit the proposal if the state still wished to obtain the facility.[28] This implies that political interest influences loan decisions.

Based on past experience, therefore, there is a strong possibility in future that the ruling party will be reluctant to aid development (by giving loans) to a state governed by an opposition party, for political reasons (party competition). As noted in Chapter 6, the

[27] *Utusan Malaysia*, 4th April 1999. *'Kelantan in need of help'*.
[28] *Utusan Malaysia*, 11th January 2000. *'Water company to be privatised if loans is rejected'*.

party system has an impact on federal-state fiscal relations, especially in cases where different political parties have power over the two levels of government. The rivalry and competition between government ruling parties at federal and state levels significantly influence the conduct of fiscal federalism, which may undermine the working of fiscal federalism.

In order to strengthen state governments, there should be an independent loan council composed of representatives from states and federal government, as well as experts from the relevant fields, to oversee federal and states' borrowing and debt management. Although there was a suggestion of establishing a loan committee by the Raja Uda Committee in 1955 to enable consultation and coordination to take place between state and the federal government in regard to borrowing, it was not incorporated in the 1956 financial reforms or in the Independence Constitution 1957.[29] In other federations, borrowing arrangements are assigned to an impartial body. In Australia, for example, the Australian Loan Council, essentially a centre-state body, controls both external and internal public borrowing. Thus, in Australia, neither the central nor the constituent governments have any independent borrowing power. The borrowing requirement by both level of government is determined by the Council. In Malaysia, the only way the states can voice their views on borrowing matter is through the NFC which, under Article 108(4) (c) and (d) of the Federal Constitution, has to be consulted by the federal government on the annual loan requirements of the states and on the making of loans to any of them. With the power to allow or refuse loans, the federal government has control over the direction of development in the states, even in areas of states' competence. With the establishment of an independent loan council, borrowing powers could be assigned to states to raise loans or bonds on a case-by-case basis, based on economic and financial justifications, unbound by any political wrangling.

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[29] See Malaya (1955) and Malaya (1957c).

7.7 Conclusion

The foregoing analysis reveals that states' finances need to be strengthened to promote states' financial 'independence' and to minimise states' over-dependence on the centre for funds. More importantly, it is hoped that strengthening states' revenue-raising power through the reassignment of revenue could alleviate fiscal imbalance. However, as noted earlier, the centre seems hesitant to reassign more revenue sources to the states, due to the 'limited revenue sources' that can be reassigned to the states, while politically giving more resources to states could weaken the political leverage of the centre.

Another way to strengthen the states' finances is through proper fiscal adjustment based on a basket of socio-economic indicators, such as the fiscal needs of the states, population, health, price index, remoteness, and states' level of economic development. In the final analysis, fiscal adjustment should be able to eliminate revenue-expenditure mismatch. Nevertheless, the significance of fiscal adjustment is undermined by the inefficiency of the NFC. The institutions of intergovernmental fiscal relations, such as the NFC, have political influence, in that most of the decisions made are the outcome of political leverage as part of the centre's political endeavour to pursue the maintenance of one-party dominance, unlike in some federations such as India and Australia, where the institutions of intergovernmental fiscal relations are to some extent politically independent.

Although the Federal Constitution has provided for flexibility in the matter of alterations to revenue assignment and fiscal adjustment, in practice, however, no significant changes have been made since independence. The underlying factor is the question of political will on the part of the federal government. Without political will, there appears to be no foreseeable prospect of fiscal reform. Put differently, resolving fiscal imbalances requires political solutions within the spirit of federalism. This is because only the federal

government can initiate any form of fiscal adjustment. For this reason, a political climate conducive to genuine co-operation will have to be created to foster co-operation between the federal and states, especially with the opposition-led state governments. Often, the opposition-led state governments claim that the federal government purposely uses delaying tactics in grant disbursement, as part of the political game. It is hoped, therefore that the federal government will make a concerted effort to have overall financial arrangements reviewed, particularly the grants system.

In light of these circumstances, it seems timely to review the financial arrangements, as since independence, there have not been any significant changes in the division of revenue arrangements. Reforms should obviously be aimed at a system of revenue allocation from the federal to states, based on objective criteria, and take into account the particular difficulties of states. More importantly, in allocating funds and in the disbursement of grant to states, political differences should not be used as one of the main determinants as that could distort the states' economic development. Otherwise, the federal government could be held partly to blame for the economic backwardness of the states ruled by the opposition party, such as the 'economic eclipse' experienced by Sabah during the PBS government as well as by Kelantan and Terengganu, simply due to political differences.

Chapter 8

Conclusion: Fiscal Federalism as a Political Process for Accomplishing Unity in Diversity

This chapter elucidates, concludes and acknowledges the achievement of research objectives drawn from the problem statements and research questions, and presents the findings of the research. This chapter also discusses research contribution as well as suggesting future directions of study for the benefit of the enhancement of knowledge in the area of fiscal federalism in general and in Malaysia in particular.

8.1 Prologue

Federation is deep-rooted in the idea of covenantal theory, in which two or more previously independent states are bound together into a larger political union in a moral contract or agreement of trust (see Chapter 2). The relationship so established is essentially federal, and the liveliness of this relationship is based on the federal spirit, that is, mutual recognition, trust, tolerance, respect, obligation, cooperation and responsibility, the underlying forces of federal creation. In short, a federal form of government results from the voluntary joining together of a number of previously independent states into a new and larger political system by way of a treaty between sovereign states, in which both the federal and the states have their own power / jurisdiction. Unlike constituent state governments, the source of the federal government's power originates from the states and is established through the bargaining process at the time of federating, while the constituent units continue to maintain significant powers and competences. This is the source of Elazar's 'self-rule and shared rule' principle, indicating power at both levels of government within the federation. This division of powers, including financial arrangements, is established according to covenantal theory. Therefore, this argument supports the hypothesis that every sphere of federal-state relations in a federal system, in

particular the aspects of intergovernmental fiscal relations or fiscal federalism, should be designed and implemented on the basis of the federal spirit and not merely on economic expediencies.

Fiscal federalism is the salient feature of any federation, which can create cordial federal-state relations, or be a source of federal-state conflict if it is not benignly managed. Inappropriate design of intergovernmental fiscal relations leads to problems of fiscal imbalance between the centre and lower levels of government (vertical imbalance) as well as among the lower levels of government (horizontal imbalance), which can cause detrimental effects on regional economic development and subsequently create conflicts and disunity and might even pose a threat of disintegration to the federation itself. Indeed, fiscal federalism is a political device used in the political process to fulfil the purpose of federation by facilitating flexibility and appropriate adjustments to accommodate diversity and thus ensure stable and cordial federal-state relations. It is a political process of unending negotiations to resolve conflicts, based on the spirit of federalism. Therefore, fiscal federalism is much more than federal-state financial arrangements. At the heart of fiscal federalism are political objectives rather than merely economic gains, which is usually found in the literature on fiscal federalism.

As a political process, therefore, the good design of fiscal federalism is of paramount importance to ensure cordial relations between federal and state governments, as it allows the voices of the constituent states to be heard in all decisions that directly affect the states' interest. Building the federal spirit into the design of fiscal federalism could promote unity in diversity. However, the conventional study of fiscal federalism views this important subject almost entirely in economic terms, focusing on the issues of efficiency and equity in the division of functions and taxes, as well as intergovernmental transfers and borrowing powers. It fails to emphasise the importance of the political aspects of the particular federation, in particular the implications of political and party

systems for centre-state fiscal relations. This gap exists in the conventional study of fiscal federalism in Malaysia where there is an absence of federal spirit and a lack of attention given to the implications of the party system in the design and implementation of fiscal federalism. Indeed, as has been seen, the working of fiscal federalism is very much influenced and shaped by the conduct of the political parties and party system. Consequently, the economic analysis of fiscal federalism, while important, has only a partial significance once the political aspects of federalism are also considered. The thesis has demonstrated that federal-state relations in Malaysia are strongly influenced by political party interactions. In this situation, the effective role of institutions of intergovernmental fiscal relations is of paramount importance. Although fiscal federalism is of great importance to ensure cordial federal-state relations, there is no concrete theory or model of fiscal federalism in the literature that can serve both the economic and political purposes of federalism, and which is universally applicable for every federation. What does exist is only a fragment of theory drawn from the economic theory of multi-level finance in a multi-level or decentralised system of government.

Due to the significant implications of fiscal federalism for federal-state relations, there is evidence of a renewal of interest in the study of fiscal federalism. Such interest is also motivated by a growing movement toward fiscal decentralisation in recent years, advancements in economic theory and, more importantly, a growing demand for local participation in the decision-making process involved in the delivering of public goods and services, as well as the high demand for public governance from the electorates. Financial arrangements in federal systems of government are constitutionally entrenched, largely the upshot of the political bargaining process at the time of federating. Hence, the fiscal relationship between federal and state governments is a relationship between co-ordinated partners in the governmental process and not between superior and subordinates. Thus, there is a fundamental difference of financial arrangements between

federal and non-federal systems / multi-level governance. Financial arrangements in the latter are not necessarily constitutionally entrenched; but are based instead on concessions, which can be rescinded unilaterally. The relationship between the higher level of government and the government below is in the form of principle-agent relationship.

