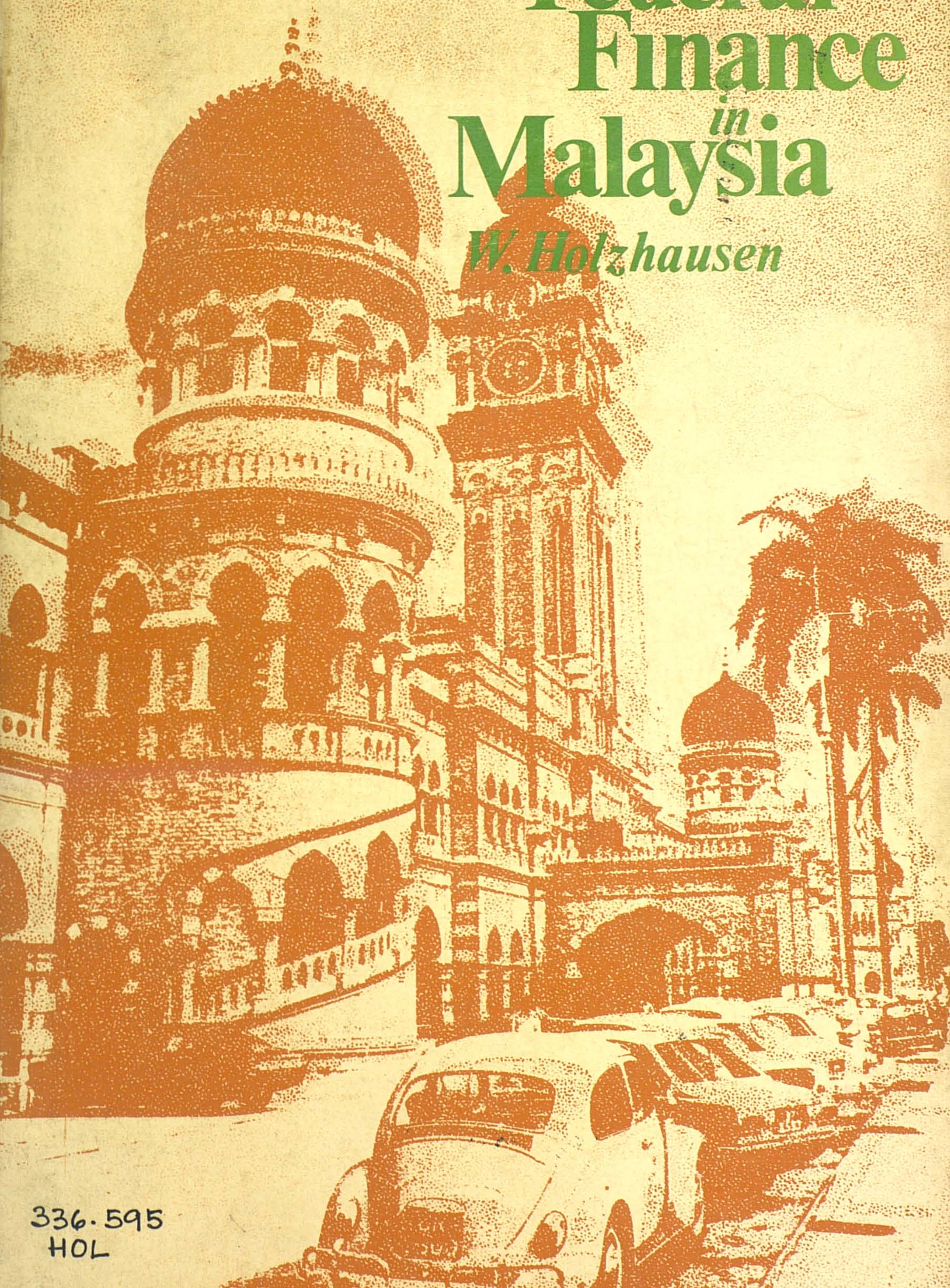
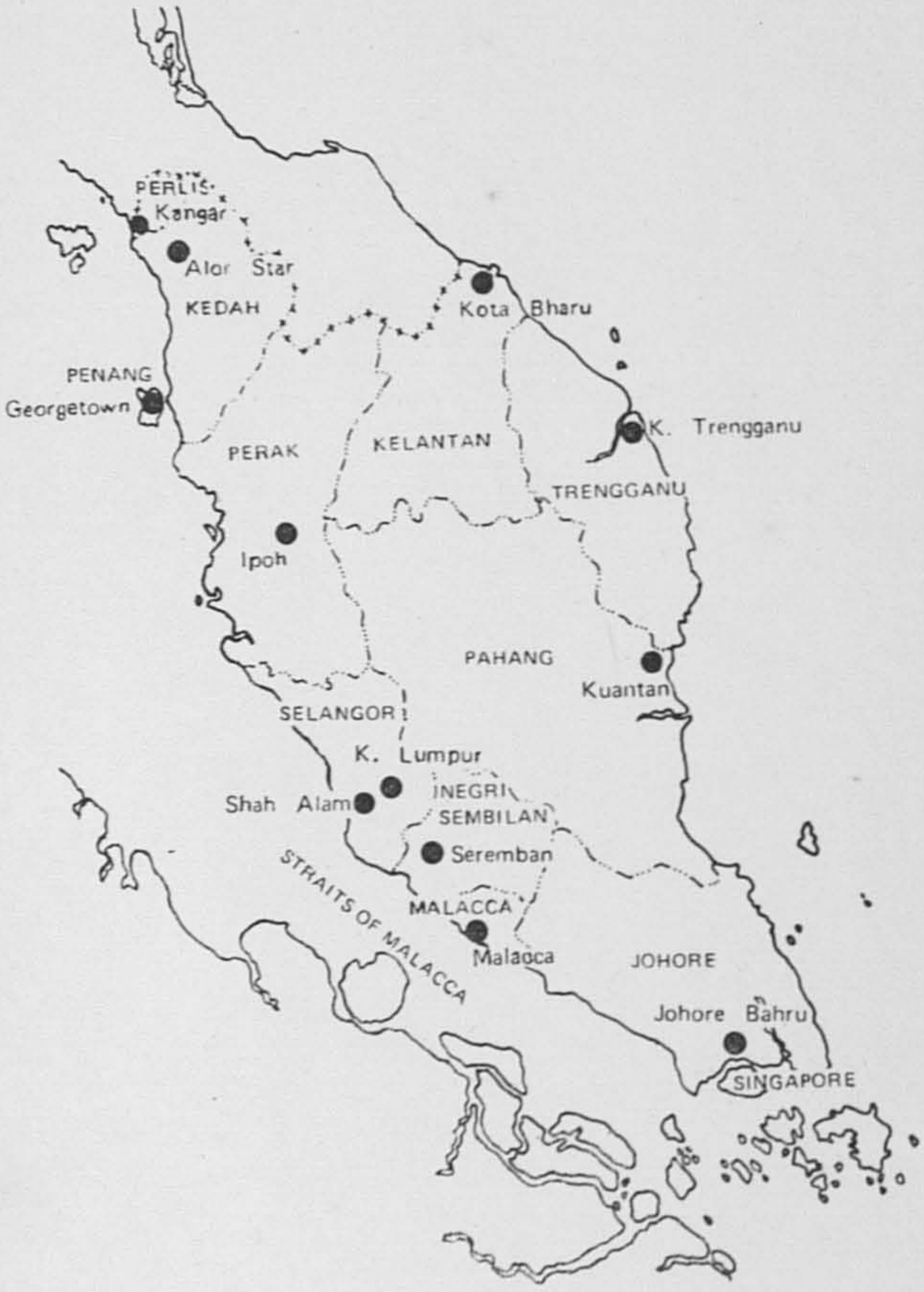
Federal Finance in Malaysia

W. Holzhausen



336.595
HOL

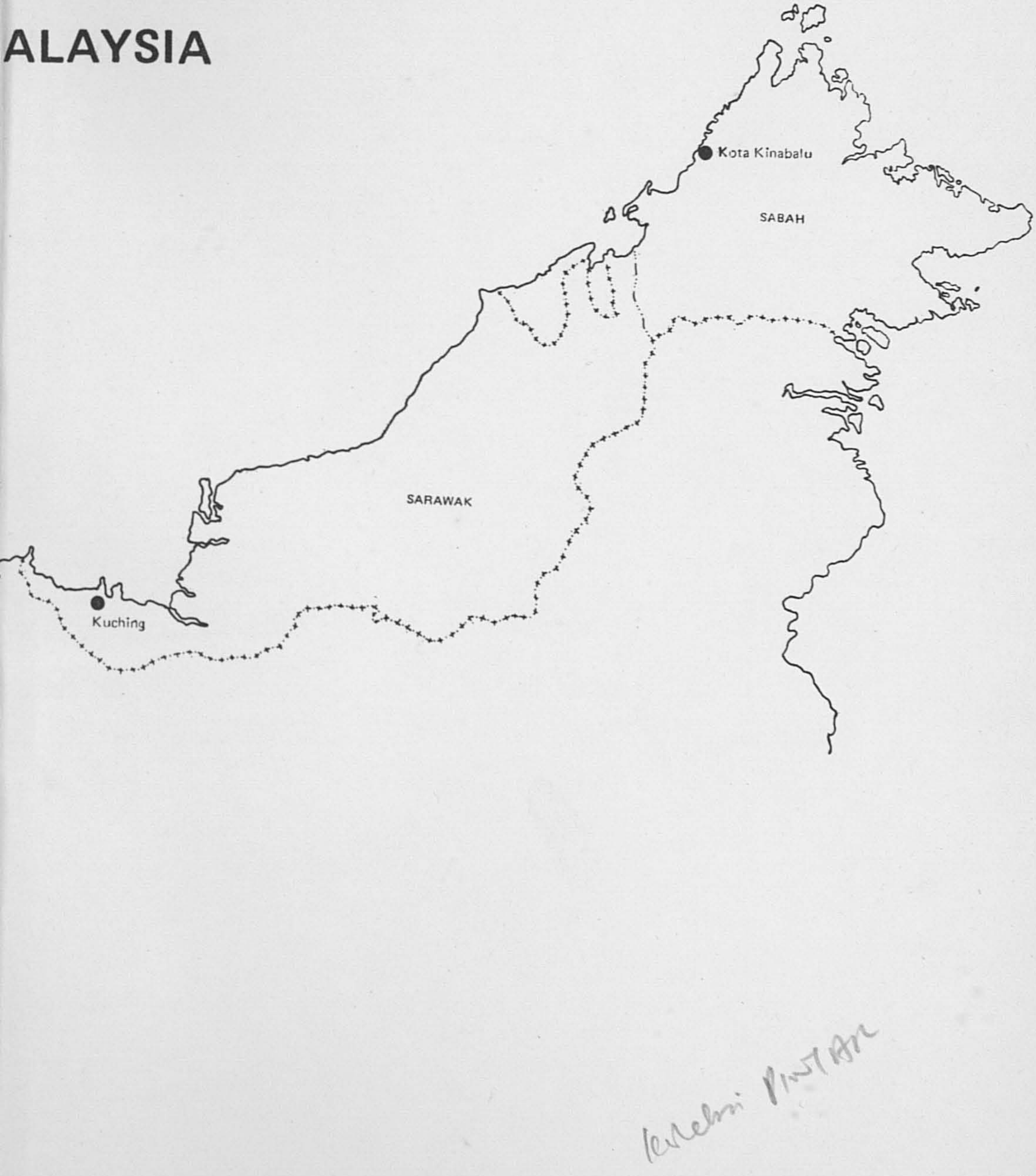
MAP OF M



Pustaka Antara
KUALA LUMPUR
TEL: 24622/3/4

KOLEKSI
ARKIB
PINTAR.

ALAYSIA



Koleksi PINTAR

Acess. No: 250 98/78
Class. No:

PENA

Georgetow

Federal Finance in Malaysia

FEDERAL FINANCE
IN
MALAYSIA

The theory and problems of federal/state government financial relations in a developing country

Walter Holzhausen

PENERBIT UNIVERSITI MALAYA
KUALA LUMPUR

1974

© *Penerbit Universiti Malaya Sdn. Bhd. 1974*

Printed in Malaysia by
ECONOMY PRINTERS LTD
12 Jalan Mountbatten Kuala Lumpur

PERKHIDMATAN ARKIB PERDANA MENTERI MALAYSIA
KOLEKSI
ARCIB
PINTAR

The views expressed in this book are those of the author and not necessarily those of the United Nations or the United Nations Development Programme with which he is currently associated.

Acess. No: 250 98/78
Class. No:

Acknowledgements

This book is based on a thesis for a doctorate written during my assignment as United Nations officer to Kuala Lumpur between 1965and1969. The subject of the thesis, Federal Finance in a Developing Country, was suggested by Professor D. C. Krogh, Head of the Department of Economics at the University of South Africa, Pretoria, who also acted as my promoter and whom I thank for his guidance and advice. The thesis proves that research is not limited by political, ideological or geographical boundaries. It was written by a German at a South African university with Dr. G. S. Gilani, a Pakistani lecturing at the University of Malaya, as co-promoter.

I am indebted to Mr. David Blickenstaff, formerly UNDP Resident Representative for Malaysia and Singapore, for his encouragement and to Mr. Zaidon bin Syed Mahmood of the Ministry of Finance in Kuala Lumpur, for his advice on a great number of technical matters. I thank Mrs. Philomena Rajendra, Miss Maimunah binte Tan Sri Hussain and my wife for their inexhaustible patience in typing and retyping the manuscript.

W. H.

Djakarta, January 1970

CONTENTS

PAGE

Introduction i

PART ONE

THE NATURE AND SIGNIFICANCE OF FEDERAL FINANCE IN DEVELOPING COUNTRIES

I. Nation-building, Economic Development and the Federal Solution 1

A. FEDERALISM AND THE PROCESS OF NATION-BUILDING 1

1. The Nature of Federalism and its Changing Features 1

2. Federalism and the New Emerging Nations 4

3. Federalism as a Solution for Malaysia 10
a. The Federation of Malaya 10
b. The Federation of Malaysia 14
c. The Failure of Federalism — Brunei and Singapore 19

4. Summary 22

B. FEDERALISM AND ECONOMIC DEVELOPMENT 23

1. The Role of the Government in the Process of Development and the Aims of Economic Policy 23

2. Federalism and the Goals of Economic Policy 25
a. The Process of Growth 25
b. The Problem of Equity 26

3. Federalism, Efficient Administration, and Development Planning 29
a. Federalism and Decentralised Decision-making 29
b. Administrative Efficiency and Development Planning 30

4. Federalism and Malaysia's Development Effort 34
a. The Framework of the Malaysian Economy 34

b. Federalism and the Aims of Malaysia's Development Policy 37
c. Federalism and Development Planning in Malaysia 43

5. Summary 44

II. The Major Problems of Federal Finance in Developing Countries 46

A. FEDERAL FINANCE AND THE PROBLEM OF EQUITY 46

1. The Origin of the Problem 46

2. Equity and the 'Pure' Theory of Federal Finance 48
a. The Principle of Financial Responsibility 48
b. The 'Principles of Federal Finance' 50
i. The Principle of Public Finance 50
ii. The Principle of Public Finance as Applied to Federations: the Principle of Federal Finance 51
iii. The Theory of Taxation in its General Application 54
iv. The Theory of Taxation in a Federal State 54
v. The Theory of Public Expenditure in its General Application 55
vi. The Theory of Public Expenditure in a Federal State 56
c. The Validity of the 'Pure' Theory of Federal Finance and its Significance to Developing Countries 57
i. The Criticism of the Method and the General Applicability of the Theory 57
ii. The Federal Aims 59
iii. Fiscal Equality in Developing Federations 60

3. Summary 61

B. FEDERALISM AND AN EFFICIENT FINANCIAL ADMINISTRATION 63

1. The Administrative Norms of Federal Finance 63

2. *The Division of Functions and Resources* 64
a. The Division of Functions and Resources 64
b. The Division of Resources 66

3. *The Problem of Financial Adjustment* 69
a. Horizontal and Vertical Imbalance 69
b. The Instruments of Adjustment and the Scope of Federal Grants 70
c. The Degree of Tax Autonomy of the States 73
d. Federal/State Fiscal Relations under a Centralised System of Tax Administration 76
e. The Problem of the Ratio of Distribution 78

4. *Periodic Reviews of Federal/State Financial Relations and the Settlement of Conflicts* 81
a. General Principles 81
b. The Australian Commonwealth Grants Commission 82

5. *Summary* 84

III. Fiscal Policy and Public Debt in Developing Federations 86

A. FEDERALISM AND FISCAL POLICY IN DEVELOPING COUNTRIES 86

1. *The Opportunities of Fiscal Policy in the Process of Economic Growth* 86
a. The Major Problems of Economic Growth 86
b. The Instruments of Economic Policy and their Role in Stimulating Growth 88
i. Monetary Policy 88
ii. Fiscal Policy 88
iii. Physical Controls 91

2. *The Implications of a Federal Structure of Government for Fiscal Policy* 92
a. Equality and the Allocation of Resources 92
b. Federalism and the Formulation and Implementation of Fiscal Policy 93

3. *Summary* 94

B. FEDERALISM AND THE PUBLIC DEBT IN DEVELOPING COUNTRIES 95

1. *Some General Characteristics of Public Debt* 95

2. The Need of Coordination in the Federal Approach to Public Debt 97

3. The Australian Loan Council 99

4. Summary 100

PART TWO

THE WORKING OF FEDERAL FINANCE IN MALAYSIA

IV. The Problem of Fiscal Imbalance in Malaysia 107

A. THE ORIGIN OF FISCAL IMBALANCE IN MALAYSIA 107

1. The Division of Functions 109

a. The Provisions of the Constitution 109

b. The Division of Functions and the Principle of Efficiency 111

c. The Balance of Power between the Federal and the State Governments 113

2. The Division of Resources 114

a. The Major Federal Sources of Revenue 114

b. The Tax Sources of the States 117

c. Comparison between the Federal and State Sources of Revenue 122

d. The Division of Resources and the Principle of Efficiency 125

3. Summary 127

B. THE EXTENT OF FISCAL IMBALANCE IN MALAYSIA 128

1. Vertical Imbalance 129

2. Horizontal Imbalance 131

3. Summary 133

V. The System of Fiscal Adjustment in Malaysia and the Question of Flexibility and Coordination 134

A. THE ROLE OF FEDERAL GRANTS AND ALLOCATIONS IN MALAYSIA'S SYSTEM OF FINANCIAL ADJUSTMENT 135

1. Conditional Grants and Allocations under Tax sharing Schemes 135

2. The Major Adjustment Grants 140

B. THE WORKING OF THE SYSTEM OF FINANCIAL ADJUSTMENT 142

1. The States of Malaya 143
a. Conditional Grants and Allocations 144
b. The Capitation Grant 144
c. Grants from the State Reserve Fund 148

2. The Borneo States 153

3. Summary 155

C. THE FLEXIBILITY AND COORDINATION OF FEDERAL/STATE FINANCIAL RELATIONS IN MALAYSIA 157

1. The Flexibility of Federal/State Financial Relations 157
a. The Division of Resources and Federal Allocations 157
b. The Major Adjustment Grants 158

2. The Coordination of Federal Finance in Malaysia and the Provisions for the Settlement of Conflicts 160
a. The Role of the National Finance Council 160
b. The Constitutional Provisions for Arbitration 162

3. Summary 163

VI. Federalism, Fiscal Policy and the Public Debt in Malaysia 164

A. FEDERALISM AND FISCAL POLICY IN MALAYSIA 164

1. The Limitations of Monetary and Fiscal Policy 164

2. The Opportunities of Fiscal Policy 165
a. Investment in Manufacturing Industries 165

b. The Promotion of Saving 166
c. The Harmonisation of Tax Rates and the Establishment of a Customs Union in Malaysia 167
d. Fiscal Policy and Social Justice 169

3. Summary 170

B. FEDERALISM AND THE PUBLIC DEBT IN MALAYSIA 170

VII. Summary and Conclusions 175

Bibliography 187

Index 193

Introduction

No other branch of economics has probably undergone such revolutionary developments in the more recent past than fiscal theory and policy. The classical economists failed to appreciate fully the advantages of public expenditure as a means to increase public welfare—which is not surprising in view of the autocratic governments which ruled in most countries until the end of the last century—and advocated a minimum amount of taxation. Typical of this attitude has been Ricardo's well-known statement: "If you want peaceful government, you must reduce the budget".

Under the impact of the First World War and the Great Depression the older objectives of minimum interference and strictly balanced budgets gave way to a growing realisation that the financial management of the ever increasing public sector could serve as a powerful weapon to raise the welfare of the people and to avoid undesirable effects on national income, production and employment. In the wake of Keynes' *The General Theory of Employment, Interest and Money* a large literature has evolved on the role of fiscal policy in promoting stability, concentrating initially on short-run aspects and shifting gradually in favour of long-run stability and economic growth.

Only after the Second World War, when most of the former colonial territories gained independence, and when there was a growing realisation of the urgency—and, in fact, of the possibility—of improving the levels of living in these countries, economists began to give closer attention to the theory and problems of public finance in underdeveloped countries. In recent years many scholars of the advanced and developing countries, as well as national and international agencies have been studying the various aspects of public finance in developing countries at a theoretical and administrative level. As a result of these studies there has been a significant improvement in the knowledge and understanding of the problems involved which in many aspects differ from those of advanced countries. The importance of an efficient system of public finance and of a dynamic fiscal policy as a condition for social and economic advancement in the less-developed countries is today fully recognised.

Public finance is one of those subjects which lie on the border-line between economics and politics and its issues are, accordingly, often of a highly controversial nature. Historical accident and political decision usually establish the confines of each national system of public finance. They also determine the framework for the operation of public finance within a country. Where a federal structure of government has been adopted for certain political, economic or other reasons, this framework will differ in many important aspects from that of a country having a unitary form of government.

However, there is not only the difference between the financial arrangements of

unitary and federal countries. Differences are also found among the various federations themselves. This is not surprising if one thinks of the dissimilarity in their historical, ethnic and cultural backgrounds, in their political and social structures, as well as in their level of economic development. Differences are greatest between the older and advanced federations and the newer ones which are mostly underdeveloped. In the latter, the system of public finance is necessarily geared to the attainment of the main goal of economic policy, namely rapid social and economic growth. It follows that the theory of federal finance, which is the theory of public finance as applied to countries with a federal structure of government, need not always have the same relevance to the advanced and backward federations.

In Part One of the following study we shall first examine the reasons why some developing countries have chosen a federal structure of government instead of a unitary one. We shall then discuss the various problems of these countries—and especially those relating to their financial set-up—which stem from the introduction of a federal structure. At the same time, the question will be examined in how far the solutions to these problems offered by the theory of federal finance are relevant to the particular conditions and the objectives of developing countries. Finally, it is intended to look into the implications of federalism on an effective fiscal as well as public debt policy.

The Second Part deals with the practical working of federal finance in the Federation of Malaysia, the only developing federation in East and South East Asia. This case study will help to illustrate and further underline some of the findings arrived at in the First Part.

