

FISCAL DECENTRALIZATION IN MALAYSIA*

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Abstract

The Malaysian Federalism is highly centralized in terms of revenue powers, expenditure responsibilities and borrowing powers. Interpreting from the Federal-State fiscal relationship, decentralization is a non-issue in the Malaysian Federalism context. The Federal Government had a very strong commitment in the economic development and transformation of the States. In fact, the Federal government is better positioned to manage social and economic agendas with the good effect of scale economy. Federal-State fiscal relations have however been affected by the problems of both vertical (Federal-State) and horizontal imbalances (State-State). This is however warranted by negotiations with the State in concerned by directing Federal sponsored development projects, transfer of financial resources (grants and loans) to the States and the setting up National Finance Council (NFC). The issue of fiscal decentralization in the future is likely to be, at best, a series of ad hoc changes and improvements in technical aspects of intergovernmental relationships for public service provisions and their finance.

Key words: Malaysia; Federation; Fiscal imbalances; Inter-governmental transfer

JEL Numbers: H71, H72, H77, O23

I. *Introduction*¹

The Malaysian federation combines the federal principle and the system of parliamentary democracy with constitutional monarchy.² The Federal Constitution of Malaysia also provides for a monarch and elected leaders at Federal and State levels. The Constitution clearly divides the authority of the federation into its legislative authority, judiciary authority and

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¹ Much of the discussion of Malaysian Federalism setting is synthesised from Umikalsum (1991) and Hui (1997).

² His Majesty the *Yang Di Pertuan Agong* as the supreme head of the nation. At the State level, every State has a ruler known either as a *sultan* (the States of Perlis, Kedah, Perak, Selangor, Negeri Sembilan, Johor, Pahang, Terengganu and Kelantan) or a *Yang Di Pertua Negeri* (for the States of Pulau Pinang, Melaka, Sabah and Sarawak). The Federal throne, the *Yang Di Pertuan Agong*, is only accessible to the nine Sultans on a rotational basis, each having the opportunity to ascend to the throne for a tenure of five years.

executive authority. In retrospective, the idea of federation dates back to 1896 when British colonial administration formed the Federated Malay States (FMS) - Selangor, Perak, Pahang and Negeri Sembilan. The FMS was the first step towards the development of the Federation of Malaya in 1948³ and 1957⁴, and the Federation of Malaysia in 1963⁵. Since then, Malaysia is a federation of 13 States, and consists of three levels of government: (i) federal government,⁶ (ii) state government,⁷ and (iii) local government.⁸ Consistent with the concept of Federalism, there is a division of authority between the Federal and the State governments.

The 9th Schedule of the Constitution delineates functions between the Federal and State governments. As can be seen from Table 1, the Constitution defined the distribution of the executive, legislative and financial powers between the Federal and State, with a predominance power in the Federal government. The Federal Parliament was empowered to make laws with respect to any of the subjects listed in the Federal List and the concurrent list for the Federal government or any part of it and having effect within as well as outside the Federation. The State legislatures, on the other hand, had powers to make laws with respect to any of the subjects enumerated in the State List and Concurrent List but only for the State or any part of it and not outside it. All residual powers remained with the States.

In the federalism setting, the Federal government represents the national government. Accordingly, they play a larger role and perform more functions than the State government. The Federal government is given all major public functions, unlimited taxation and borrowing powers, and considerable authoritarian excesses which include the wide ranging emergency powers. They also undertake national development planning in the national interest. The function of stabilization and equity and distribution are the Federal's main functions and responsibilities. The Federal Government has the capacity and resources to carry out these functions efficiently.

