

FINANCING OF PENANG STATE, 1960-72: AN ENQUIRY INTO  
MALAYSIA'S FEDERAL-STATE FISCAL RELATIONSHIP.

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ABSTRACT

This study adopts an ex-post analysis of the Federal-State fiscal relationship in Malaysia, over the period of 1960-1972, with specific reference and emphasis on Penang. The impact of this relationship on the states' financial positions is discussed critically.

The subject of intergovernmental relations in Malaysia has long been neglected by Malaysian academicians and government bodies. There is hardly any economic literature or studies made on this topic. The lack of research in this area and a special interest in the subject which I believe touches the 'root' of the problems of financing state governments have prompted this study to be undertaken.

This study shows that the then existing Malaysian Federal-State fiscal relationship has resulted in vertical and horizontal fiscal imbalances. The Federal Government controls most of the productive sources of revenue, leaving the states with non-productive revenue sources. This problem is further aggravated by widespread interstate fiscal disparities in the country. In Penang, the lack of natural resources reduces its ability to raise revenue. The State's domestic revenue lags continuously behind its current expenditure. With rising development and current expenditures, Penang will continue to face financial constraints, though Federal grants have been used to bridge the fiscal gaps of the states. However, the fiscal adjustment system is not effective in solving the problems of imbalances.

The defects of the present fiscal adjustment system call forth various improvements as envisaged by the present study. These include introducing tax supplements, tax credits and deductions, using an objective criterion to allocate the unconditional grant, and changing the status of the National Finance Council, (NFC). The last suggestion should have the top priority over the others because the existence of an impartial and independent body would ensure further changes to the system. Otherwise, the decision to change would have to rest upon the Federal Government, which is unlikely to take any positive steps towards making changes in the near future. This is because it has placed national development and poverty eradication as its prime objectives. Changes in the fiscal arrangements, which could reduce its role in the economy, are unlikely to be favoured in this context.

### ABSTRAK

Kajian ini meminjamkan dan mengadakan analisa perhubungan kewangan antara Kerajaan Pusat dengan kerajaan negeri, terutamanya kerajaan Pulau Pinang, pada tahun 1960-72. Kesan perhubungan kewangan terhadap kerajaan negeri dibincang secara kritis.

Subjek perhubungan antara kerajaan di Malaysia sering di lupai para akademik dan badan-badan kerajaan. Jarang sekali terdapat tulisan-tulisan ekonomi atau kajian keatas topik ini. Kurangnya penyelidikan dan minatnya dalam bidang ini, yang mana saya fikir adalah punca kepada masalah membiayai kerajaan negeri, telah mendorong kajian ini.

Kajian ini menunjukkan bahawa perhubungan kewangan yang wujud antara Kerajaan Pusat dan kerajaan negeri di Malaysia telah menyebabkan ketidakseimbangan upaya mengutip hasil diantara Kerajaan Pusat dan kerajaan negeri dan diantara tiap-tiap kerajaan negeri. Kerajaan Pusat mengutip semua hasil yang baik dan tinggalkan yang kurang baik bagi kerajaan negeri. Masalah ini makin dirumitkan dengan adanya ketidaksamaan pungutan hasil antara negeri dengan negeri. Pulau Pinang tanpa sumbar-sumbar alam semula jadi, pungutan hasilnya kurang sekali. Hasil tempatan telah tidak dapat menampung perbelanjaannya. Keadaan seperti ini telah menghalang kemajuan pembangunan dalam masa diperlukan perbelanjaan yang besar. Walaupun Kerajaan Pusat memberi bantuan wang, tetapi ini masih belum memadai masalah keperluan wang kerajaan negeri. Sistem penyesuaian kewangan walau bagaimanapun bukan cara yang berkesan demi penyelesaian terhadap

masalah ketidakseimbangan hasil antara kerajaan.