Public finance is essentially a matter of practical politics and administration rather than of theoretical reasoning. Moreover, since conditions prevailing in each country and the objectives of a government's socio-economic policy are never stagnant, one should avoid being dogmatic about the various issues involved in state finance. On the other hand, for the sake of better understanding it is often useful to consider essentially practical issues also from a theoretical point of view.

The practical effects of theoretical findings in the field of public finance have been remarkable in the past. One need only think of the readjustment of approach to the role of fiscal policy as a stabilising factor which was brought about by the Keynesian revolution. Without a valid theory one gropes one's way. Public finances have a profound effect on the whole economy of a country and influence the life of each citizen. It is therefore regrettable that, in actual fact, fiscal measures are often taken merely in an attempt to overcome some particular difficulty without taking the wider implications of such measures into consideration. This means that fiscal measures frequently do no more than correct the mistakes of previous decisions. This, obviously, is most unsatisfactory from the point of view of financial efficiency and sound economic development.

The administrator who has to make day-to-day decisions has often neither the time nor the peace of mind to get to the root of the problems he is confronted with. He has to decide instantly in the face of opposing representations of vested interests and, having to choose between various conflicting possibilities, would welcome a

theory, based on scientific principles, which provides him with an objective criterion for his decision.

Each theory is limited in its practical applicability. Its solutions, based as they are on various more or less valid assumptions, are often very general and give no answer to specific questions. This may be unsatisfactory. Yet, it often happens that theoretical reasoning points to practical solutions which, normally, would not have entered the mind of the politician or administrator. Given the constant fertilisation which economic theory derives from the study of practical economics, there is thus a constant interaction between theory and practice from which both profit.

PART ONE

The Nature and Significance of Federal Finance in Developing Countries

CHAPTER I

Nation-building, Economic Development and the Federal Solution

Each fiscal system is limited by its competence and, since competence in a federal state is determined by political decision, the entire political and administrative structure of a country is relevant to the understanding of the working of federal finance. If, furthermore, it is intended to highlight the problems of federal finance and their significance to developing countries, the whole socio-economic background of these countries and their major policy objectives are of importance to the discussion.

It would appear opportune, therefore, to begin the present study of the theory and problems of federal finance in developing countries with a chapter dealing with the general characteristics of federalism and its attractiveness to the developing countries of the world, among them Malaysia, that are still in the process of nation-building.

The first chapter will, moreover, deal with the implications of the introduction of another layer of government on a policy of economic development. This mainly involves the complex question of equity in relation to growth, as well as the problems of administrative efficiency, and the formulation and execution of a policy of development. The discussion will thus serve as an introduction to the more detailed analysis, in Chapter II, of the specific problems of federal finance and their significance to developing federations.

A. FEDERALISM AND THE PROCESS OF NATION-BUILDING

1. *The Nature of Federalism and its Changing Features*

To begin with: what is federalism?[1] A simple question, yet difficult to answer, because it means different things to different people. There is no such thing as a prototype federation. The term 'federation' is seldom given a meaning which is at once clear and distinct and it has been used, on the one hand, to cover little more than a simple customs union, or the linking-together of sovereign countries for defence purposes, and, on the other, to denote tight federations which are virtually identical with unitary states. Federalism can be interpreted from various angles,

[1]The word 'federalism' is derived from the Latin word 'foedus', meaning 'covenant'.

similar to the concept 'democracy' with which federalism is closely linked. Each definition is likely to be derived from the federal practice of particular country and may involve rather subjective attitudes towards certain political, social and economic issues. Federalism holds out numerous possibilities of political associations and keeps the door open for evolution and change.

In general terms, a federation may be defined as a union into a single sovereign state of two or more states which waive the unilateral right of seceding from it.[1] The constituent states retain a maximum of sovereignty and continue to act directly on the people, but transfer simultaneously certain sovereign rights and duties to the federal government. Consequently, neither the federal government nor the constituent states are fully independent bodies. In fact, divided sovereignty is the very essense of federalism.[2]

In practice it is sometimes difficult to clearly distinguish between federal and unitary states. In unitary states a great number of functions are usually performed on a regional basis and local authorities, including municipalities, frequently enjoy large measures of independence, quite similar to that of the states in a federation. There is, however, a vital difference between the unitary and the federal state: in the former the central government may rescind, at least in theory, at any time the powers delegated to a local authority. In a federation, on the other hand, the powers of the states are guaranteed by the constitution and cannot be withdrawn by the central government.

In a federation the constitution is the final document to which all parties would refer in the case of dispute. The constitution cannot be changed unilaterally. It is supreme and, under ideal conditions, should define exactly and in unambiguous language the division of powers among the federal and state authorities. In actual fact, however, the framers of the constitution cannot always foresee the constitutional problems which would arise in the course of history. New forces are constantly appearing in the political, economic and social spheres to which the administrative machinery of a country has to be adapted. Moreover, from time to time the authorities may have to assume new powers and functions and their distribution between the central government and the states may easily lead to conflict. Disagreement may also arise where there are instances of overlapping jurisdiction. Federal constitutions therefore normally provide for conflicts to be referred to the country's

[1]No state can withdraw from a federation without the consent of the others. The question was first raised when, in 1861, the Southern States of the USA wanted to secede. President Lincoln at that time felt justified to use force for the preservation of the union and this was subsequently, in 1868, confirmed by a ruling of the Supreme Court to the effect that the constitution of the USA provided for an indestructible union.—Similarly, when in 1934 the State of Western Australia sought permission to secede from the Commonwealth of Australia, a Select Committee of the British Parliament decided that Parliament could not act on the request of a single member of the Commonwealth of Australia. Cf. Bhargava, R.N., *The Theory and Working of Union Finance in India*, London, 1956 (reprinted Allahabad, 1965), p.41.

[2]Wheare, drawing mainly from the federal character of the constitution of the United States, defines the federal principle as meaning "a method of dividing powers so that the general and regional governments are each within a sphere, coordinate and independent". Wheare, K.C: *Federal Government*, London, 1963, p.10. Wheare calls those "constitutions or governments in which the federal principle, though not predominant, is none the less important," *'quasi federal'*. *Ibid.*, p.33.

supreme judicial authority for decision.

Obviously, federalism cannot flourish unless there is a respect for the constitution and the rule of law and unless there is an independent judiciary. It seems to have a fair chance to survive only in countries where liberal democracy has been firmly established. Unconstitutional government and dictatorship have been the main causes of the failure of federalism in many South American countries in the last century and, more recently, in several African and Asian countries. Two other influences which have constituted serious threats to the survival of federalism have been war and economic crisis.

Despite the stability, and often rigidity, created by the constitution, the relations between the two layers of government in a federation are subject to constant evolution. One of the main features of modern federalism has been its growing centralisation. This process has been very strong in the older federations where there is nowadays a considerable divergence between the original theory, as embodied in the constitutions, and current practice. The tendency towards increasing unitarianism has been partly the result of the war efforts of these countries which strengthened the position of the centre vis-a-vis the state governments. It has also been ascribed to the ramification of big business, the integration of economic life and the increased economic and social responsibilities of the central government in respect of economic stability, full-employment and social security. Most of the newer federations have profited from the experience of the 'classical' federations and have from the outset adopted constitutions giving far-reaching powers to the central government in the political, economic and social fields.

It may be anticipated here that centralisation has been particularly pronounced in the field of public finance. Revenue is nowadays increasingly collected by the central government which has a greater competence in collecting certain types of taxes. The centralisation of taxes has led to an increasing dependence of the states on grants from the centre. This, in turn, has forced the states to co-operate with the central government in all the more important matters of its overall socio-economic policy. The state governments have thus lost part of their independence of action within the spheres originally allotted to them including their financial autonomy which, formerly, was thought to be the very essence of federalism.

On the side of expenditure, however, an opposite trend has steadily been gaining ground. Here some of the functions formerly performed by the federal government, in such fields as social welfare, health and education, have been transferred to the states because these functions are considered to be administered more effectively on a regional basis. It is in this way that everywhere, in varying degrees, the old 'dualistic' federalism has given way to what has been termed 'cooperative' federalism. "Whereas the guiding principle of eighteenth-century and nineteenth-century federalism was the independence of state and federal authorities, the guiding principle of mid-twentieth-century federalism is the need for cooperation between them."[1]

[1]Birch, A.H.: *Federalism, Finance and Social Legislation in Canada, Australia, and the United States,* Oxford, 1957, p. 305. Cf. also Birch's definition of a federal system as being "one in which there is a division of powers between one general and several regional authorities, each of which, in its own sphere, is coordinate with the others, and each of which acts directly on the people through its own administrative agencies". *Ibid.*, p. 306.

The 'classical' examples of federal states are the United States of America, Canada, Australia and Switzerland.[1] Their federal structure is the outcome of the merger of a number of separate states into a single sovereign state, with legislative and executive powers divided coordinately between federation and unit governments, each of which acts directly on the people.[2] The 'classical' federations resulted from the coming together of until then independent units ('federalism by aggregation'). Some of the new federations, on the other hand, have emerged from former unitary and colonial-type structures ('federalism by devolution').[3] Examples are India, Nigeria, and the Federation of Malaya.

According to Wheare, federalism should never be interpreted dogmatically.[4] It is not synonymous with good government; nor an end in itself, or a form of government superior to other forms of democratic rule. Nor is any deviation from it in law or in practice a weakness or a defect in the system of government. What kind of government is the most appropriate, whether a unitary one, a federal, or a 'quasi federal', or, whether strict federalism is followed in a few matters, or modified federalism in all, will always depend on the circumstances prevailing in the country. Also, if a country introduces changes in its federal structure, say, towards greater centralisation, this may have to be viewed as a normal evolutionary process rather than a deterioration in the quality of government. Similarly, a substitution of a unitary for a federal structure of government does not necessarily mean that a country has abandoned the path of good government.

2. *Federalism and the New Emerging Nations*

The next aim is to examine the forces in the developing world making for amalgamation, on the one hand, and separation, on the other, and to show why a federal form of government has in many cases been found an acceptable compromise solution.

In general, federalism still has many of the merits originally claimed for it as the right form of government for people of heterogeneous units who wish to maintain some of their special characteristics, but who, for political and economic reasons, wish to unite. In fact, federalism may claim to have united in the more recent past several areas which are characterised by extreme cultural and ethnic diversity and

[1]According to Riker, the following countries call themselves federations "with some justification, however slight": In North America: Canada, Mexico, USA; in South America: Argentina, Brazil, Venezuela; in Europe: Austria, the Soviet Union, Switzerland, West Germany, Yugoslavia; in South East Asia: Australia, India, Malaysia, Pakistan; in Africa: Congo, Ethiopia, Nigeria. Cf. Riker, W.H.: *Federalism, Origin Operation Significance,* Boston and Toronto, 1964, p.1. Of these countries only Canada, USA, Austria, Switzerland, West Germany, Australia, India, Malaysia and Nigeria should be regarded as 'genuine' federations. Other more recently established federations are the West Indies (established in 1958 and again dissolved in 1962) and the Federation of Arabian Emirates (established in 1968).

[2]Cf. Carnell, F.G.: "Political Implications of Federalism in New States", in Hicks, U.K. and others: *Federalism and Economic Growth in Underdeveloped Countries,* London, 1963, p.16.

[3]Cf. Prest, A.R.: *Public Finance in Under-developed Countries,* London, 1963, p. 144. The Federal Republic of Germany is also a more recent example of 'federalism by devolution'. Here the federal structure was imposed on part of the former 'Reich' by the Western Allies after the Second World War partly in order to weaken the power of the central government. Cf. Friedrich, C.J.: "Federal Constitutional Theory and Emergent Proposals", in MacMahon, A.W.: *Federalism Mature and Emergent,* New York, 1955, p.511.

[4]Cf. Wheare, K.C.: *op.cit.,* p. 34.

by different stages of economic and social development. In some of the newly independent countries federalism has been something of a political panacea for the uneasy tension between the forces directed towards the building-up of a large political structure and equally potent counter-forces which encourage political 'balkanisation'.[1]

On the other hand, the attempts to give to some of the newly emerging states federal structures of government have not always been successful. The Dutch effort, for instance, to impose a federal structure on Indonesia failed and, after attaining independence in 1950, the Indonesian leaders immediately substituted a unitary state for the Dutch-imposed federation. Federalism has also been a failure in Pakistan, where the parliamentary regime was expelled by the army in 1958. In Nigeria, too, recent political events have threatened to end what has been regarded as a rather successful venture into federalism. The break-up of the Central African Federation in 1963 is another example of the forces of conflict being stronger than those of coalescence. Here the clash of interest was basically racial.[2]

What, then, are the amalgamation and separation motives present in the new, or in potentially new federations? For the sake of convenience, we may distinguish between political, ethnical, cultural and religious forces, as well as economic and social considerations, although it may be difficult to determine in any particular case what their relative strength will be. Usually none of these forces operates alone. They are all interrelated to some extent. The following is a survey of the more important of these forces:[3]

Political forces

Nationalism; the desire to be independent from the control by some outside power; the desire to play a role in world affairs.
Defence requirements; an outside threat or pressure.
Desire of local leaders for greater power and prestige.
Reluctancy of a retreating colonial power to allow partition of former unitary structures, or its desire to unite territories considered too small for independent nationhood.
Group solidarities: tribalism, provincialism, regionalism, communalism; all of which may have a political, social or economic bias.
Fear of the states of too powerful a central government, and fear of regional rules and politicians of being stripped of their personal power and prestige.
Differences in the political relations between the territories concerned and the former colonial power; for instance differences in the degree of domestic self-government enjoyed by the territories.

[1]Cf. Carnell, F.G.: *op.cit.*, p. 21.

[2]History has seen other examples of the failure of federalism. This form of government was, e.g., fashionable when the South American states gained their freedom in the nineteenth century. Federal constitutions were introduced in a number of states, notably Columbia, Brazil, Argentina and Mexico, where federalism soon gave way to centralisation and often dictatorship.

[3]For a discussion of the influence of these forces on the formation of some of the existing federations cf. Carnell, F.G.: *op.cit.*, pp.20-36.

Fear of minorities of loosing their political independence vis-a-vis a majority.

Ethnical forces

Desire to protect one's own ethnical characteristics against a powerful majority of different ethnical background.

Cultural and religious forces

Desire to protect one's cultural heritage, social customs, language or dialect against a majority of a different heritage.
Desire to avoid religious strife between different communities and to protect religious minorities.

Economic and social forces

Genuine or alleged economic and administrative advantage of the economies of scale in larger political structures.
Fear, justified or not, that a particular territory might be too small to be viable economically.
Desire for rapid economic growth and for centralised development planning on a larger scale.
Advantages from a unified monetary system.
Desire for increased social services which are considered to be available more readily in larger and financially stronger political unions.

The above list is proof of the great variety of motives making for amalgamation and separation. Where forces tend towards unity, they are likely to be opposed by equally or, at least, almost equally strong counter-forces. The stronger the factors pulling towards aggregation (disaggregation), the tighter (looser) one can expect the union to be.

On the political plane strong forces tend to pull in both directions. Much depends on the personal attitudes and aspirations of those in power. Where a territory attains independence, the preference of the colonial power, too, is of significance. The existence of some outside threat or pressure is probably the strongest political force supporting the union of otherwise weak and defenceless political entities.[1] Prestige and the desire to participate in world politics would be strong motives in favour of building up large political structures, but they may be offset by equally strong counter-forces on the regional level encouraging political 'balkanisation'. Nationalism may be opposed by tribalism and communalism.

Economic motives are usually advanced in conjunction with political ones to justify federation. Alone they might lead to no more than to common market arrangements, free trade areas or customs unions. Often a clear distinction between

[1]Carnell ascribes the fact that countries such as Malaysia and India have relatively strong centres to the outside threats and pressure to which they were subjected in the early days of their independence. The much looser federations of the West Indies and Nigeria, on the other hand, have lacked the unifying influence of common perils. Carnell even alleges that "a pronounced outside threat or pressure is all but indispensable to the creation of the social and political cohesion necessary for nationhood", Carnell, C.F.: *op.cit.*, p.57.

the various economic motives cannot be made. Most important are the alleged advantages of the economies of scale. The various European organisations and communities, and the European Common Market in particular, have not failed to attract the attention of politicians in Asia and Africa to the advantages of large political and economic units. Although it is still doubtful whether the postwar European experience can be applied successfully to the developing countries in their present stage of development, it is nonetheless true that politicians in most of the developing countries support the view that larger political units can more readily exploit economic resources and expand markets and thereby achieve rapid economic growth.

The extent to which advantage can be taken of economies of scale depends on a variety of factors such as the extent to which goods and capital resources are permitted to freely flow between the units and whether there is an unrestricted migration of labour. The advantages of the economies of scale are obviously not confined to federations. They would also accrue to customs unions and countries which, in their economic relations with each other, allow for an unrestricted flow of resources and commodities. Other economic arguments favouring joint action may be the desire to ensure a better balance of natural resources and population in a larger area, and the hope that a large free market and a unified monetary system would make it easier for all to obtain external loans. Moreover, a currency union alone, as the one that existed between Malaysia and Singapore until 1967, might not be sufficient to ensure that effective use can be made of monetary and fiscal policy as a means to further the economic development of all territories. To take full advantage of these factors some sort of political union is needed.

The desire to unite is often strong in very small or sparsely populated territories which cannot conceivably afford sovereignty because of the high costs for defence, diplomatic representations, the collection of taxes, etc. The colonial power wishing to be relieved of its responsibility may also prefer to see such territories joining larger and stable political entities. Examples would be the West Indies and, in South East Asia, the desire, supported by the British, of the Borneo States and Singapore, to join the Federation of Malaya in 1963. Whether the larger territories with which union is intended, are willing to accept amalgamation will depend on a variety of political and economic circumstances. Where the smaller territories are relatively poor, the richer regions may fear that they would have to support the poorer ones. This consideration has been (and probably still is) playing a role in the attitude of some politicians in West Malaysia vis-a-vis the relatively poorer Borneo territories.

In each federation one finds a highly delicate balance of coalescing and conflicting forces—a general desire for political union and a contrary desire of the states to maintain their independence. Ethnic, cultural, religious and linguistic differences are the most important forces which may oppose political and economic motives favouring the formation, or retention, of a larger political unit. Turning to federalism may sometimes be the only means for establishing, or retaining, political and economic unity in countries where minorities fear discrimination at the hands of numerical majorities and where the minorities would otherwise prefer to set up independent states of their own.

Conditions for federalism are most favourable where differences are territorially expressed as would be the case in a country where a particular racial minority, or a separate language group, is confined to one or two states or provinces. An example would be the French speaking population of Canada which is concentrated in the province of Quebec. In Switzerland, too, the German, French and Italian speaking population groups are confined to certain geographical areas. Where diversities of the kinds mentioned have no territorial base, as is the case in so-called 'plural' societies, it is extremely doubtful whether federalism is really a workable solution for the prevention of communal conflicts. Examples of plural societies would be the former federations of Central Africa and Malaya where the diversity was mainly one of race and where the various races intermix especially in the urban centres.

Although the circumstances bringing about political union have differed in the case of each federation, there appears to have been certain similarities in the conditions prevailing at the time when the 'classical' federations were established in the nineteenth century. According to Wheare the following factors have contributed towards creating a favourable climate for the formation of these federations:[1]

(i) A feeling of insecurity arising from an outside threat or pressure.
(ii) The previous existence of the federating states as distinct colonies or states with distinct governments of their own.
(iii) Some form of common political association prior to the formation of the federal union, such as the political subjection to the same colonial power.
(iv) Similarity of political institutions of the federating states.
(v) Similarity of the ethnic and cultural backgrounds as well as language (except in the case of Switzerland and Canada).
(vi) Geographical obstacles to effective unitary government, such as large areas and poor communications.
(vii) Geographical neighbourhood of the federating states.
(viii) Ability of the states to finance and administrate the powers allotted to them, i.e. availability of a sufficient supply of political leadership and of a capable administration.

The conditions prevailing at the time of the formation of the newer federations in Asia and Africa differed in many respects. These federations did not result from the coming together of hitherto independent units. They emerged from former colonial territories with the colonial power often being responsible for their post-independence structure of government. They are all characterised by comparatively depressed levels of economic development and by populations largely illiterate and poor, though multiplying fast. Compared with the older federations, the newer ones have experiences far more striking divergencies in respect of race, religion and language which even an artificially stimulated national consciousness cannot always easily reconcile. Differences of these kinds may sometimes help to maintain the federal balance—especially if they are expressed territorially—but they may also present almost insuperable difficulties and, as in the Central African Federation, finally shatter federation.

Another significant difference is the comparatively low standard of public

[1]Cf. Wheare, K.C.: *op.cit.*, Chapter III, pp. 35-52, and Carnell, F.G.: *op.cit.*, p. 23.

administration of the developing federations; and this at a time when the demands on the state for social services have greatly increased and when governments are expected to play a dynamic role in a nation's economic affairs. In most of the new federations, expatriate officers had still to be retained in key administrative posts also after independence. Nor do the constituent states nowadays always have the financial resources to carry out their varied obligations under the constitution. The administrative difficulties of some of the new federations have been further increased by the fact that they do not form geographical units. Pakistan with its two wings and Malaysia, being divided into two parts by hundreds of miles of sea, serve as examples.

The lack of political leadership is another feature of the developing world. Parliamentary government is nowhere firmly established. The dangers to the survival of federalism arising from unstable government, dictatorship, or army rule, have been mentioned earlier. Not only do developing countries often lack the men and financial resources to maintain an efficient opposition, for which reason they have to put up with one-party systems, but since these countries are invariably confronted with rapid political, social and economic change, it is often felt that they cannot really afford a complicated parliamentary system and, much less, an additional layer of government.

The difficulties facing the new federations are probably somewhat compensated by their desire to build up, or to retain, as large as possible political structures, so as to make their voice felt in world politics and world councils. There has never before been an age in which so much attention has been given in international politics to the views and interests of the relatively poor and powerless countries. On the other side, this powerful motive working towards amalgamation has often been weakened by opposing political forces on the regional level. Again, the desire to achieve rapid economic progress and the recognition that this could be enhanced by a strong central government capable of carrying out large-scale development programmes, is nowadays a powerful force in the direction of large and strong political units. This desire hardly existed at the time when the older federations were formed and when governments were only remotely and indirectly concerned political units. This desire hardly existed at the time when the older federations were formed and when governments were only remotely and indirectly concerned with development and welfare activities.

From the above it follows that in dealing with the problems of the new federations the experience of the old ones is often of a doubtful relevance. The conditions under which federalism has to prove its usefulness in the developing world are often all but favourable. Yet, it would appear that even today federalism has lost little of its original attraction as being the best form of government for a people who, for political and economic reasons, wish to unite but who, in the face of extreme cultural and ethnic diversity and regional economic inequalities, would prefer to retain a large amount of regional independence. In certain circumstances there may be no alternative form of government.

The success of federalism depends on the maintenance of the delicate balance of coalescing and conflicting forces. These forces are subject to constant evolution. Regional political and social factors would, on the whole, seem to tend against a

greater degree of integration. Economic motives, on the other hand, pull in the opposite direction. The initial balance between the forces for or against joint action may easily get disturbed in the course of time. The federal arrangements may tend to become increasingly tight, almost unitary. On the other hand, there have been a number of cases where a federation eventually collapsed under the pressure of the forces of separation. Federalism is not an end in itself. It is rather a compromise political solution and essentially of a temporary nature. Therefore, where it is found necessary to break up a federation in the face of certain apparently incompatible differences, such a decision need not necessarily be in conflict with the wider interests of the territories concerned. In the next chapter, which deals with federalism as a solution for Malaysia, we shall see this confirmed in the case of Singapore's secession from Malaysia in 1965.