The State governments are responsible for regional matters, particularly with land, agriculture, and forestry. They also handle state works and water as well as local government and local public services. States in Peninsular Malaysia have the same powers, while Sabah and

³ The Federation of Malaya (1948) consists of the Federated Malay States (Perak, Pahang, Selangor and Negeri Sembilan; the Unfederated Malay States (Perlis, Kedah, Johor, Terengganu and Kelantan); and the Strait Settlements States (Pulau Pinang and Melaka). In fact, the 1948 Federation replaced the short-lived 1946 Malayan Union due to the strong Malay opposition against the implementation of Malayan Union which threatened the Malays' special rights and privileges and the Malay States by transferring sovereignty from the Malay Rulers to the King of England and by granting equal citizenship rights to the Chinese and Indian immigrant communities.

⁴ Following independence in 1957, the Constitution of 1957 created the federation of 11 States - Perlis, Kedah, Pulau Pinang, Selangor, Perak, Terengganu, Negeri Sembilan, Melaka, Johor, Pahang and Kelantan.

⁵ The Federation of Malaysia (1963) consists of the Malayan Federation, Sabah, Sarawak and Singapore. Singapore left the federation in 1965.

⁶ The Federal Government refers to the elected members of the Parliament, who are either directly elected or representatives of the State governments. The Federal Government is headed by a Cabinet of Ministers under the leadership of a Prime Minister, chosen from the majority party in the House of Representatives. The executive authority of the federation is exercisable by the Cabinet.

⁷ The State Government refers to the elected members of the 11 States in Peninsular Malaysia, the States of Sabah and Sarawak. Each State is headed by a Chief Minister who is chosen from and supported by a majority party in each State Legislative Assembly.

⁸ The local government refers to political sub-units of the States, consisting of municipalities councils and districts councils. The local governments are formed and regulated by the respective State legislations and subordinate to the respective State governments.

TABLE 1. DISTRIBUTION OF POWER AND RESPONSIBILITIES

Federal List	State List	Concurrent List (Federal-State)
1. External affairs	1. Muslim and custom	1. Social welfare
2. Defense	2. Land	2. Scholarships
3. Internal security	3. Agriculture and forestry	3. Protection of birds and wild animals
4. Civil and criminal law and administration of justice	4. Local government	4. Animal husbandry
5. Federal citizenship and naturalization, aliens	5. Local public services - boarding houses, burial grounds, pounds and cattle trespass, markets and fairs and licensing of theatres and cinemas	5. Town and country planning
6. Federal government machinery	6. State government machinery	6. Vagrancy and itinerant hawkers
7. Finance	7. State works and water	7. Public health
8. Trade, commerce and industry	8. State holidays	8. Drainage and irrigation
9. Shipping, navigation and fisheries	9. Inquiries for State purposes	9. Rehabilitation of mining lands and land which has suffered soil erosion
10. Communication and transport	10. Creation of offences and indemnities related to State matters	10. Fire safety measures
11. Federal works and power	11. Turtles and riverine fishing	11. Culture and sports
12. Surveys, inquiries and research	Additional Responsibilities for the states of Sabah and Sarawak	12. Housing and provisions for housing accommodation
13. Education		Additional Shared Responsibilities for the states of Sabah and Sarawak
14. Medicine and health	Additional Responsibilities for the states of Sabah and Sarawak	
15. Labor and social security	1. Native law and custom	1. Personal law
16. Welfare of the aborigines		2. Adulterations of foodstuff and other goods
17. Professional licensing	2. Incorporation of State authorities and other bodies	3. Shipping under fifteen tons
18. Federal holidays	3. Ports and harbors other than those declared Federal	4. Water power
19. Unincorporated societies	4. Cadastral land surveys	5. Agricultural and forestry research
20. Agriculture pest controls	5. Libraries and museums	6. Charities and charitable trusts
21. Publications	6. In Sabah, the Sabah Railway	7. Theatres, cinemas and places of amusements
22. Censorship		
23. Theatres and cinemas		
24. Federal housing and improvement trusts		
25. Co-operative societies		
26. Prevention and extinguishment of fire		

Source: The Constitution of Malaysia

Sarawak are granted additional power and guarantees. The local governments undertake local services on behalf of the respective State governments. In fact the role of the local government is to provide services which are local-specific. They include water supplies, refuse collection, maintenance of drainage, sewerage treatment, fire services, street lighting, markets, parks, sport facilities, and community centers.