Kekurangan-kekurangan sistem penyesuaian kewangan memerlukan pelbagai pembaikan, seperti diseru oleh kajian ini. Ini termasuk cukai tambahan, kredit cukai dan pemotongan cukai, menggunakan satu ukuran objektif bagi membahagikan bantuan wang tanpa bersyarat dan menukarkan kedudukan 'National Finance Council'. Cadangan terakhir ini harus diberi keutamaan kerana dengan adanya satu badan yang tersendiri dan tidak belah-menyelah akan menjamin perubahan yang lanjut terhadap sistem penyesuaian kewangan di Malaysia. Jika tidak, ketentuan bagi mengubahkannya terletak pada Kerajaan Pusat, yang mana tidak akan ambil apa-apa langkah positif dalam jangka masa yang akan datang. Kerajaan Pusat kini menganggap pembangunan negara dan penyingkiran kemiskinan sebagai tugas-tugas yang maha penting. Maka, dalam konteks ini, perubahan dalam perhubungan kewangan yang mana dapat mengurangkan peranan Kerajaan Pusat dalam ekonomi tidak sangat diminatkannya.

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I, alone, am responsible for any errors and shortcomings that may remain.

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LIST OF ABBREVIATIONS

GDP	Gross Domestic Product
GNP	Gross National Product
NEP	National Economic Policy
NFC	National Finance Council
SRF	State Reserve Fund

## CHAPTER 1

### INTRODUCTION

According to R.A. Musgrave,<sup>1</sup> public finance is concerned with the basic problems that center around the revenue and expenditure processes of government and these problems are not associated with the issues of finance such as money, liquidity or capital markets, but they are concerned with resource allocation, distribution of income, economic growth and price stability. In short, it is the study of the revenue and expenditure activities of government and the effects of the public budget on the economy in terms of equity, efficiency, stability and economic growth.<sup>2</sup>

Thus, the scope of contemporary public finance extends beyond that of Classical. The Classical economists had failed to appreciate fully the advantages of public expenditure as a means to raise public welfare. Instead, they had advocated for a minimum amount of taxation.<sup>3</sup> Typical of this attitude was Ricardo's argument for smaller budgets to ensure 'peaceful government'. However, in the wake of Keynes' The General Theory of Employment, Interest and Money, there was a shift in attitude and emphasis so that a large amount of literature which recognized the importance of fiscal policy as a measure to promote stability and economic growth has evolved. This post-Keynesian trend is well-reflected in Musgrave's work in which he emphasized the significance of the role of fiscal policy as a stabilizing tool.

Since public finance is primarily concerned with the economic effects of government fiscal policies on an economy, and as a government is a political institution, it is likely that the determination and implementation of fiscal policies are often influenced by political ideologies and guided by political motives so that what is essentially a social and economic need may in part become a political issue.

In general, the traditional approach to fiscal theory has been in the context of unitary government. Reflecting the centralized nature of British finances, Adam Smith and his successors were mainly concerned with public finance at the national level. Even as late as the 1930's, the Keynesian renaissance in the economics of public finance continued to focus on the central government and failed to penetrate to the regional and state levels.<sup>4</sup> There was no frontal attack on the problems of fiscal federalism (the fiscal relations between different levels of units) and multi-unit finance (the fiscal relations between units of the same level). However, historical incidents and political decisions which frequently define the boundary and framework within which a 'national system of public finance' can operate, resulted in the emergence of many federations in the world after World War II.

The emergence of these federations points to the fact that problems of intergovernmental fiscal relations could not be ignored or neglected. There is a need to conduct research and enquiries into these problems in order to bring about a greater understanding of the

problems of fiscal relations among the different levels of government. Thus, the realization of these facts has led to a gradual shift in emphasis, away from the pre-war unitary bias and towards a post-war interest in the subject of fiscal federalism and multi-unit finance. Although they are concerned with a federal system, the issues of fiscal federalism lie within the framework of public finance. The difference is that the principles of public finance are adapted into a federal system.

In this paper, the principles of public finance are applied to Malaysia in order to understand and to analyse the prevailing federal fiscal problems in the country.

a) PURPOSE AND SCOPE OF THIS STUDY

The present study is prompted by the lack of economic literature on the subject of intergovernmental fiscal relations in Malaysia<sup>5</sup> and by a profound interest in the subject itself.

The study intends to pursue a comprehensive and exhaustive analysis of the Federal-State fiscal relationship in Malaysia, with special reference to the State of Penang and its financial position within the framework of the Constitutional Federal-State financial provisions for the period 1960-72. A particular emphasis of the study is on the Federal system of federal fiscal adjustment, that is, to find out the extent to which the system of fiscal adjustment in Malaysia, especially the Federal grants system, helps the component states to cope with their financial problems.