Intergovernmental fiscal relations in federal systems should ideally guided by three principles. First, the economic functions of government (stabilisation, redistribution and allocation) and the principles of public / federal finance (utility maximisation). Second, the federal spirit (cooperation, trust, partnership and respect). Finally, the political aspect of federation (the political system and its operation). However, the second and third principles have usually not been given due recognition in the design of conventional studies of fiscal federalism. This is the missing link of conventional studies of fiscal federalism, in particular, the role of the various political parties and the party system in shaping intergovernmental fiscal relations. Therefore, this study aims to fill the gap in previous studies on Malaysia's fiscal federalism, which were limited to the economic approach. In order to appraise the significance of these principles, it is necessary to examine both the economic and political aspects of Malaysian fiscal federalism in order to assess to what extent it conforms to the concept of federalism and the theory of fiscal federalism. By so doing, it is then possible to analyse the reasons why fiscal federalism in Malaysia is not working as effectively as it should. The following section will summarise the research findings of this study.

8.2 Research findings

As mentioned in Chapter 1, the general research question addressed in this study is why fiscal federalism entrenched in the Constitution is not working according to the federal spirit. Is this due to shortcomings in the design of intergovernmental fiscal relations in Malaysian fiscal federalism that cause persistent long-term fiscal imbalance? Due to

inherent weaknesses in the existing fiscal adjustment system, is there any political will to introduce structural reform of federal-state fiscal arrangements to eliminate endemic fiscal disparity and bring unity in diversity to the Malaysian federation? These issues suggest that better use should be made of the National Finance Council (NFC) as an institution of intergovernmental fiscal relations in order to foster cordial federal-state relations. In the final analysis, the findings of the research are aimed at strengthening the financial position of the constituent states, thereby reducing their financial dependence on the federal government. This is one of the key issues that has been verified in this thesis, using a case study approach drawn from Bell (1993), Stake (1994), Yin (1994) and Punch (1998). The reason for choosing the case study approach, as discussed in Chapter 1, is the strength of the case study method in allowing the researcher to concentrate on one detailed specific case, namely, that of intergovernmental fiscal arrangements in the Malaysian federation, which is a matter of particular public interest.

As examined in Chapter 3, fiscal federalism in Malaysia evolved from the political process leading to the creation of the Federation of Malaya in 1948 and subsequently to the Federation of Malaysia in 1963. Given the 'design' of fiscal federalism, the study undertook to investigate the concept of federalism and the theory of fiscal federalism and subsequently conducted an analysis of Malaysian fiscal federalism and its implementation, its strengths, weaknesses, and threats, to gauge the extent to which it relates to the federal concept and the theory of fiscal federalism. The conclusion reached is that, due to shortcomings in the design of fiscal arrangements during the creation of the federation, the constituent states are heavily dependent on the federal government for funds to finance their constitutionally assigned functions. Given the background of the political system, fiscal federalism has been used to maintain the dominance of the incumbent ruling party, to ensure its continuation in power, and to make states dependent on the largesse of the federal government so that they remained subordinate and

subservient to the centre. This is why fiscal federalism as set out in the Constitution is not working properly. As a result, if a constituent state is ruled by a political party or coalition of parties different from that of the centre, it will be subjected to undue financial pressure to come back into line. On the other hand, if a state is ruled by the same political party as the centre, the state will become complacent and unable to prevent federal coercion and usurpation. In the final analysis, this practice of fiscal federalism leads to the emergence of a so-called 'leviathan government', referred to later in the conclusion. This conclusion supports and reinforces the findings of the study by Rais Yatim concerning executive supremacy in Malaysia:

> 'The supremacy of the executive in Malaysia is complete and comprehensively self-sustaining. There does not seem to be any sign of a major fissure in its propulsion to stay that way for some time to come. It has come to occupy a truly supreme position that renders the other segments of government – Parliament and the judiciary – subservient to it' (Rais Yatim, 1994: 362).

Hence, Rais Yatim's assertion and the conclusions of this study demonstrate that the dominance of a leviathan government for years to come is self-evident and irrefutable. Indeed, it has already taken root.[1] This conclusion is supported by what follows in the next section.

8.2.1 Lack of priority on federal-state fiscal arrangements during the creation of the federation.

As hypothesised, there are a number of flaws in the structure of Malaysian fiscal federalism originating from its design, which have caused persistent long-term fiscal imbalance and subsequently reduced its efficiency. From close analysis, it was found that fiscal federalism in Malaysia is not designed according to the federal spirit (see Chapter 3) in that states have little bargaining power because the Malay states during the federating process were not yet independent; they were still under British colonial rule.

[1] This was evident in the political sphere, in which the ruling elite uses the most powerful instruments to strengthen its continuation in power, such as the powerful Internal Security Act (ISA), the mass media control (the Printing and Publication Act and the Sedition Act), judicial interference and executive supremacy, in the guise of maintaining security and public order. In the sphere of fiscal federalism, this study shows how political affiliation shaped the federal-state fiscal arrangements. Thus, all available means are used to create a larger and more powerful central government.

There was no representation from the states in the making of the memorandum for the independence Constitution, except by the Alliance Working Party composed of UMNO, MCA, MIC, and the rulers' representatives entrusted to review the Reid Commission Report. The members of the Alliance Working Party was primarily concerned with communal and political issues, notably, citizenship, Malay rulers' position and the desire of the Malays to preserve their political supremacy over non-Malays, especially the Chinese. As such, political interests were given more attention than fiscal matters and state rights. In addition, a strong central government theme imposed by the British authority as prerequisite for self-government, resulted in the centralisation of functions. The creation of a strong central government was seen as important in view of the prevailing situation at the time of federating, that is, for the fostering of national unity in the new union as well as for facing the common threat (a communist insurgency) in the newly formed federation. As a result, the majority of powers including federal-state fiscal matters were assigned to the centre, while the less important powers remained with the states, namely, those functions traditionally associated with the sultans - religion, religious education, and cultural affairs. The Constitution therefore severely limits the importance of state governments in the overall fiscal arrangement.

However, when the Federation of Malaysia was formed in 1963, the asymmetrical position of Sabah and Sarawak put them in a much better position than that of the original member states in the sense that these states enjoyed some degree of fiscal autonomy (more revenue sources, transfers and borrowing powers). This constitutional asymmetry was a result of the strong political bargaining by the two states concerned before they entered the federation, since prospective members enter a federation voluntarily only if they expect to gain from it; otherwise they can remain outside, as in the case of Brunei.

The upshot of these circumstances is that fiscal federalism in Malaysia has many shortcomings, especially concerning the division of revenue (taxation) sources, intergovernmental transfers and borrowing. The federal government has exclusive power over important functions, making state governments subordinate to the centre. The federal government also possesses lucrative revenue sources and vested with the power and responsibility to obtain and collect all major revenues, as well as access to sources of borrowing (domestic and external). Thus, all major taxes such as income tax, customs duties, and licences from motor vehicles, which in most federations (such as in the USA, India, and Canada) are also available to individual states, are not available to the constituent states in Malaysia. Hence, the federal revenue has grown much faster than the states' revenues, because the federal government administers all income-elastic taxes. The assignment of favourable revenue sources to the federal government is justifiable from the point view of the economic functions of the government - stabilisation, allocation and distribution functions (See Chapter 2).

The Federal Constitution also provides for all major areas of expenditure to be borne by the federal government. Expensive matters such as education and health, which in other federations are undertaken by the states, are in Malaysia undertaken (both policy and executive authority) by the federal government. The significance of federal responsibility for important expenditures is understandable, as the Constitution assigns the bulk of the revenue sources, that is, the power to raise all major taxes and to raise new sources of revenue, to the federal government. The federal government, therefore, is in a position to undertake surplus or deficit budgeting to suit the prevailing economic conditions in order to meet intended national economic objectives. This power is not available to state governments. Thus, the centralising forces in Malaysia are further strengthened by the exclusive fiscal powers of the federal government, because fiscal and monetary policies are within the control of the federal government, which can raise revenues or loans and

increase its expenditure at any time. Overall, the federal government has complete fiscal power to determine the direction of the public sector, leaving the state governments with matters of secondary importance.

On the other hand, the state governments are assigned the less productive sources of revenue in line with their constitutionally assigned functions. The states' independent revenue sources are limited, local in nature and more difficult and expensive to administer and to collect than federal revenues, which are more productive, lucrative and elastic. With limited sources of revenue and restricted borrowing powers, state governments face great financial difficulties in seeking to finance their own functions. This situation has resulted in a long-term fiscal imbalance, vertical and horizontal, due to non-correspondence or mismatch between revenue collected and responsibilities to be performed. Consequently, transfers of funds from the federal government to states are needed to meet states' financial difficulties.