As for Malaysia's fiscal system, it operates under the Federal structure. The Federal government has exclusive powers to levy and collect all taxes and other forms of revenue except from the minor sources, which are assigned to the States. The main revenue sources assigned to the States are receipts from land sales, revenue from lands, mines and forest, entertainment duty and Islamic religious revenue. Additional sources of revenue are assigned to the states of Sabah and Sarawak. These include import and excise duties on petroleum product and export duty on timber and other forest produce.

The Constitution makes specific provisions for the transfer of financial resources from the Federal to State. The primary purpose is to bridge the resources gap at the State level. Other consideration include the narrowing of differences in State taxable capacities and compensat-

ing the States for their involvement in Federal functions and supporting them in matters of joint responsibilities. A State Reserve Fund was established to assist the States in balancing their budget. Federal grants are distributed among the States on the basis of origin of collections, population, State Gross Domestic Product and other social and economic indicators and actual cost of projects.

There was little change with respect to the distribution of financial powers between the Federal and State governments [Holzhausen (1974), Shafruddin (1987), Umikalsum (1991), Ariff (1991) and Wilson and Sulaiman (1997)]. The Federal Government monopolized the revenue structure, which provided the fundamental basis of the political power. All major and most elastic revenue sources remained with the Federation, while insignificant and less flexible sources of revenue were assigned to the States. Consequently, the planning of economic development in the States depended much on Federal funding.

The rest of the paper is organized as follows. Section II discusses the States' fiscal position. Section III highlights Federal-State transfers. Section IV raises the issue of fiscal decentralization and reassignment of tax powers between Federal and State. Section V concludes this paper.

II. *States Fiscal Position*

There exist problems of fiscal relationship between Federal and States and between State and State. The Federal government raises more revenue than the States. The State governments are forced to stretch their limited revenue base and to rely heavily on grants and loan from the Federal Government. State own revenue (excluding Federal transfer), which being made up of mostly land-based taxes, could only finance to about 81 percent of its expenditure in the 1990s (see Table 2). Federal transfer, notably grants and loans to State governments, filled the remaining gap. The proportion of Federal grants to States' receipts and expenditures was respectively about 22 percent and 17 percent in the 1990s. The overall budget balance of the 13 State governments worsened in the 1990s with a deficit averaging RM52 million per annum, placing them in a relatively weak fiscal position vis-a-vis the Federal. The deficit is however financed from the drawdown of State assets.

Table 3 shows State governments' fiscal position with and without inter-governmental transfer. Disparities in States' taxable capacity are attributable to uneven distribution of natural resources revenues and limited tax-base. The biggest revenue for the State governments is from forest, land and mines. However, not all States have sufficient land endowments.

TABLE 2. CONSOLIDATED STATE GOVERNMENTS FISCAL POSITION

<i>Selected Indicators</i>	Average		
	71-79	80-89	90-98
State Overall Deficit, (RM million)	+ 127	+ 78	-52
State Own Revenue/ State Expenditure, (%)	71	70	81
Federal Grants/State Revenue, (%)	24	21	22
Federal Grants/State Expenditure, (%)	25	22	17
State Own Revenue/Federal and State Revenue, (%)	16	14	12
State Expenditure/Federal and State Expenditure, (%)	21	18	18

Source: States Financial Statements and Ministry of Finance (various years)