Given these intentions, the study will discuss and analyse critically the various issues pertaining to the fiscal functioning of Penang and the existing Federal-State fiscal arrangements such as the optimal allocation of functions among the different levels of government, the problems of fiscal imbalances, the nature of the State of Penang's revenue sources and the implication of this on the State's efforts to solve problems of development and growth, the fiscal adjustment system in Malaysia and finally, the possible changes that could be made to the existing system of fiscal adjustment in Malaysia in order to improve it.

Firstly, the question of optimal allocation of functions and revenue sources among the various levels of government will be examined critically. Equity and efficiency considerations will be discussed in this context. The extent of demarcation of functions and revenue sources will indicate the degree of centralization or decentralization of the fiscal system in the country and will have certain implications on the ability of the state governments to bring about changes in the Constitutional fiscal arrangements.

Secondly, the study will look into the problems of fiscal imbalances. The extent of vertical and horizontal fiscal imbalances will be determined and specific references will be made to the State of Penang. The implication of such problems on the states' finances will be included in the discussion. If vertical and horizontal fiscal imbalances are found to be considerable, the country will find that not only is its fiscal system overtly biased towards the Federal Government but interstate fiscal disparities could also seriously affect



the nation's attempts at balanced regional growth.

Thirdly, the nature of the sources of revenue available to Penang, under the Constitution, is compared with that of the other states in the Federation. This is to determine the strength of the State's finances - the amount of revenue it could raise from its own sources compared to its expenditure requirements. Within this context, the State's fiscal gap, its tax effort and rates of tax buoyancy will be determined and compared with those of the other states in the Federation in an attempt to assess Penang's fiscal position against the others. The discussion also attempts to look into the implication of the State's financial position and its ability to deal with its development and growth problems - to find out to what extent the State could solve its problems of unemployment, rapid population growth, housing shortage and development - given the nature of the Constitutional financial framework within which it operates.

Fourthly, the study attempts to evaluate the system of fiscal adjustment in Malaysia in order to find out the extent to which the system is effective in helping the states to cope with its shortage of financial resources. Particular attention will be paid to the system of Federal grants in Malaysia and its ability to adjust to changes in the states' financial needs.

Lastly, the scope for improving the prevailing system of fiscal adjustment is examined. The discussion focuses on the possibility of introducing and improving the various measures of fiscal adjustment used in Malaysia. Some of these measures are commonly used

in other federations such as the United States, Australia and India, They include tax supplements, tax credits and deductions, conditional grants and unconditional grants.

As such, this study hopes to provide an understanding of the working of the Malaysian Federal-State fiscal relationship and its impact on a state like Penang and, perhaps, to pave the way for further studies in the same subject.

#### b) METHODOLOGY AND DATA SITUATION

This study is essentially a probe into the existing Federal-State fiscal relationship in Malaysia between 1960 and 1972. The approach to the study on intergovernmental fiscal relations in Malaysia involves primarily an exploratory and descriptive analysis of the working of these relations between the Federal Government and the state government and among the state governments. At the same time, various techniques have been adopted to study the Federal-State fiscal relationship and to evaluate the states' financial positions. Examples of these measures are the formula for allocating unconditional grants suggested by R.A. Musgrave,<sup>6</sup> K.V.S. Sastri's model<sup>7</sup> of calculating tax efforts using actual tax revenue and personal income, D.M. Nanjundappa's approach<sup>8</sup> to calculating states' tax buoyancy rates, relative fiscal capacity and relative tax efforts, and a simple regression to test Wagner's hypothesis of Increasing State Activity in Penang.<sup>9</sup> Wherever necessary, tables are used not only to illustrate the financial position of Penang within the existing Federal-State fiscal relationship

but also to compare the State's position with those of other states in Malaysia.

The study serves only to illustrate and exemplify the issues and problems related to fiscal federalism in Malaysia, which it purports to consider. It is not intended for prediction purposes. Thus, the study is essentially an ex-post evaluation of the financial position of Penang within the Constitutional framework during the period 1960-72. The attention paid to the financial positions of the other states in Malaysia has to be brief because they lie beyond the scope of this study.

i. Sources of data

The data used consist mainly of annual observations of the State Financial Statements of the different states in Malaysia for the period 1960-72 expressed in millions of Malaysian ringgit (M\$) and at current market prices.