However, the federal transfers, as a means of financial adjustment to overcome fiscal imbalance, were not properly designed: they were not intended to eliminate the financial non-correspondence facing the state governments. As a result, the design of fiscal adjustments made to remedy this problem were not sufficiently effective in bringing financial relief to state governments and have failed to have an equalising effect, as not all grants are real grants intended to balance out state governments' accounts. Furthermore, total federal transfers are too small compared to the total federal government revenue. To make matters worse, the grants system does not have a built-in mechanism to respond to economic changes, and the distribution, more often than not, is partisan. As a result, the current practice of transfers not only fails to bring equalising effects, but also is used as a political instrument to strengthen the power of the ruling party and to prevent the opposition from rallying political support. Hence, in the final

analysis, the 'have' states (those with high GDP) receive higher amounts of grants than the 'have not' states, and consequently, in the long term, the rich states become richer (see Chapter 4).

Moreover, the role of the NFC as an institution designed to foster intergovernmental relations is also not effective. By and large, the decisions it makes are indirectly influenced by political motivation, they are not binding on the federal government, and only the federal government can initiate changes on fiscal matters concerning the states' finance. Hence, the NFC acts only as an agent of endorsement of the federal government's fiscal policies involving states' matters, in line with its role as a 'caretaker' of the state government. Clearly, state governments are firmly subordinated by the actions of the federal government. Although this makes state governments weak, there is no concerted action by the states to improve the current arrangement. This is because one political party has dominated the federal government since independence, making it impossible for state politicians to oppose existing arrangements (see Chapter 6) for fear of losing political popularity in the eyes of federal political elites. Hence, the behaviour of state politicians that puts their political interests first has 'let the federal government pursue their priorities' (Abdul Aziz Bari, 2003: 135).

Although the design of Malaysian fiscal federalism exhibits some shortcomings, there are some elements that conform to the economic theory of fiscal federalism, in particular, the subsidiarity and efficiency principles in the division of power / function (see Chapter3). According to these principles, functions that have benefit throughout the federation and are important for macroeconomic purposes (for stabilisation, allocation and redistribution) are assigned to the centre, while selective functions of a localised nature are assigned to the state governments. Nonetheless, there are some violations of the efficiency principle in the division of the revenue sources, in that localised taxes such as

property taxes, consumption taxes, and vehicle taxes, which should be handled by the state governments, are assigned to the centre. However, the assignment of important revenue sources - corporate tax and income tax - to the centre does not violate the principles of efficiency and equity, instead will promote economic incentives and will avoid unnecessary tax competition.

8.2.2 Increasing states' dependence on the largesse of the federal government for funds

The constitutionally assigned state revenue sources are characterised as narrowly based, inelastic and lacking in buoyancy. The finding from this study suggests that states' revenue raising powers should be strengthened. This means that reassignment of revenue sources to the states is necessary. Reforms should obviously be aimed at a system of revenue allocation to states, as of right, based on objective criteria and taking into account the particular difficulties of the individual states. Of particular importance, states' revenue sources should be stable and unimpeded by political wrangling. In doing so, the combination of the derivation principle, federal-state revenue sharing arrangements, the efficiency principle, and compensation for states' revenue losses can be considered (see Chapter 7). Besides, three important principles should also be considered in reassigning revenue sources to the states. First, the adherence to the economic functions of government (stabilisation, distribution, and allocation functions). Second, the federal spirit (cooperation, partnership and respect). Third, the political aspects of federation. These three principles bring together economics and politics, thus affording a proper design of fiscal federalism. From the economists' point of view, the most important criterion for intergovernmental fiscal arrangements is that the design should be capable of promoting incentives at all levels of government, fostering business activity / growth, providing public services efficiently, and promoting equity. From the political standpoint of the federal system, however, the design should be capable of

providing territorial justice and political stability: a fundamental prerequisite for any stable government and federation.

Apart from these measures, the modernisation of the tax collection system at states' level is important. It is noticeable that the system of tax collection by the state governments is not consistent from one state to another. No standard mechanism of administration is practised. There is also tremendous revenue potential in land taxation, as land tax collection is still not fully developed. State governments should therefore improve the efficiency of their land office administration and should take steps to ensure regular collection of land revenue and arrears. State governments need to explore the potential of land tax as a major source of revenue in the future. Long term planning of state taxation should be carried out to encourage them to explore the potential of land tax and betterment charges. Without proper planning of future resources, state governments will be forever dependent on the federal government, leaving state government as beggars for federal funds and further strengthening federal encroachment on state affairs.

8.2.3 The 'breach of political contract' in the implementation of intergovernmental transfers

The existing arrangement of intergovernmental fiscal relations causes a revenue-expenditure gap among and between states, due to the limited, narrow and unproductive revenue base, as the most productive taxes fall under the federal government's jurisdiction. This problem creates fiscal imbalances (vertical and horizontal) as some states have more than enough revenue to meet their expenditure while others struggle in debt. Vertical imbalance (non-correspondence between revenue and expenditure) occurs as a result of limited revenue versus expenditure requirements (or needs), escalating maintenance costs and inflation, and an increase in the number of federally sponsored projects in the states. Horizontal imbalance, on the other hand, occurs among states arising from differences in their fiscal capacities, and differences in the cost of fulfilling

state responsibilities and duties. Although fiscal imbalance is a normal characteristic of every federation, fiscal imbalance in Malaysian fiscal federalism is different, because no adjustment is made to attempt to eliminate the revenue - expenditure mismatch. These imbalances need to be corrected through fiscal / financial adjustments. There are three methods to remedy fiscal imbalance: by federal transfers, by reassignment of revenue, or by changes in tax components. However, the most practical choice is by federal transfers, as it is relatively less difficult to administer and recognises the lack of efficiency in revenue collection machinery at the state level. To this end, the grant design should not only be able to eliminate the revenue-expenditure gap, but, more importantly, it should be able to encourage local tax effort, discourage wasteful spending and ensure that grant objectives are achievable.

Analysis of fiscal imbalance in Chapter 4 and regression analysis of determinants of federal transfers in Chapter 5 showed that federal transfers are inevitable, as most of the productive resources and revenue raising power are centralised. Thus, federal transfers become important elements in intergovernmental fiscal arrangements. As discussed in Chapter 4, federal transfers have been ineffective in bringing about fiscal equalisation effects, and the size of transfers are small compared with the amounts of revenue collected by the federal government. Currently, the federal government gives little attention to the issue of federal transfers in the annual budget. The federal government should act as 'helping hands', not 'grabbing hands'. This problem is further exacerbated by a lack of political commitment on the part of the federal government to undertake transfer reforms that can have an equalising effect on state governments, although the Constitution provides for such flexibility.

To achieve optimum distribution of income and wealth, balanced geographical development, national unity, harmonisation and integration among members in the

federation, the issue of transfers must be addressed amicably within the framework of the federal spirit. It is a form of political contract established during the time of federating and therefore should be honoured. Thus, the federal government should take the initiative to improve the current practice of transfers to the state governments, as provided in the constitution (Article 110), to address the problems of vertical and horizontal imbalance. Failure to undertake necessary adjustments means a breach of political contract and an undermining of the common purpose of federation. In this case, an effective equalisation programme as practised in Canada, Australia and Germany could be an alternative worth considering in Malaysia's fiscal federalism. However, an equalisation programme (as a means of redistribution of wealth) across the federation may not be viewed as fair, especially by richer and more prosperous states, unless there is a strong sense of nationhood and if the political power of the poorer states is important to the politics of the ruling government. Equalisation requires the 'have' states to share their good fortune with the 'have-not' states; otherwise an equalisation programme will not work effectively. This is evident in the case of German unification, in which the richer Länder in the west shared their wealth with their new counterparts in the former East Germany.

Inappropriate design of intergovernmental transfers can give rise to financial constraints on the constituent governments' finance and, as a result, other sources of financing, notably borrowing rights, are needed to overcome the constraint. However, as state borrowing also has a significant impact on the overall national economic management, proper design of state borrowing is needed to ensure that it will not cause unnecessary fiscal imprudence, without undermining the states' rights and the importance of the states' fiscal affairs. Therefore an independent loan council, not bound by political wrangling, is of paramount importance in this matter. This is another area of concern for fiscal federalism.

From the economic point of view, the constituent governments should be granted borrowing powers, as their revenue raising powers are limited and the federal transfers are not intended to meet the states' full financial needs. However, borrowing should be allowed only to finance long-term public investment projects, which can generate long-term benefits to tax payers. For this reason, the state governments should be allowed to borrow from domestic sources, provided borrowing is not excessive, does not cause financial crowding out effects on the private sector, and the funds are raised at market interest rate, without any implicit or explicit government subsidy. The states should also be allowed to raise loans or bonds from the capital market to finance long-term development projects. However, borrowing from the central bank should be prohibited; otherwise the central government could lose its control over the country's monetary policy. This is important to ensure that constituent governments' borrowing does not become a major cause of macroeconomic instability and unnecessary inflationary pressure put on the economy.