TABLE 3. STATE GOVERNMENTS' FINANCIAL POSITION WITH AND WITHOUT INTER-GOVERNMENTAL TRANSFER, 1998

RM million

	State Revenue	Inter-Governmental Transfer (IGT) (grants and loans)	State Revenue	State Expenditure	State Fiscal Position	
					Without IGT	With IGT
Johor	500	118	619	654	(154)	(36)
Kedah	220	256	475	300	(80)	176
Kelantan	175	111	286	243	(68)	43
Melaka	132	108	241	283	(150)	(42)
N.Sembilan	267	219	486	275	(8)	211
Pahang	352	167	519	511	(159)	9
Pulau Pinang	226	159	384	363	(138)	21
Perak	461	104	565	508	(47)	57
Perlis	85	119	204	106	(21)	99
Sabah	1,219	257	1,476	1,652	(433)	(177)
Sarawak	2,358	243	2,601	4,882	(2,524)	(2,281)
Selangor	902	223	1,125	1,389	(487)	(263)
Terengganu	723	194	917	942	(219)	(24)
Consolidated	7,620	2,277	9,897	12,106	(4,486)	(2,209)

Source: Ministry of Finance, Malaysia

Neither do all States have tin (like Perak), petroleum (i.e. Sarawak, Sabah, and Terengganu) and other mineral deposits or significant forest reserves (such as Sarawak and Sabah, and to a lesser extent, Pahang). Revenue from entertainment brings a significant income to the more developed States (such as Selangor, Johor and Pulau Pinang) but the amounts are small in States (for e.g. Kelantan and Terengganu) where entertainment are, for religious reasons, controlled.

State own revenue exerts significant influence on State expenditure. State expenditure tends to rise with State own revenues. The operating expenditure of the State is mostly for emoluments and supplies of services. As the State governments are directly involved with the administration of land and natural resources, the scope of development expenditure mainly focus on agriculture, rural development, and road construction and maintenance. Further, State (development) expenditure tends to depend upon the stage of development. For instance, the less-developed States such as Kedah, Kelantan, Melaka, and Sarawak had relatively higher development expenditure than the other developed States like Johor, Selangor and Pulau Pinang. Looking at the State expenditure as a whole, it is small by that of the Federal standard. Total State spending as a proportion of total Federal and State expenditure declined from an average of 21 percent in the 1970s to 18 percent during the 1990s (see Table 2). This therefore rules out many significant roles on State governments in the function of equity, distribution and stabilization at regional level.

In sum, the allocation of revenue powers is highly in favor of the Federal government. The share of State revenue in Federal-State revenue remained significantly low. There has been no apparent shift in revenue shares of the Federal and State governments throughout the period of analysis. Further there are marked inter-State differences in own source revenue following uneven distribution of natural resources. State taxes are not related to economic

growth such as income tax and trade taxes, which are under the Federal powers. The State governments however managed to keep the fiscal gap from deteriorating mainly by restraining their spending accordingly to their own revenues. The States' dependence on Federal transfers to finance their expenditure may involve further sacrifice of their financial autonomy.

III. *The Role of Inter-Governmental Transfer*

The Constitution makes specific provisions for the transfer of financial resources (grants and loans) from Federal to State. The intention is to bridge the resource gap at the State level and compensating the States for their involvement in matters of joint responsibilities. Federal grants are distributed among the States on the basis of origin of collections, population, State Gross Domestic Product and other social and economic indicators and actual cost of projects.⁹ The grants are classified into three major categories: (i) tax-sharing grants; (ii) general-purpose grant; and (iii) specific-purpose grant. Tax-sharing grants include 10 per cent of export duties on tin, iron, and other materials that are extracted in the State. General-purpose grants consist of capitation grants, growth revenue grants, State Reserve Fund grants and special grants. Specific-purpose grants include road grants, economic development grants, services charge grants and cost reimbursement grants. The Federal-State grant structure is dominated by the state road grants, capitation grant, revenue growth grant and State Reserve Fund. These grants have been incessantly used by the Federal government to supplement State revenues.