The data are drawn mainly from the following sources:-

- 1) State Financial Statements of all the states in Malaysia for the period 1960-72
- 2) Economic Report, 1973-74, Federal Treasury.
- 3) Estimates of Revenue and Expenditures, (1960-72), of all the states in West Malaysia.
- 4) Penang Development Corporation, Penang: Investment Guide, 1970.
- 5) Nathan, R., Assos., Penang Master Plan - Final Report, Penang Master Plan Committee, June 1970.

- 6) GDP Estimates by States, Economic Planning Unit, Kuala Lumpur, 1972.
- 7) City Treasurer's Annual Report and Audited Accounts, City Council of Georgetown, Penang, 1960-72.
- 8) Annual Statistics and Bulletin, Malaysia, 1972-73, Department of Statistics, Kuala Lumpur.
- 9) Revised Inter-Censal Population Estimates, Malaysia, 1970, Department of Statistics, Kuala Lumpur.

In addition to the above, the Statements of Accounts of the Rural District Council, and of the North, South and Central District Councils of Penang for the period 1960-72 have been used to obtain data for local government financing in Penang.

ii. Limitations of Data and Data Collection

The collection of data pertaining to the above sources was beset with numerous difficulties. A complete set of the various Financial Statements for the entire period 1960-72 was difficult to obtain because no central institution in the country maintains a complete set of these Statements for the period mentioned. Although the Penang State Treasury and the Federal Treasury have the Financial Statements of various states for different years, the sets are not complete and access was made difficult by the fact that these Statements could not be taken out of the Treasuries for a closer examination. Therefore, in many cases, the Financial Statements of some states for certain years were not available.

The Gross Domestic Product Estimates for each state in West Malaysia were available from the Economic Planning Unit, Kuala Lumpur. They covered a period from 1963 to 1970. However, GDP data for Sabah and Sarawak could not be obtained from the same source. The GDP data for each state in West Malaysia for the years 1971 and 1972 were estimated, using the national average rate of growth of GDP in Malaysia which was stated as 11% in the Mid-Term Review of the Second Malaysia Plan. As a result, some discrepancy in the GDP data is unavoidable.

Data on the personal income of taxpayers of residents by states are not made available to the public in Malaysia. The Malaysian Government has always been very stringent and cautious about making data and information on personal income or the actual amount of income tax collected in each state available for public and for individual purposes. The lack of data on personal income according to states has impaired the computation of tax efforts, estimation of tax burden in each state and the specification of a definite criterion for allocating unconditional grants, using per capita personal income as part of the formula. Throughout the study, GDP data have been substituted for personal income, wherever applicable. This has led inevitably to some distortions in the results.

It should be realized that because of the absence of consistent and standard presentation of data in the Statements of Accounts of the various local councils in Penang, the data obtained are also subject to some degree of discrepancy and uncertainty.

c) A PREVIEW OF THE FEDERAL-STATE FISCAL RELATIONSHIP IN MALAYSIA

Unlike Nigeria or the West Indies, where the formation of a federation was based on geographical or racial considerations, the nature of the Federation of Malaysia<sup>10</sup> is based primarily on political considerations. It is the natural outcome of a series of historical and political developments within the country, which began as early as in 1874 when the British first officially intervened into the Malay States in Peninsular Malaya.

An attempt was made to set up a unitary government in 1946 but, owing to political pressures from the Malays, the Malayan Union, as it was then called, was replaced by the Federation of Malaya in 1948.<sup>11</sup>

Although it was to be a federal system, yet the actual operation of the system was guided by unitary forces, reflected in the Federal Government's domination over the states in both political and financial matters. The former British Colonial power had desired a more centralized government and the Federation of Malaya Agreement was designed to coincide with this intention.<sup>12</sup> The identity of the states were maintained for political rather than economic reasons.

Since 1948, political and financial powers have been biased towards the Federal Government. The states have been politically dominated by the Federal Government and without the political force, their bargaining power for financial rights and claims with the Federal Government is adversely affected. They could not bring about changes in the prevailing Constitutional financial provisions. Any changes in

the allocation of revenue sources would have to be initiated and approved by the Federal Government. Under these circumstances the states are put in a weak financial, economic and political position vis-a-vis the Federal Government.

