Federal-State Fiscal Arrangements in Malaysia

L.S. Wilson

State Revenue Equalization in Malaysia

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Preface

This JDI publications series arises from our CIDA-supported projects with the Thailand Development Research Institute (TDRI) and the Malaysian Institute of Economic Research (MIER). Central to these projects is collaboration by Canadian, Malaysian and Thai researchers. These monographs are intended to make research results available to broader Canadian and international audiences. We are grateful to CIDA for its financial support.

These papers by Professor L.S. Wilson of the University of Alberta address important issues concerning fiscal arrangements between the federal and state governments of Malaysia. Following up on earlier work done by Professor Paul Hobson of Acadia University, Professor Wilson provides an analysis of the important issues facing Malaysia at this time and in the medium- to long-term future, and suggests policy alternatives for addressing them. In the process of conducting this research, Professor Wilson had many discussions with the state and federal government officials and with researchers at MIER and elsewhere. The result is an improved understanding of many of the important issues that will have to be faced as Malaysia moves towards its "Vision 2020" and a contribution to MIER's capacity to assist policymakers in dealing with them.

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I. INTRODUCTION

This is the first of two papers on issues of federal-state finance and intergovernmental transfers in Malaysia. In this paper we outline what we see as the major issues, discuss the theory of the assignment of tax and expenditure powers and the resulting need for intergovernmental transfers, and look at the Malaysian situation in the context of this theory. In the second paper of the series (Wilson, 1996) we look more closely at the particular issues of the design of transfer systems and make proposals for modifying the current Malaysian arrangements. There are a wide range of concerns which result from the fact that Malaysia is a federal, rather than a unitary, state. It is worthwhile to try to sort through these to clarify what these issues are with a view towards, one, outlining what we can deal with here, and, two, introducing the other issues such that discussion can be initiated with respect to priorities for further research.

First and most amenable to treatment here is what I will call the "fiscal-federalism" issue. This is the issue of whether, given the current allocation of the tax and expenditure responsibilities between the states and the federal government, the transfer of revenues system that has evolved is optimal.

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There are two sets of problems here. The first is whether there is a “fiscal gap” (see Boadway and Hobson, 1993, pp. 28, 78-79) at one of the levels of government. This is essentially the question of whether the “marginal cost of public funds”, the “political difficulty” of raising tax revenue, differs between levels of government. In the Malaysian case it is accepted that the own-tax sources available to the state governments are insufficient to fund their expenditure responsibilities and the important question is what level of transfers are necessary from the federal government to the states to close this gap. The second problem is that of “horizontal equity”. As is well known, when the states within a common labour market have individual tax and expenditure responsibilities, problems can arise both in the equitableness of treatment of individuals by government “as a whole”, that is,
including both federal and state governments, and in the efficiency of the allocation of labour and capital. This is particularly likely to be a problem where some states have access to “source-based” taxes (see Boadway and Hobson, 1993, p. 31) and in particular has arisen in federal states where some states have access to resource revenues that others do not. In these cases, equalization schemes must be designed to emulate a system of unitary government if misallocation of mobile factors of production is to be avoided. These issues are discussed in considerable detail in Section II below.

A particular manifestation of fiscal gaps in excess of the amount of transfer payments might be persistent state government borrowing. This is a difficult area to say anything absolute about as whether states need to borrow must be a matter of judgment. States have tax bases which they can pursue more or less ruthlessly and expenditure responsibilities which they satisfy more or less satisfactorily. Federal politicians in conjunction with, or in response to representations from, their state counterparts must decide whether state revenues are adequate. An alternative margin for states, beyond curtailing expenditure or raising more taxes, is to borrow. Thus, excess borrowing may indicate inadequate transfers. This may be a reason why state debt has received particular attention. At the same time, the incentives for states not to borrow may not be correct. If, for example, state administrators expect that excess borrowing will be repaid by the federal government, should the state government not be able to repay, then there is less incentive not to borrow. In the Malaysian case this tendency on the part of state governments is, of course, controlled by constitutional limitations on where the states might borrow from.

Related to this are two other issues; first, the reallocation of tax and expenditure responsibilities between the federal and state governments and, second, the question of whether particularly the states are efficient in the application of the tax sources they do have. Powers in Malaysia are very centralized, compared to other federal systems (see Noh, 1991, p. 199) and there may be some arguments that efficiency could be enhanced by the devolution of several powers of the federal government to more local levels which could be more responsive to variations in local needs and perhaps more accountable to those being served. The general principles for the allocation of tax and expenditure powers are outlined in Boadway, Roberts and Shah (1994) and Shah and Qureshi (1994). These are surveyed in Section III and suggest that some reallocation of expenditure powers would be consistent with theory.