3. *Federalism as a Solution for Malaysia*

Why has a federal form of government been found a workable solution under the particular circumstances prevailing in Malaysia? Here it will be necessary to distinguish between the old Federation of Malaya, established in 1948, still under British rule, and the Federation of Malaysia which was formed in 1963 through the amalgamation with the Federation of Malaya of the former British dependencies, Singapore, North Borneo (or Sabah) and Sarawak.

a. *The Federation of Malaya*

Political conditions were generally favourable for federation in Malaya when the British returned after the Japanese surrender in 1945. There existed already a considerable federal tradition on the Malayan Peninsula from the times before the Second World War. Except for the British possessions on the Peninsula, i.e. Singapore, Malacca and Penang, which were combined in 1826 to form the so-called 'Straits Settlements', all the Malay States had accepted British Advisers in their governments during the last decades of the nineteenth or in the beginning of the twentieth century. In 1895, four of them, Perak, Selangor, Negri Sembilan and Pahang, became a federation with a British Resident-General and a system of centralised government.

When the British returned after the end of the Second World War they proposed that the pre-War system of federated and unfederated Malay States should be replaced by a centralised Malayan Union which would include Penang and Malacca, but not Singapore. Under the Union the Malay Rulers (Sultans) and the Malay States would have been deprived of all but nominal authority. However, the British proposal was never fully implemented because the Malays were strongly opposed to certain details, in particular those transferring jurisdiction from the Malay Rulers to the British Crown and those stipulating the conditions for citizenship. The latter proposals, it was feared, would eventually result in Chinese domination.

In 1948 the Malayan Union was replaced by a federal scheme which had been drawn up by a Working Committee comprising Government representatives, on the one hand, and the Rulers and representatives of the United Malays National Organization (UMNO), on the other. The draft Constitution drawn up by the Committee eventually found the support of both the non-Malay communities in

Malaya and the British Government. Under the *Federation of Malaya Agreement* of 1948 the states and the Settlements, with the exception of Singapore which had become a separate colony in 1946, were to retain their own individuality, but were to be united under a strong federal government. The Sultans remained sovereign in their states while Penang and Malacca remained British territory.[1]

The Agreement provided for a High Commissioner and a Federal Legislative Council consisting of 75 members, 50 of whom were unofficials. The states and Settlements were to surrender most of their functions to the federal government, but retained executive control, and, to a limited extent, legislative control over matters of more regional concern, particularly land administration. A common citizenship was created for all those accepting Malaya as their permanent home. Under the new citizenship legislation the special position[2] of the Malays was recognized and reaffirmed. Out of a total population (1947) of 4.9 million some 3.1 million—the majority of whom were Malays—qualified automatically for federal citizenship. *The Federation of Malaya Agreement* remained in force until 1957, though it was amended several times to allow for a greater measure of internal self-government.

We should pause here for a moment to look once more into the reasons why the proposals for a centralised Malayan Union were so bitterly opposed and why it became necessary to replace them by a new federal agreement. A discussion of these reasons will throw light on the forces of amalgamation and separation which have been, and are still operating in Malaya and which have eventually led to the adoption of the Federal Constitution in 1957 under which Malaya gained independence in the same year.

First, what were the forces tending towards amalgamation? Here the outstanding motives was the desire of the British Government to introduce a more centralized system of government in Malaya mainly in order to achieve greater simplicity and efficiency in administration through direct rule.[3] In this connection it may be recalled that before the Second World War the British had never possessed direct jurisdiction over the Malay States. Under the treaties concluded with the Malay States, the Sultans continued to act in their own name, although they had to accept the advice given to them by the British advisers on all matters except those pertaining to the Muslim religion and Malay customs.[4]

Two other motives favoured a strong centralised form of government. Firstly,

[1]Although outwardly the Federation appeared to be a loose one, it was in actual fact a highly centralised colonial structure, for not only were the Rulers compelled to follow the counsel of their British advisers, but the British High Commissioner was also authorised to enact legislation without the approval of the Legislative Council. Cf. Groves, H.E.: *The Constitution of Malaysia,* Singapore, 1964, p. 11.

[2]The 'special position' of the Malays relates mainly to the reservation of land for the exclusive use by Malays, and the the reservation, for the welfare and advancement of the Malays, of quotas of posts for them in the public service, in occupational positions and with regard to licences in commerce. The Malay language became West Malaysia's only official language in 1967.

[3]Ratnam, K.J.: *Communalism and the Political Process in Malaya,* Kuala Lumpur, 1965, pp. 43-57.

[4]Islam is the state religion of Malaysia. Article 3 of the *Federal Constitution* provides, however, that "other religions may be practised in peace and harmony in any part of the Federation". Malaysia: *The Federal Constitution,* Kuala Lumpur, 1964.

the desire of Great Britain and of the post-war leaders of Malaya to modernise the country through a concerted effort towards rapid social and economic development and, secondly, the threat to orderly government on the Peninsula posed by the Communists ever since the surrender of the Japanese in 1945.[1] It was felt that the armed Communist insurrection could be dealt with only by a powerful central government. A white Paper published by the British Government in 1946 summed up the position: "A stage has now been reached when the system of government should be simplified and reformed. International relations as well as the security and other interests of the British Commonwealth require that Malaya should be able to exercise an influence as a united and enlightened country appropriate to her economic and strategic importance."[2]

The opposition against the British proposals which finally caused their withdrawal, came chiefly from the side of the Malays and their Rulers. Their hostility can only be understood in the light of the racial situation of Malaya, where the Malays have been struggling, as an economically backward community, against the threat of Chinese domination. In 1947 the Malays represented approximately 49% of the total population of Malaya, the share of the Chinese and Indians being 38% and 11% respectively.

Table 1:
GEOGRAPHICAL AND RACIAL DISTRIBUTION OF THE POPULATION OF MALAYSIA, 1964[1]
- in 1,000 -

	Malaya		Sarawak		Sabah		Malaysia	
	No.	%	No.	%	No.	%	No.	%
Malays	3,965	50.1	142	17.5	32	6.4	4,011	44,7
Chinese	2,920	36.8	255	31.5	117	23.5	3,213	35,8
Indians	885	11.2	—	—	—	—	843	9.4
Sea Dayak	—	—	254	31.4	—	—	254	2.8
Kadazan	—	—	—	—	160	32.0	160	1.8
Other Indigenous	4	—	150	18.5	177	35.5	331	3.7
Other Non-Indigenous	153	1.9	9	1.1	13	2.6	157	1.8
	7.923	100.0	810	100.0	499	100.0	9,273	100.0
Percentage Distribution	85.4		9.0		5.6		100	

[1]The figures for Malaya are end-1964 and those for Sabah and Sarawak end-1963 estimates.
Source: Information supplied by the Department of Statistics, Kuala Lumpur.

Whereas the Malays lead a predominantly rural life as agriculturalists and fishermen, the Chinese and Indians, who came to Malaya mainly during the British period, dominate the urban scene. Indians are also found in great numbers as workers on the rubber estates. The Malays, too, are now increasingly moving from the overcrowded coastal belts to the urban areas where they, unlike the Chinese,

[1]A state of emergency was declared in Malaya in 1948 and lifted only in 1960 after final victory over the Communists had been achieved.
[2]United Kingdom, Colonial Office: *Malayan Union and Singapore: A Statement of Policy on Future Constitution*, cmd. 6724, London, 1946, p. 2.

prefer to work inside organisations that offer protection in return for service, such as the civil service, the police and the army. According to Silcock, aggregate Chinese income in Malaya and Singapore was about two and a half times that of Malay income in 1947. The average Chinese income per head was M$656 p.a. in 1947 as against M$258 for the Malays and M$560 for the Indians. The respective figures for 1957 were M$848, M$359 and M$691, respectively.[1]

The hostility of the Malays against a unitary Malayan Union was only partly anti-federal; for their chief objection was directed against the proposed common citizenship which would entitle everyone, born and resident in Malaya, regardless of race, to equal rights and which thereby threatened to undermine the privileged status of the Malays vis-a-vis the immigrant Chinese and Indians. The second major cause for dissatisfaction among the Malays, though of the same origin as the first, was directly concerned with the survival of federalism in Malaya. The Rulers and the Malay community feared that the proposed transfer of the Sultans' jurisdiction to the British Crown would reduce their status to that of puppets. This would have further reduced the privileged status of the Malays, bearing in mind the political and social prestige of the Sultans as Heads of State and their special responsibilities with regard to Muslim religion and customs.[2]

The British attempt towards creating a unitary Malaya for the sake of better administration, rapid socio-economic development, and greater internal security was thus foiled mainly by racial considerations, namely the fear of the Malays, as a group, to loose their protected position and their identity as a people. For them there was a potential danger that Malaya would cease to be primarily a country of the Malays. Federation was a solution not because it would preserve any geographically bound differences between the states, but because it was the only way of retaining the institution of the Sultans who, with their prestige as Heads of State, were one of the pillars for safe-guarding the 'special position' of the Malays throughout the Peninsula. On the other hand, since Malaya is basically a plural society with Malays, Chinese and Indians living together in the same urban and rural localities, federalism could not be expected to be a panacea for all her racial problems.[3]

Since the division of Malaya into distinct states was desired chiefly to preserve the position of the Malay Rulers—little, if any, attention was given to economic or financial considerations—there were no objections against adopting a tight federal constitution. In fact, the British refused to abandon their stand with regard to

[1]Silcock, T.H. and Fisk, E.K., eds.: *The Political Economy of Independent Malaya*, Canberra, 1963, pp. 2-3.

[2]It may be useful, in this connection, to point out that the prestige of the Sultans among the Malays originates from the fact that all the Malays in Malaysia are Muslims. The Chinese, on the other hand, call themselves 'Buddhists', although their religious belief is an amalgam of Taoism, Confucianism and Buddhism. The Indians in Malaysia follow mostly the Hindu religion. Christianity has followers among both the Chinese and Indians, but not among the Malays.

[3]The racial composition of the States of Malaya varies considerably. The more developed West Coast states have the largest percentage of Chinese, whereas the less advanced East Coast states have the lowest share. The following is the estimated percentage of Chinese in the total population of the States of Malaya: Penang 57.2%, Selangor 47.8%, Johore 40.9%, Negri Sembilan 40.4%, Malacca 40.0%, Pahang 34.6%, Perak 30.8%, Kedah 20.3%, Perlis 18.0%, Trengganu 6.2% and Kelantan 5.6%. *Source:* Department of Statistics: *Annual Bulletin of Statistics Malaysia 1965*, Kuala Lumpur, p. 1.

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.

When in 1955 an independent Constitutional Commission was set up by the British Government for the purpose of drawing up a constitution, its terms of reference included recommendations for the creation of a strong central government while at the same time maintaining the rights of the states and safeguarding the position of the Sultans. The Commission was also to respect the 'special position' of the Malays. In other words, due regard was given to the outcome of the struggle of the years 1946-48 between the supporters of a unitary form of government and those opposing it on racial grounds. In those years the die was cast in favour of federation and this was to be the future of Malaya.

Hence, federalism in Malaya was the outcome of the desire of the former colonial power to create a strong, centralised state, on the one hand, and the opposing interests of one of the racial communities of the country, on the other. Both the British and the Malays were willing to compromise; the British, because the issues at stake were not really preventing them from creating a country with a powerful central government and, in any case, they were unwilling to take unpopular actions at a time when there existed a potential threat of a Communist takeover; the leaders of the Malays, because federation to them had no other meaning than the preservation of the sovereignty of the Rulers and, hence, of the privileged position of the Malays.

When we now turn to creation of the Federation of Malaysia in 1963 we shall see that the underlying motives for giving the new grouping a federal constitution differed in many respects from those discussed above. Political motives were again mainly responsible for bringing about federation; but in view of the geographical distance of the Borneo States, the considerable ethnical diversities, and the different economic conditions prevailing in the states joining Malaya, it was clear from the outset that Malaysia would have to be a much looser federation than its predecessor. Moreover, forces hostile to federation did not cease to operate once the new federation had been established in 1963 and, in fact, led to the separation of Singapore two years later.

b. *The Federation of Malaysia*

In considering the conditions surrounding the formation of Malaysia, our first observation would be that West and East Malaysia—West Malaysia is the official name of the Malay Peninsula and East Malaysia that of the Borneo States—do not form a natural geographical unit as does the Malay Peninsula, including Singapore. There are also considerable differences in the ethnic and cultural backgrounds of the people living in the two parts of Malaysia. All the states of West Malaysia show a certain similarity in the composition of their population, their historical development, and in their political and administrative institutions. These similarities would also include Singapore despite the fact that its population—just as that of all the major towns on the Malay Peninsula—is predominantly of Chinese origin.[1] Ever since

[1]In 1966 Singapore had a population of 1,913,500 of which approximately 75% were Chinese, 14% Malays, 8% Indians, 1% Europeans, and 2% others. *Source:* Information

its foundation in 1819, Singapore maintained very close ties with the various states of Malaya, politically, economically and culturally. Until recently, people had always been permitted to move freely between the island of Singapore and the mainland.

Such close ties never existed between West and East Malaysia. In fact, they did not even exist between the territories of East Malaysia themselves. The internal means of communication and those linking them together were poorly developed, although the main ports of the two states were regularly served by boat from Singapore. The composition of the population of Sabah and Sarawak also differs from that of Malaya. In both territories the Malays, together with other immigrant races, form a minority as against other indigenous people. Furthermore, both territories are still less developed than the mainland. At the time of federation education, for instance, had hardly advanced beyond the primary school standard. Yet, there were also a number of similarities: both part of Malaysia were subjected by the same colonial power and had thus similar political, administrative, and social institutions. They shared the fate of Japanese occupation during the Second World War[1] and were facing complex racial problems. Both were keen to develop economically and shared a common currency, the Malayan Dollar. There have also been no real language difficulties between East and West Malaysia, at least not among the English-educated elite; the main languages being English, Malay and Chinese in both parts of the country.

Two factors mainly set the stage for the formation of Malaysia, namely the desire of the British to relinquish their obligations in South East Asia and the desire for independence of the peoples of Singapore and the Borneo territories. None of these territories was regarded politically and economically viable and, accordingly, a basis for a greater regional union was sought. This basis was to be provided by the Federation of Malaya which had already become an independent nation in 1957. Politically the Federation showed a remarkable stability. Moreover, it had maintained its traditionally friendly ties with the United Kingdom and the Commonwealth, and was a staunch supporter of the West. Economically the Federation continued to make great strides after gaining independence.

Politically Singapore with its rapidly growing population and serious unemployment problem, and its strong, leftist trade union movement was less stable than the other territories to be included in the merger. The island had become a separate Crown Colony in 1946. The motive why the British Government had not included it into the Malayan Union plans, were probably racial; for Singapore, with its strong concentration of Chinese, would seriously have disturbed the racial balance in Malaya. If Singapore had been included in the Malayan Union, the Chinese would have outnumbered the Malays and this would have created an immediate danger of the Malays being politically submerged by the Chinese.

Political developments in Singapore in the second half of the fifties were all in the direction of eventual independence. In 1955 Singapore got a new Constitution

---

obtained from the Chief Statistician, Singapore. The racial composition of the urban population in Malaya was in 1957: Chinese: 67.8%, Malays 19.4% and Indians 10.2%. In the same year only two of the 21 towns in Malaya having a population of more than 20,000 had a Malay majority. Cf. Silcock, T.H. and Fisk, E.K., eds.: *op. cit.*, p. 85.

[1]The Japanese occupation, destructive though it was, greatly stimulated the desire of all sections of the population for national independence.

which took her far on the road towards self-government. Two years later agreement was reached between the British and the Singapore governments on a new Constitution which was to give full internal self-government to Singapore whilst leaving the responsibility for defence and external affairs to Great Britain. The new Constitution became law in 1958. The first election under the new Constitution in 1959 resulted in a victory of the moderate left-wing Peoples' Action Party (PAP) led by Mr. Lee Kuan Yew who was to become Singapore's first Prime Minister. The party made it clear from the beginning that its ultimate hope was independence through a merger with the Federation of Malaya.

Such merger, it was clear, would be difficult to achieve because of the suspicion of the Malays in Malaya of the left-wing elan of the people of Singapore and their fear of being outnumbered by the Chinese. The Singapore Government had therefore to respect the interests of the more traditional and conservative Malayan Government and cooperate with them. However, even if certain sacrifices had to be made, Singapore had much to gain. Foremost, of course, there was independence itself. In addition a large market would be assured for the industries which the Government hoped to see established under its vigorous industrialisation programme and which would eventually provide jobs for Singapore's tens of thousand unemployed.

Merger with Singapore also held out certain prospects for Malaysia, and it was, in fact, the Prime Minister of Malaya, Tunku Abdul Rahman, who, in a historic speech held in Singapore on 27 May 1961, put out the first public feeler on the desirability of a closer association. Malaya reluctantly but increasingly realised that there was more danger of communist subversive elements succeeding in Singapore than anywhere else in the region and that the only alternative was merger with Singapore or Communism on her doorstep. There were also more positive aspects. Malaya's international prestige and capability of facing the future in a basically unstable South East Asia would be enhanced by a merger, especially also if the British were to continue to feel responsible for the military defence of the area. Moreover, the inclusion of Singapore was likely to strengthen the overall financial position of the enlarged union.

Merger with Singapore alone was out of the question since this meant a clear-cut Chinese majority in the new state. The balance between the two main races for the sake of racial harmony could, on the other hand, be maintained approximately if the Borneo territories could find a place in Malaysia, for the population of Singapore was 1.7 million and that of the Borneo States 1.5 million. It would even be better if the representatives of the Borneo territories could be made to balance or exceed those of Singapore.

Amalgamation with the Federation of Malaya also meant independence for the Borneo territories. However, despite considerable progress after the War towards greater self-government, no major political grouping existed in these territories as yet, and it was Great Britain which for all practical purposes represented the people of the Borneo dependencies. The British desire to relinquish its obligations in Sabah, Sarawak and Brunei at an early date was, therefore, decisive. From the British point of view a political arrangement with Malaya was the ideal solution. Within the greater grouping the Borneo territories would be viable both politically

and economically.

Although conditions for amalgamation were favourable in Malaya, Singapore and the Borneo territories, all the parties were in agreement that a political union could only be achieved on the basis of federalism. Malaya, as the only independent and at the same time most powerful partner in the proposed union, was already a federation with one of the nine Sultans being elected King quinquennially. Abolition of the federal structure of Malaya and of the sovereignty of the Rulers was out of the question. Too close an association with Singapore was at the same time not desirable from the point of view of racial harmony in the country.

Nor did Singapore wish to be too closely united with the other partners. It could not allow being put on an equal basis with the rather powerless individual States of Malaya. Singapore was, moreover, not willing to surrender some of its more important powers over such matters as education and labour legislation. Economically, its interest as a free port and international trading centre naturally differed much from that of the rest of Malaysia. Its comparatively large tax yield could not be allowed to flow uncontrolled into the pockets of her poorer partners.

The Borneo territories also favoured a loose union. The Cobbold Commission which was appointed early in 1962 and which subsequently toured the Borneo dependencies to examine the views of the people with regard to joining Malaya and Singapore, found that 70% of the population of Sabah and Sarawak were in favour of Malaysia. In its report the Commission listed, however, a number of points why the Borneo people were against joining Malaya 'just as another state', but wished to retain certain important powers. One of the points was the extreme suspicion of the Borneo people of Malay nationalism which pressed at making Malay the official language of the whole of Malaysia and the main medium of instruction in schools and which wished to set up Islam as its state religion.

Another important power which the Borneo territories wished to retain was immigration. Sabah and Sarawak feared that politically and economically undesirable Chinese from Singapore and Malaya would flow into their sparsely populated territories in large numbers if free movement of people was to be allowed throughout Malaysia. More generally, it was feared that Malaysia could merely mean an exchange of the British overlordship for that of Kuala Lumpur with the latter being probably less efficient and impartial. Other reservations of the Borneo States concerned the head of state, citizenship and the Borneonisation of the civil service.

If one compares the motives underlying the formation of the two federations, Malaya and Malaysia, one notices the much greater complexity of factors making for unity and separation in the latter case. The main political considerations favouring amalgamation were the prospect of independence for Singapore and the Borneo territories, the desire of the British to gradually relinquish their obligations in the Far East and the potential danger of Singapore turning Communist. Economic considerations again played a minor role, although, unlike in the case of the creation of Malaya, the representatives of Singapore and the Borneo territories were fully aware of the need to secure for their territories a maximum of economic and financial advantages from federating. For Singapore, the prospect of a potentially strong market for its products was probably an additional attraction.

Racial suspicion was in both cases a main force tending towards separation. In

the case of Malaya, federalism was found to provide a workable solution to preserve the privileged position of the Malays. As to Malaysia, racial considerations acted against an alliance with Singapore alone; but a union with that State was acceptable provided the Borneo States could be federated at the same time.

Malaysia was feasible only as a comparatively loose federation. Neither Singapore nor the Borneo States favoured the idea of federating on the same terms that were previously acceptable to the States of Malaya. The reason for their attitude was basically racial—the fear of Malay domination—but largely also economic if one thinks of Singapore's different interests as a seaport and trading centre. Furthermore, neither Singapore nor Malaya wanted to pay the bill for the backwardness of the Borneo territories. Administrative reasons, too, especially the great distance between the Malay Peninsula and the Borneo States and the poor means of communications between the two parts of Malaysia, as well as differences in their administrative institutions, also made the retention of a large measure of independence for the Borneo territories advisable.

In view of these basic differences the Constitution of the Federation of Malaysia differed in many important aspects from that of the Federation of Malaya. The Constitution of the latter had in general provided for a nation of equal states with a preponderance of power in the central government. Under the Constitution of Malaysia, on the other hand, some of the states enjoy more power than others, while the representation of the states in the Federal Parliament is not proportionate. Groves, therefore, rightly comments on the Constitution of 1963: "For some significant purposes the federation has the appearance of a four unit entity with one of the units, Malaya, being subdivided into eleven parts. The Malaysian Constitution did not in any very real sense bring the new States of Singapore, Sarawak and Sabah into association with the former States of Malaya, as such. What it did was bring the new States into association with the former Federation of Malaya, *per se*."[1]

On 16 September 1963 the Federation of Malaysia came into being. It consisted of the eleven States of Malaya (Johore, Kedah, Kelantan, Malacca, Negri Sembilan, Pahang, Penang, Perak, Perlis, Selangor and Trengganu) Singapore and the two Borneo states of Sabah and Sarawak. The creation of the Federation was violently opposed by neighbouring Indonesia and the Philippines. In Indonesia where the Communists had a strong influence, Malaysia was denounced as a form of 'neo-colonialism'. President Soekarno personally supported the anti-Malaysia campaign because he felt that he should have been consulted in such an important development along Indonesia's frontier. He probably also welcomed the opportunity to focus the peoples' eyes on an external foe rather than on the internal sores. The Indonesian army, the power of which was diminishing rapidly after West Irian had become a part of Indonesia, was also looking for a new field of action. At the same time, the Philippines claimed that Sabah had never legally been British but belonged to the Philippines. They based their claim on the suzerainty of the former Sultan of Sulu over portion of the territory in the nineteenth century. However, neither the Indonesian nor the Philippine opposition could prevent the establishment of Malaysia. On the contrary, their hostility acted as a strong unifying force.