The strong unitary tendency in both political and economic affairs means that the thirteen states<sup>13</sup> which form the Federation of Malaysia are often treated as an entity. Their significance as separate units, each with a vital task to perform within the federal system, is frequently overlooked. In addition, few commissions or Royal studies have been set up to investigate and enquire into the fiscal relationship between the Federal Government and the states. This is in contrast to what are being done in other federations like India, the United States, Australia and Canada, where studies in public finance frequently focus on the existing federal-state fiscal arrangements and the problems generated. At present, in Malaysia, these issues should not be ignored any longer, especially with development uppermost in the minds of the Federal leaders. There is pressure on the states to assume a more active and viable role in the development process.

To do this, the states would require a large amount of financial resources. Their current expenditures have been rising. The expected increase in development expenditures together with rising current expenditures would imply heavier fiscal pressures on the states' revenue. Given this, a question arises as to whether the states had been able to cope efficiently with rising fiscal pressures

against constant revenue in the period 1960-72 and whether they will be able to do so in the future. To answer this question will be the major task of the following chapters.

d) BACKGROUND PERSPECTIVE TO THE STATE OF PENANG: GEOGRAPHY, HISTORY AND POLITICS.

The state of Penang presents an interesting topic for research. Although it is the second smallest state (in terms of acreage) in Malaysia and lacking in rich natural resources, it is considered as one of the well-developed states in Malaysia, with an estimated GDP of M\$ 939 million in 1970.<sup>14</sup> However, the State is not without problems of its own. It has one of the highest population figures in Malaysia and experienced one of the highest rate of unemployment in the country, particularly in the sixties and early seventies.

The State economy had, for a long time, been dependent upon trade and agriculture to generate economic growth and employment within Penang. However, at present, the two sectors are unable to perform these functions effectively. Consequently, the State Government was forced to turn to industrialization in 1970 to solve its economic problems.

To embark on a dynamic industrialization program, the State Government of Penang has to develop initially a broad industrial and infrastructural base in order to attract the investors. Before it can do this, the State Government has to have substantial amount of



financial resources. Unfortunately, the State does not have abundant natural resources which it can depend upon. This gives rise to another problem - the shortage of available public funds for both development and current expenditures. The State's rising population indicates that the demand for public services, utilities and housing will tend to rise. Consequently, not only will development expenditure increase, but also current expenditure. The present and future fiscal pressures on the State Government's ability to raise revenue within the Constitutional financial framework will be considerable and may be beyond the scope of the State Government's ability to cope under the present fiscal arrangements.

i. The Geography of Penang

Geographically, the State of Penang is a combination of an island and part of the Mainland Peninsula known as Province Wellesley.<sup>15</sup> It is the second smallest state in Malaysia, with an estimated total area of 403 square miles. It is situated on the north-western coast of West Malaysia, within latitudes  $5^{\circ} 7'N$  to  $5^{\circ} 35'N$  and longitudes of  $100^{\circ} 9'E$  and  $100^{\circ} 32'E$ . It is bounded to the north and east by the State of Kedah, to the south by the State of Perak and to the west by the Straits of Malacca and Sumatra.<sup>16</sup> In 1970, the population of the State of Penang was estimated at 808,627 persons.<sup>17</sup> Its average density of population was thus estimated at 2006 persons per square mile. This makes the State the most densely populated state in the country.

ii. The Historical Background of Penang

Historically, very little is known about the State before 1786, and the island of Penang laid in virtual obscurity until the

British made it its first stronghold in Malaya and South-East Asia. When the British first took possession of the Island from the Sultan of Kedah, the Island was largely uninhabited.<sup>18</sup> Later, as Penang grew into a thriving port of call for traders en-route to South-East Asia and the Far East, its population began to increase. Its early growth was mainly due to its activity as a free port.<sup>19</sup> Large numbers of immigrant races - Chinese, Indians and Bugis - came to participate in the trading activities and to settle down. The main supports of the state economy were trade and agriculture, but its importance as a port was soon overshadowed by the emergence of Singapore.