8.2.4 The National Finance Council (NFC) as an instrument of control and centralisation

The NFC is an institution of intergovernmental fiscal relations, which promotes and fosters better fiscal relations between federal and state governments, to ensure no open clashes in intergovernmental fiscal relations. It is a high level intergovernmental consultative body as far as fiscal federalism in Malaysia is concerned. Both levels of government should be free to bring forward any financial matters that require consultation between the federal and state governments. This is the spirit of the NFC's real role, inspired by the Constitutional Commission during the drafting process of the Federal Constitution.

This thesis, however, has shown that the NFC is not effective in fulfilling its role as an institution of intergovernmental fiscal relations, as the decisions made by the Council are (indirectly) politically influenced. This is not surprising, as the members of the Council are largely drawn from the ruling party (see Chapter 7). In effect, the position of the federal government through the controlling power of the Prime Minister, as the chairman of the Council, is stronger than that of the thirteen states taken as whole. Thus, federal political strength actually dominates the Council, and hence, the impartiality of the Council is in jeopardy. In other words, the federal government virtually controls the NFC through political hegemony and allows little opposition. At the same time, fiscal federalism in Malaysia suffers from the lack of intergovernmental institutions that could foster good federal-state relations, in particular with states ruled by different political parties from that of the centre. The existing mechanism, such as the Council of Chief Ministers Meeting, presided over by the Prime Minister, only involves the Chief Minister of states from the ruling party. In the Canadian, Australian and German federations, intergovernmental institutions are very well developed, which promotes a high degree of cooperative federalism, regardless of political party differences (Jeffery, 1999; Watts, 1999d).

The failure of the NFC has led the federal government to assume a supervisory role over state finances, even to the extent of coercing state governments to follow the centre. As a result, any differences of opinion are easily overruled by the federal government. Thus, the Council is little more than a platform for the exchange of views between the two levels of government, given the political supremacy of the federal government on the Council. Consequently, the NFC is an indirect instrument of federal control of the state governments' fiscal affairs, further strengthening centralising forces and buttressing the federal government's overall hegemony. This has become a major hindrance, preventing the Council from becoming an impartial body able to discharge its function as an

institution of intergovernmental fiscal relations. In addition, the decisions made by the Council are not binding on the federal government, even though the Constitution provides that the federal government must consult the Council should financial conflicts arise. To be significant, the decisions made in the Council should be final and binding on both levels of government.

In other federations, the institution fostering good intergovernmental fiscal relations is an impartial body. For instance, the Finance Commission of India and the Commonwealth Grant Commission of Australia are two good examples of institutions of intergovernmental fiscal relations. The members of these institutions are professionals familiar with the various aspects of intergovernmental fiscal relations. In this way, any political influences on decisions are minimised. The NFC, which to date acts merely as an advisory body to the federal government, could be reorganised so that its members consist of professionals from various backgrounds and decisions made would be binding on both levels of government. To strike a balance, there is an urgent need for an impartial institution of intergovernmental fiscal relations, so that the Council can effectively coordinate and review federal-state financial relations on a regular basis, unimpeded by party politics, as the states are becoming politically and economically mindful of their rights. Regular meetings should be held to supervise any practical difficulties in federal-state fiscal matters.

8.2.5 Increasing states' fiscal complacency, deteriorating fiscal responsibility and public governance

Shortcomings in the design of fiscal federalism have resulted in a lack of states' fiscal responsibility as state governments become highly dependent on the federal government for funds to finance their own responsibilities. This is noticeable in the way state governments respond to citizens' demands for public services. Instead of responding positively, state governments, especially those ruled by the same political party as the

centre, have a tendency to transfer the responsibility to the federal government, since they rely on having good political relations with the federal political leaders. This is how their political allegiance to the centre is 'compensated', though it makes the state government complacent. This practice of fiscal federalism is clearly inimical to the principle of public governance, as fiscal relations between states and federal government become less transparent, especially when the institution of intergovernmental fiscal relations (the NFC) is also ineffective. This has led to excessive, inefficient, irresponsible public spending, and the sidestepping of financial accountability. As a result, states are unable to protect themselves from the growing centripetal force of the centre, as states become financially weaker and incompetent in every sphere, and hence strengthen the federal claims that states should be put under federal supervision; in short, the federal claim becomes a self-fulfilling prophecy.

In the light of the centralising nature of the Malaysian political system, states' over-dependence on funds from the federal government has political consequences if the state government is controlled by the opposition. The effect can go far beyond the financial consequences– more often than not it results in political leverage for the federal political elites in the face of severe party competition to control states. This is an undesirable aspect of the states' financial over-dependence on the federal government, as it is used to maintain one-party rule over the country.

8.2.6 The political uses of fiscal federalism

The division of power between federal and state governments into three lists, the Federal List, the State List and the Concurrent List, shows the kind of fiscal federalism existing in Malaysia. These lists provide legal boundaries, within which the constituent members of the federation work. In other words, the division of powers and functions as enumerated in the constitution is only a guideline – the dos and don'ts – to be followed by both

federal and state governments to avoid possible clashes of powers / functions between the two levels of government. Due to comprehensive lists of functions, conflict between the states and the federal government over the division of functions and revenue seems unlikely (see Chapter 3).

Nevertheless, difficulties arise in the course of time due to unforeseen circumstances, especially owing to changes in political conditions which affect the conduct of federal-states fiscal relations, as evident in the case of royalties payments, disbursement of grants, borrowing and other forms of fiscal control by the federal executive. Therefore, the actual working of fiscal federalism lies not so much in the Constitution per se, but in accordance with the political operations, in particular the political interaction between federal and state levels, which affects the whole spectrum of federal-state relations (see Chapter 6). With regard with the disbursement of grants, Abdul Aziz Bari commented,

> 'it may be argued that the situation would not have become worse if the provisions have been implemented as they are; hence there should be no question of federal grants being denied or delayed for political reasons. And the situation would not have deteriorated had the state governments put their constitutional rights above their party's political interest. Alas, in practice politicians tend to give priority to their parties rather than their states' (Abdul Aziz Bari, 2003: 135)

Hence, the political system and its operations have a significant bearing on the working of fiscal federalism. The economic model alone cannot entirely explain this phenomenon; it is necessary to look at the non-economic factors - political, cultural and social - which affect the conduct of fiscal federalism. As Vile claimed,

> 'The major characteristics of the federal structure, a mixture of mutual independence and interdependence, must have their political aspects as well as their constitutional basis, and in the long run their continuance will depend more upon the political than upon formal legal structures' Vile (1973: 16).

Thus, the best guarantee of cordial federal-state relations and fiscal federalism in Malaysia lies not in the Constitution provisions per se but rather in the political system, in particular, membership of the same party at federal and state levels. In the words of Abdul Aziz Bari, 'it is quite apparent that thus far the problems that have undermined

Malaysian federalism were not entirely legal but instead political' (Abdul Aziz Bari, 2003: 140).

To make matters worse, the Senate, which is supposed to safeguard state interests, is also ineffective, as its members are largely from the ruling party, which prevents the opposition from rallying support on matters of the states' interest (see Chapter 3). Furthermore, the federal and states bureaucracy is also controlled by the federal government (Zakaria Ahmad, 1987). For instance, the legal advisers and state financial officers (except in the former non-federated Malay states (Kelantan, Kedah, Terengganu and Johor) appointed from the federal service. Besides, the federal influence is also significant through the nationwide economic development policy and federally sponsored projects which require states to accept federal bureaucracy.

8.2.7 The deterioration of fiscal federalism in the presence of 'leviathan government'

Another key finding of this study that supports the emergence of a 'leviathan government' is the implication of political interaction between federal and states which significantly determines, shapes and influences the conduct of fiscal federalism. The centre exercises its fiscal muscle over states led by any political party not affiliated to the centre, and the centralising nature of the political system, as well as the executive supremacy of the ruling party, encourages a sustainable 'leviathan government'. The emergence of a 'leviathan government' is based on the leviathan hypothesis expounded by Brennan and Buchanan (1980), which state that the size of a government will be smaller if more tax and expenditure functions are decentralised. Put differently, the size of government will be larger ("leviathan") if more and more government functions are centralised. Using the justification of economic efficiency, the Malaysian federal government has successfully usurped the role of the constituent state governments on grounds of their fiscal inadequacy. In the final analysis, the centralisation of power makes

the role of the federal government in the economy dominant. The bigger and more dominant fiscal function of the federal government and the centralising nature of the Malaysian political system undoubtedly help the federal government to maintain control over state governments in the party competition. Indeed, the shortcomings of fiscal arrangements, which favour the centre, provide political leverage for the federal government to prevent the states from joining the ranks of the opposition. Therefore, to combat a leviathan government, fiscal decentralisation should be promoted (Oates, 1985; Rodden, 2002).