Under the Constitution of 1963 the Yang Di-Pertuan Agong, or King, is the

[1]Groves, H.E.: *op.cit.*, p. 35.

supreme head of Malaysia. He is elected by the Conference of Rulers for a term of five years. To qualify for election, the King must be one of the nine Rulers of the States of Malaya who, together with the Governors of Penang, Malacca and Sarawak and the Head of State of Sabah, form the Conference of Rulers. Every act of government flows from the King's authority, although in most matters he acts on the advice of Parliament and the Cabinet.

The Federal Parliament has two Houses, the Senate and the House of Representatives. The Senate has a membership of 58, made up of 26 members elected by the Legislative Assemblies of the States and 32 members appointed by the King. The House of Representatives consists of 144 elected members; 104 being elected by the eleven States of Malaya, 24 by Sarawak and 16 by Sabah. General elections are held every five years. Parliament is the legislative authority for the Federation although, within their own jurisdiction, the Legislative Assemblies of the thirteen states comprising the Federation are also empowered to make laws.[1]

The King appoints a Cabinet to advise him on the exercise of his functions. The Cabinet consists of the Prime Minister and an unspecified number of Ministers. The Prime Minister must be a person who, in the opinion of the King, commands the confidence of the majority of the House of Representatives, and Ministers are appointed on the advice of the Prime Minister. The Cabinet meets regularly to formulate the policy of the Government. If the Government loses the confidence of the House of Representatives, the Prime Minister must either request the King to dissolve Parliament or must tender the resignation of his Cabinet.

Each of the thirteen states forming the Federation of Malaysia has its own written constitution which is guaranteed by the Federal Constitution. Each state also has its own Legislative Assembly (although no Senate) which has powers to legislate on matters not specifically reserved by the Federal Constitution for the Federal Parliament.

The constitutions of the various states, though differing in detail, all aim at maintaining a monarchical system of government based on the system of parliamentary democracy. The Ruler or Governor of each state acts on the advice of the State Cabinet, or Executive Council, which is headed by a Principal or Chief Minister. The state governments are responsible for all their activities to the State Legislative Assemblies which, for all practical purposes, follow the same procedures as the Federal Parliament. The rules for the formation of a government in any of the states and for the dissolution of a State Legislative Assembly are the same as those prescribed in the Federal Constitution for the Federal Government and Parliament. Each state also has its own civil service.

c. *The Failure of Federalism—Brunei and Singapore*

The oil-rich State of Brunei was one of the Borneo territories which was to be federated with Malaya. The Sultan's foreign affairs were in the hands of a British adviser whereas the State's legislature was entrusted with full home rule. The Sultan and his British advisers strongly favoured Malaysia but the unofficial minority in the legislature, all members of the left-wing socialistic Party Ra'ayat, were

[1]For a detailed discussion of the working of the Central and State Governments cf. Malaysia: *Official Year Book 1972*.

hostile to this. They feared that Malaysia would further strengthen the aristocratic and feudal attitudes of the Sultan and of the official members of the legislature.

An armed insurrection led by A.M. Azahari, the leader of the Party Ra'ayat, occurred in Brunei in December 1962. The revolt failed due to measures taken by British troops, but the Sultan eventually decided not to join Malaysia, mainly on account of the fact that a satisfactory solution to the question of his precedence among the Rulers could not be found.

In the case of the Brunei Sultanate both the amalgamation and separation motives were, in general, similar to those of the other two Borneo territories. They were initally stronger in the direction of federation because of the added support of the Sultan. Later it was he who decided against joining Malaysia because of the uncertainty regarding his own personal status and also because no satisfactory agreement could be reached on the financial conditions under which the wealthy State would enter Malaysia.[1] In how far the leftist opposition against Malaysia was really representative of the public opinion in Brunei cannot be answered with certainty.

The relations between the Central Government and the Government of Singapore grew increasingly tense during her two-year membership of the Federation and resulted in Singapore's secession on 9 August 1965. The differences between Kuala Lumpur and Singapore were numerous and included political, racial and economic matters. In the field of politics antagonism between the ruling party of Singapore, the Peoples' Action Party (PAP) and the powerful United Malays National Organization (UMNO) in Malaya increased strongly after the former decided to cross the Causeway linking Singapore with the mainland, and to put up candidates for the 1964 elections in Malaya. Although the PAP was decisively defeated in Malaya, many of the Chinese in Malaya continued to see in the intellectual and dynamic Singapore Prime Minister Lee Kuan Yew, an ideal successor, or even alternative, to the Prime Minister of the Federation, Tunku Abdul Rahman.

Differences between the Federal Government and the State of Singapore, even on issues of minor importance, were fought out in the Federal Parliament with vehement hostility. Racialism poisoned the atmosphere. A campaign under the motto 'to fight for religion, race and homeland', was launched by Malay extremists throughout the Peninsula and aimed chiefly at the Singapore Government and its Prime Minister. On the other hand, efforts of the non-Malays and many Malays to promote the idea of 'a Malaysian Malaysia' aroused the suspicion of the conservative Malays who regarded the concept of multi-racialism as yet another attempt at depriving them of their rightful position. Again, there were numerous occasions where leading Singaporeans forgot the delicate situation of their State which its Prime Minister had compared to that of a ship floating in a Muslim sea, and abused the Malays and their Rulers.

There were also conflicting economic and financial issues, though these were probably only of secondary importance in the decision to separate. A great amount of rivalry prevailed especially in the field of industry, and the greater success of Singapore in attracting foreign investment and the dynamism with which Singapore tackled its economic problems were frequently viewed with misgivings from

[1]Cf. "Cash is why Brunei stayed out ...", in *The Straits Times,* Kuala Lumpur, 4 September 1968.

Kuala Lumpur. Difficult financial questions and the problems posed by the proposed common market in Malaysia were still awaiting a solution.

Despite separation, Malaysia and Singapore remain neighbours and have to live with each other. At the time when customs and immigration controls were imposed at the Causeway, following Singapore's secession, and measures were taken to deviate trade from Singapore to Malaysian ports, and when, moreover, the introduction of separate currencies was announced, a steady improvement in the basic problem of race relations took place. Tension lifted gradually and leaders in Malaysia and Singapore reflected a general consensus of opinion when they forecast that one day, for political and economic reasons, Singapore would again have to link up with the Federation. Finally, neither Malaysia nor Singapore seem to have suffered a serious setback in their economic development following separation. Singapore, especially, has been able to record further great strides in its industrialisation programme after only a short period of stagnation.

Forces within the rest of Malaysia have not been stagnant either. Whereas the States of Malaya seem to be undergoing a period of increasing dependence from the Federal Government, particularly in the fields of public finance and economic development, the two Borneo States have tried to evade control from Kuala Lumpur wherever possible. This has even gone so far as to retard the Malaysianisation of top government posts by refusing to allow the substitution of British expatriate personnel for officers from West Malaysia. Since the ending of the Indonesian Confrontation in 1966 and the resumption of diplomatic relations with the Philippines in 1967, Malaysia's sovereignty became fully recognised throughout the region. However, with the falling away of outside pressure, it is quite likely that politicians in East Malaysia may one day feel that their relations with West Malaysia need reassessment. Also in West Malaysia there has been frequent talk about the ever increasing financial burden of supporting the Borneo States with regard to their defence and economic development.

Earlier it was stated that federalism is a compromise political solution and necessarily of a temporary nature. This transitory nature appears to be one of the basic characteristics of a federation. Accordingly, it would appear to be no exception to all other political forms in the modern world.[1] Federation is an intermediate state between a unitary state and a number of separate units. A unitary form of government would, in general, seem appropriate where there is little danger of one region being overwhelmed politically, economically or culturally by foreigners. Federation, on the other hand, would be appropriate where such danger still exists. The greater the danger, the greater the degree of independence which the region would desire, and *vice versa*. Applied to Malaysia, this means that, if it were not for the special position of the Rulers and their meaning for the continuation of the privileges of the Malays, West Malaysia would probably have already adopted a unitary structure of government. Regarding the Borneo States, on the other hand, the most that one can hope for under present conditions, is a continuation of the much looser federal arrangements with the Centre.

[1]Cf. Niculescu, B.M.: "Comment" (on the Role of Fiscal and Monetary Policy), in Hicks, U.K.: *op.cit.*, p. 107.

4. *Summary*

The more important findings of the first part of Chapter I may now be summarised.

First it was attempted to define the term 'federalism'. It was stated that there should be a division of powers between the federal and the unit governments, each of which, in its own sphere, is coordinate with the others, and each of which acts directly on the people. Moreover, each government should be limited to its own sphere of action and each should be independent of the others (Wheare). The first two conditions are still generally accepted today, but not so the latter two, for which reason federalism has become less tightly defined so as to allow for a greater measure of administrative cooperation and a certain degree of dependence of the states from the centre, especially in the field of socio-economic planning and finance.

Circumstances in a federation are never stagnant, and at the same time federalism was found to be a compromise political solution of a temporary nature. However, administrators and economists are not called upon to change the political structure of a federation. They should rather try to transform it into a viable economic unit, capable of accomplishing rapid growth, while at the same time avoiding political stress which might endanger the existence of the wider economic unit.

We then questioned why federalism still offers an acceptable political solution for a number of developing countries in the process of nation-building. The answer was that federalism is still the best and, in some cases, the only form of government for people who differ in their ethnic, religious, social and cultural background and who wish to be united—without being too united—mainly for political and economic reasons. Economic reasons are nowadays probably the strongest forces pulling towards amalgamation. The stronger the forces tending towards unity in relation to the forces tending towards separation, the tighter are the federal arrangements likely to be.

In the case of Malaya, we found a political motive—the desire of the former colonial power for a greater degree of administrative centralisation in the face of an armed Communist insurrection—to be the main force pulling towards amalgamation, and the fear of the Malays of being politically and economically overwhelmed by the Chinese, to be the major motive drawing in the opposite direction. Racial problems were again a decisive factor in the formation of Malaysia in 1963. But there were also geographical, ethnic and a number of important economic reasons which made it clear from the outset that Malaysia would have to be a much looser federation than its tight predecessor. Politically, federation with Malaya held out the prospect of independence for the Borneo States and Singapore, and presented a welcome means for the British to relinquish their responsibilities in South East Asia.

Little or no attention was given to economic and financial considerations as the time of the formation of Malaya. This explains the weakness of the States of Malaya vis-a-vis the Centre. In the case of Malaysia, however, the three territories joining the Federation of Malaya were well aware of the need to obtain a maximum of economic and financial advantages.

Since 1963 Malaysia has been making great strides in its socio-economic develop-

ment. However, political divergencies coupled with racialism forced Singapore to separate in 1965. On the Malay Peninsula we noted a trend towards an increasing dependence of the states on the Central Government. Sabah and Sarawak, on the other hand, have been anxious to remain as independent from Kuala Lumpur as possible.

B. FEDERALISM AND ECONOMIC GROWTH

The decision to adopt a federal system of government is a political decision which should be respected by administrators and economists. It is not for them to alter the political structure, for instance, by moving the regions gently into centralised statehood. Their aim should rather be to devise the best possible means for ensuring, within the framework of the constitution, the proper functioning of the government machinery and to overcome the various important economic and administrative difficulties created by the introduction of another layer of government. In view of the transitional character of the federal form, a more dynamic approach may, however, be warranted in the long-run. For, over a longer period, administrators and economists should aim at transforming "a federation into an economic unit in which there can be rapid movement of capital and labour to facilitate the highest rate of investment, of division of labour, and of specialisation, while avoiding all political stresses which might endanger the existence of this wider economic unit".[1]

We shall now turn to the general economic administrative problems created in developing countries by the adoption of a federal structure. Of these those posed by federal finance are probably the most complex ones.

1. *The Role of the Government in the Process of Development and the Aims of Economic Policy*

The conditions prevailing in the underdeveloped world differ from country to country. There are, however, certain characteristics which they have in common and which may be summarised as follows:[2]

(i) The basic human needs—for food, improved health, clothing and housing—are far greater than the resources immediately available to meet them. Moreover, the gap between the people's standards (or expectations) of living and their actual level of living is steadily widening and the demands upon government for more and better services and other remedial measures are ever increasing.

(ii) A large percentage of the population lives in rural areas. Although conditions in developing countries are generally poor, the differences in levels of living between urban and rural areas and between people within the same area are usually great. These differences are aggravated by the concentration of public services in the national capital and other principal cities, and this is a major cause of the rapid growth of such cities.

[1]Niculescu, B.M.: *op.cit.*, p. 109.

[2]Cf. United Nations Technical Assistance Programme: *Decentralisation for National and Local Development*, New York, 1962, p. 5.

(iii) Differences in language, culture and traditions, coupled with wide-spread illiteracy and poor transportation and communication facilities, result in physical and cultural isolation and complicate the problems of administration. The social organisation, economic structure and land-tenure system are often additional obstacles to change.

(iv) Shortages of public revenues and of trained personnel seriously handicap public administration. Moreover, community, voluntary, private and other institutions outside large urban areas, especially capital cities, seldom have the leadership, skills or funds to initiate the new services and functions required locally for social and economic betterment.

In these circumstances, and given the urgency of lifting the general level of living of the people, politicians and economists agree that the government of a developing country must initiate and, at least in the early stages, carry out most of the steps which have to be undertaken to accelerate social and economic development. This would involve (i) the provision of the administrative machinery necessary for the formulation of comprehensive development plans as a basis for the allocation of resources in the public and, possibly, also in the private sector on a functional and geographic basis; (ii) the provision of the funds for the execution of development plans, and the creation of the infrastructure and the provision of basic services essential for creating a modern economy; and (iii) the provision of leadership and inspiration, and the introduction, through educational institutions, information media and extension services, of new ideas and practices among the people.

All governments have to perform most of these functions in the initial stages of development. However, the extent to which the government interferes, through economic policy, with the activities of the private sector of the economy varies from country to country. The role of the government in this respect depends not only on economic considerations, such as the level of economic development and the size and structure of the private sector, but to an even larger extent on the political attitudes of those in power. In centrally planned economies, economic policy objectives, as laid down in long-term plan targets, may even determine and direct all economic activities throughout the country. In private enterprise countries and those with mixed economies the role of government economic policy is more limited. Here it depends on the socio-political outlook of the leaders and the political structure adopted, whether the government will actively control and direct the economy, or whether it will confine itself to construct and maintain the framework within which the individual members of the society pursue their activities, with a minimum of official interference.[1]

The aims of economic policy do not differ basically between the advanced and developing nations. They usually include:[2]

(i) A high and stable level of employment;

[1]If we look at the Asian scene, the economic structure of Burma and, to a lesser degree, of Ceylon and Pakistan, may serve as examples for an active direct interference of the government in the economic activities of the nation. Malaysia and Thailand are examples of the second more liberal approach. Cf. Onslow, C., ed.: *Asian Economic Development,* Singapore, 1965, p. 182.

[2]Cf. United Nations, Economic Commission for Asia and the Far East: *Programming Techniques for Economic Development,* Bangkok, 1960, p. 6.

(ii) A rapid increase in per capita income;
(iii) A relatively stable price level;
(iv) Equilibrium in the balance of payments;
(v) A reduction of inequalities in income distribution;
(vi) The avoidance of marked disparities in the prosperity and growth of different regions within a country;
(viii) A diversified economy.

The emphasis of economic policy in the advanced countries may be more on economic stability and long-term growth. Developing countries, on the other hand, will invariably regard the improvement of the living conditions of the people as the most urgent goal of economic policy. Again, the main problem of economic policy in an advanced economy is frequently to balance the different objectives against one another and against other socio-political aims. This is so because the pursuit of all of them at any one time may lead to conflicts—for instance, between growth and full-employment, on the one hand, and price stability and equilibrium in the balance of payments, on the other. Developing countries experience the same difficulty, but here the emphasis on rapid growth—in the broadest sense—is usually so strong that the other objectives of economic policy, important though they are, are being subordinated to this main goal.

2. *Federalism and the Goals of Economic Policy*

A policy aiming at rapid growth presents considerable difficulties in a country with a federal structure of government, especially if balanced geographical growth is a major goal of economic policy (point *(vi)* above), as one would expect it to be in tight federations, or in those loose federations where, owing to the political power of the poorer states, equalisation has become an accepted policy objective. Where this is the case, a further decision has to be made, namely, to what extent shall regional differences be evened out? Shall a policy of equalisation aim at removing eventually all the existing geographical differences in wealth and income or shall it merely aim at reducing differences in the rate of growth and thus prevent the gap between the richer and the poorer regions from growing wider?

a. *The Process of Growth*

To better understand what is involved in the question of equity it may be useful to examine briefly the nature of the process of growth as experienced by both developed and developing countries. According to Hicks,[1] wealth can grow most easily in those particular places of a country which are marked out by geographic advantages, such as proximity to minerals or sources of power, or in areas particularly suitable for specialised crops, or having naturally good communications. In addition to these geographical reasons, which make for unequal development, there is another immensely important economic reason. For, as soon as industry and trade become established in a particular centre, they themselves give to that centre an advantage for further development. New enterprises will prefer the neighbourhood of the established centre, because it provides a source of skilled

[1]Cf. Hicks, J.R.: *Essays in World Economics,* Oxford, 1959, Chapter 8, and Hicks, J.R.: "The Nature and Basis of Economic Growth", in Hicks, U.K. and others: *op.cit.*, pp. 70-80.

labour and because a wide range of auxiliary goods and services are available on the spot. These advantages of concentration are so great that they are nowadays the main reason for the growth of cities and industrial 'conurbanations'. Although such centres will usually have grown, in the first place, through some geographical advantage, they are likely to continue to grow through the economies of concentration even where they have lost their initial geographical advantage.

There are, however, certain forces which tend to work against this concentration of wealth, namely (i) the movement of labour from the countryside to the centres, which prevents average earnings in the centres from rising as high as they would otherwise have done and which, through a shortage of labour in the rest of the country, tends to raise wages in the countryside; and (ii) the movement of capital, because with growing wages in the growth centres, or the availability of raw materials elsewhere, investors may find it more profitable to invest outside the established centres. Such movement of capital would then in the long-run be the 'natural' way by which new centres develop.

b. *The Problem of Equity*

The process of wealth concentration also operates in federations. However, whereas regional differences in the level of economic development do not create too great a political and economic problem in unitary countries, the same problem, on the federal scale, is much more serious.

In a unitary developing country with a strong feeling for national unity, it would probably matter little where the development occurred. Not only would the forces of equalisation work towards spreading the wealth of the growth centres also to more distant regions, but the nation would probably also take pride in having a few large administrative, educational and industrial centres. People from all over,the country would flock into these urban areas in which the new elite gathers. Little difficulty would also arise in tight federations where the idea of autonomy is less pronounced and where regional jealousies hardly exist. An example would be the States of Malaya where the Federal Capital and the other regional growth centres are regarded as the pride of the nation. In a loose federation, on the other hand, regional competition and the desire for independence are more pronounced and cannot easily be neglected. An example to this would be the wider Federation of Malaysia where the Borneo States have little interest in developments taking place in West Malaysia and prefer to pursue their own development.

Why is the desire for geographical equity between the various regions much more pronounced in a federation than in a unitary country? And why is the public more conscious of existing regional differences in the socio-economic development and likely to insist on equal standards and opportunities? According to Scott[1] there are mainly two reasons for this:

(i) States' rights

In a federation, the political majority is not morally free to encourage or tolerate the concentration of income and wealth in one region. Citizens are aware of the need to be 'fair' to all regions.

[1]Cf. Scott, A.: "The Economic Goals of Federal Finance", in *Public Finance*, Vol. XIX, No. 3, 1964, p. 248.

(ii) State powers

In a federation there is also a distribution of powers and responsibilities by which each region can, to a certain extent, affect its own position relative to that of other regions. The depressed regions will voice their demand for the gradual removal of geographical differences and lend their full political support to this demand.

The problem is, however, not only one of equalising existing differences in the distribution of income and wealth, but also one of removing differences created by the development policy itself. For, where a government pursues an active policy of economic growth it will no longer merely perform the old-style public services (mainly defence and administration) the benefit of which is diffused over the whole community, but it will also undertake an increasing amount of social (e.g. education and health) and economic services (e.g. the servicing of industrial estates). It will, moreover, incur large social overhead investments and occasionally even go into production itself. These additional services and investments will usually embody a choice of locality and it is hardly surprising that the already existing growth centres are likely to be the chief beneficiaries of such expenditure. The question to be decided will therefore not merely be how to equalise already existing differences; but also, whether the richer states should be allowed to have higher standards of social and economic expenditure, or whether an attempt should be made to enforce uniform standards through the federation. In other words, a decision has to be made if the wealthier regions should be permitted to develop faster and thus to further increase their lead over the poorer regions. Whatever the decision, there is likely to be a clash of interest between the poorer and the richer states, the former demanding equalisation, and the latter invoking 'states' rights' in defence of their privileged position.

The problem of equalisation is closely bound up with the nature of the federal arrangements. In a loose federation the central government may lack the powers and financial means to carry out an active policy of equalisation. The richer states may demand to be left free to secure, within their own sphere, such higher standards as they can from their own resources. In respect of centrally collected revenue they may, moreover, demand that they are allotted grants and obtain a portion of total government development expenditure which bear relation to the federal taxes they pay ('principle of derivation'). In other words, the richer states may resist the attempt of the centre to deviate funds, collected within their area, to the poorer states in support of public services and development expenditures in the latter. In a tight federation, on the other hand, the centre would probably have sufficient political power, as well as the financial means, necessary to carry out equalisation. Such policy would also be acceptable under less tight conditions where strong feelings of national unity prevail throughout the country and where the wishes of the poorer states carry great political weight.

A policy of equalisation may sometimes not be acceptable on economic grounds. Much will depend on the size of the richer states as compared with the poorer ones. For, if the poorer areas are small, equalisation means only a comparatively moderate sacrifice to the richer units. However, if the richer states are smaller and fewer than the poorer ones, as this is invariably the case in developing countries, the strains

caused by a policy of equalisation will be much greater on the former areas. In these circumstances it would be unwise for the federal government, looking as it does at the long-term interests of the whole country, to foster economic activities in the large depressed regions at the expense of the still small and unstable modern progressive centres. A policy favouring the depressed areas would hardly make a significant impact on them, although it could seriously discourage progress in the growth centres. Governments of developing countries usually recognise that the prosperity of the people is closely bound up with the expansion of the modern sector which is mainly concentrated in the urban areas. They will, therefore, encourage expansion wherever it occurs even if this should mean a continuation of the existing differences between the richer and the poorer areas. Federation, therefore, appears to be an attractive solution for the richer states. It seems to offer little to the poorer ones, unless they can obtain, through federation, certain political advantages or enforce economic and financial equalisation through political pressure.