Parallel to this is the question of whether some tax sources might be better allocated to different levels of government. In particular, given the general acceptance that there is a permanent "fiscal gap" between expenditure obligations and tax revenues at the state level the question arises of whether more tax sources might be allocated to the states. Theory suggests, as well, that it is preferable to allocate "source-based" taxes to the national government leaving states to meet their obligations from "residence-based" taxes such as consumption taxes. At the same time the limited powers and budgets of the states means that problems of inequality and inefficiency arising from differences in "net fiscal benefits" will be limited in scope.

It is argued by some that states do not use their tax bases very efficiently (Noh, 1991, p. 334), that if they were administered better, more revenue would be collected and there would be less of a "fiscal gap" between their revenues and the costs of meeting their obligations. See, as well, World Bank (1992, para. 3.4), which suggests more revenue could be collected from forestry. It should be remembered, though, that the tax bases assigned to the states are extremely limited. Related to this issue is the question of the prospects for state tax revenues given growth and the industrialization of the economy. Also related to this is the question of whether a given federal-state granting structure, either the current one or some alternative proposal, provides disincentives against efficient application of state taxes. These are important issues which will only be dealt with peripherally here. They are issues, however, that merit further study.

Also related to this is the more general issue of overall tax reform. Tax reform is going on now and has been the subject of a major MIER study in the past. In addition there are studies of resource taxation ongoing or proposed. See, as well, World Bank (1992, p. xii). All of these have potential implications for state revenues as well as federal ones because of both the revenue-sharing schemes and the implications of the tax regime changes on economic activity in the states. Again this is an issue we will not address directly here.

A second broad issue which has arisen in discussions with central government officials is the more general one of the "regional balance sheet" of federal taxes and expenditures in the individual states. Separate, of course, from transfers to state governments are expenditures within states and transfers to individuals within states by the federal government in meeting the expenditure responsibilities of the federal government. A policy, for example, of equal expenditure per capita on health care and education financed by a proportional or progressive income tax would result in net transfers to those of below average income. If a region or individual state, therefore, had a disproportionate number of poor, that "region" would be a net recipient of federal spending.

Some might argue that this could overcome a difference in the "net fiscal benefits" accruing from total government taxation and expenditure between states but this seems unlikely. While it might be possible to design a system of direct transfers and expenditures which would overcome the inefficiencies of a poorly designed government to government transfer system it is difficult to see how this could be done while retaining horizontal equality of treatment of all individuals by the federal government. Related to this as well is the whole issue of regional development and regional disparities and whether the transfer system should be used more "actively" to encourage development in slow growing or poor regions.

In the next section we survey the current situation - the constitutional allocation of powers, the structure of federal-state transfers, level of state government revenues and expenditures, and the importance of transfers in these. Figures show there to be quite a wide variance in expenditure per capita across states. This does not, of course, necessarily mean that "net fiscal benefits" differ across states but it might be some evidence that they do. It is also a fact worthy of comment in any case.

Section III is a long section surveying and outlining the literature on the assignment of powers across levels of government and the need for intergovernmental transfers. An issue receiving particular attention is that of differences in "net fiscal benefits" across states. If these differences are significant there are in theory problems of both horizontal inequity and inefficiency in the allocation of factors of production which need to be corrected for through some system of intergovernmental transfers.

Section IV draws on the material of Sections II and III to discuss problems of the Malaysian structure. Two main sets of problems are discussed. First, from the theory of Section III, there seems to be arguments for some further decentralization of powers to state and local governments. This might be seen as a long-term goal. Second, from the work of the two preceding sections, there is some evidence of significant differences in net fiscal benefits such that there are arguments for a more equalizing system of transfers between governments.

In Section V various general proposals for improving the current transfer scheme, from modifying the existing set of grants to introducing a new explicit “Equalization Grant”, are discussed. This can be seen as preliminary discussion as the topic is dealt with in more detail in the second of the papers in this series (see Wilson, 1996).

Finally, in the last section, we discuss the need for more careful study of a number of issues before the proposals of Section V can be made specific. Projections of revenues and expenditure needs should be made along with more detailed analysis of the exact amounts proposed for the various revised grant systems.

II. THE CURRENT SITUATION

Malaysia was federated in two stages with the original eleven states joining together in 1957 under equal conditions and then the states of Sabah and Sarawak entering in 1963 under somewhat different arrangements. Two of the basic ideas at the root of the allocation of powers in the original, 1957, federation are particularly important for our purposes here. First is the idea of equality between the states. Before federation the states differed somewhat in their structure of government, political and administrative tradition, as well as economic structure and stage of development (Shafruddin, 1988, pp.4-5). The 1957 constitution “eschewed ‘special privilege’ status being accorded to any founder state, rich or poor, of the federation” (Shafruddin, 1988, p.9). The former Crown colonies were assigned appointed state governors to perform the non-religious roles of the Sultans in the former Malaya states. All of the original eleven states, therefore, entered as “equal partners” in the 1957 federation.