Close analysis reveals that the real reason behind the federal move to push states towards federal patronage is primarily to promote the building of 'a nation state' *(negara bangsa)*, a vision that sees Malaysia as a single state based on one culture and one political belief. This vision cannot be realised if the states are moving in the opposite direction to the centre. Therefore, the federal government sees fiscal federalism as an instrument of national integration that will guarantee the dominance of the BN, led by UMNO, in a reconstituted nation state. However, this notion of a nation state means renunciation of the existence of the state government concept, which is clearly antithetical to the federal principle.

8.3 Research contribution and direction for future research

8.3.1 Research contribution

This thesis represents the first ever study of Malaysian fiscal federalism from the perspectives of both economics and political science. This is as it should be, because a more holistic approach recognises the fact that fiscal federalism is essentially a political process whose ultimate aim is unity in diversity within the federation. As the study of federalism and fiscal federalism in Malaysia is still relatively new, this study is a

contribution to the body of existing knowledge on the study of fiscal federalism. Specifically, the contribution of this research is as follows:

i. One significant contribution from this study is that the working of the federal system, in particular the federal-state fiscal relations, should be based on the spirit of federalism, that is, partnership, cooperation, trust and tolerance between federal and constituent state governments. Federal-state financial conflicts in the federal system cannot be solved by economic mechanisms alone, in particular using efficiency and equity considerations, but, more importantly, by adherence to the federal spirit in conflict management. Hence, the states' financial problems arising from structural shortcomings in the design of fiscal federalism require treatment using both economic and political considerations within the federal framework. Having examined the case of Malaysian fiscal federalism, where a federal culture is not well-established, fiscal federalism, as set out in the Constitution, will not work properly. Therefore, given the strong centralist nature of the Malaysian political system and single party dominance since independence, fiscal federalism becomes an important political instrument of the ruling party to maintain its power. In a nutshell, if the federal and state governments are ruled by different political parties, the ruling party at the centre will use fiscal means to put undue pressure on those states led by the opposition in order to maintain its power, making states dependent on the mercy of the federal government and permanently subordinated to the centre. As has been demonstrated, this practice of fiscal federalism leads to the emergence of a 'leviathan government'. Therefore, no matter how good the economic justification of fiscal federalism is, it will not work well in Malaysia if the governing ruling party is different at federal and state levels. So this is why fiscal federalism as set out in the Constitution is not working effectively: if states are ruled by the opposition, fiscal federalism will be

strained and, if states are ruled by the same political party of the centre, the states become complacent.

ii. This study is also important for many people who have an interest in fiscal federalism and wish to understand how it works as a political device for achieving the goal of federating. The conventional study of fiscal federalism, which focuses on economic efficiency and equity considerations (for stabilisation, redistribution and allocation purposes, as well as the principles of federal finance, that is, utility maximisation), has only a limited application when the political aspects of federalism are added into the picture, as in the case of the Malaysian political system. The operation of fiscal federalism therefore is a delicate process involving the solving federal-state conflicts. If conflicts are not solved according to the spirit of federalism, the consequences are beyond mere economic matters, and can extend to matters of political legitimacy, stability and even the disintegration of the state.

iii. Last but not least, this thesis helps the governing political elites and policy makers to understand why the federal spirit and democratic culture are so important in the design and implementation of fiscal federalism. Fiscal federalism is an implicit political contract that cements members of the federation together to achieve unity in diversity. As such, the spirit of federalism should be the guiding principle in solving any conflicts affecting states' interest in the federation.

In light of the practical suggestions to strengthen state government finance, as discussed in Chapter 7, structural reform of the federal-state fiscal arrangements seem timely. This is due to the fact that, since independence, no major change has been made to alleviate the states' financial difficulties. Any structural reform should obviously take into consideration the socio-economic and political developments that have taken place since independence.

To summarise, this thesis as a whole paves the way for the future study of fiscal federalism in Malaysia to be understood from a political economist's perspective rather than just as economics. This is the missing link in previous studies of fiscal federalism in Malaysia, that is, the ignorance of the federal spirit and the crucial political aspects of federalism. Hence, this research will open new dimensions and debate in the study of fiscal federalism.

8.3.2 Directions for future research

Studies of fiscal federalism and federalism have been growing significantly in parallel with the movement towards greater fiscal decentralisation. Fiscal arrangements continue to be salient features in the study of federal systems. They create much conflict and will shape the future of any federation. Ultimately, it is a political process towards the goal of federating: unity in diversity. As such, research on intergovernmental fiscal relations in federal systems is now growing widely and reflects the interest of many academic disciplines. Political scientists continue to study the implications of fiscal relations for the future of federation, especially with regard to conflict management in federations, in order to achieve unity in diversity, while economists' interest in the study of fiscal aspects of the federal system is primarily to investigate whether functions should be centralised or decentralised, based on efficiency and equity considerations. Those in favour of centralisation will argue that fiscal matters should be put under the central government, while those in favour of decentralisation argue that fiscal aspects should be decentralised to the lowest level possible.

The findings of this case study open up more areas of study on Malaysian fiscal federalism in the future. One possible area is a more focused investigation into the politics of fiscal federalism, which requires in depth interviews with politicians – their attitudes, aspirations and perceptions towards federalism, unity in diversity, and

democratic government as well as the federal culture. Indeed, very few politicians apparently care about federalism. A second area of study that merits close scrutiny is the comparative analysis of fiscal federalism and fiscal decentralisation, following the states' growing economic and political awareness, and its implications for federal-state relations. A third is a study of the significance of federal transfers for regional economic development and their relation to national integration, based on both economic and political perspectives. Finally, based on the findings of this thesis, a comparative study of the relationship between the fiscal aspects of federalism and its role as an instrument of national integration is an important project that should be undertaken in the future.

8.4 Epilogue: The future of fiscal federalism - maintaining unity in diversity

Federalism is like a living organism. It is dynamic in the sense that each federation will change according to complex social, economic and political transformations over time. Concomitantly, the issues of what are to be federal matters and what belongs to the states are changing. Hence, the fiscal aspects of federations, in particular the states' development needs, are growing in line with changes in socio-economic and political conditions. Therefore, the functions of both levels of government, the fiscal arrangements and subsequently their financial requirements are bound to change over time, according to the prevailing economic and political situation of the federation. Therefore, as the federation evolves, the initial Constitutional arrangements need to be re-examined. This is because the articles in the Constitution only reflect a political accommodation among all members of the federation and its inhabitants at the time of federating.

In view of the above circumstances, structural reform should be considered in order to guarantee a significant measure of constituent states' fiscal autonomy. Structural reform requires political commitment. Nonetheless, given the nature of the political and the party systems in Malaysia, it is impossible to undertake structural reform without strong

political backing from the government of the day. Therefore, any attempt to improve the practice of fiscal federalism in Malaysia requires not only economic but, more importantly, political determination.

As noted above, it has been proven that fiscal federalism is indeed a political process for achieving unity in diversity. Conflicts in fiscal federalism pose threats to the federation, even to the extent of disintegration. Examination of political aspects in this study reveal that the present fiscal arrangements in Malaysia can only work well when political cohesion at the states and federal level is maintained. In other words, the best guarantee of cordial federal-state fiscal relations continues to depend on the harmonising influence of membership of the same party at the federal and state levels, nonetheless, this makes states complacent and contingent on the federal government. With the highly centralised structure of the ruling party (the *Barisan Nasional*, led by UMNO), a cordial relationship hence depends heavily on the UMNO and its political operations. Succinctly, if the political party at the federal level is different from that at the states level, fiscal relations will be strained and federal-states relations will be difficult, in that federal funds would not be forthcoming in the normal way. This is evident from the experience of states ruled by the opposition party (during PAS rule in Kelantan and Terengganu and PBS rule in Sabah), as compared to the states led by the same political party as the centre. This is the main source of future conflict in Malaysian federalism. As states are now economically and politically becoming more self-aware, they will demand more fiscal powers in future, especially those states ruled by the opposition. As such, fiscal federalism goes beyond the constitutional and economic division of fiscal functions and revenue assignments; it is a mode of political activity necessary to achieve unity in the federation, and this requires certain kinds of cooperative relationships in the political system. Alas, unity in diversity in Malaysia can only be attained through the dominance of the BN government;

currently, the BN believes that, as a stakeholder of states, only the BN government can ensure national unity.