A policy of balanced geographical growth can sometimes even be directly opposed to the objective of rapid growth. In determining the economic activities which can profitably be developed, a government will have to take account of the natural advantages of each area in respect of labour, natural resources, climatic conditions and the means of communications available. It will also have to consider the availability of ancillary services (economies of centralisation). For, the place selected for the production of some article or crop should have some advantage over competing places. If this consideration was brushed aside by policy makers, equalisation may well prove too expensive and the country as a whole might suffer economic loss. Needless to add, in determining the establishment of an industry, or a particular crop, which could profitably be developed in a particular area consideration will also have to be given to the question of comparative advantage over competing areas abroad. This would bring the theory of international trade into the picture. With regard to specific industries or crops not all regions in a developing country will have an equal natural advantage over others in foreign countries. Consideration of production will therefore have to be limited to those particular areas where it may be profitable and a policy of equalisation could hardly be regarded as feasible in these circumstances.

Equalisation may not always be feasible on political and economic grounds. Where political circumstances favour equalisation, as this is the case on the Malay Peninsula, such policy might prove too expensive and stand in the way of rapid growth. Large differences in the level of economic development exist also in some of the advanced countries. In Italy, for instance, there is a striking difference between the industrialised Northern and the poor Southern provinces. If these advanced countries find it almost impossible to achieve balanced geographical growth, it is hardly surprising that developing countries can even less afford it.

Finally, if equalisation is a desirable goal of economic policy, how can it be achieved in practice? Three ways are open in the main: Firstly, the federal government may help the poorer regions to catch up with the richer ones by giving preference to the former in its current and development expenditure. Secondly, federal fiscal policy may incorporate certain measures discriminating in favour of the more backward states and, thirdly, the federal government may try to equalise

differences through its grants policy, i.e. by giving larger grants to the poorer states and thereby placing them in a position to improve their standard of services and embark on development projects on a large scale.

3. *Federalism, Efficient Administration, and Development Planning*

Next, attention should be given to another major implication of federalism on the development effort of developing countries, namely its relation to administrative efficiency in general and to the formulation and execution of a policy of economic development in particular. We shall start with a discussion of decentralised decision-making, a topic central to the problem of federalism and efficient administration.

a. *Federalism and Decentralised Decision-making*

In a modern state there are decisions which affect only individual persons, a particular group, a certain area or a larger region of the country, and others which affect the nation as a whole. There are decisions which become the law of the country and thus concern the whole nation, and there are others which mean no more than the application of a general rule or law to a particular case. Decisions which the government has to take in the course of its day-to-day operation thus vary in scope and in level of importance. Clearly, only the more important decisions should be taken by the central authority. This avoids a congestion of work at the top level of the administration and allows those who are responsible for the fate of the nation to devote their time and energy to the service of the country at the appropriate level. Matters other than major policy issues and programmes should be handled at a subordinate level by departments and sections of ministries, by state or local authorities, or by regional and area offices. These subordinate authorities, moreover, are usually better informed, more interested and much better equipped to deal with problems concerning individuals or people living in a certain region or district of a country.

Area administration and decentralisation of responsibility are of particular importance to developing countries which often suffer from an overwhelming concentration of government services in the capital city at the expense of the smaller towns and rural areas. The majority of decisions are frequently taken by high-ranking political officials with the result that the ensuing concentration of authority delays business in the top departments and burdens the few capable officials available with so many matters of little importance that really outstanding issues do not receive the attention they deserve. In these circumstances "a plan of administration which will permit the greatest possible number of actions to be taken in the areas, states, provinces, districts, towns and villages where the people reside is an inherent need of an effective government".[1] Besides, administrative decentralisation has proven an efficient means for the development of increased understanding, cooperation and participation of the citizens in the national programmes of economic and social development.

It follows that in developing countries the delegation of power should be started

[1]United Nations, Technical Assistance Programme: *A Handbook of Public Administration*, New York, 1961, p. 63.

as early as possible to relieve the central authorities and top government officials of those decisions which can in fact be taken at lower levels. At the same time this will help build up a feeling of responsibility among the subordinate ranks of the administrative machinery and speed up the day-to-day administrative work, encourage initiative, increase the dedication of civil servants to their duties, and prevent red-tape and unnecessary delays in the handling of public affairs in general. Obviously, the delegation of authority to subordinate bodies and officials should be carried on only to the extent that the central authority can rely on them to take good decisions. Decisions involving major political or administrative issues should be made by subordinates only after having obtained the necessary 'clearance', i.e. the approval from the next highest level of authority, or 'multiple clearance', i.e. the approval by a number of offices staffed by various types of experts.

The above discussion shows that decentralised decision-making is essential for the proper conduct of a modern administrative machinery. There is no hard and fast rule on how to proceed with decentralisation and each country will have to find a solution which suits its particular conditions best. In a unitary state delegation of power is likely to take the form of greater responsibilities being assigned to regional and local authorities. In a federation, on the other hand, delegation of power will have to follow the guiding principles of the constitution.

Given the necessity of decentralisation and provided there is an 'ideal' distribution of powers and functions between the centre and the unit governments and, hence, no overlapping jurisdiction, there would seem to be no *a priori* reason why decentralisation should not be carried out as effectively in a federation as in a unitary state. Nor need such decentralisation of authority be more expensive in the era of 'cooperative federalism' and involve a wasteful proliferation of civil services, as is sometimes alleged.[1]

Local authorities in unitary states often assume the role of state governments in Federations with far-reaching powers. Decentralisation of authority in centralised states has, therefore, even been described as a movement towards federalism which, if carried far enough, would eventually lead to a federation.[2] The approximation of unitary and federal types of administration is also reflected in the modern trend of decentralised government finances. In unitary states subordinate regional and local authorities, such as large municipalities, today frequently enjoy a wide measure of financial autonomy which includes independent or assured sources of income. This financial autonomy differs very little from that enjoyed by unit governments in federal countries, so that the trend towards growing centralisation of public finance in federations, mentioned earlier, is today matched by an opposing trend of increasing fiscal decentralisation in unitary states.

b. *Administrative Efficiency and Development Planning*

Critics maintain that in a federation a certain amount of overlapping and duplication between the centre and the states cannot be avoided even where the division of powers is well devised. There are certain irreducible overheads of the state

[1]Cf. Carnell, F.G.: *op.cit.*, p. 45. A discussion of the expense of federalism may also be found in *ibid.*, pp. 63-64.

[2]Cf. Bhargava, R.N.: *op.cit.*, p.39.

governments, particularly concerning the heads of states and state legislatures which would not arise in the case of local governments in unitary countries. Although this criticism may be valid, it will be difficult to measure these additional costs in a given country. In West Malaysia, for instance, it is sometimes alleged that the costs of maintaining the Royal households and the State Legislative Assemblies is excessive.[1] However, any judgement on this matter would be arbitary because it would not be possible to work out the additional costs that would accrue to the Federal Government and to local authorities if they were to take over the functions now performed by the states.

More important appears to be another argument against the efficiency of a federal administrative machinery. In countries which experience a serious overall shortage of trained ability, state governments often find it difficult to attract competent administrators into their services. This is so, because all the more prestigious career openings are with the central government. This problem is felt particularly by developing federations, such as Malaysia, where the shortage of well-trained staff is very acute in view of their ambitious targets in the field of social and economic development and where most of the more capable government employees crowd in the ministries in the capital city. The state governments have either to be satisfied with personnel of inferior quality, or, as is the case in the States of Malaya, request the Federal Government to temporarily second officers from its own service to fill vacant state posts. Although one might expect difficulties arising from the dual loyalty of these civil servants, such difficulties have not been experienced in practice. The self-awareness of the States of Malaya is not much pronounced and, moreover, since all the states, except Kelantan, were until recently ruled by the Alliance Party which also forms the Federal Government, there exists a maximum of cooperation between the states and the Federal Government. In contrast thereto the Borneo States have so far preferred to retain expatriate officers in those top positions which they themselves cannot yet fill.

In general, it remains open to question if the difficulty of the unit governments to attract well-trained civil servants and thus to maintain an efficient administration, is something peculiar only to federations. One may expect to find a similar lack of good administrators in regional and local authorities of unitary countries, although unitary governments may be in a better position to spread able men more or less evenly throughout the country.

The danger of administrative inefficiency and waste is probably least in tight federations where all the functions of nation-wide importance, such as the formulation and execution of development plans, are centrally administered and where only typical regional functions are left with the states. However, any generalisation may be misleading because the whole question of governmental efficiency in developing countries is very often not at all related to the structure of the administrative machinery, but is rather a matter of competency, organisational ability and honesty of the individual officials. It is also closely related to the question of political stability. For, if the central government is an uneasy coalition of groups with differing socio-economic outlooks, whereas the regional governments are

[1]Cf. also the discussion of the sliding scale of the Capitation Grant in Malaysia on pp. 215-217.

stable and ambitious, economic development planning and the execution of development schemes would be better left to the latter.[1] Regional governments are sometimes just as well as or even better equipped to maintain economic progress and stability than the federal government. In this connection one can point to Singapore's vigorous development effort during and after its membership of Malaysia.

From the above it appears that it is almost impossible to strike the balance between the relative efficiency and expense of a unitary and a federal administration. All seems to depend on the particular underlying circumstances: the degree of development of the various states, their size and geography, the density of population, the development of the means of communications, the availability of efficient administrators, etc. Although one may be inclined to agree—as in fact Carnell does[2]—that federalism tends to increase the administrative and financial strain of the new federations, there remains the practical difficulty of comparing the administrative system of any given federation with what it would be if its various units would be independent states or if they would have formed a unitary country. Finally, it needs to be stressed that the problem of efficiency and cost is one that should be seen in proper perspective. The question is not whether federalism is superior to a unitary system, or *vice versa* but rather that for certain important reasons a country has chosen a federal structure of government and that, if this choice entails certain sacrifices, this after all is the price that has to be paid for the continuance of such a structure.

In the final analysis, the efficiency of the administration in a federal state is mainly a matter of coordination and adjustment. A lack of these often seems to have hampered the proper functioning of the administrative machinery of the older federations and it is not suprising, therefore, that even today federalism is often believed to be particularly harmful to developing countries. The successful implementation of development plans requires uniformity of design and management because this would guarantee that the best possible use is made of scarce resources. This presents no problem in unitary states where the central planning authority, in cooperation with the country's treasury, the central bank and other government departments, can design and implement a nation-wide economic policy without constitutional impediments. In a federation, on the other hand, in which financially independent state administrations operate side by side with the federal government, it is felt that the rigidities of the constitution may impede development planning and seriously handicap the federal government in performing expeditiously and efficiently its extensive duties in the nation-wide effort to improve the standard of living of the people[3].

Critics also maintain that the history of the advanced federations has been one of continuous circumvention of the rigidities imposed by the federal constitution,

[1]Government officials in India often claim that the unsatisfactory conditions of their country are the result of its being 'too big'. They feel that with greater decentralisation and more responsibility on the regional level, progress could be more spectacular.

[2]Cf. Carnell, F.G.: *op.cit.*, p. 46.

[3]Garmany, e.g. states that "federation is in some (largely economic) respects a second-best solution, for it means a certain loss of efficiency through duplication and overlap and an extra cost through having several layers of government each with its own *armour propre* ... " Garmany, J.W.: "Revenue Allocation in a Federal State", in *South African Journal of Economics*, Vol. 30, 1962, Johannesburg, p. 52.

and that such circumvention was necessary in order to ensure a proper functioning of the state. They say that in the older federations adjustments to new circumstances were usually made over long periods. In the new federations, however, adjustments often have to be made over short periods of time in order to cope with the speed with which political, social and economic changes are taking place. Thus new government departments and institutions have to be established within a few years, health and educational services have constantly to be expanded and own security forces may have to be build up. All this exercises great strain on the administration of developing federations.

Despite this criticism, most of the existing federations have been rather successful in overcoming certain rigidities imposed by their constitutions. In the older federations these have been adjusted repeatedly to suit changing conditions. The fact that there has been a growing tendency towards centralisation in response to the needs of a modern society is proof of a considerable amount of flexibility. If the older federations have been able to adapt themselves to the requirements of changing circumstances, one may reasonably expect the same of the new federations. This all the more so since their constitutions have been drawn up in the light of the experience of the older federations and often with a view to eliminating possible obstacles which could prevent the central government from carrying out its vital functions and a forceful policy of economic development.

Neither the old nor the new federations appear to have suffered much in their rate of development from obstructions caused by their constitutional set-up. In fact, the growth rates, during recent decades, of the advanced federations have been among the highest in the world and, as to the developing federations, all of them have central planning authorities[1] and pursue more or less dynamic policies of development.

Although it is true that in respect of economic planning federations would seem to suffer from a theoretical defect, one should not forget that in actual fact central governments in the old and new federations have nowadays not only assumed far-reaching responsibilities for the welfare of the nation, but also possess the corresponding power to meet these demands. Where federal governments lack the authority to carry out a national economic policy, they can normally count on the willingness of the states to coordinate their own plans with the national development plan.[2] As Scott points out, "federations ... have already experience in coordinating national and provincial plans, even if only for public works or social services. They have thus a set of ground-rules on which to build the best of both worlds: provincial planning, with special regional knowledge of obstacles, opportunities and tastes, plus national planning which not only can coordinate (and

[1]The various planning organisations in the countries of the ECAFE region, including the two federations India and Malaysia, are described at length in United Nations, Economic Commission for Asia and the Far East: *Economic Bulletins for Asia and the Far East,* December 1961, Bangkok, pp. 39-50, and December 1966, pp. 55-76.

[2]Strong federations, such as India and Malaysia are probably better off in respect of the formulation and execution of development plans than weaker federations, such as Nigeria and the former West Indian Federation. As regards India, there may occasionally have been tension between the central planning authority and the state governments, but the former does not seem to have been thwarted in its efforts by the federal nature of the Indian constitution. Cf. Prest, A.R.: *op.cit.*, p. 145.

cooperate with) provincial efforts but can in certain functions reach down to the level of the individual, the firm or the local government".[1]

4. *Federalism and Malaysia's Development Effort*

a. *The Framework of the Malaysian Economy*

The states of Malaysia differ widely in their size and their human and natural resources and are at different stages of economic and social development (see Table 2).

Table 2:

STATES OF MALAYSIA: POPULATION, AREA AND POPULATION PER SQUARE MILE (JUNE 1965 ESTIMATES)

State	Population 1,000	Area sqm.	Pop. per sqm.	State	Population 1,000	Area sqm.	Pop. per sqm.
Johore	1,216	7,330	166	Perak	1,548	7,980	194
Kedah	874	3,660	239	Perlis	112	310	362
Kelantan	637	5,750	111	Selangor	1,316	3,160	417
Malacca	384	640	600	Trengganu	356	5,050	71
Negri Sembilan	480	2,580	186	Malaya	8,036	50,840	158
Pahang	399	13,820	29	Sabah (1964)	518	29,338	18
Penang	714	390	1,831	Sarawak	838	48,250	17
Total Malaysia					9,392	128,302	137

Source: Department of Statistics: *Annual Bulletin of Statistics* 1965, p. 1, and Department of Information: *Malaysia in Brief*, Kuala Lumpur, 1967, p. 1.

These differences exist not only between Malaya and the Borneo States but within Malaya and between Sabah and Sarawak. The modern sector of the economy is located primarily in the Western coastal plain of the Malay Peninsula extending from the island of Penang in the North to the island of Singapore in the South. Most of the rubber estates and tin mines, most of the towns—including Georgetown (Penang) (population: 300,000), Ipoh (200,000), Kuala Lumpur, the capital (600,000), Klang (100,000), and Johore Bahru (100,000)—and 80% of Malaysia's population are in the West coast region[2], which comprises about 40% of Malaysia's land area. The East Coast of Malaya comprising the states of Kelantan, Trengganu and Pahang, is far less affected by modern life. There are few towns and vast areas of virgin jungle. Sabah and Sarawak, which together account for 60% of the total area of Malaysia, have small scattered populations (together 14% of the total population of Malaya). Both states rely primarily on small-scale agriculture and fishing. There are only a few rubber and oil palm estates, while timber is a major industry in both territories.

If per capita income is accepted as a general indicator of the prevailing standard

[1]Scott, A.: *op.cit.*, p. 276.

[2]The following is the population per square mile for the two main geographical regions of West Malaysia: West Coast: 321 and East Coast: 46. Cf. Malaysia: *First Malaysia Plan 1966 -1970*, Kuala Lumpur, 1966. p. 3.

of living, Malaysia is one of the wealthiest developing countries in the region. Per capita income of the Federation as a whole amounted to M$928 in 1965 (States of Malaya: M$952, Sabah: M$862, Sarawak: M$737).[1] Official per capita income figures have not been calculated for the eleven states of Malaya, but Table 6 gives some rough indication of the per capita gross domestic product for the various states of Malaya, as obtained from the Department of Statistics, Kuala Lumpur.

The Federation's gross national product (GNP) has been estimated at M$9,502 million for 1967. The figure for 1966 was M$9,239 million, with the States of Malaya contributing M$8,058 million (87.2%), Sabah M$431 million (5.7%), and Sarawak M$651 million (7.1%).[2] The annual rate of increase of GNP was 7% between the years 1962—1966, despite the Indonesion Confrontation (1963—1966). Domestic output in real terms, as measured by gross domestic product at constant prices, increased by 6.4% in 1965, 6.4% in 1966, and 5.8% in 1967.[3] The GNP is expected to continue to grow at about 5% p.a. in the years to come, provided the country's export receipts for rubber and tin remain fairly stable. Total capital investment in both the private and public sector represented 17.6% of the gross national product in 1967 (1966: 18.5%), and gross domestic savings accounted for 17% of the gross national product (1966: 19%).[4] Public expenditure amounts to approximately 25% of gross national expenditure.

The West Malaysia economy is served by a well-developed system of transport and communications, including good roads, a railway system linking the main towns with one another and with Singapore, and coastal transport services. There are sufficient power facilities and other basic infrastructural installations.[5] The standard of these services is particularly advanced on the West Coast of the Malay Peninsula which is also served by the modern port facilities of Port Swettenham and Penang/Butterworth. The means of transport and communications are much less developed in the Borneo States. There are no railways in Sarawak and the total mileage of railways in Sabah is only approximately 100 miles. The Borneo States account for only 5% of the total mileage of bituminous roads in Malaysia.

Despite these favourable aspects, Malaysia is still a typical developing country with vast unutilised resources. In view of the rapid population increase of about 3% p.a., unemployment has become an urgent problem. According to official estimates approximately 7% of the total labour force is unemployed. Underemployment, too, is a serious problem especially on the countryside. As regards natural

[1]Cf. Malaysia: *First Malaysia Plan 1966-1970*, p. 4.—The *IRBD: World Bank Atlas of Per Capita Product and Population*, Washington, D.C., 1967, gives the following figures for the per capita income of South East Asian countries: Malaysia: US$260, Singapore: US$450, Philippines: US$150, Thailand: US$120, Indonesia: US$85, Burma: US$65. This compares with Australia: US$1,750 and Great Britain: US$1,550.

[2]Cf. Department of Statistics: *National Accounts of West Malaysia 1955—1964*, Kuala Lumpur, 1967, p.32.—National accounts estimates are prepared for the States of Malaya as a unit, and for Sabah and Sarawak separately. The States of Malaya are usually treated as a unit also for other statistical purposes.

[3]Cf. Bank Negara Malaysia: *Annual Report and Statement of Accounts 1967*, Kuala Lumpur, p. 13.

[4]Cf. *ibid.*, p. 13.

[5]During the period 1961–1965 the power consumption in Malaysia increased by 11.8% p.a. In 1965, 94.4% of the total power was consumed in West Malaysia, 2.4% in Sabah and 3.2% in Sarawak. Cf. Department of Statistics: *Annual Bulletin of Statistics Malaysia 1965*, p. 26.

resources, the mere fact that about 70% of Malaysia's total area still consists of virgin jungle proves that there is much scope for an expansion of economic activities. Moreover, Malaysia's economy is basically still dependent on two major export products, namely rubber and tin. In 1967 rubber alone accounted for approximately 34% (1966: 38%; 1965: 39%) of total exports, for about 16% of the combined national product and for over 20% of total employment. On the Malay Peninsula alone, two million acres of land are under rubber estates and almost $2\frac{1}{2}$ million acres under rubber smallholdings, and the number of workers on the estates alone is about 300,000.[1] Rubber also plays a prominent role in the economies of the Borneo States.

Table 3:

COMPOSITION OF MALAYSIA'S EXPORTS 1964–1967

- in M$ million -

	1964	1965	1966	1967	Percentage share of total exports in 1967
Rubber	1,396	1,462	1,474	1,275	34.3
Tin	728	872	792	756	20.3
Timber	295	357	467	583	15.6
Iron ore	163	161	136	122	3.3
Palm oil and kernels	88	116	129	122	3.3
other exports	712	814	847	863	23.2
Total	3,382	3,782	3,845	3,721	100.0

Source: Bank Negara Malaysia: *Annual Report and Statement of Accounts 1967* p. 30.

Tin ranks second in Malaysian export earnings, accounting for approximately 20% of total exports in 1967. At the same time, the Federation is the largest producer of tin in the world, accounting for about one third of the total world output. The contribution of tin to the value of gross domestic income is exceeded only by that of rubber. It is mined in over a thousand mines situated in the states of Trengganu, Pahang, Johore and along the Western coastline of the Malayan Peninsula. All the tin is exported after smelting, mainly through the port of Penang. The industry employs approximately 50,000 people.

Secondary industry is based on the processing of rubber, tin and foodstuffs and on serving the domestic market where this is economically feasible. The development of secondary industries has made great strides in recent years notably in West Malaysia where new factories have been established, partly on a joint-venture basis, around Kuala Lumpur, Penang, Ipoh and Johore Bahru., In the States of Malaya the contribution of manufacturing to the gross domestic product (GDP) has risen from 9% in 1960 to 11% in 1965.[2] Industries in the Borneo States are so far confined to the processing of timber and foodstuffs. It is the de-

[1]Cf. Department of Information: *Malaysia*, August 1965, p. 22.

[2]The following were the contributions of the various sectors of industry to Malaysia's GNP in 1965: Agriculture 34%, Mining and Quarrying 7%, Manufacturing 7%, Construction 5%, Trade 16%, Government and Defence 12%, others 19%. Cf. Malaysia: *First Malaysia Plan 1966—1970*, p. 37.

clared policy of the government to leave the operational role in the industrial sector as far as possible in the hands of private enterprise.

Trade and commerce are well-developed and banking and insurance services are of excellent standard. There is no restriction on the free flow of money between the various states of Malaysia. The Malaysian currency has been one of the hardest currencies in the world with little signs of depreciation through domestic inflation. Foreign exchange and foreign trade are subject to a minimum of restrictions and Malaysia's gold and foreign exchange reserves have been kept at a satisfactory level. They stood at the end of 1967 at M$1,963 million which is equivalent to about eight months retained imports.[1]

With exports accounting for approximately 50% of gross domestic product, Malaysia's economy must be regarded as strongly export-oriented. Rubber and tin together accounted for approximately 55% of the country's total exports in 1967. The fact that world market prices of both these products are subject to wide fluctuations makes the Malaysian economy extremely vulnerable to outside influences. Concern has also been expressed about the gradual depletion of Malaysia's tin reserves, although off-shore prospecting has indicated the existence of vast new tin deposits in the Straits of Malacca.