This equality was lost, however, with the 1963 amendment to admit the states of Sabah, Sarawak and Singapore into the federation. There are a number of political differences, for example, any amendment to the constitution applying to the Borneo states requires a two-thirds vote in both houses of Parliament (Shafruddin, 1988, p.13), but, more importantly for our purposes here, there are also differences in the revenue and expenditure powers of these states from the first eleven. An important consideration in a federal state is equal treatment of individuals by government in total, by federal and state governments in combination, and this is made more difficult if the constitutional position of some states differs from the others.

Second, the assignment of powers to the states was broadly based on having, on the one hand, a strong central government but, on the other, accepting that the Sultans were important symbols of authority. National unity, the fostering of which was very important in the new state, was seen as requiring that most important powers be assigned to the federal level. At the same time the realization that the Sultans attracted clear individual loyalties was accepted. As such, many of the powers remaining with the states were those traditionally associated with the Sultans, such as religious education. Similarly, some of the tax sources left with the states are those related to Muslim religious taxes (see Ariff, 1991, p. 195). The assignment of powers such that there is a strong central government leaves the powers and expenditures of the states small compared with other federations. This in turn makes absolute differences in net fiscal benefits not as large as they might be if state responsibilities were greater.

The Assignment of Tax and Expenditure Powers

The constitution specifies the areas of federal, state and joint responsibility for expenditure and taxation. State responsibilities are limited. Shafruddin (1987, p. 80) argues that this was arrived at from two basic principles. First it was argued that the federal government needed control of the major sources of revenue to equalize the “levels of wealth among the states” (Shafruddin, 1988, p. 10). It was argued that only if the federal government had the main taxation powers could income be redistributed from rich to poor states. Second, it was argued that the principle of financial responsibility implied that responsibility for raising and spending money should rest with the same authority (Shafruddin, 1987, p. 48). This, in turn, meant that if the provinces were to have limited taxing powers they must also have limited expenditure responsibilities. Despite this idea that the principle of financial responsibility be satisfied, it is clear that state tax revenues are insufficient to meet expenditure needs and several categories of federal-state grants are necessary.

Expenditure responsibilities are as specified in the Ninth Schedule of the Constitution. List I details areas falling under federal jurisdiction, List II state jurisdiction, and List III concurrent jurisdiction. A complete list of these responsibilities is provided as Appendix A. Important federal responsibilities are defence and security, foreign affairs, education, social security, trade and industry, communications and health. State governments are responsible for local government, matters relating to Islamic religion and Malay custom, land and mines, and water supplies. Finally, the concurrent list includes public health and sanitation, drainage and irrigation and social welfare. There are special provisions extending the state powers of Sabah and Sarawak in both Lists II and III which can be seen in Appendix A.

Powers of taxation are mainly in the hands of the federal government. The constitution lays out explicitly those tax powers available to the states leaving the residual to the central government. In addition to taxation powers, the constitution also enshrines two types of federal to state transfers as well as allowing for emergency funds. States also have other sources of revenue beyond taxes and grants such as the returns from state-owned enterprises (see Shafruddin, 1987, p. 53).

Article 110 of the constitution delineates the sources of revenue available to the state governments. Part III of the tenth schedule enumerates in detail these taxes, fees and other sources of revenue. These are listed in Appendix B. Part V of the tenth schedule lists those additional revenue sources assigned to Sabah and Sarawak. These are also listed in Appendix B. Article 109 enshrines two sets of federal to state grants - the Capitation Grant and the State Road Grant - and also makes provision for the possibility of other grants being introduced. This provision has allowed for, for example, the Revenue Growth Grant and grants to local governments. The constitution thus explicitly recognized that there was a “fiscal gap” between the expenditure responsibilities and the taxing powers of the states. The Capitation Grant as well reflects recognition of a need for some equalization of revenues across states.

The Importance of State Expenditures

The constitution, then, severely limits the importance of state governments in overall taxation and expenditure. State governments' expenditure, as a result, is of restricted impact overall. In 1994, for example, aggregate state government operating expenditure was only 12.8% of total government operating expenditure and state development expenditure was only 14.2% (see *Economic Report 1995-96*). Aggregate state revenues make up an even smaller proportion of consolidated government revenue as approximately 22-25% of state revenues are transfers from the federal government. These figures mean that the problems of inequality in revenues and expenditures across states documented below are less serious than they would be in countries where state and local governments play a larger role. In Canada or Australia, for example, state government expenditure approaches half of all government spending, making inequalities in revenues per capita between the states an important issue.