In light of these circumstances, there are two developments that can be expected to happen to Malaysian fiscal federalism in the future, both of which are equally strong but pull in opposing directions. The first is the continued strong centripetal forces that buttress the centralisation of constitutionally assigned state functions, justified by increasingly inadequate state financial capacities, and the states' apparent complacency. The federal government views the centralisation of functions as inevitable, as can be seen from the expanding privatisation programmes, for example, in the privatisation of sewerage, garbage collection and centralisation of water management, all of which are constitutionally located under the States List. While privatisation could ensure efficiency in the provision of public goods and services, federally sponsored privatisation of state functions results in states losing power to the centre, as the supervision and policy of the privatised entity become federal matters. If this happens, states will be subordinated to the centre and the original arrangement of the federal system will become complete unitary in character. As Malaysia is a small country and determined to achieve the status of a developed economy, many state functions are being usurped by the centre for the sake of optimal management of resources and balanced economic development. Therefore, centralisation of functions, which the states fail to undertake efficiently due to lack of 'resources and expertise', as a result of shortcomings in the design of fiscal federalism, is inevitable. Consequently this further strengthens the case for the federal government to retain full control of taxation and expenditure functions. At the same time, the federal government's move is justified on the grounds that the sense of nationhood and national unity can be achieved only by a strong central government, led by the BN, which controls both federal and state politics. Unfortunately, this move has caused the states to lose their fiscal autonomy. To Riker (1964), the cause of federal usurpation of

states' functions is due to the strong executive branch of the ruling party, and hence to protect against federal intervention strong state-based political parties could be promoted. According to Inman and Rubinfeld (1997), there are three ways to protect states from federal intervention: first, the rational behind the division/assignment of functions should be understood by both federal and state governments; second, any violation of those assigned functions should be exposed to the public; and finally, political institutions must have the capability to provide protection to the assigned functions against any threat of usurpation.

The second development is a growing trend towards fiscal decentralisation as states are becoming politically and economically self-aware. Therefore, most economists view fiscal decentralisation as a retreat from the centralising nature of fiscal federalism. The underlying premise of fiscal decentralisation is that decentralised decision-making for the provision of local public goods and services is more efficient, as lower level governments are closer to local citizens and thus they will easily monitor the government's activities. Based on this hypothesis, then, more powers should be assigned to state governments, unless there are strong arguments for leaving them with the federal government, such as national defence.

Why fiscal decentralisation? It is rational to assign responsibilities to lower levels of government for several reasons. First, local provision of public goods and services allows for differences in tastes and needs of the residents of the different states. Second, provision of these goods and services at a lower level is likely to be more efficient than by the federal government, as state governments are in a better position to monitor local projects and local residents are better able to communicate with their nearest level of government. Besides, inter-jurisdictional competition may lead to efficiency in the provision of public goods and services. Currently, Malaysia is one of the most centralised

federations, with comparatively few powers assigned to the states (see Chapter 3). As such, to gain the benefits of fiscal decentralisation, states need to be assigned more functions and sufficient revenue sources. Third, fiscal decentralisation could promote a democratic culture and encourage re-democratisation of government operations and institutions as well as their political system. This is because 'a decentralised country is less likely to become a dictatorship than a centralised one' (Prud'homme and Shah, 2002: 2). At the same time, fiscal decentralisation can promote public governance in the public management system as local citizens can participate in the decision-making process and perform 'checks and balances' on their elected representatives. Finally, fiscal decentralisation would empower the states when facing the worldwide trend of globalisation. Globalisation, combined with reconciling unity in diversity (due to ethnic, religion, linguistics, and economics diversity), will put further pressure on the federal political system, as there are already strong tendencies for states to be involved in international trade, which affords opportunities in some cases for participation in foreign affairs.

However, the literature reveals mixed views on the advantages of fiscal decentralisation. Some are in favour of fiscal decentralisation (McLure and Martinez, 2000; Bird and Vaillancourt, 1998, Bahl and Linn, 1994). Knowledge of local conditions, the ability to vary provision in line with local preferences, and local government's efficiency in the provision of public services, are among the arguments for implementing fiscal decentralisation. However, decentralisation does not automatically mean that state governments will become more efficient in discharging their functions and contribute to higher economic growth. Excessive decentralisation is likely to increase corruption. As such, some other economists are sceptical about the advantages of fiscal decentralisation (Zhang and Zou, 1998; Tanzi, 1996; Prud' homme, 1992).

For states to be able to undertake more functions, sufficient and stable independent revenue sources should be assigned to the states. Otherwise, the development of an effective transfer system to strengthen the fiscal position of the states is desirable, as states' revenue sources are limited. Prudent fiscal management is also equally important to the success of fiscal decentralisation apart from strong political commitment. In particular, the federal government must be willing to assign more fiscal power to the states. Without prior political commitment, fiscal decentralisation could not be implemented efficiently. This is the major obstacle in the design of fiscal decentralisation. Only when there is a strong political commitment can fiscal decentralisation be successfully implemented. As Vile (1973: 16) claimed, 'any attempt to analyse or indeed to create a decentralised system of government whether federal or not, must pay at least as much as attention to the political as to the legal'. According to Abdul Rahim (2000), in the case of Malaysia, fiscal decentralisation is irrelevant, as the federal government is serious in its commitment to deliver development to each and every constituent state.

Another argument against fiscal decentralisation is that improvement in communications and information technology, as well as better transportation in Malaysia, have reduced regional and local variations in consumers' preferences and tastes. In other words, preferences are becoming homogenous across states of the federation. As a result, the argument for decentralisation of residence-based services to accommodate the variation of consumers' preferences is not fully justified. Unlike in the case of a geographically large country, tastes and preferences differ significantly; hence, it would be justifiable for residence-based services to be decentralised, as the local state understands better the needs of the citizens and can tailor its services accordingly. For example, in the USA and Canada, where tastes and preferences of the citizens differ, residence-based services are better delivered by the states than the federal government.

Those against fiscal decentralisation also argue that only the federal government can best manage equity and distribution functions, because not only are resources at the disposal of the state government extremely limited, but they also vary.significantly from one state to another. Therefore, the issue of distribution has to be looked at from the national perspective; otherwise it may exacerbate interstate disparities if it is left entirely to the respective state governments to undertake the redistribution function. As Malaysia accords a high priority to economic growth with equity, there is a tendency for more and more responsibilities to be assigned to the federal government. However, it should be borne in mind that over-centralisation could result in serious threats to public governance and, hence, the future will feel these two opposing forces: the first pulling towards fiscal decentralisation and the second towards fiscal centralisation. Looking at the current political system of the highly centralised structure of the governing ruling party, the Barisan Nasional (BN) and UMNO, as well as the supremacy of federal executive power, centralisation forces continue to dominate, making states subordinate to the centre.

To sum up, despite several shortcomings and some disturbances, federal-state fiscal relations in Malaysia are regarded as stable and have been so since independence in 1957 and after the formation of the Federation of Malaysia in 1963. This is primarily attributed to the ability of the BN government to prevent the federal and state governments from falling into opposition hands. Also, the federal government, with the power to manage the country's resources (finances) and regulate policies on major areas of public affairs, has a firm grip on the states. This has contributed to the accomplishment of unity in diversity in the federation. However, this success has been achieved at the expense of states' being subordinate to the centre and continue to be dependent on the federal government through one-party dominance and executive supremacy of the centre. This is Malaysia's version of federalism as a means of accomplishing and maintaining unity in diversity.

However, the future of Malaysian fiscal federalism remains bleak, unless political congruence and cohesion at the federal and state levels can be maintained, as experienced by the government of Kelantan, Terengganu and Sabah, while ruled by the opposition party. More often than not, states led by the opposition have been treated with contempt, solely because of political differences. In future, the use of fiscal means by the ruling party at the centre to put undue pressure on the state led by the opposition can be expected, which increases economic 'collateral damage' on the citizens' well-being as federal funds would not be forthcoming in the normal way. This is due to the 'democratic and federal spirit deficits' in the overall conduct of federal-state relations. Therefore a high premium on the quality and creativity of central political leadership is essential if federalism in Malaysia is to continue to flourish. As has been seen, states are becoming politically and economically aware of their rights; this poses a serious threat to the federal political elites. Having said that, fiscal federalism in Malaysia works reasonably well, but much needs to be improved. Ideally, fiscal federalism should be able to promote territorial justice, economic efficiency and, more importantly, political stability, regardless of which political party has control of the federal and state governments. In a nutshell, fiscal federalism is a real test of federalism for it to achieve and preserve unity in diversity. Therefore, it is right to conclude that fiscal federalism is not merely an economic matter, but is the interaction between economics and politics, that is, a political process for resolving conflicts in the quest for unity in diversity, the underlying aim of the federal raison d'être.

'Like a river, Malaysian centre-state relations have a starting point and that is the federal design. As a river flows it, so to speak, 'lives'. So it is with centre-state relations. It flows precisely because federalism is a living thing, and its process very much determines the nature, style and content of this flow which, unlike that of a river, need not necessarily be only in one direction.' (Shafruddin, 1988: 3)

TREATY OF FEDERATION, 1895

AGREEMENT between the Governor of the Straits Settlements, acting on behalf of the Government of Her Majesty the Queen, Empress of India, and the Rulers of the following Malay States: - that is to say, Perak, Selangor, Pahang and the Negeri Sembilan.

1. In confirmation of various previous Agreements, the Sultans of Perak, the Sultan of Pahang and the Chiefs of the states which form the territory known as the Negeri Sembilan, hereby severally place themselves and their states under the protection of the British Government.