The country's imports consist mainly of foodstuffs (24.8% of total imports in 1966), manufactured goods (23.6%), machinery and transport equipment (23.7%), mineral fuels (12.9%) and chemicals (7.5%).[2] Imports of items such as food, beverages and tobacco have declined substantially in recent years due to increased local production. Imports of capital goods and raw materials show an increasing trend.

Malaysia's main trading partners are the United Kingdom, the USA, Japan and the other industrialised countries of Western Europe. Neighbouring countries such as Thailand and the Philippines are also important in Malaysia's foreign trade. Singapore acts as an entrepot for all territories of Malaysia and about 40% of all goods exported and imported find their way through that State.

Malaysia has so far not experienced balance of payments difficulties. Surpluses were experienced in 1962 (M$35 million) and 1965 (M$134 million). The balance of payments closed with deficits in the years 1963 (M$77 million), 1964 (M$138 million), 1966 (M$171 million), and 1967 (preliminary: M$247 million).[3] These deficits were financed mainly by drawing on the country's official reserves and by a decline of the net foreign assets of the commercial banks.

b. *Federalism and the Aims of Malaysia's Development Policy*

We shall now turn to the implications of Malaysia's federal structure of government on the aims of her development policy. The various socio-economic problems facing the country reflect the major aims of her development effort. As explained in the previous section the country is characterized by the following:[4]

[1]Cf. Bank Negara Malaysia: *op.cit.*, p. 39.
[2]Cf. Bank Negara Malaysia: *Annual Report and Statement of Accounts 1967*, p. 34.
[3]Cf. *ibid.*, p. 37.
[4]Cf. Malaysia: *First Malaysia Plan 1966—1970*, p. 1.

(i) A heavy dependence upon two products, namely rubber, whose world price is falling steadily, and tin, the known reserves of which are rapidly being depleted;

(ii) A high rate of population increase which poses the problem of finding productive employment for each year's new entrants into the labour force and imposes a social cost in that resources which might otherwise have been used to increase levels of welfare must instead be devoted to supporting the growing population at the existing standard of living;

(iii) An uneven distribution of income, which involves wide disparities between rural and town dwellers and between inhabitants of Malaya and the Borneo States, as well as among various social groups;

(iv) A relatively low level of human resource development, which results in shortages of many of the skills needed to carry out development.

In the light of these specific problems Malaysia's development policy, as embodied in her current development plan, is chiefly designed:[1]

(i) to promote the integration of the peoples and states of Malaysia;

(ii) to improve the economic and social well-being of all sectors of the population and to redress the imbalance between rural and urban areas;

(iii) to raise the per capita output of the economy and thus the income-earning capacity of the people;

(iv) to provide employment opportunities for the growing population and to open up new lands to reduce the number of landless people desiring land for agricultural purposes;

(v) to reduce Malaysia's dependence on rubber and tin and to this effect diversify the Malaysian economy by promoting the development of agricultural crops other than rubber and by promoting industrialisation;

(vi) to improve the country's supply of electric power, its transportation facilities and communication services;

(vii) to improve and expand the coverage of social services in such fields as public health, housing and especially education, so as to equip the people of Malaysia to participate effectively in the process of development.

What then is the implication of Malaysia's federal structure on the above aims? Points *(i)* and *(ii)* of these aims are of particular significance. Viewed against the recognition of the existence, between the various states, of wide differences in the distribution of human and natural resources and of income, as well as differences in their stages of development,[2] the desire to integrate the people and the states of Malaysia must be taken as a clear indication of the government's intention not to perpetuate interstate differences indefinitely.[3] In fact, the government aims at raising the well-being of all population groups throughout the nation, irrespective of ethnical differences and the country's political structure.

It is significant that the policy-makers in Malaysia prefer looking at the existing regional differences in the level of socio-economic development from a geographical

[1]Cf. Malaysia: *First Malaysia Plan 1966—1970*, p. 2.
[2]Cf. Malaysia: *First Malaysia Plan 1966—1970*, p. 2.
[3]With regard to the Borneo States it was always a declared policy objective that the development of East Malaysia should be accelerated to bring it to the level of West Malaysia. Cf. "A new deal soon with Sabah and Sarawak", in *The Straits Times*, 23 August 1968.

point of view, rather than from that of the boundaries of the constituent states. For, the Federal Government does not break up its programme of development projects and its sectorial expenditure targets under the development plan according to states, but rather according to the two main geographic regions, West and East Malaysia; the latter being subdivided into Sabah and Sarawak which, by themselves, form natural geographical units. The States of Malaya are treated as a unit. This is important from the point of view of equalisation as practically no attempt is being made to equalise the large differences in the level of development especially between the comparatively wealthy West Coast and the much poorer East Coast states. In fact, the large public investment expenditures foreseen under the development plan in the Federal Capital and in the industrial towns on the West Coast tend to further aggravate the already existing differences in the level of development in West Malaysia.

On the other hand, great efforts are made to uplift the economy of the Borneo territories. This is evident from Tables 4 and 5. Table 4 shows the Federal Develop-

Table 4:
FEDERAL DEVELOPMENT EXPENDITURE FOR THE STATES OF MALAYA, SABAH AND SARAWAK, 1964–66
- in M$ million -

	MALAYA		SABAH		SARAWAK	
	Amount	M$ per capita	Amount	M$ per capita	Amount	M$ per capita
1964	447.4	55.70	15.1	29.20	36.9	44.00
1965	493.2	61.40	33.3	64.30	55.5	66.20
1966	556.9	69.30	33.8	65.30	60.3	72.00
1964/66 Average	499.2	62.10	27.4	52.90	50.9	60.70
Increase 1966 over 1964 in %	—	24.4	—	123.6	—	63.7

Source: *Federal Financial Statements*, and information supplied by the Ministry of Finance, Kuala Lumpur.

ment Expenditure for the States of Malaya, Sabah and Sarawak during 1964/66 and clearly indicates that per capita expenditure for the Borneo States has been rising at a much faster rate (at 123.6% in respect of Sabah and 63.7% in respect of Sarawak) than that for the States of Malaya (24.4%). Table 5 demonstrates the preferential treatment of the two Borneo States with respect to planned development expenditures, especially in the fields of agriculture and rural development, transport, communications and health. Total expenditure during the 1966-70 plan period is to increase by 46.4% over the amount expended during 1961-65, but the expenditure for Malaya is to increase by only 40.0%, whereas for Sabah it is to increase by 84.1% and for Sarawak by 82.4%. If defence and internal security expenditure

Table 5:

SECTORIAL ALLOCATION OF PUBLIC DEVELOPMENT EXPENDITURE DURING PLAN PERIODS 1961–65 AND 1966–70

- in M$ million -

	MALAYA			SABAH			SARAWAK			MALAYSIA		
	19 61—65	19 66—70	In-crease %	19 61—65	19 66—70	In-crease %	19 61—65	19 66—70	In-crease %	19 61—65	19 66—70	In-crease %
Agriculture and Rural Development	411.1	900.2	119.0	18.0	55.0	205.0	46.5	131.4	182.6	475.6	1,086.6	128.5
Industrial Development	59.1	110.3	68.6	4.6	1.7	–63.0	5.5	2.5	–54.5	69.2	114.5	65.5
Transport	588.5	365.3	–38.0	67.9	68.8	1.3	90.6	111.9	23.5	747.0	546.0	–26.9
Communications	113.3	156.6	38.2	8.2	25.6	212.3	8.3	23.3	180.7	129.8	205.5	58.3
Utilities	527.4	695.0	31.8	28.5	58.0	103.6	34.3	33.3	–2.9	590.2	786.3	33.2
Education and Training	236.5	368.0	55.6	18.2	27.2	49.5	22.7	45.6	101.8	277.4	440.8	58.9
Health	101.9	150.4	47.6	7.2	18.0	150.0	8.0	21.0	162.7	117.1	189.4	61.7
Others	306.6	368.2	20.1	50.3	43.4	–13.7	34.2	31.2	–11.7	391.1	442.8	13.2
Sub-Total	2,344.4	3,114.0	32.8	202.9	297.7	46.7	250.1	400.2	60.0	2,797.4	3,811.9	36.3
Defence and Security	307.3	599.6	82.1	—	75.9	—	4.1	63.5	1,449.0	311.4	739.0	137.3
Total	2,651.7	3,713.6	40.0	202.9	373.6	84.1	254.2	463.7	82.4	3,108.8	4,550.9	46.4

Source: *First Malaysia Plan 1966-70*, pp. 69—70.

targets are excluded, the overall development expenditure envisaged for 1966-70 exceeds that for 1961-65 by 32.8% for Malaya, 46.7% for Sabah and 60.0% for Sarawak. Per capita development expenditure target figures for the period 1966-70, excluding expenditure for defence and internal security, amount to M$41.10 for the Federation as a whole, compared with M$39.30 for Malaya, M$59.70 for Sabah and M$49.40 for Sarawak.[1] According to the *First Malaysia Plan* the higher expenditure targets for the Borneo States "are clearly indicative of the Government's determination to ensure that as large an allocation is provided as can be expected to be achieved within the technical and administrative capacities of these states."[2]

Only in the field of industrial development, the 1966-70 expenditure targets are strongly biased in favour of West Malaysia. This reflects the fact that industries are so far concentrated in Malaya. Although it is the declared policy of the Government to encourage industralisation also in the Borneo States,[3] little is being done at present to stimulate the expansion of industries in these states. This is not surprising in view of the very limited home markets in Sabah and Sarawak and the lack of raw materials other than timber. At the same time there is an acute scarcity of skilled labour in East Malaysia while labour is not allowed to flow freely from West to East Malaysia. An industrialisation policy outside the timber sector might be uneconomical at the present stage and may put undue strain on the economic development of the nation as a whole.

An examination of the various programmes to be undertaken under the *First Malaysia Plan* reveals that the concentration of financial, research and training institutions in Kuala Lumpur and vicinity as well as in other growth centres along Malaysia's West Coast will continue. In an attempt to stimulate economic activities on the East Coast the Government has been investigating, together with a team of World Bank experts, the feasibility of constructing a highway through the central mountain range connecting Kota Bharu (Kelantan) and the port of Butterworth, situated on the mainland opposite Penang Island. The construction of a port on the Malayan East Coast was also given serious consideration, but the plan was abandoned in early 1968 because of the high costs of such a project.

An analysis of Table 6 which shows the extent of Federal assistance to the development effort of the States of Malaya in the form of extraordinary conditional grants, reimbursements of state development expenditures and loans for development purposes, does not permit us to draw a final conclusion as to the Central Government's policy vis-a-vis these states. All that can be said is that the poorer states of Kelantan, Perlis, Kedah and Trengganu have obtained comparatively large amounts in Federal reimbursement of state development expenditures. Since Federal development assistance to the states depends on the availability of suitable projects rather than on a predetermined formula, a comparison of the figures for

[1]Figures calculated from Tables 2 and 5.

[2]Malaysia: *First Malaysia Plan 1966—70*, p. 71.

[3]Cf. Malaysia: *Official Year Book 1965*, p. 310. On 22 March 1968, Dr. H. Rudolph, Director of the Federal Industrial Development Authority (FIDA), stated in Kuching, Sarawak, "that it was not the intention of the Government to concentrate all its industries at Batu Tiga and Petaling Jaya (Selangor) and to forget certain empty spots". Department of Information: *Siaran Akhbar*, Kuala Lumpur, PEN. 3/68/266 (PEN).

reimbursements and loans with a view to establishing any particular trend, will be possible only after figures have become available for a considerable period of time.

In general, it would appear that no serious attempt is being made to change the economic predominance of the West Coast states and that the concentration of economic activities along the West Coast will continue.[1] Nor does Malaysia's

Table 6:

FEDERAL SUPPORT TO STATES OF MALAYA IN RESPECT OF SPECIFIC STATE SERVICES AND STATE DEVELOPMENT EXPENDITURE, 1964–65

- Annual Averages -

	Suggested GDP per Capita[1])		Extroardinary Federal Conditional Grants to States		Federal Reimbursements of State Development Expenditures		Federal Loans for State Development Purposes	
	Per Capita M$	% of Malayan Average	M$ 1,000	M$ per Capita	M$ 1,000	M$ per Capita	M$ 1,000	M$ per Capita
Kelantan	347	41	204	–.30	3,931	6.20	4,047	6.40
Perlis	492	57	60	–.55	996	8.90	570	5.10
Kedah	500	58	542	–.60	6,212	7.10	195	–.20
Trengganu	555	65	343	1.00	3,127	8.80	348	1.00
Malacca	593	69	29	–.10	1,460	3.80	314	–.80
Johore	784	92	292	–.25	3,559	2.90	6,843	5.60
Penang	809	95	100	–.15	2,731	3.80	535	–.70
Perak	853	100	83	–.05	6,053	3.90	865	–.60
N.Sembilan	918	107	216	–.45	1,754	3.70	292	–.60
Pahang	987	115	301	–.75	7,067	17.70	535	1.30
Selangor	1,558	182	355	–.30	4,062	3.10	9,732	7.40
States of Malaya	856	100	2,525	–.30	40,952	5.10	24,276	3.00

1) The figures, obtained from the Department of Statistics, Kuala Lumpur, are merely rough estimates which carry no official authority.

Source: *State Financial Statements.*

agricultural policy give preference to development schemes in the more backward states of the Malay Peninsula. The areas for the large irrigation and land development schemes, to which the Government is committed and which are partly financed by the World Bank, such as the Muda (Kedah) and Kemubu (Kelantan) irrigation projects for the double cropping of rice, and the Jengka Triangle land development project in Pahang, were selected for their suitability rather than for

[1]On 23 February 1968 the Minister of Commerce and Industry, Dr. Lim Swee Aun, declared in Parliament that at the present stage of industrial development the Government was not in a position to insist that businessmen set up their factories in rural areas. Cf. "Factories in rural areas: We can't insist, says Dr. Lim", in *The Straits Times*, Kuala Lumpur, 24 February 1968.

reasons of equity.

The foregoing indicates that from an economic point of view the Borneo States profit considerably from federating with the rest of Malaysia. In 1967 Federal ordinary and development expenditure together exceeded total revenue collected by the Federal Government in the Borneo States by 18.7% (1966: 37.0%) in respect of Sabah and 143.3% (1966: 92.9%) in respect of Sarawak.[1] These financial advantages, together with the joint defence arrangements represent today the most important link between East and West Malaysia. For political reasons alone, one would expect the preference given to the Borneo States to continue in future despite the financial sacrifice it means to West Malaysia. The latter with its industries built almost exclusively for the substitution of imports on the Malayan market, is not yet equipped to take full advantage of the larger Malaysian common market.

A policy of active equalisation is, on the other hand, no political necessity with regard to the States of Malaya. Nor may it be a wise policy from a wider economic point of view since, under present circumstances, it could probably be carried out only at the expense of the rapid development of the existing growth centres along the West Coast.

c. *Federalism and Development Planning in Malaysia*

The success of a country's development effort depends largely on the uniformity of design and a high degree of administrative efficiency which presupposes close coordination among the various levels of government. Fortunately, so far, federalism has created little difficulty in the formulation and execution of Malaysia's development policy.

Before federation, each of the component parts of Malaysia had undertaken its own development planning. Today the ultimate responsibility for planning rests with the Federal Cabinet. The detailed consideration of the many policy problems involved is the special responsibility of the National Development Planning Committee (NDPC) to which the Economic Planning Unit (EPU) of the Prime Minister's Department provides secretariat services.[2]

Within their limited field of responsibility the states, too, follow long-term investment goals. In Malaya these are established by the State Rural Development Committees which are headed by the Chief Minister of each state. In the Borneo States this responsibility is borne by the state governments. The investment plans of the states are not published. The states and local authorities also carry out projects under the national development plan on behalf of the Central Government. In these cases the Federal Government reimburses the states for their expenditure and issues clear-cut directions and planning guidelines to them.

The predominance of the Central Government in the field of national economic development is reflected by the fact that in 1966 about 80% of the total public development expenditure throughout the Federation was financed by the Federal

[1]Figures quoted in Parliament by the Minister of Finance, Tun Tan Siew Sin, on 20 February 1968. Cf. "$123 Mil. Help for Borneo", in *The Straits Times*, 21 February 1968.

[2]A full description of the administrative machinery for planning and implementation is provided in the *First Malaysia Plan 1966—1970*, Chapter VI, pp. 89-96. Cf. also Waterson, A.: *Development Planning, Lessons of Experience*, Baltimore, 1965, p. 548.

Government, about 13% by public authorities—mainly the National Electricity Board—and only about 7% by the thirteen state governments.[1] This predominance is hardly surprising if one considers the overwhelming powers vested in the Central Government which include almost all subjects of importance to the nation's socio-economic development. Other factors contributing to the integrated approach to national economic development are (i) Article 92 of the Constitution providing that any state area may be proclaimed as a 'development area', which means that a national development plan for the development, improvement, or conservation of natural resources can be implemented in the area in question, even if such development would normally be a state matter; (ii) the dependence of the states on federal loans and reimbursements for the greater part of their development schemes; and (iii) the fact that the Rural Development Committees in Malaya are composed of Federal and state officers—the former representing the Federal Ministries and Departments concerned with development.

The coordination of the development effort of the states with the national development policy is further enhanced by the fact that the senior professional staff of the states is frequently posted to the various state departments from the Federal Civil Services. These officials can normally be expected to favour the broader national interest. Coordination through such personal channels is less pronounced in the case of the Borneo States, however, which have been more reluctant to employ officers from the Federal Civil Service. Nevertheless, since the ruling political groups in the Borneo States have been closely affiliated to the Alliance Party which has constituted the Federal Government ever since independence, difficulties that may arise in the coordination of the national development effort can easily be overcome through political channels at present.

From the above it follows that there is not much scope in Malaysia for conflicting policies in respect of development planning. The Federal Government not only possesses all the powers necessary to carry out an effective development policy in the thirteen states forming the Federation, but it can also control directly or indirectly, the limited independent development activities of the states.

5. *Summary*

After considering in the first part of Chapter I the role of federalism as an attractive solution to the problem of nation-building in developing countries, the second part focussed attention on its implications for the economic development of such countries. The major problems were considered to centre around two issues: equity and administrative efficiency. With regard to equity it was found that existing wealth concentrations are further aggravated by the development expenditure of the federal government which has to support growth where it occurs and where it yields highest returns. Though equity between various regions is certainly a desirable policy objective, it is not always feasible to implement it. On the political plane, the richer states are likely to be opposed to funds raised within their area being used in support of the poorer states. Only in tight federations, or in countries where the poorer states have a strong political say, can such opposition be easily overcome. A number of economic arguments strongly point against a policy of equalisation.

[1]Cf. Bank Negara Malaysia: *Annual Report and Statement of Accounts 1966*, p. 21.

Poor countries can ill afford to weaken the progress of their small growth centres by draining away funds from them which, in any case, would make little impact on the advancement of the large depressed areas. Moreover, public and private funds are likely to yield greater returns if invested in the growth centres than in the less progressive regions.

From a theoretical point of view, a federation need not always be worse off with regard to administrative efficiency than a unitary country. This is so because administrative decentralisation is a necessity in all countries. Nor need the maintenance of an efficient administrative machinery be more expensive in a federation. Unitary states themselves are experiencing a trend towards greater administrative decentralisation. Much will depend, however, on the way in which resources and functions are distributed in the federation, on the degree of geographical unity, the general level of economic and administrative development of the states, etc. The constitutions of the new federations usually provide for a large measure of concentration of the vital functions of government so that federal governments experience little difficulty in carrying out dynamic policies of growth.

With regard to Malaysia, we found that the Government is committed to a policy of equalisation among the thirteen states forming the Federation. Per capita development expenditure foreseen under the national development plan is much higher for the Borneo territories than for West Malaysia which, as a unit, is more advanced economically. Equalisation between the States of Malaya, on the other hand, has been given much less attention. As a matter of fact, the concentration of economic activities along the West Coast of the Malay Peninsula is likely to remain uncontested for the time being. For political reasons one would expect the preference given to East Malaysia in the Federal expenditure policy to continue. In the absence of similar political reasons, it may be unwise, under present conditions, to pursue a policy of balanced geographical growth on the Malay Peninsula because this would probably have to be at the expense of the rate of progress in the established growth centres.

Federalism does not present any real difficulty in Malaysia as regards the formulation and implementation of a national development plan. This is so because of the predominance of the centre in almost all aspects of the socio-economic life of the nation, including the field of public finance. Less than 10% of the nation's total development expenditure originates from state sources.

CHAPTER II

The Major Problems of Federal Finance in Developing Countries

In the previous chapter we discussed the nature of federalism and its attractiveness to a number of underdeveloped countries which are still in the process of nation-building. We also gave attention to the problems of equity and administrative efficiency from the viewpoint of general economic policy in developing federations and with specific reference to Malaysia. The two following chapters of Part One are more specifically concerned with four major issues of federal finance in developing countries, namely fiscal equity and financial administration, and fiscal policy and public debt policy.

The present chapter begins by tracing the origin of the problem of fiscal equity. It will then outline the solution offered to the problem by the theory of federal finance and critically analyse the so-called 'principles of federal finance' from the viewpoint of developing federations.

Thereafter we shall survey the more important administrative difficulties which may arise between the federal government and the states in the context of their financial relations. These difficulties culminate in the complex problem of financial adjustment. We shall also have occasion to suggest possibilities of overcoming this problem.

Finally, we shall look into the question of periodic reviews. These are necessary to ensure the coordination of the relations between the two layers of government under constantly changing circumstances. We shall also touch on the question of settlement of disputes, and outline the working of the Australian Commonwealth Grants Commission which has been pioneering in the field of coordinating inter-governmental fiscal relations.

A. FEDERAL FINANCE AND THE PROBLEM OF EQUITY

1. *The Origin of the Problem*

Before discussing the problem of interstate fiscal equity it may be useful to define the concept of 'federal finance' and to explain the relation of public finance, and more specifically federal finance, to the goals of a policy of socio-economic development.

First then, what is meant by 'federal finance'? According to Bhargava, the term

federal finance "means the finance of the federal as well as the state governments, and the relationship between the two".[1] It has thus a similar meaning to that of 'public finance' in a unitary state. Accordingly, the theory of federal finance is not a theory independent from that of public finance. It applies the same principles to a specific case, namely the financial administration of the two layers of government in a federal setting and the relationship between the two. Of particular interest to us is the second part of the definition, namely the intergovernmental fiscal relations in a federation.

Second, what is the relation between public finance and the goals of a national development policy? Here it is important to state that public finance does not follow any aims of its own. This also applies to federal finance which merely forms a special department of the science of public finance. The latter belongs to the field of applied economics and derives its significance from its subject matter, namely the provision of 'public' and 'collective' goods and services by government machinery rather than the free price mechanism, and the way in which these functions are financed. The nature and extent to which public goods and services are made available to private individuals and organisations vary in accordance with a government's overall socio-political and economic objectives, which in developing countries, would normally be laid down in a national development plan. This then confirms that public finance, or federal finance, does not follow any independent aims of its own, but is rather instrumental in implementing wider government policy objectives.