Under the tax-sharing grants, taxes are imposed and collected by the Federal government and the proceeds are returned in specific proportions to the State governments on the basis of origin of collection. The Federal government determined the structure, rate and percentage sharing. Once apportioned, the State governments are free to spend the shared revenues for any social and economic development programs. Tax-sharing grants are concerned with the problem of vertical imbalances. Like the tax-sharing grants, the general-purpose grants provide funds to the State governments with no restrictions on spending and not subjected to requirements on revenue raising. The amount of total grant and the distribution to each State are either prescribed in the Constitution or determined by the Federal government on formula or ad-hoc basis. They are designed primarily for vertical fiscal adjustment purpose. The general-purpose grants are distributed on the basis of State population and State Gross Domestic Product per capita and they also address the problem of social and economic disparities between States. The specific-purpose grants are tied to particular expenditure but not to revenue conditions. Their objectives vary from equalization of performance, compensation for State involvement in Federal functions and helping the State governments to meet State expenditures in matters of joint responsibility.

Federal-State financial relations have been affected by the problems of both vertical (Federal-State) and horizontal imbalances (State-State). Fiscal imbalances are adjusted with a view to supplement the States' fiscal gap and to equalize inter-State fiscal capacities.

⁹ Grants from the Federal government do not change much on a yearly basis as they are based on a set mechanism or formula. There would be significant changes in grants only if this mechanism or formula is changed or when extraordinary transfers are made to the State for specific purpose.

Specifically, fiscal imbalances may be adjusted by [Shafruddin (1987)]; (1) Federal grants and allocation; (2) transferring more State functions or responsibilities to the Federal Government; (3) tax devolution by increasing the fiscal autonomy of the State governments by instituting a redistribution of tax powers from the Federal to the States (tax devolution); and (4) changing the ratio of distribution under the tax revenue sharing arrangements. For the States, Federal grants and allocations and tax-revenue sharing arrangements represent the critical means of adjusting fiscal imbalances. With regard to States financial autonomy, the prescription has been mainly based on transferring functions (or responsibilities) to the Federal rather than providing States with more tax-revenue powers.

Apart from Federal-State grants, the Constitution also regulates the borrowing powers of the Federal and State governments.¹⁰ The Federal government can borrow from domestic as well as from foreign sources. The State government, on the other hand, can borrow only from the Federal government or from a bank or other financial sources approved by the Federal government, for a period not exceeding 5 years.¹¹ In other words, States' borrowing comprised of loans from the Federal government and market borrowing from the domestic financial market. The State governments can however borrow for capital spending only. The loans were mainly to help finance agricultural and rural development projects, industrial estates, low cost housing, water supply and other miscellaneous expenditures like office building. As for current budget, the State governments are usually required to finance the budget by State own revenue (in particular taxes and charges alone). Over the period 1990-1998, the State Governments borrowed almost entirely, if not all, from the Federal Government. Federal loans however contributed for about one percent of States' total revenue.¹² On the whole, borrowing powers are centralized with the Federal government. The State government had no powers to raise fund externally and had restricted powers to acquire debt domestically.

Taking example of the 1998 data, the Federal transfers (notably grants and to a lesser extent loans) did not only supplement State fiscal gaps but also provided positive balances to Kedah, Kelantan, Negeri Sembilan, Pahang, Perak, Perlis, and Pulau Pinang, Selangor. The remaining States however had to fall back on their reserves. This suggests that the Federal transfers have not done much to equalize the financial capacities of States. Thereby the Federal-State transfer system for fiscal adjustment is not based on the criterion of financial need. The system has also not been able to correct for State-State imbalances, as indicated by differences in States' taxable capacity. Therefore there is a need to further improve the present system of Federal-State transfer.

Federal-State transfers were however inadequate to reduce States' fiscal gaps effectively due to a number of reasons. Firstly, State governments' expenditure has been increasing to cater for expansion in services and development programs as the State economies grow. Beside that, State governments' operating expenditure is influenced by Federal government policies,

¹⁰ 'Borrowing' under Article 160 of the Constitution includes raising money by granting annuities or by entering into any arrangement which requires the payment before the due date of any taxes, rates, royalties, fees or any other payments or by entering into any agreement by the Government has to repay or refund any benefits that it has enjoyed under the agreement.

¹¹ Prior to the 1976 Constitution Amendment, the State Governments could only borrow from the Federal Government or from an approved bank for a period not exceeding 12 months. The State Governments are also limited in their ability to guarantee loans.