2. The above-named Rulers and Chiefs of the respective States hereby agree to constitute their countries a **Federation**, to be known as the Protected Malay States, to be administered under the advice of the British Government.

3. It is to be also understood that the arrangement hereby agreed upon does not imply that any one Ruler or Chief shall exercise any power or authority in respect of any State other than that which he now possesses in the State of which he is the recognised Ruler or Chief.

4. The above-named Rulers agree to accept a British Officer, to be styled The Resident-General, as the agent and representative of the British Government under the Governor of the Straits Settlements. They undertake to provide him with suitable accommodation, with such salary as is determined by Her Majesty's Government, and to follow his advice in all matters of administration other than those touching the Muhammadan religion. The appointment of the Resident-General will not affect the obligations of the Malay Rulers towards the British Residents now existing or to be hereafter appointed to offices in the above-mentioned Protected States.

5. The above-named Rulers also agree to give to those States in the Federation which require it such assistance in men, money, or other respects as the British Government, through its duly appointed officers may advice; and they further undertake, should war break out between Her Majesty's Government and that of any other Power, to send, on the requisition of the Governor, a body of armed and equipped Indian troops for service in the Straits Settlements.

Nothing in this Agreement is intended to curtail any of the powers or authority now held by any of the above-named Rulers in their respective States, nor does it alter the relations now existing between any of the States named and the British Empire.

The above Agreement was signed and sealed by the under-mentioned Rulers and Chiefs of the various States in July 1895.

His Highness of the Sultan of Perak
His Highness of the Sultan of Selangor
His Highness of the Sultan of Pahang
His Highness of the Yam Tuan Besar of Sri Menanti
The Dato' Bandar of Sungei Ujong
The Dato' of Johol
The Dato' of Jelebu
The Dato' of Rembau
The Tungku Dewa of Tampin

AGREEMENT BETWEEN HIS MAJESTY'S GOVERNMENT WITHIN THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND AND THE STATE GOVERNMENT

WHEREAS mutual agreements subsist between His Britannic Majesty and His Highness the Sultan of the State and territory of [name of the State]:

AND WHEREAS it is expedient to provide for the constitutional development of the Malay States under the protection of His Majesty and for the future government of the State and territory of [name of the State]:

It is HEREBY AGREED between Sir Harold Mac Michael, G.C.M.G., D.S.O., the Special Representative of His Majesty's Government within the United Kingdom of Great Britain and Northern Ireland on behalf of His Majesty and His Highness [name of the ruler of the State] the Sultan of the State and territory of [name of the State] for himself, heirs and successors:-

1. His Highness of the Sultan agrees that His Majesty shall have full power and jurisdiction within the State and territory of [name of the State].
2. Save in so far as the substituting agreements are consistent with this Agreement or with such future constitutional arrangements for Malaya as may be approved by His Majesty, the said agreements shall remain of full force and effect.

Signed this [date]

H.A Mac Michael

Special Representative of His Majesty's Government within the United Kingdom of Great Britain and Northern Ireland

[Name of the ruler of the State]

His Highness the Sultan of the State and Territory [name of the state]

Note:
The date of agreement is as follows: Johor (20th October, 1945), Selangor (24th October, 1945), Pahang (2nd November, 1945), Negeri Sembilan (14th November, 1945), Perak (22nd November, 1945), Kedah (2nd December, 1945), Perlis (4th December, 1945), Kelantan (17th December, 1945), and Terengganu (21st December, 1945).

THE TWENTY- POINTS[1]

1. Religion
While there was no objection to Islam being the national religion of Malaysia, there should be no state religion in North Borneo, and the provisions relating to Islam in the present Constitution of Malaya should not apply to North Borneo.

2. Language
   a) Malay should be the national language of the Federation.
   b) English should continue to be used for a period of ten years after Malaysia day.
   c) English should be an official language of North Borneo for all purposes, State or Federal, without limitation of time.

3. Constitution
Whilst accepting that the present Constitution of the Federation of Malaya should form the basis of the Constitution of Malaysia, the Constitution of Malaysia should be a complete new document drafted and agreed in the light of a free association of states and there should be a series of amendments to a Constitution drafted and agreed by different states in totally different circumstances. A new Constitution of North Borneo (Sabah) was of course essential.

4. Head of the Federation
The Head of State in North Borneo should not be eligible for election as Head of Federation

5. Name of Federation
Malaysia but not Melayu Raya

6. Immigration
Control over immigration into any part of Malaysia from outside should not rest with the Central Government but entry into North Borneo should also require the approval of the State Government. The Federal Government should not be able to veto the entry of persons into North Borneo for State Government purposes except on strictly security grounds. North Borneo should have unfettered control over the movements of persons other than those in Federal Government employ from other parts of Malaysia into North Borneo.

7. Right of Secession
There should be no right to secede from the Federation.

8. Borneonisation
Borneonisation of the public service should proceed as quickly as possible

9. British Officers
Every effort should be made to encourage British Officers to remain in the public service until their places can be taken by suitably qualified people from North Borneo.

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[1] The Twenty Points were a memorandum submitted by the five political parties to the I.G.C, aiming to safeguard State as well Sabah interests in the federation. This is the full text of the memorandum extracted from the Sabah Annual Report, 1962 (pp24-26).

10. Citizenship

The recommendations in paragraph 148(k) of the Report of the Cobbold Commission should govern the citizenship rights of persons in the Federation of North Borneo persons subject to the following amendments:

a) Sub-paragraph (1) should not contain the proviso, subject to five years' residence;
b) In order to tie up with our law, sub-paragraph (ii)(a) should read 'seven out of ten years' instead of 'eight out of the twelve years'.
c) Paragraph (iii) should not contain any restriction tied to the citizenship of parents- a person born in North Borneo after Malaysia must be a Federal citizen.

11. Tariffs and Finance

North Borneo should retain control of its own finance, development and tariff, and should have the right to work up its own taxation and to raise loans on its own credit.

12. Special Position of Indigenous Races

In principle, the indigenous races of North Borneo should enjoy special rights analogous to those enjoyed by the Malays in Malaya, but the present Malay's formula in this regard is not necessarily applicable in North Borneo.

13. State Government

a) The Chief Minister should be elected by unofficial members of Legislative Council.
b) There should be a proper Ministerial system in North Borneo.

14. Transitional Period

This should be seven years and during such period, legislative power must be left with the State of North Borneo by the constitution and not merely delegated to the State Government by the Federal Government.

15. Education

The existing educational system of North Borneo should be maintained and for this reason it should be under state control.

16. Constitutional Safeguards

No amendment, modification or withdrawal of any special safeguards granted to North Borneo should be made by the Central Government without the positive concurrence of the Government of the state of North Borneo.

The power of amending the Constitution of the State of North Borneo should belong exclusively to the people in the State. (Note: The United Party, the Democratic Party and the Pasok Momogun Party considered that a three-fourth majority would be required in order to effect any amendment to the Federal and State Constitutions whereas the UNKO and the USNO considered a two thirds majority would be sufficient).

17. Representation in Federal Parliament

This should take account not only of the population of North Borneo but also of its size and potentialities and in any case should not be less than that of Singapore.

18. Name of Head of State

Yang Dipertua Negari

19. Name of State.
Sabah

20. Land, Forest, Local Government, etc.
The provision in the Constitution of the Federation in respect of the powers of the National Land Council should not apply in North Borneo. Likewise, the National Council for Local Government should not apply in North Borneo.

AGREEMENT BETWEEN PETRONAS AND STATE OF TERENGGANU ON ROYALTY PAYMENT[1]

AN AGREEMENT made this **22nd day of March 1975** BETWEEN **the Government of the State of Terengganu** (hereinafter referred to as the government) of the one part AND **Petroliam Nasional Berhad**, a company incorporated under the Companies Act, 1965 whose registered office is situated at No. 21, Jalan Melaka, Kuala Lumpur (hereinafter referred to as PETRONAS of the other part.

WHEREAS by the Petroleum Development Act, 1974 the entire ownership in, and the exclusive rights, powers, liberties and privileges of exploiting, winning and obtaining petroleum whether lying onshore or offshore of Malaysia is vested in PETRONAS.

AND WHEREAS the vesting of the ownership, rights, powers, liberties and privileges hereinbefore mentioned and taken effect pursuant to the execution of the instrument in that behalf;

AND WHEREAS the Government and PETRONAS are desirous of entering into an agreement pursuant to section 4 of the aforesaid Act regarding the cash payment to be made by PETRONAS to the Government in return for the ownership and the rights, powers, liberties and privileges vested as aforesaid in respect of petroleum;

NOW THEREFORE in return for the ownership and the rights, powers, liberties and privileges in respect of petroleum vested by the Government in PETRONAS, IT IS HEREBY AGREED as follows:

1. (1) PETRONAS shall make to the Government cash payment in the form of yearly sum amounting to the equivalent of five percent of the value of the petroleum won and saved in Terengganu and sold by PETRONAS or its agents of contractors during the period provided in clause 2.
   (2) The value to be applied for the purpose of subclause (1) shall be the realised six-monthly average f.o.b price obtained by PETRONAS or its agents.
   (3) Any petroleum which is use by PETRONAS, its agents of contractors for purpose of carrying on drilling and production operations shall be deemed to be sold for the purpose of calculating the cash payment under this clause.