According to this approach the goals of federal finance are the same as those of a country's general economic policy. Consequently, the problem of equity discussed in Chapter I with regard to the process of economic development reappears in the context of federal finance. What was considered in the wider field of economic policy as a problem of balanced geographical growth, or of the equalisation of interstate differences in wealth and income, now becomes the problem of fiscal equity in the more limited field of federal finance. Similarly, the problem of administrative efficiency outlined previously in respect of the federal system of government and development planning presents itself again in the field of federal finance as one of administering the financial relations between the federal and state authorities.

In the field of federal finance the problem of fiscal equity is encountered in respect of both taxation and public expenditure. Some states invariably lag behind the others with regard to natural and human resource endowment as well as in the level of economic development. They will thus have a lower taxable capacity than the wealthier and more advanced states. Since their standard of public services may accordingly be expected to be low, they would require additional funds for fulfilling uniform constitutional functions.

Direct and indirect taxes would normally yield more revenue in an economically advanced state, or in one that is endowed with rich natural resources, than in a poorer one with relatively few companies and well-to-do individuals. This disparity will be particularly pronounced where densely populated areas and prosperous city-states form part of the federation, such as Hamburg and Bremen in the

[1]Bhargava, R.N.: *op.cit.*, p. 62.

Federal Republic of Germany and Singapore during its membership of Malaysia. These states are likely to show a much higher yield with respect to income taxation and duties than primarily rural states.

With regard to public expenditure there may also be wide interstate differences in the cost of providing certain important state services. In the field of transport, for instance, costs for maintaining a given standard of service may be expected to be much higher in a sparsely populated area than in a more densely populated one. In the fields of education and health, too, the costs per head will tend to vary inversely with the density of population. Whilst the pace in development of social services is set by the wealthier states, the poorer ones are faced with the formidable task of finding the necessary funds to give their citizens social amenities at the relatively high national standards. In some advanced federations, for instance, where there has been a trend towards the provision of uniform social security benefits, this has meant a more than proportional financial strain for the poorer states, insofar as the provision of such services is a state responsibility.

It follows that disparities in the tax yield of the various states and in the costs of fulfilling state functions are dependent on such structural factors as the natural wealth of the different states, their size and other geographical characteristics, the density of their population, the degree of urbanisation and the general level of economic development. Fiscal disparities also depend on the amount and quality of central and state services available in each state, and on the extent of public investment activity undertaken in each. If these as well as the relevant structural features differ markedly, the disparity in public revenue between the various states will not only tend to persist, but may indeed aggravate.

All this holds true in varying degrees for both advanced and developing federations. If the interstate differences in the general level of development and in the standard of public services are substantial, the citizens of the poorer states are likely to demand special financial assistance from the federal government so as to ensure that education and health as well as other social services will be of reasonably similar standards all over the country. They will probably also demand extra funds for large-scale infrastructural development programmes that would help them to gradually catch up with the richer states.

The important question whether or not, to what extent, or at which rate interstate fiscal differences should be equalised must be decided on the political plane. The reasons why equalisation would be desirable in a federation have been mentioned earlier, and so also the more important political and economic grounds why such policy is not always feasible.[1] The remainder of Section A of this chapter examines the solutions to the problem offered by the 'pure' theory of federal finance.

2. *Equity and the 'Pure' Theory of Federal Finance*

a. *The Principle of Financial Responsibility*

Earlier writers on federal finance have maintained that "the responsibility of raising revenue and the freedom of spending it ought to go hand in hand".[2] This

[1] Cf. pp. 50–55.

[2] Adarkar, B.P.: *The Principles and Problems of Federal Finance*, London, 1933, p. 219.

so-called 'principle of financial responsibility' was then thought to be fundamental for the proper working of federal finance. According to the principle, the pleasure of spending tax revenues should be linked with the pain of collecting them, because unless there is this link, the fiscal authorities may tend to be lax in collecting revenue and extravagant in spending it.

The principle of financial responsibility touches the question of financial autonomy of the states and of administrative efficiency in a federal setting. As regards efficiency it is, of course, difficult to prove or to disprove the fears expressed. Why, for instance, should the federal government be lax in raising revenue if a portion thereof is subsequently passed on to the states in the form of grants? Or, why should the states spend grants received from the central government less carefully than resources collected by themselves? All that seems important is that the states should, as far as possible, assume the greatest responsibility for the way these funds are spent. For, the said danger may in fact arise where the states act merely as agents of the central government and where they carry out certain programmes on a reimbursement basis or, wholly or partly, under conditional grants. Equally harmful to the financial responsibility of the states could be a state of affairs where they depend largely on federal grants, or loans, for balancing their budgets and where the amount of such adjustment grants, or loans, is not fixed according to some predetermined formula or by an independent authority. In these circumstances it would be hardly surprising if the states show little interest in the irksome task of increasing their own income from taxation.

Despite these possible drawbacks regarding the efficiency of a fiscal system that does not follow the principle of financial responsibility, the principle must be regarded as absolete. For strict adherence would not only preclude any kind of adjustment of existing financial imbalances between the various governments in a federation, but it would also seriously handicap the federal government in carrying out a nation-wide fiscal policy. In actual fact, of course, the fiscal practice of all the existing federations depends heavily and increasingly on some system of federal grants which violates the principle of financial responsibility.[1]

The postulates of the principle date back to a time when the role of the government in the economic affairs of the nation was still narrowly conceived and when federalism was essentially based on the principle that federal and state governments should operate, with minor exceptions, in 'watertight' compartments ('dualistic federalism').[2] It was then held that a system of federal grants would debase the very essence of federalism, namely the independence of the states which ought to include not only the freedom of spending but particularly also that of raising revenue. Today, however, this approach is considered absolete because the transfer of funds from the federal to the state governments need not necessarily imply that the states become subordinate to the federal government. The independence of the states can easily be ensured by constitutional provision for such transfers.

For a detailed discussion of the principle of financial responsibility cf. also Bhargava, R.N.: *op.cit.*, pp. 70–71.

[1]Cf. Sastri, K.V.S.: "Comment" (on Intergovernmental Financial Relations), in Hicks, U.K. and others: *op.cit.*, pp. 129–130.

[2]Cf. Birch, A.H.: *op.cit.*, p. 304.

If it is no longer necessary that the taxing authority be identical with the spending authority, it follows that tax sources need not be divided between the federal and the state governments in a manner which ensures that they can always balance their budgets by merely relying on their own tax sources. Instead, resources can be divided according to the principle of efficiency.[1]

b. *The 'Principles of Federal Finance'*

i. *The Principle of Public Finance*

The 'classical' economists held that the duties of the state should culminate in the preservation of internal order and in the protection against external attack. All other state expenditure was thought to be a waste and an unjust and oppressive imposition on the general public. Such a narrow conception of the responsibilities of the state is no longer entertained today. The modern state is more broadly based and, whatever its political outlook, is generally believed to have in mind the active pursuance of the welfare of its people. In a modern society an intrinsic control of public expenditure by parliament and special commissioners or committees, and an efficient system of public accounting and auditing have greatly lessened the danger of a misuse of public funds.

In a democratic state, where the wishes of the people ultimately prevail, the government will generally follow objectives which are in accordance with the socio-political conceptions of at least the majority of the community. Once these objectives are given, the science of public finance will assist the government in achieving them in the most economical manner. Expressed differently, under ideal circumstances the objective of public finance is the welfare of the people, whereby the practical interpretation of the concept 'welfare' and the manner in which its immediate aims are translated into practice by the government should closely follow current political thought.[2] This statement, however, is too general to serve as a guiding principle for the operations of the treasury, for it does not indicate the limit up to which the financial activities of the state should be pushed. Nor is the taxpayer likely to agree that whatever the treasury does, amounts to actual 'welfare'. He will rightly point out that the funds to finance public expenditure must be collected through taxes and that taxes mean sacrifice. Although it may be true that up to a certain point taxation may be advantageous to the community, because of the benefits that accrue from public expenditure, it will nonetheless be necessary to take account of both sides of the activities of the treasury and to balance against the benefits of public expenditure (and in certain cases also of taxation) the sacrifice imposed on the people by raising revenue for the government.

Up to which point taxation may be regarded as beneficial is a matter of judgement, but in theory it will be advantageous to the nation to continue to raise taxes so long as the difference between the benefit of public expenditure and the sacrifice imposed by raising the corresponding amount of revenue is positive. Once benefit

[1]For a discussion of the principle of efficiency cf. pp. 65—69.

[2]A state which is guided by the wishes of the public and aims at the welfare of the community is, of course, a theoretical concept. In practice it will be difficult to exactly ascertain the wishes and interests of the people as a whole and to avoid partiality in favour of a political party, a certain group of people, or of vested interests.

and sacrifice are equal the optimum of public finance is reached. Any further increase in taxation would mean a greater sacrifice than is warranted by the benefits that would accrue from the corresponding higher expenditure and thus cause a net loss to the nation.[1] This, then, is the principle of public finance. It gives us the norm by which the government can determine the optimum volume of public revenue and expenditure. It is obvious and clear and has far-reaching consequences though, admittedly, it is difficult to apply in practice.[2]

The principle may also be stated in terms of the marginal utility theory: More and more units of tax collected from each individual impose an increasing sacrifice on him which corresponds to the rise of the marginal utility of money to the individual. Hence, also the sacrifice of the people as a whole increases with every successive unit of taxation. At the same time, according to the law of diminishing marginal utility, additional units of state expenditure yield diminishing returns, or benefits, to the nation. The optimum of public finance will be reached at that point where the benefit of an additional unit of public expenditure is just equal to the sacrifice imposed by the corresponding unit of revenue. Any further unit of tax will cause a greater sacrifice than is warranted by the benefit which would accrue from its expenditure.

The principle of public finance lays down that the state should aim at maximum welfare. It does so when minimising the sacrifice imposed by taxation and maximising the benefit flowing from public expenditure. The latter two principles are called the principle of taxation and the principle of public expenditure. They are corollaries of the more fundamental principle of public finance and will be dealt with below after first determining to what extent the principle of public finance as such applies to federations.

ii. *The Principle of Public Finance as Applied to Federations: the Principle of Federal Finance*[3]

If the federal and state governments of a federation try to follow the principle of public finance in their respective spheres, differences in the financial strength and economic development of the states may prevent the principle from operating for

[1]Cf. Dalton, H.: *Principles of Public Finance,* London, 1964, p. 14.

[2]Pigou calls the principle of public finance the 'principle of maximum aggregate welfare' and defines it as follows: "If a community were literally a unitary being, with the government as its brain, expenditure should be pushed in all directions up to the point at which satisfaction obtained from the last shilling expended is equal to the satisfaction lost in respect of the last shilling, called up on government service." Pigou, A.C.: *A Study in Public Finance,* London, 1928, p.31.—Dalton calls the principle that of 'maximum social advantage' and suggests as to its practical application: "Take account of all the probable effects, which can reasonably be foreseen, of any financial proposal which is under discussion; strike a balance of probable gain and loss to the community; compare this balance with that of alternative proposals, and act upon the result of this comparison." Dalton, H.: *op.cit.,* 10-11.

[3]The theory of federal finance was expounded for the first time by B.P. Adarkar in his *The Principles and Problems of Federal Finance,* London, 1933. The theory was subsequently refined and extended by R.N. Bhargava in "The Theory of Federal Finance", published in *The Economic Journal,* March 1953, London. The theory of federal finance has been incorporated by Bhargava in Chapter III of his *Theory and Working of Union Finance in India.* His theory is mainly an attempt to adapt the general theory of public finance, as put forward by Pigou and Dalton for unitary states, to the special conditions prevailing in a federation. The discussion on the following pages follows closely that of Bhargava.

the nation as a whole. This needs further explanation.

Suppose the federal government *f* applies the principle of public finance to all its functions and resources by taxing those under its jurisdiction up to that point where the aggregate marginal benefit of an additional unit of expenditure *E* is equal to the aggregate marginal sacrifice of the corresponding unit of taxation *T*. In this way then the principle, in relation to its working in the federal sphere, may be expressed by $Ef = Tf$.

Suppose, further, that the constituent states, *a*, *b*, and *c*, too, apply the principle of public finance in their respective spheres, but that *a* is more advanced economically than *b*, and *b* more advanced than *c*, and that, consequently, the citizens of *a* are wealthier on average than those of *b*, and those of *b* wealthier than those of *c*. If *E* stands again for the marginal benefit of an additional unit of expenditure and *T* for the marginal sacrifice from an additional unit of taxation, then $Ea = Ta$, $Eb = Tb$ and $Ec = Tc$, if each state follows the principle of public finance in its own sphere. However, if the amount of taxes is equal in *a*, *b*, and c, the marginal unit of taxation will cause less sacrifice to the citizens of *a* than to those of *b*. This is so because the citizens of *a* are relatively more prosperous than those of *b* and the sacrifice of a marginal unit of taxation is likely to be less for them than for the citizens of *b* who are poorer. The same can be said of the relation between the citizens of *b* and *c*.

Similarly, the benefit derived from the expenditure of a marginal unit of taxation may be supposed to be smaller for citizens of *a* than for those of *b* and *c*, because the utility of a given amount of government expenditure is likely to be much smaller for the, in general, wealthier citizens of *a* than for the poorer citizens of *b* and *c*. It follows "that equality between the sacrifice imposed by the marginal unit of taxation and the benefit derived from the marginal unit of expenditure in a richer state is brought about at a lower level (in terms of the magnitude of the units of sacrifice/benefit) than in a comparatively poorer state".[1] In other words, the marginal sacrifice and benefit of a given unit of taxation/expenditure is less in a richer state than in a poorer one and, consequently, *Ta* is smaller than *Tb*, and *Tb* is smaller than *Tc*. Similarly, *Ea* is smaller than *Eb* and *Eb* is smaller than *Ec*. Expressed differently, $Ta < Tb < Tc$ and $Ea < Eb < Ec$.

The difference in marginal sacrifice and benefit between the richer and poorer states of a federation is clearly contrary to the principle of public finance as applied to the nation as a whole. This is so because once one adopts the national viewpoint, the expenditure made possible by a further small increase in taxation in the richest state *a* beyond the point of that state's optimum (i.e. where the aggregate sacrifice of this small increase is counterbalanced by the aggregate benefit of the corresponding small increase in expenditure) would still be of distinct advantage to states *b* and *c*. For the nation as a whole the principle of public finance would, therefore, be fulfilled only if the aggregate marginal benefit of successive unit of expenditure in the poorest state is just equal to the aggregate marginal sacrifice imposed in raising that unit of revenue in the richest state, or if $Ec = Ta$. Thus, taxation in the richest state should be pushed to that point where the benefit derived from the marginal unit of expenditure in the poorest state is equal to, or slightly more than,

[1]Bhargava, R.N.: *op.cit.*, p. 62.

the sacrifice imposed in raising the corresponding unit of revenue in the richest state.

This important conclusion suggests that from the national point of view the richer states should be taxed more heavily than the poorer ones and that the additional revenue so obtained should be spent on the economic and social development of the poorer states. In a federation composed of states differing in their social and economic development, there should hence be a constant flow of public funds from the richer to the poorer states, and these transfers should continue until the level of living in all the states in the federation is approximately equal, or until $Ec = Ta$.

The transfer of funds from the richer to the poorer states cannot easily be effected by the states themselves and should be carried out by the central government. Consequently, the federal government should not be satisfied with applying the principle of public finance in its own limited sphere, but it should rather act as a national coordinating agency which taxes the richer states more and effects such transfers of revenue from the richer to the poorer states as are necessary to make the principle of public finance work on a nation-wide basis. If the federal government fails to carry out such equalisation, the optimum application of the principle of public finance for the nation cannot be attained.

The conclusion drawn from the principle of federal finance is supported by the theory of fiscal justice. Buchanan compares the burden of taxation and the corresponding benefit of state expenditure of equals.[1] Citizens living in states with similar fiscal capacities are treated equally because the burden and the benefits of the financial activity of the federal and state governments will be identical. If states differ in their fiscal capacity the people in the low capacity states are likely to have either a higher tax burden or a lower level of public services, or both, than the people in the financially stronger states. Hence, the people of the former states suffer from greater fiscal pressure. To prevent resources from flowing from states with a high to those with a low fiscal pressure, and to assure an optimum allocation of resources, the federal government would have to transfer funds from the high capacity states to those with a low capacity. Such transfers would equate the fiscal pressure on equals living in the different states, and would also gradually offset divergencies in the levels of economic development and wealth of the states.

The principle of federal finance has its counterpart in unitary states where the government is required to even out differences in local wealth. Such differences are often confined to certain towns (some of which may suffer from depression whereas others enjoy boom conditions), but also extend to whole regions. Moreover, differences occur in large towns where slum areas exist side by side with flourishing suburbs. "In all these situations the crucial point is that wealth is in inverse relation to needs; so that to finance a given standard of services required, not merely a greater expenditure per head in a poor than in a rich town, but a much more than proportionately higher rate of tax, if the service is to be financed by local resources."[2]

[1]Cf. Buchanan, J.M.: "Federalism and Fiscal Equity", in *American Economic Review*, September 1950, Wisconsin. Cf. also Haller, H.: *Finanzpolitik*, Tubingen, 1965, p. 268, and Musgrave, R.A.: *The Theory of Public Finance*, New York, 1959, p. 160.

[2]Hicks, U.K.: *Public Finance*, Cambridge, p. 235.

iii. *The Theory of Taxation in its General Application*

It is not easy to define the term 'taxation'. This is so because of the great variety of sources of public income which may not all be classified as taxes. 'Taxation' is used to include the whole range of compulsory charges or rates on income, property, commodities or services imposed by the government for the conduct of the government and the supply of general services to the community, without a direct and specific *quid pro quo* being rendered to the individual taxpayer. This then excludes all those sources of public income which resemble prices in the way that they are paid by private persons to public authorities in exchange for specific benefits. Also excluded are receipts from public borrowings and the sale of public assets.[1]

It follows that taxes constitute a genuine sacrifice for those who have to pay them. Justice and equality demand that taxes should be raised in a manner that makes the sacrifice of each citizen as little as possible and that everyone should bear part of the total burden of taxation. This requires qualification inasmuch as the poorer people are likely to feel the burden of a given amount of taxes more than the richer. Therefore, to impose the least sacrifice on each subject means that the rich should be taxed more heavily than the poor or that—in terms of the marginal analysis—marginal sacrifice of individual taxpayers, rich and poor, should be as equal as possible.

Again, the theory of taxation in a unitary state calls for taxes to be raised in such a manner that the aggregate of individual sacrifice is the least (principle of minimum sacrifice). This, in turn, means that the marginal sacrifice of all taxpayers should be equal (principle of equal sacrifice).[2] The latter principle stands for progressive taxation.

iv. *The Theory of Taxation in a Federal State*

If the federal and the state governments have independent sources of revenue and tax their subjects according to the principle of taxation, i.e. if they both equate the marginal sacrifice of taxpayers in their respective spheres of jurisdiction, this does not necessarily mean that the burden of taxation will be the same for all citizens throughout the country. Taxation on the state level may differ from state to state. However, even if the states would apply equal rates, the sacrifice of taxpayers in the richer states would be less than the corresponding sacrifice of the taxpayers in the poorer states, supposing that, on average, taxpayers in the wealthier states are financially better off than those in the poorer states and supposing, furthermore, that a given amount of tax means less sacrifice to the rich than to the poor.

It follows that differences in the economic development and prosperity of the various states will prevent an equalisation, on the state level, of marginal sacrifices of taxpayer throughout the country. Equal marginal sacrifice for all citizens in

[1]Cf. Dalton, H.: *op.cit.*, pp. 17-18.—Dalton defines a tax as being "a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the taxpayer in return, and not imposed as a penalty for any legal offence". *Ibid.*, p. 23.

[2]The practical application of the principle of equal sacrifice will, of course, meet with innumerable difficulties. Moreover, since all modern systems of taxation are multiple tax systems (relying on a number of substantial, and less substantial taxes for the bulk of revenue), the effect of all types of taxes should be taken into account when measuring the sacrifice of taxpayers. Cf. also Dalton, H.: *op.cit.*, p. 29.

respect of the aggregate amount of all taxes—federal and state—can only be achieved if the federal government undertakes to balance the inequality, with regard to sacrifice, of the different state tax systems.

The theory suggests that the federal government should counterbalance the inequality of marginal sacrifice originating from state taxation by taxing the richer states more heavily than the poorer ones or, what amount to the same, that the federal government should induce the poorer states to reduce their taxation, and that it compensates them for any loss of revenue. The federal government should carry on its compensatory operation until the marginal sacrifice, imposed by federal and state taxation, is equal for all citizens throughout the country.

The principle of taxation, as applied to federal states, calls for the constituent states to tax their citizens according to the general principle of taxation. The federal government, on the other hand, will have to discriminate in its taxation policy and tax the wealthier states more heavily. In this way the equal marginal sacrifice of all citizens in respect of state plus federal taxation will be ensured.

v. *The Theory of Public Expenditure in its General Application*

The principle of public finance also implies that public expenditure should be carried up to the point where the marginal social advantage of this expenditure just balances the marginal social disadvantage of raising additional public income. Having described the principle of taxation, attention may next be given to the principle of public expenditure.

The principle of public finance is based on the notion that the state should maximise public welfare. Of course, not all monies spent by the state benefit the society as a whole. There are many items of expenditure that benefit only certain individuals or certain groups of individuals (e.g. old age pensioners). Generally speaking, however, the state, in framing its expenditure policy, should always aim at maximising the welfare of the entire nation. This would include present as well as future benefits, for any undue insistence on present social welfare may adversely affect future welfare. The state should take a more far-sighted view than most private individuals do and, in fact, can afford to take, and provide for a long-term policy of increased growth and productivity. This includes investment in the development of human and material resources. Public expenditure on human capital and knowledge is of particular importance, for the return from such investment is usually small in the short-run, but much higher than from material capital in the long-run. Statesmen, who are the trustees of the future of the community, should always prefer a larger social advantage in the future to a smaller one today.[1]

Another aspect to be taken into account in determining the best form of spending public revenue is that the benefit from marginal units of public expenditure is likely to be higher for the poor than for the rich. Aggregate benefit will be at a maximum when the marginal benefit derived by each person in the community is equal. It will profit the nation if the pattern of public expenditure is changed to achieve equal marginal benefit including equal marginal utilities of present and future expenditure. Moreover, the marginal benefit obtained from the various types of public expenditure should be equal.

[1]Cf. Dalton, H.: *op.cit.*, p. 9.