Revenues and Expenditures

The states differ considerably in size and GDP/capita as well as in the degree of poverty - Table 1 contains information on these variables. There are several particularities worth comment. First there are differences across the three states, which are oil producers in terms of the GDP/capita with Terengganu significantly above the average and Sabah and Sarawak below. It is not, with the exception of Terengganu, the oil states which are the highest in GDP/capita but rather those most developed or industrialized such as Selangor, Jahor and Pinang. Second, despite being the richest state on average, Terengganu also has the highest incidence of poverty. Finally, wide discrepancies in GDP/capita are noticeable with the richest two states, Terengganu and Selangor having roughly four times the average income of the poorest state, Kelantan. Even more surprising is that the incidence of poverty
is almost the same in the richest and poorest state with Kelantan having 31.6% and Terengganu 36.1%.

TABLE 1

GDP per Capita by State

	Pop. 1991	*GDP/cap. (1978$) 1993*	*Incidence of Poverty (1987) %*	*Malaysia Average*
Johor	2153	4991	11.1	0.95
Kedah	1440	3327	31.3	0.63
Kelantan	1258	1954	31.6	0.37
Melaka	595	4721	11.7	0.89
Negeri Sembilan	739	4512	21.5	0.86
Pahang	1083	4274	12.3	0.81
Perak	2259	4252	19.9	0.81

Perlis	191	3588	29.1	0.68
Pulau Pinang	1159	6728	12.9	1.28
Sabah	1529	3677	35.3	0.70
Sarawak	1709	4450	24.7	0.84
Selangor	2033	7698	8.9	1.46
Terengganu	775	7837	36.1	1.49
Malaysia		5275		

Source: Author's Calculations

Tables 2 and 3 contain information about state revenues and expenditures so that we might get a sense of the degree of vertical and horizontal balance in the system. The fiscal gap or the "vertical fiscal imbalance" refers to the gap between the expenditure needs and the revenues available to various levels of government. As we will see below, there are often good arguments for assigning tax powers and expenditure responsibilities to different levels of government and it may be that these are not balanced. As such, there may be a fiscal gap requiring transfers from one level of government to another. Most frequently the arguments are strong for assigning more tax powers to higher levels of government and more expenditure powers to the lower levels who may be more responsive to local needs. This means that the fiscal gap is most often at the lower levels of government, and this is the case in Malaysia.

Table 2 provides information on the extent to which federal government grants make up state total revenues for 1992 and Table 3 extends this information to show that, even with these grants, state revenues seldom cover total, current plus development, expenditure. These figures are typical of other years (see *Economic Report 1992-93*, Table 6, p. 174). Table 2 shows that the states raise between 38% and 92% of their revenues from their own sources. Only the petroleum states, Sabah with 84.1%, Sarawak with 91.2% and Terengganu with 91.8%, and Pahang at 80.0% are able to raise more than two-thirds of their revenues from their own sources. Two states, Kedah and Perlis, are dependent on federal grants for more than half of their total revenues.

These aggregate revenues, including federal grants, are not enough, with some exceptions, to cover consolidated state expenditures. Table 3 gives these figures for the 13 states for 1992 showing all states to have overall deficits. The pattern portrayed in this table also is fairly typical of past years (see *Economic Report 1992-93*; Shafruddin, 1987; and Ariff, 1991, p.210). Most states in most years show a surplus on their current accounts but development expenditures are greater than this surplus so that they are in overall deficit. Some states in some years have an overall surplus (see *Economic Report 1992-93,* Table 2) but across states there has always been an aggregate deficit. Similarly, some states have shown deficits in the current account in some years but the overall pattern has been one of surplus on current accounts.

These overall state deficits are funded from a combination of the running down of state-held reserves and loans from the federal government. The states are restricted in their ability to borrow, being only allowed to borrow directly from the federal government or from Malaysian banks for periods of less than one year with the approval of the federal government (see Shafruddin, 1987). At the same time, states often borrow under very favourable terms, sometimes even interest free for some types of development expenditure. It is notable that state governments often build up reserves at the same time as they are borrowing (see Ariff, 1991, p. 201). Over the period 1964 to 1984 total reserves across states were built up in 15 of these 21 years even though in all the years there was aggregate borrowing.

Table 2 also provides evidence about horizontal balance - the balance across the states in financial capacity in order to meet their expenditure responsibilities (see Shafruddin, 1987, p.50). Table 2 presents information for 1992 across states on per capita revenues before and after federal transfers. We see that before transfer amounts available to individual states vary from 21% of the national average (in Kedah) to 293% (in Sabah). Even excluding