2. The cash payment payable under this Agreement shall be paid semi-annually. Payment in respect of petroleum won and saved and sold in the first half-year period shall be made on or before the first day of September and payment in respect of petroleum won, saved and sold in the second half-year period shall be made on or before the first day of March of following year.

3. It is agreed and declared that the cash payment payable under this Agreement shall be payable only for so long petroleum is obtained and shall not be payable if petroleum ceases to be obtained due to any reason or case whatsoever, in which case no payment by way of compensation shall be payable for the loss of the cash payment which would otherwise be payable under this Agreement.

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[1] Similar agreements were also signed with other states' governments as follows: Penang (14 March 1975), Sarawak (27 March 1975), Malacca (23 April 1975), Perlis (25 April 1975), Kedah (26 April 1975), Perak (26 April 1975), Kelantan (9 May 1975), Negeri Sembilan (12 June 1975), Johor (24 June 1975), Pahang (11 September 1975), Selangor (1 June 1976), and Sabah (14 June 1976)

4. In this Agreement, the word 'petroleum' has the meaning assigned to it by the Petroleum Development Act, 1974.

5. The marginal notes are for convenience only and do not form part of this Agreement.

6. This Agreement shall be expressed in Bahasa Malaysia and the English Language. In case of doubt the text of Agreement in English shall prevail.

IN WITNESS WHEREOF the parties hereto have caused this Agreement to be duly executed.

PETROLEUM DEVELOPMENT ACT, 1974

Schedule
Section (2))

GRANTS OF RIGHT, POWERS, LIBERTIES, AND PRIVILEGES IN RESPECTS OF PETROLEUM

I, **WAN MOKHTAR BIN AHMAD**, Menteri Besar of Terengganu on behalf of the Government of Terengganu, on this 22nd day of March 1975, hereby grant in perpetuity and convey to and vest in PETRONAS the ownership in and the exclusive rights, powers, liberties and privileges of exploring, exploiting, winning and obtaining petroleum whether lying onshore or offshore of Malaysia. The grant, conveyance, and vesting made hereunder shall be irrevocable and shall tenure for the benefit of PETRONAS and its successor.

IN WITNESS whereof I on the behalf of the Government Terengganu hereunto set my hand the day and year first herein above written.

MENTERI BESAR
TERENGGANU

.....
on behalf of the Government of
Terengganu

DATO WIRA JAYA
SETIAUSAHA KERAJAAN
TERENGGANU

.....
Witness's signature

I, TENGKU RAZALEIGH BIN TENGKU MOHD. HAMZAH, Chairman and Chief Executive of PETRONAS, on behalf of PETRONAS hereby accept the grant, conveyance, and the vesting made above.

.....

.....
Witness's signature

Done at Kuala Terengganu this 22nd day of March 1975.

The Data Used for Regression Analysis (Model 1)

$$\ln Tf_{t-2} = \alpha + \beta_1 \ln X_{1t} + \beta_2 \ln X_{2t} + \beta_3 \ln X_{3t} + \beta_4 \ln X_{4t} + \beta_5 \ln X_{5t} + \beta_6 \ln X_{6t} + \beta_7 X_{7t} + \beta_8 X_{8t}$$

Year	$\ln Tf_{t-2}$	$\ln X_{1t}$	$\ln X_{2t}$	$\ln X_{3t}$	$\ln X_{4t}$	$\ln X_{5t}$	$\ln X_{6t}$	X_{7t}	X_{8t}
1970	2.24	3.38	3.46	2.80	2.84	4.09	1.03	0	1
1971	2.22	3.38	3.54	2.84	2.89	4.11	1.03	0	1
1972	2.29	3.47	3.63	2.86	3.02	4.15	1.04	0	1
1973	2.34	3.53	3.65	2.96	3.03	4.27	1.04	0	1
1974	2.41	3.68	3.79	3.01	3.10	4.36	1.05	0	1
1975	2.53	3.71	3.85	3.06	3.20	4.35	1.05	0	1
1976	2.44	3.79	3.90	3.17	3.15	4.45	1.07	1	1
1977	2.59	3.89	4.01	3.24	3.27	4.51	1.10	0	1
1978	2.61	3.95	4.05	3.28	3.30	4.58	1.11	0	1
1979	2.57	4.02	4.09	3.49	3.45	4.67	1.12	0	1
1980	2.57	4.14	4.25	3.48	3.53	4.73	1.14	0	1
1981	2.57	4.20	4.40	3.49	3.65	4.76	1.15	0	1
1982	2.94	4.22	4.44	3.59	3.67	4.80	1.16	0	1
1983	2.94	4.27	4.41	3.60	3.73	4.85	1.17	0	1
1984	3.00	4.32	4.41	3.65	3.71	4.90	1.18	0	0
1985	2.94	4.32	4.41	3.62	3.69	4.89	1.20	0	0
1986	3.06	4.29	4.44	3.65	3.68	4.85	1.21	0	0
1987	2.95	4.26	4.40	3.67	3.65	4.91	1.22	1	0
1988	2.97	4.34	4.42	3.73	3.77	4.97	1.23	0	0
1989	3.05	4.40	4.49	3.75	3.79	5.02	1.24	0	0
1990	3.09	4.47	4.55	3.83	3.86	5.08	1.26	0	0
1991	3.11	4.53	4.58	3.79	3.89	5.13	1.27	0	0
1992	3.02	4.59	4.62	3.83	3.86	5.18	1.28	0	0
1993	3.09	4.62	4.63	3.87	3.86	5.24	1.29	1	0
1994	3.11	4.69	4.67	3.90	3.89	5.29	1.30	1	0
1995	3.12	4.71	4.70	3.92	3.91	5.35	1.32	1	0
1996	3.13	4.77	4.77	3.98	3.96	5.40	1.33	1	0
1997	3.16	4.82	4.78	4.00	3.99	5.45	1.34	1	0
1998	3.21	4.75	4.80	3.93	3.97	5.45	1.35	0	0
1999	3.16	4.77	4.84	3.92	3.95	5.48	1.36	0	0
2000	3.18	4.79	4.93	3.93	3.96	5.51	1.37	0	0

Source: Ministry of Finance

Note:

$\ln Tf_{t-2}$ = log federal transfers – two years lagged effect

$\ln X_{1t}$ = log federal government revenue (FGREV) (from all sources of revenue – tax revenue, non-tax revenue and non-revenue receipts, classification used by the Ministry of Finance, Malaysia)

$\ln X_{2t}$ = log federal government expenditure (FGEXP) (operating expenditure and development expenditure combined)

$\ln X_{3t}$ = log state government own source revenue (STREV)

$\ln X_{4t}$ = log state government expenditure (STEXP)

$\ln X_{5t}$ = log GDP (current)

$\ln X_{6t}$ = log population (POPVAR)

X_{7t} = Dummy variables of state governments financial position (STFINPOS) (0 = deficit / 1 = surplus)

X_{8t} = Dummy variable of political affiliation (POLVAR) (0 = non-affiliated (at least one state is rule by the non-BN party) / 1 = affiliated (all states are rule by the BN party).

The Data Used for Regression Analysis (Model 2)

$$\ln Y_t = \alpha + \beta_1 \ln X_{1t} + \beta_2 \ln X_{2t}$$

Year	ln Y_t	ln X_{1t}	ln X_{2t}
1970	2.84	2.80	2.24
1971	2.89	2.84	2.22
1972	3.02	2.86	2.29
1973	3.03	2.96	2.34
1974	3.10	3.01	2.41
1975	3.20	3.06	2.53
1976	3.15	3.17	2.44
1977	3.27	3.24	2.59
1978	3.30	3.28	2.61
1979	3.45	3.49	2.57
1980	3.53	3.48	2.57
1981	3.65	3.49	2.57
1982	3.67	3.59	2.94
1983	3.73	3.60	2.94
1984	3.71	3.65	3.00
1985	3.69	3.62	2.94
1986	3.68	3.65	3.06
1987	3.65	3.67	2.95
1988	3.77	3.73	2.97
1989	3.79	3.75	3.05
1990	3.86	3.83	3.09
1991	3.89	3.79	3.11
1992	3.86	3.83	3.02
1993	3.86	3.87	3.09
1994	3.89	3.90	3.11
1995	3.91	3.92	3.12
1996	3.96	3.98	3.13
1997	3.99	4.00	3.16
1998	3.97	3.93	3.21
1999	3.95	3.92	3.16
2000	3.96	3.93	3.18

Source: Ministry of Finance

Note:

$\ln Y_t$ = log state government expenditure (STEXP)
$\ln X_{1t}$ = log state government own source revenue (STREV)
$\ln X_{2t}$ = log federal government transfers (FGTF)

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