After the acquisition of Singapore and Malacca, the British grouped the three Settlements together into a Crown Colony and thus, Penang came under direct British rule as opposed to the other states in Peninsula Malaya (with the exception of Malacca) where the British were able to assume domination but indirect control. This was achieved by maintaining the indigeneous political leadership in each state, as reflected in the adherence of the positions of the Malay Sultans. It was only in 1948, under the Federation of Malaya Agreement, that Penang and Malacca were brought under the authority of a Malayan Central Government in Kuala Lumpur which had similar jurisdiction over the other states in Malaya. Hence, Penang became a part of the Federation of Malaya.

### iii. The Political Structure of Penang

The State of Penang is politically divided into two levels of government - the State Government and the Local Government. At the

local level, the State was divided into five local Councils, two on the island of Penang - the City Council of Georgetown and the Rural District Council, and three on the Mainland - the North, South, and Central District Councils.<sup>20</sup> Of the five local Councils, the City Council of Georgetown was the most prominent in terms of finances. Unlike the rest of the Councils in Penang, the City Council of Georgetown seldom incurred deficits in its budgets and therefore did not rely upon the State Government financially. One peculiar aspect of the City Council was that it had the tendency to accrue annual total revenue which was larger than that of the State of Penang.

Given the background to the Federal-State fiscal arrangements in Malaysia and that of the State of Penang, the remaining parts of the study will attempt to evaluate and analyse the fiscal arrangements and the position of Penang within this fiscal framework.

NOTES

- <sup>1</sup> Musgrave, R.A., The Theory of Public Finance, McGraw-Hill, 1959, p.3.
- <sup>2</sup> Eckstein, O., (ed.), Public Finance, 3rd ed., Modern Economic Series, Prentice-Hall, 1973, p.1.
- <sup>3</sup> Holzhausen, W., Federal Finance in Malaysia, Universiti Malaya Press, 1974, p.i.
- <sup>4</sup> Musgrave, R.A., Essays in Fiscal Federalism, Brookings Institution, 1965, p.i.
- <sup>5</sup> The study of intergovernmental fiscal relations in Malaysia has been somewhat neglected in the literature of public finance in Malaysia. Except for publications by C.T. Edwards (Public Finances in Malaya and Singapore, Australian National University Press, 1970, Chaps. 11 & 12); W. Holzhausen (Federal Finance in Malaysia, Universiti Malaya Press, 1974); R.J. May (Federalism and Fiscal Adjustment, Oxford University Press, 1969); and Huan Tzu Hong ("The New System of Revenue Allocation to States and Settlements in the Federation of Malaya," Malayan Economic Review, Vol. II, No.1, April, 1957.)
- <sup>6</sup> Musgrave, R.A., and P. Musgrave, Public Finance in Theory and Practice, McGraw Hill, 2nd ed., 1973, Chap. 27, p. 643, footnote 13.
- <sup>7</sup> Sastri, K.V.S., Federal-State Fiscal Relations in India, Oxford University Press, 1966, p. 37.
- <sup>8</sup> Nanjundappa, D.M., Intergovernmental Financial Relations in India, Sterling Publishers (India), 1974, p. 89-90.
- <sup>9</sup> Michas, N.A., "Wagner's Law of Public Expenditures: What is the Valid Test?" Public Finance, Vol. XXX, No. 1, 1975, p. 76.
- <sup>10</sup> In 1957, when Malaya gained independence, it was known as the Federation of Malaya. Only in 1963, it became known as the Federation of Malaysia.
- <sup>11</sup> In 1948, Singapore was excluded from the Federation. It became a Crown Colony.