¹² Calculated from each State Financial Statements (various years, 1990-1998).

particularly with regard to public sector's revision of salaries, following the Federal government's policy to standardized salaries throughout the level of government. Further, the Federal government provides the bulk of financing for State's development expenditure but the States have to maintain these development projects, thereby imposing additional strain on States' operating expenditure. Secondly, the revenue from the States' sources did not increase accordingly with the growth of the economy. In some cases the revenue sources are deteriorating partly due to States' inefficiency in generating enough revenue from their assigned revenue power. Apart from this, State governments do not directly benefit from income tax and trade tax generated by the projects because such revenues goes to the Federal government. 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 the original purposes. Therefore, federal grants and allocation to the States have to be periodically reviewed so as to establish new grants or changes in the mechanism or formula in the calculation of existing grants.

IV. *Fiscal Decentralization*

Despite the problems of fiscal imbalances, fiscal decentralization in Malaysia is a non-issue. This is warranted by direct negotiations with the State concerned by directing Federally sponsored regional development projects to the States. In fact, since independence in 1957, the Federal government has been involved in the state development planning, through the five-year Malaysian plans.¹³ The Federal government has the capacity and resources to carry out the function of distribution, stabilisation, and growth efficiently and with a good effect of scale economy. Table 4 shows the Federal government's development expenditure allocation to the States for the 6th and 7th Malaysian Plan. Through such sponsored development projects, the Federal government had contributed to the growth of the States' economies. Taking example of 1997 GDP data, in spite of the States' fiscal gap, the level of economic activity of each state increased. Of the 13 states, eight states recorded GDP growth rates that were higher than the national average, with Sarawak growing at 11.9 percent. The states of Johor, Kedah, Melaka, Negeri Sembilan, and Terengganu grew at more than 9 percent per annum, while Perak and Perlis grew at more than 8 per cent over the same period. The remaining states - Kelantan, Pahang, Pulau Pinang, Sabah and Selangor - recorded growth rates, which were however lower than the national average, ranging from 5 to 8 percent.

The problem of fiscal imbalances is also tolerated by the setting up of National Finance Council (NFC).¹⁴ The NFC is to look into the various aspect of financial management in the states and to co-ordinate the Federal-State financial matters. In this regard, the Federal government is required to consult the NFC in the following matters: (1) the making new federal grants to the States; (2) proposal to introduce a bill varying the rates of the capitation grant, or affecting the receipt by a State of the export duty on tin or other minerals produced in the State; (3) the assignment to the States of the whole or any portion of the proceeds of any

¹³ The present national five year plan is the 7th Malaysia Plan (1996-2000).

¹⁴ The NFC comprised the Prime Minister (PM) as chairman, one other Federal Minister designated by the PM; and one representative from each of the States, appointed by the Ruler or the Governor. The NFC was to meet at least once a year, or when called by the PM, or requested by at least three States.

TABLE 4. SELECTED ECONOMICS INDICATORS FOR STATES

State	Federal Government Development Expenditure Allocation To State				GDP per capita		GDP Growth Rate	State Own Revenue Per Capita	
	1991-95		1996-2000		1990	1998	1996-97	1990	1997
	(6 th Malaysia Plan)		(7 th Malaysia Plan)						
	RM		RM		RM	RM	%	RM	RM
Johor	3,344	5.7	3,613	5.3	4,008	5,728	9.8	4,009	5,784
Kedah	3,208	5.5	3,341	4.9	2,526	7,148	10.1	59	50
Kelantan	1,527	2.6	1,850	2.7	1,679	2,203	5.8	62	72
Melaka	1,009	1.7	1,191	1.8	3,361	5,687	9.3	606	1,808
Negeri Sembilan	1,325	2.3	1,801	2.7	3,720	5,318	9.8	108	137
Pahang	2,734	4.7	3,090	4.6	3,633	4,680	7.9	3634	4680
Perak	2,321	4.0	3,216	4.8	3,113	5,040	8.3	78	205
Perlis	614	1.0	953	1.4	3,032	3,834	8.3	147	157
Pulau Pinang	1,672	2.9	1,968	2.9	5,096	7,949	7.4	78	147
Sabah	2,595	1.1	4,495	6.7	4,402	3,288	3.1	934	794
Sarawak	3,133	5.4	4,548	6.7	3,926	5,514	11.9	820	1236
Selangor	4,345	7.4	4,296	6.4	7,415	8,507	8.0	187	350
Terengganu	2,096	3.6	2,553	3.8	7,089	9,269	10.8	529	657
Malaysia	58,500	100.0	67,500	100.0	—	—	8.2	—	—
<i>Memo item</i>									
Multi-state@	22,604	38.6	24,829	36.8	—	—	—	—	—

