Fiscal Federalism in Malaysia: Challenges and Prospects

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Although the Federal Constitution of Malaysia assigns clear responsibilities to the federal, state, and local orders of government, the much greater taxation power assigned to the federal government has led to fiscal centralization. The federal government has the power to collect individual income and corporate tax, sales tax, and taxes arising from exports and imports. With little left for each state to raise tax revenues, state governments are further constrained from borrowing by the Constitution and are too dependent on federal grants and loans to undertake increasing expenditures arising from rapid economic growth and urbanization. Tax revenues from fees, licenses, assessment rates, and taxes on minerals are simply not sufficient to cover modern-day expenditures by state and local governments.

To balance this equation, the Constitution allocates responsibility to the federal government to deliver services in administration, defence, internal security, education, medicine, health, labour, and social security. To some extent, these expenditures have generated economic development in the federated states and may constitute indirect equalization as the states no longer pay for basic public amenities and infrastructure, such as interstate roads and public universities. In some sense, the state governments have less to worry about impending fiscal deficits since the federal government consistently provides loans to finance the shortfalls.

With such great powers in taxation and expenditure, it is possible for the federal government to initiate mega-projects such as the “national car project,” “multimedia super corridor project,” and the establishment of the Federal Administration Center at Putrajaya. The national car project is expected to push Malaysia forward in engine, component, and automobile design technology – although challenges resulting from the highly competitive global automobile industry could be an obstacle. The multimedia super corridor (MSC) project is Malaysia’s initiative for the global information and communication technology (ICT) industry. Finally, the federal administrative center at Putrajaya is a new hub intended to establish all major government ministries and departments in one location. Using lease and buy structure finance, the government does not initially bear the cost of development. Companies that won building contracts are expected to source their own capital. Unlike the state governments, the federal government has the power to borrow to finance public expenditures. In this case, payment of lease constitutes a public expenditure as well.

Although a state government is not permitted to raise loans to carry out state-related projects, the federal Constitution does not prohibit state-owned companies from raising funds from bank loans and debt securities. Privatization in Malaysia usually gives birth to government-controlled companies at both the federal and state orders and does not imply a complete transfer of government assets into private hands. Rather, it introduces the corporate culture into the new outfit, but majority shareholding remains with the government. Privatization is expected to increase efficiency and reduce government expenditures. If all goes well, a government-linked company should be able to create new employment and further widen the federal tax base. However, if the company fails, it asks for a federal government bailout – a move that increases the burden of taxpayers. Government-linked companies have ventured into healthcare, auto and industrial products, transportation, property and construction, financial institutions, technology, power, media, and communication.

The powers and fiscal resources given to state governments are carefully balanced in the federal Constitution. A "capitation grant" is given to each state based on its population size (although more variables should be added to the current formula) and a road-building grant based on the geographic size of each state. There are also tax-sharing grants such as revenue growth grants, which reflect tax revenues from economic growth in each state. Payment of funds may be held back or delayed, but funding is never cut outright. Federal loans to most state governments are usually written off as the states have no capacity to pay and will not be financially independent in the foreseeable future.

Fiscal decentralization may not be the answer to the fiscal problems of Malaysia's states. Because of the small size of most states, the lack of any "economies of scale" may not make fiscal decentralization a good option. Instead, state grants could be revised every five years so that state governments would be able to fulfill their promises to the electorates, especially on such programs as the prevention of squatter settlements and the provision of subsidized housing for the poor. **A brighter future lies ahead for the local governments, which have more autonomy than state governments.** A local government can obtain bank loans and use asset-backed securities to finance projects deemed profitable for the locality. Some local governments have substantial land assets that can be mobilized to raise funds for capital formation.

There is a great need to examine Malaysian federalism in a modern context since new issues have surfaced in the last twenty years. Considering that the federal Constitution provided for special grants to the state of Sabah and Sarawak in 1967, it should be able to structure new grants based on current needs, which include those to address environmental degradation in the states and water supply issues involving rivers flowing from one state to the next. For example, lack of state funds to enforce monitoring operations led to a failure to stop severe illegal logging and disposal of toxic wastes in rivers, although acts of corruption by some government officials may also have contributed to these problems.

Another issue is fiscal centralization in the government's recent exercise to further cut subsides on petrol, which has caused public uproar and discontent. These saved subsidies (i.e., US$1.2 billion or MYR4.4 billion) will be spent on improving the current transport system and infrastructure. But how the money is distributed to the states and federal agencies would demand closer consultation among officials at all orders of government, even though the federal government still holds the upper hand in making the final call. Apart from fuel price increases arising from a move to reduce government expenditures, the impending increase in electricity tariffs in the coming months further demonstrate the federal government's decisive control of utility companies and hence centralization of fiscal federalism in Malaysia.

To some extent, federalism in Malaysia is able to foster a stable federal government, although at the state order it has not had a perfect score. The extraordinary power of taxation assigned to the federal government in Malaysia provides a potent instrument to ensure the long-term political reign of any political party elected into government. One counterbalance to this power would be continuous dialogue and consultation among political parties in the Parliament and State Executive Councils, carried out with vigour and sincerity.