- <sup>12</sup> In fact, the British refused to abandon their stand with regards to establishing a strong and effective central government and were thus, responsible for the pronounced unitary features of both the Federation of Malaya Agreement and the Federal Constitution of 1957. (See Holzhausen, W., op. cit., p. 13-14).
- <sup>13</sup> They are Johore, Kedah, Kelantan, Malacca, Negeri Sembilan, Pahang, Penang, Perak, Perlis, Selangor, Trengganu, Sabah, and Sarawak.
- <sup>14</sup> GDP Estimates by States, Economic Planning Unit, Kuala Lumpur, 1972.
- <sup>15</sup> Ryan, N.J., The Making of Modern Malaysia and Singapore, 4th ed., Oxford University Press, 1970, p. 85. Province Wellesley was bought from the Sultan of Kedah in 1800.
- <sup>16</sup> Penang Development Corporation, Penang: An Investment Guide, Government Printer, 1970, p.2.
- <sup>17</sup> Department of Statistics, Kuala Lumpur, Revised Inter-Censal Population Estimates, Malaysia, 1970, Table 11, p. 41.
- <sup>18</sup> Ryan, N.J., op. cit., p. 84.
- <sup>19</sup> Ibid., p. 84-85. Until 1801, Penang was a free port with no tax on its imports and exports. In 1801, a 5% tax on imports and exports was imposed and henceforth, it was no longer a free port.
- <sup>20</sup> In 1974, the structure of Local Government in Penang was changed. Instead of five local Councils, there were two local Councils - an Integrated Council on Penang Island, which comprises of the former City Council of Georgetown and the Rural District Council; and an Integrated Council in Province Wellesley, comprising of the North, South, and Central District Councils on Mainland Penang.

## CHAPTER 2

### FISCAL FEDERALISM AND PUBLIC FINANCE: A THEORETICAL EXPLORATION

Given the purpose of this study, that is, to study and evaluate the Federal-State fiscal relationship in Malaysia, it is important to develop a strong theoretical analysis of fiscal federalism by looking into the general functions of government (whether in a unitary or federal structure), particularly with respect to the attainment of an efficient resource allocation, an equitable distribution of income and the stabilization of income, output, employment and balance of payments. Accordingly, the main preoccupation of this chapter is to determine and discuss theoretically the optimal distribution of these functions among the different levels of government in a federal structure which would then provide a basis for the empirical research in the following chapters.

#### I. ECONOMIC OBJECTIVES WITHIN FISCAL FEDERALISM

##### 1) Federal-State Functional Demarcation and Resource Allocation

###### a) Reasons for Government Intervention

To ensure that there is an efficient allocation of resources in an economy, the government concerned has to step in to make adjustments to the pattern of allocation determined by the market forces. Misallocation of resources can result because of market failure and the existence of public wants. In a federal structure, there are more than one level of government involved in

allocating resources. Each level of government is supposed to have some degree of final autonomy within its jurisdiction. Under these circumstances, it is important that the function of allocating resources should be shared optimally among the various levels of government in order to avoid conflicts among the different governments and inefficiency in the economy.

i) Market Failure in the Economy

In a market system where all the goods produced are private goods whose benefits accrued directly to a particular consumer, the conditions for efficiency are similar to Pareto's. Pareto's efficiency criteria state that the marginal rate of substitution in consumption for any two products must be the same for all consumers and equal to the marginal rates of substitution in production. Efficiency in this context means that no change can be made which will improve a person's position without harming another's position. Therefore, under the market system, the price mechanism is expected to ensure that all consumers are charged a uniform price which is equal to the marginal rates of substitution and transformation, hence, fulfilling Pareto's efficiency conditions. Accordingly, the price mechanism appears to be a convenient and effective device for securing a more or less efficient allocation of resources in the economy.

However, this does not always happen. In some cases, due to inefficiencies in the market system, the price mechanism

fails to bring about an efficient allocation of resources.

The market system may fail to produce certain goods and services, or at least fail to produce them efficiently because of divergencies from purely competitive markets, for example, the existence of a monopoly. It can also occur if the productive factors in the production process are bulky and it is difficult to subdivide them into smaller and easily manageable sizes, or, if the production process is subject to decreasing cost, or external diseconomies or economies of scale.<sup>1</sup>

In addition to the above, market failure can also **occur in the case of social or public wants.** "Social wants are those wants satisfied by services that must be consumed in equal amount by all. People who do not pay for the services cannot be excluded from the benefits",<sup>2</sup> so they will not engage in voluntary payments. Since they know they cannot be excluded from the benefits and that the satisfaction of their wants is not contingent to their payments, they will, thus, refuse to reveal their preference. Without the **revelation of preferences**, the price or market mechanism cannot satisfy such wants and a budgetary process becomes necessary to ensure that these goods and services are supplied to all.