@Multi-state projects are those whose beneficiaries are nation-wide.

Source: 7th Malaysia Plan and Mid Term Review of 7th Malaysia Plan, State Financial Statements

federal tax or fee; (4) the annual loan requirements of the Federal and State Governments and the exercise of their borrowing powers; (5) the making of loans to the States; and (6) the making of national development plans.

In the longer term, increasing liberalization and deregulation in the Malaysian economy would require fiscal decentralization. The reason for this is to provide State governments free to pursue tax and expenditure policies in line with their responsibilities and to further strengthen States' role in the promotion of regional economic growth and stability. In the present situation, as argued by Umikalsum (1991), it is however impracticable to recommend a reassignment of tax powers to the States to reduce the problems of fiscal imbalances, following the Federal government's strong participation in state development planning and the establishment of the NFC. Nevertheless, for future policy purposes, an important solution to fiscal decentralization is to improve the tax sharing arrangements between the Federal and States. This gives the State government greater budgetary flexibility and certainty, without impeding the overall objectives of economic policy, national tax uniformity and tax effectiveness. For example, as suggested by Umikalsum (1991), which is still presently valid, the existing arrangement of sharing mineral resources taxes (benefiting only the mineral resource rich States) should be extended to income and trade taxes. The sharing of these income taxes for example would give all States a guaranteed source of revenue, the growth of which bears

a close relation to the movements of business and economic activity within the boundaries of the States.

Regarding, horizontal imbalances, as pointed out by Umikalsum (1991), the Federal Government should make equalization payments to States with taxable capacity below the all-State standard. The affected States should receive enough transfer to bring them up to an acceptable percentage of the all-State average. The population criterion in the Capitation Grant, population and Gross Domestic Products factors in Revenue Growth Grant, for example, have accomplished little horizontal fiscal equalization. Transfer, therefore, should be based on the size of State tax based and potential tax revenue [Wilson and Sulaiman (1997)].

V. Conclusion

The allocation of revenue powers is highly in favor of the Federal government. The share of State revenue in Federal-State revenue remained significantly low. There has been no apparent shift in revenue and expenditure shares of the Federal and State governments throughout the observation period. There are marked interstate differences in own source revenue following uneven distribution of natural resources. State taxes are not associated with economic growth such as income tax and trade taxes, which are under the Federal powers as provided by the Constitution. The State governments however managed to keep the fiscal gap from worsening mainly by restraining their spending accordingly to their state own revenues, apart from handing over some of their (expenditure) responsibilities to the Federal Government. As a result of the limited revenue base, the States' dependence on Federal transfer and loans to finance either their expenditure involves further sacrifice of States' financial autonomy. The effect of Federal transfer on the State governments' finances however varies. Despite the problems of fiscal imbalances, fiscal decentralization in Malaysia is a non-issue. This is warranted by direct negotiations with the State concerned by directing Federally sponsored regional development projects to the States and the setting up of the NFC. The issue of fiscal decentralization in the future is likely to be, at best, a series of ad hoc changes and improvements in technical aspects of intergovernmental relationships for public service provisions and their finance.

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