In view of these divergencies, it becomes necessary for the government concerned to intervene into the economy and to regulate the process of production as well as to produce certain goods and services which cannot or will not be supplied



by the private sector. These goods are known as social or public goods.

ii) Characteristics of Social Goods

One of the characteristics of public good is that once the good is supplied, there is no device by which anyone can be excluded from enjoying it, regardless of whether he or she contributes towards the cost of provision.<sup>3</sup> Examples of social goods are national defence and law and order. Since the exclusion cannot be adhered to, this implies that an individual consumer will not feel obliged to reveal his preferences for the public good.

Another characteristic of <sup>a</sup>social good is that it can be consumed by all individuals in equal amounts.<sup>4</sup> It has a beneficial consumption externality whereby "each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good."<sup>5</sup> Unlike <sup>a</sup>private good where the consumption of it by one person would deprive another of its use, the benefits that a person obtains from the consumption of <sup>a</sup>public good do not affect the benefits that the second, third or nth person obtains from it.

iii) Merit Wants and Quasi-Public Goods

In addition to public goods, there are merit wants which refer to "wants which are met by services subject to the exclusion principle and are satisfied by the market, within

limits of effective demand. They become public wants when they are considered meritorious and thus, they are provided for through the public budget over and above what is provided by the market and paid for by the private buyers."<sup>6</sup>

The satisfaction of merit wants, by its very nature, involves interference with consumer preferences. These wants do involve substantial elements of social wants in the sense that the exclusion principle can be applied, but only to a part of the benefits gained and not to the total. For example, the provision of free educational services may be of immediate benefit to one particular pupil, but the community as a whole also gains from having a larger number of educated people.

R.A. Musgrave<sup>7</sup> has developed a taxonomy of public goods which provides a bridge between purely private goods and purely social goods. His definition of quasi-public goods is based on the degree of consumption externalities or spillovers from the provision of the goods in question. There are cases where there are no spillovers at all and these cases refer to private goods whose consumption is internalized. In the case of pure public goods, the spillovers or consumption externalities are full and reciprocal. However, not all goods and services provided by the public sector fall into the latter category since it is possible that their spillovers are partial or non-reciprocal and thus, they cannot be termed as pure public goods. They are often referred to "quasi-public goods".<sup>8</sup> This analysis of quasi-public goods provides

a basis on which to argue for transfer of resources from "inefficient own-consumers or recipients of spillins to efficient own-consumers or originators of spillouts"<sup>9</sup> in the provision of social goods.

It can, therefore, be said that public goods are usually provided through the public sector. Although the consumption externality is a necessary element to identify a public good, it is not sufficient and one has to consider the fact that, because it is difficult to apply the exclusion principle (no one can be prevented from consumption), it is not easy to fix prices to public goods. When the exclusion principle can be applied it may not be considered desirable to do so because of the high costs of exclusion or certain characteristics which are peculiar to the good itself which make it necessary for government to step in to produce the good for the public.

iv) The Cost and Benefit Spillovers in a Federal-State Fiscal system

In a federal system, the process of demarcating the function of allocating resources can be complicated by the emergence of benefit and cost spillovers. Benefit and cost spillovers result because existing jurisdictions do not always correspond to benefit and tax cost areas and also because some social goods experience spatial limitations in their benefit and cost incidence. In a federal system, these spillovers have

to be accounted for in order to prevent the occurrence of undue fiscal pressures on some states in the federation, thereby, extending further any existing inequalities among the states.

Take for example, in Penang, the proposed bridge linking the Island to the Mainland is one good illustration of a state or local government public good which is expected to generate benefit spillovers. While it has been generally acknowledged that the bridge would benefit the residents of Penang<sup>10</sup>, on the other hand, residents from other states in Malaysia are also expected to benefit from the construction of the bridge. They will find that with the bridge, it will be relatively easy to travel to the island of Penang compared to the present ferry facility which links the Island to the Mainland. In addition, the bridge will also facilitate the easy movement of goods and services to Penang from Peninsula Malaya and vice versa. As a result of these expected spillovers, it would be inequitable to expect the residents of Penang to pay the full cost of the construction of the bridge through higher taxes or less public expenditure on other public goods and services whose benefits are primarily localised. Some form of compromise in cost-sharing will need to be reached and since it is expected to benefit the country as a whole, it is appropriate that the Federal Government should step in to give financial help or to assume the full cost of production.

Furthermore, spillovers should also be accounted for and internalized because it could lead to the undersupply of