The principle of public expenditure or, as it has also been called, the principle of equi-marginal social benefit, may also be expressed differently. Pigou states that "resources should be so distributed between different uses that the marginal return of satisfaction is the same for all of them",[1] while Dalton demands that "the marginal utility to the community of all forms of public expenditure should be equal".[2]

Since the marginal benefit of a given unit of public expenditure is supposedly higher for the poor than for the rich, there is a theoretical case for increasing public expenditure on the poor and decreasing public expenditure on the rich, analogous to the principle of taxing the rich more heavily than the poor. In practice it will be rather difficult to incorporate such differentiation into the general expenditure policy of a country although there are certain types of public expenditure which, in fact, purposely favour the less well-to-do classes of a society. Examples are government allowances for each dependent child as introduced by France after the Second World War, maternity grants, free social and health services, and low-cost housing schemes.

vi. *The Theory of Public Expenditure in a Federal State*

In a federation both the federal and the state governments will try to apply the principle of public expenditure in their respective spheres of competence. They will arrange their patterns of expenditure in such a way that every citizen under their jurisdiction will as far as possible obtain equal marginal satisfaction from a given unit of expenditure. However, if the constituent states differ in the level of their economic development, and hence in the standard of living of their people, the principle of public expenditure cannot work for the country as a whole. This is so because the level of marginal benefit derived from a given unit of state expenditure is likely to be lower in the richer states and relatively higher in the poorer ones, supposing that, on average, the people of the richer states are financially better off than those in the poorer ones, and that in the latter the people will be in greater need of services provided by the state. This inequality cannot be made up for by the states themselves, nor could it be achieved if the central government should continue to merely equate marginal benefits in its own sphere. To make the principle of public expenditure work for the entire country, the federal government will have to reduce its own spending in the richer states in favour of higher federal expenditure in the poorer states. It will continue to do so until marginal units of total public expenditure, i.e. federal plus state expenditure, yield the same aggregate benefit in the poor states as in the rich states. At this point the national benefit from state plus federal expenditure is a maximum.

According to the principle of public expenditure as applicable to federations, the central government should iron out differences in the marginal levels of benefit flowing from the expenditure patterns of the states. The federal government need not itself undertake this compensatory spending in the poorer states, but can employ grants-in-aid which place the poorer states in a position to increase their expenditures.

[1]Pigou, A.C.: *op.cit.*, p. 31.
[2]Dalton, H.: *op.cit.*, p. 14.

c. *The Validity of the 'Pure' Theory of Federal Finance and its Significance to Developing Countries*

The 'pure' theory of federal finance and especially the principle of federal finance has not remained uncontested. Some of the more important criticisms will be considered here with a view to determining the validity and significance of the theory to developing federations.

i. *The Criticism of the Method and the General Applicability of Theory*

Firstly, critics object to the application of marginal analysis in the reasoning of the 'pure' theory of federal finance.[1] For instance, one of the assumptions underlying the theory is that the marginal sacrifice of an additional unit of taxation will be less in a richer than in a poorer state and this, in turn, rests on the assumption that marginal income has a comparatively smaller utility for the rich than for the poor. The validity of such a supposition may be questioned on the grounds that the utility of a marginal unit of income cannot be measured and will vary from person to person quite irrespective of the amount of his income. This is especially true in the case of persons belonging to the modern sector, on the one hand, and those belonging to the traditional sector of a developing country, on the other, and between city and country dwellers. However, common-sense tells us and most politicians readily accept that, in general, a rich person will be in a much better position to sacrifice an amount of money which represents only a small portion of his income, than a poor person to whom the same amount of money means a fairly large portion of his income.[2]

A second objection is that the theory fails to take into account the manifold effects and counter-effects of taxation and expenditure and especially of the relative post-taxation positions of taxpayers.[3] Yet, in a theoretical analysis it is often necessary and even desirable to concentrate only on the major forces affecting a certain problem and leave aside, for the sake of simplicity, the affects of minor influences. Nevertheless, the objection would appear valid because the effects of taxation and public expenditure are constantly changing. Similarly, it is often quite feasible to treat certain outstanding aspects of a complex scientific problem (such as taxation and public expenditure in the foregoing discussion) separately without impairing the general validity of the principles established by such an analysis; but this seems questionable in many matters of public finance in view, for instance, of the close relationship between taxation and public expenditure.

[1]Tripathy remarks in this connection that "redistributive fiscal policy for maximizing aggregate utility might have no scientific validity due to the difficulties of inter-personal comparisons of utility and its cardinal measurability". Tripathy, R.N.: *Federal Finance in a Developing Economy,* Calcutta, 1960, p. 2. Cf. also Buchanan, J.M.: "The Pure Theory of Government Finance", in *The Journal of Political Economy,* December 1949, Chicago, pp. 496-505.

[2]Cf. Dalton, H.: *op.cit.,* p. 4.

[3]Adarkar maintains that the best way in which a given amount of money can be spent can only be devised when the relative post-taxation positions of the taxpayers are known, and that the best way of distributing the burden of taxation can only be determined if the compensating element of expenditure among the taxpayers is known, because there is always the possibility of the latter nullifying the optimum of the former distribution. Cf. Adarkar, B.P.: *op.cit.,* pp. 198-199.

Politicians and administrators having to deal with intricate problems such as public finance usually welcome well-founded scientific principles which can guide them in their decisions even if these principles do not always take all the various circumstances of a given situation into account. Fortunately, no government needs to completely rearrange a country's system of public finance. Usually decisions are restricted to minor changes that affect only a small portion of the whole.[1] Moreover, the constant rivalry among government departments for funds and the presence of public criticism of the government's financial policy, as well as the effects of pressure from organised interests will help the authorities to take the 'right' decision or, expressed negatively, prevent the government from taking a decision that would seriously harm the interest of the nation.

Thirdly, there is the more serious drawback regarding the actual implementation on the federal as well as state level of the desired equation of aggregate marginal benefits and sacrifices. Who, after all, can claim any objectivity in assessing whether marginal benefit and marginal sacrifice is in fact equalised throughout the federation? Moreover, there are no objective criteria to determine even approximately the weights to be attached to the various sacrifices and fiscal advantages of the different people living in the various states.

A related and equally serious problem arises with the practical application by the federal government of the implied policy of discriminatory taxation vis-a-vis the various states, as demanded by the theory of taxation in a federal setting. For it is not the states but people and companies that are taxed, and any direct geographical discrimination by the central government among persons and firms is out of the question, so far as normal operations are concerned.[2] This is not only because of strong legal-constitutional opposition to such practices but also because of the administrative difficulties to prevent tax evasion. For, such discrimination would foster either a real shift of economic activities to those regions where the central tax burden is lightest, or an alleged one in the sense that companies would tend to move their official headquarters in order to reduce their tax liability. Furthermore, discrimination between the states in respect of import and excise duties and for that matter also sales taxes if these are federal subjects, would encourage smuggling.

On the other hand, the equalisation of interstate fiscal differences (or 'horizontal adjustment' as it is often called) can to a certain extent be effected through the federal expenditure policy (for instance, if the federal government undertakes to finance certain additional large-scale development schemes in the poorer states) and through special federal grants. Unfortunately, the 'pure' theory of federal finance pretends to be neutral as to the particular method which should be followed, whereas this may very well be crucial to its acceptability. Several ways have been suggested for bringing about horizontal, or interestate, fiscal equity which will be discussed later on.[3] For the present it is only required to point out that these proposals are often

[1] Cf. Dalton, H.: *op.cit.*, pp. 14-15.

[2] Cf. Scott, A.: *op.cit.*, p. 251.

[3] Cf. e.g., Buchanan's theory of equality of the fiscal residuum, the implementation of which would leave the states fairly autonomous, but would require the federal government in its taxation to take account of the net tax-benefit 'residuum', or surplus, for every person living in the federation. Cf. Buchanan, J.M.: "Federalism and Fiscal Equity", in *op.cit.*, pp. 583-593.—Various other solutions to the problem of equalisation are discussed in this book under the heading "The Problem of Financial Adjustment" on p. 69 ff.

far from being realistic, chiefly because they do not take into consideration that complete horizontal equalisation is very seldom a federal objective as such.

ii. *The Federal Aims*

Probably the most fundamental criticism of the principle of federal finance is that it disregards the desire for autonomy by the states. Complete, or nearly complete equalisation in respect of taxes and benefits may be acceptable in a very tight federation or where the poorer states are politically strong enough to push for regional equality. In a loose federation, however, where the objective is to provide local autonomy, each state may have its own preferences and ideas with regard to its tax and service structure and the local redistributive effects of public finance. Each will be virtually free to put its preferences into practice. If such differentiation of policies has detrimental effects on the rate of growth and the degree of equity or stability of the national economy then this must be taken as the price of federation.

In a federation where the idea of national unity and common citizenship is less pronounced, the wealthy states may demand that the federal government returns the revenue to those states in which the revenue was raised ('principle of derivation') This then obstructs from the outset any serious attempt at equalisation. Where the states enjoy full fiscal autonomy, federal government expenditure will still have a slight redistributive effect inasmuch as central government expenditure on such items as defence, communications, and education and health (if these services are centrally administered) are likely to benefit the poorer states more than the richer ones.

It follows that the question of geographical fiscal equity is closely related to the aims of federation. In a loose federation, the desire for equalisation may be weak, or non-existent, and it will therefore matter little whether or not the central government can implement a policy towards this end. In a tight federation, on the other hand, one is likely to find a strong popular demand for equal treatment of equal citizens in all the various states of the country. The people and their political representatives will continually be aware of the need to be 'fair' to all regions. In these circumstances the federal government will, however, also have the power to carry out a policy of equalisation.[1]

The question to be decided in a federation is not one of two exclusive alternatives, namely equalisation or no equalisation. For, although a federal government may constitutionally aim at the complete elimination of existing interstate differences, as advocated by the 'pure' theory of federal finance, it is likely that its operational aims will be more moderate. It will merely aim at evening out differences in respect of certain selected taxes and revenues or in respect of the extent and quality of certain state services. The central government may be prepared to accept interstate differences as they actually exist and be satisfied with assisting the poorer states only in so far as is necessary to prevent their rate of growth falling further behind that of the richer states. In other words, the federal government may merely

[1]In a tight federation the federal government may, however, also more easily ignore the demands for equalisation. In Malaysia we have met a situation where the Federal Government has apparently assigned a low priority to equalising differences between the States of Malaya because this is believed to be in conflict with the goal of rapid growth. Cf. pp. 38-43.

wish to ensure that the gap in the level of development between the progressive and the more backward states does not grow wider.

iii. *Fiscal Equality in Developing Federations*

Generally speaking, the 'pure' theory of federal finance would be equally applicable to developed and underdeveloped countries. The principle of federal finance and its corollaries, the principles of taxation and public expenditure in a federal state, are but simple statements on the method by which the optimum of public finance should be determined in a federation and how, in a very general way, the central government should raise and spend its revenue in order to balance interstate differences in wealth and in the level of economic and social development. They do not say anything on the kind of taxes that should be levied or on the way in which public revenue should be spent. The principle of federal finance also leaves undecided the wide field of fiscal policy as a means to further stability and economic growth.

It would appear, therefore, that the principle of federal finance and its corollaries are not related in any way to the degree of a country's economic development and that, consequently, they are equally valid for both advanced and backward federations. Nevertheless, this view has been challenged on the grounds that in a developing country the welfare consideration in the operation of public finance should be subordinated to the supreme objective of promoting and accelerating economic growth. Accordingly, the goal of federal finance in a developing country should not necessarily be the achievement of regional balance (in terms of aggregate marginal sacrifice, and benefit), but rather the attainment of a production optimum that is reached when the allocation of productive factors in the whole economy conforms to the principle of equimarginal productivity.[1]

Tripathy objects to the conclusion drawn from the principle of federal finance which demands the transfer of funds from the higher to the lower income states up to a point where the aggregate marginal benefit (utility) of a unit of combined state and federal expenditure derived by the people of the poorest state is just equal to the aggregate marginal sacrifice (disutility) sustained by the people of the richest state in raising the corresponding unit of taxation. He maintains that this principle, based on the objective of maximising aggregate social utility, holds true only for conditions in developed federations. In a developing federal state, however, "the transfer of resources from a high-income state to a low-income one will be compatible with the criteria of economic growth only if such a transfer results in a higher marginal productivity of the transferred resources".[2] Marginal productivity rather than marginal utility should therefore be the criterion for the redistribution of national resources in a developing economy.

The federal government should be more concerned with the transfer of resources from areas with a low marginal productivity to those with higher ones until equimarginal productivity is reached in the whole country. It follows that transfers according to the principle of highest marginal productivity, need not result in regional balance, nor need the central government find it advantageous to transfer

[1]Cf. Tripathy, R.N.: *op.cit.*, pp. 1-3.
[2]*Ibid.*, p. 1.

resources from the richer to the poorer states if the marginal productivity of a given unit of revenue is higher in richer state than in a poorer one.[1] Scott also warns against equalisation grants because their effect might be to dissuade workers from moving to the richer provinces where it is assumed that their productivity would be higher.[2]

From the above discussion it is clear that the need for a higher rate of economic growth may not be compatible with the objective of regional balance in a federation, especially not in the initial phases of development. This is in agreement with the conclusion drawn from the discussion of the implied effects of federalism on the process of economic growth.[3] If each region were equally endowed with productive resources, the problem of regional balance would not present any serious difficulty. But where natural advantages, including human resources, mineral wealth and climatic conditions are unequally distributed and where growth centres with all their ancillary services have already been established, the government in its development policy should give priority to the utilisation of those resources which yield the highest productivity.

The rule that preference be given to the development of resources yielding the highest marginal rate of return can, at best, also be no more than a guiding principle. This is so because there is an inherent conflict of interests among the states on the geographical distribution of the benefits flowing from the federal government's development policy. The extent to which the central government can afford to neglect the demands for equalisation of differences in the stages of development and the rates of growth of the various states will largely depend on the degree of social and economic integration and the balance of power in the federation. Where the poorer states are politically strong they will most certainly insist on obtaining at least a fair share of the federal development expenditure, irrespective of whether or not this may retard the development of the nation as a whole.

In a tight federation the federal government may more easily ignore the demand for equalisation in the interest of a maximum rate of social and economic growth; but at the same time, any preferential treatment of the wealthier states in such fields as education and health would virtually be out of the question.

3. *Summary*

Here again are the more important postulates of the 'pure' theory of federal finance and a summary of the results of the discussion of its significance to developing federations.

The theory of public finance applies to the financial operations of each member state of a federation. Accordingly, each state follows the principles of public finance in its own sphere of jurisdiction and carries taxation and public expenditure to that point where the benefit derived from the marginal unit of expenditure is equal to the sacrifice caused by raising that unit of revenue. However, where the states differ in their level of development and prosperity, and where the levels of marginal benefit and marginal sacrifice from a given unit of taxation differ between the

[1]Cf. *Ibid.*, pp. 7-8.
[2]Cf. Scott, A.: *op.cit.*, p. 274.
[3]Cf. pp. 27-28.

states, the application of the general theory by the individual states will not ensure maximum social advantage for the nation as a whole. Therefore, whereas the states continue to apply the principle of public finance in their sphere, the federal government is called upon to even out these differences. An optimum condition for the country as a whole is reached when the marginal benefit of a unit of (federal plus state) expenditure in the poorest state is just equal to the marginal sacrifice caused by a corresponding unit of (federal plus state) taxation in the richest state. This so-called 'principle of federal finance' advocates higher taxation of the richer states and a transfer of public funds to the poorer states until they have reached equal levels of prosperity.

The principle of federal finance is supported by the principles of taxation and public expenditure as applicable to federations. The former stands for higher taxation of the richer states and the latter for the transfer, by the central government, of funds collected in the richer states to the poorer and more backward ones. The principle of public expenditure in a federation also advocates that in equating marginal benefits throughout the nation, the federal government should aim at balancing present and future marginal utilities and prefer a larger social advantage in the future to a smaller one today.

In the final analysis, the theory of public finance advocates the reduction of inequalities on all social levels through the transfer of purchasing power from the richer to the poorer individuals and local authorities. More specifically, according to the theory of taxation the inequalities of income will be diminished while adherence to the principle of public expenditure will reduce the differences in the opportunities of personal advancement. The theory of federal finance extends the postulates of the theory of public finance to the reduction and gradual elimination of differences in the level of social and economic development of the various states forming a federation.

In a unitary country the question of equity is mainly one of fairness or justice in the distribution of wealth and income between the rich and the poor. In federations, on the other hand, the question is given an additional dimension, namely that of interstate equity in wealth and opportunity which, on the fiscal plane, amounts to horizontal equity in respect of taxation and benefits flowing from the operation of public finance. Fiscal theory supports the popular demand for fiscal equity among the states and suggests that horizontal adjustment be effected by the federal government through a discriminatory policy of taxation and expenditure favouring the poorer states.

Fiscal theory provides politicians and administrators with general guidelines. There may be instances, however, where a policy of equalisation would be impracticable. In fact, equalisation may not be a federal objective at all, and states may prefer to have their own tax and service structures adapted to the local distribution of income and, hence, may not wish to be part of a nation-wide redistributive policy. In a loose federation the financially strong states may hold the view that the revenue ought to be returned to the region where it was raised and may invoke state rights against a deviation to the poorer states of resources collected within their areas. In a tight federation, or where the wishes of the poor states carry great political weight, a policy of equalisation can be implemented more easily.

The instruments of a policy of equalisation would mainly comprise the federal expenditure policy and equalising grants. The imposition of discriminating tax rates on a geographical basis is a less satisfactory solution because this will be difficult to administer and might lead to the vexing problem of smuggling between the various states and to the migration of firms wishing to reduce their liability. Complete overall horizontal equity is seldom an aim of federation. In practice a policy of equalisation is more likely to aim merely at evening out differences in respect of certain public revenues and services, and at reducing differences in the rates of growth.

The question of how far the 'pure' theory of federal finance is applicable to developing federations was also examined. Firstly it was observed that, theoretically, it should apply equally to developed and underdeveloped countries. This view has, however, been contested on the grounds that the aim of equating aggregate marginal benefit throughout the nation may be in conflict with the aim of attaining a production optimum for the whole federation. This would be the case especially where economic resources are unequally distributed among the states. Here federal development expenditure will yield higher returns in the more advanced states and existing growth centres. In a loose federation equalisation is unlikely to be an important policy aim, any way, while in a tight developing federation with an unequal resource distribution and different levels of development it will most probably be subordinate to the more urgent objective of rapid growth.

B. FEDERALISM AND AN EFFICIENT FINANCIAL ADMINISTRATION

The discussion of the 'pure' theory of federal finance made it clear that the principle of federal finance and its corollaries are no more than general guidelines which require different interpretation depending on the political, social and economic conditions prevailing in a country and on the socio-economic objectives of the particular government. We shall now examine the major administrative problems of a system of public finance arising from the introduction of a federal structure of government. This involves an analysis of, firstly, the division of functions and resources, secondly, the various approaches to the complex problem of financial adjustment and, thirdly, the need for a periodic review of federal/state fiscal relations as well as the settlement of conflicts.

1. *The Administrative Norms of Federal Finance*

The so-called 'norms of federal finance' are accepted by all writers on the subject of federal finance and they continue to be the core of the more elaborate modern theories of fiscal administration in a federal setting. Adarkar lists three essential requirements for the satisfactory working of federal finance, namely independence and responsibility; adequacy and elasticity; and, administrative economy.[1] To these Singh adds the norm of equity.[2] We shall briefly outline each of these

[1]Cf. Adarkar, B.P.: *op.cit.*, p. 218.
[2]Cf. Singh, B.: *Federal Finance and Underdeveloped Economy,* Bombay, 1952, p. 78.

administrative 'norms of federal finance' since they form the basis of the subsequent analysis of the financial administration in a federation.

(a) Independence and responsibility

The federal and state governments should enjoy as much freedom and initiative as possible to raise and spend revenue. A certain measure of co-ordination and overall supervision by the federal government may, however, be desirable in the interest of the nation. The independence of the states should be clearly spelled out in the constitution and any overlapping jurisdiction in respect of functions and resources should be avoided. No state should have the right to tax residents of other states.

(b) Adequacy and elasticity

The resources assigned to each layer of government should be adequate to meet their immediate needs and enable them to fulfil the functions allotted to them. If needs grow, there should be a corresponding increase of resources. This is particularly important in times of emergency such as war, famine, or depression. Flexibility is needed to prevent the federal fiscal set-up from becoming rigid under constantly changing conditions. The question of attaining economic and financial equilibrium for the country presents one of the greatest problems of federal finance and provision should be made in the constitution for an appropriate scheme of financial adjustment between the federal and state governments.

(c) Administrative economy

Each system of public finance must be administered efficiently and in a manner that burdens the economy least. Under ideal conditions there should be no opportunity for fraud and tax evasion. The cost of collecting taxes should be a minimum. A lack of co-ordination between the central and state governments in fiscal programmes and measures may easily cause unnecessary burdens to the taxpayers and increase the cost of administration. Care should be taken, therefore, to prevent administrative duplication. Where practical experience has shown that certain types of taxes can be collected more economically by the central government, due regard should be given to such experience. Typical example are the personal and corporate income taxes and death duties. Wasteful expenditure is another burden to the national economy. It is especially harmful in poorer countries.

(d) Equity

Equity should be the guiding principle in taxing individual taxpayers. To put this principle into practice may be more difficult in a federation than in a unitary state, because the various taxing authorities frequently apply different rates and bases to the various types of taxes. Such discrimination and inequality may easily "create a 'fiscal illusion' which tends to cause locational changes in industry and trade which are not necessarily conducive to optimum resource relationship".[1]

2. *The Division of Functions and Resources*

a. *The Division of Functions*

We start with the division of functions, which has precedence over the division

[1]Singh, B.: *op.cit.*, p. 81.

of resources, mainly because of its significance to the political structure of a country and to the subject of public finance. This importance becomes immediately clear if one substitutes the term 'division of powers' for 'division of functions'. The division marks off the sphere of jurisdiction of the centre as against that of the states, and *vice versa,* and determines the degree of tightness of a federation. India and Malaysia, for instance, are regarded as strong federations because of the large powers assigned to their central governments. The former West Indian and Nigerian federations, on the other hand, have much weaker centres. From the point of view of government finance the division of functions takes precedence over the division of resources because, contrary to private finance where the income of a person determines the amount he may spend, a government will usually first determine the amount it wishes to spend on the various functions assigned to it and then raise the funds necessary to finance that amount.

It should be mentioned at the outset that thus far little attention has been given to the problem of how to divide functions between the various layers of government most appropriately. In fact highly divergent views are often held on this subject. The problem arises not only in federations, but also in unitary states where it has to be decided which functions should be assigned to local governments. The way in which functions have actually been divided in the various federations of today differs widely, depending on such divergent factors as the traditional pattern of administration, the various political and socio-economic circumstances prevailing at the time of federating and on the relative bargaining powers of the parties to the federation, including in the case of most of the new federations, that of the retreating colonial power. It follows that a comparison of the division of functions as applied by the various federations would not be very instructive. [1] Nonetheless, there seems to be a consensus of opinion among both politicians and economists that, as far as possible, functions should be divided according to the principle of efficiency.

This means that functions of an international character and those concerning the nation as a whole should fall within the jurisdiction of the federal authorities. Typical examples would be defence, foreign policy, and external economic relations; justice; labour legislation; currency and banking; transport and communications as far as they involve more than one state; and, the framing and co-ordination of the national economic policy. The state governments, on the other hand, should be assigned functions which are more of a local or regional character, such as agriculture, forestry and primary industries. This may sometimes sound ambiguous, for it is difficult in a modern society to always clearly distinguish between functions that are mainly of a regional and those of a nation-wide nature. Thus states that differ in size and geographical features and in the composition of their population and level of economic development, are most likely also to differ in their approach to such matters as public health and education programmes. One may argue therefore that these services are more efficiently handled on a state basis. [2] This would

[1] For examples of how functions have been divided in various federations cf. Bhargava, R.N.: *op.cit.*, pp. 73-75, and Buchanan, J.M.: *The Public Finances,* Homewood, Illinois, 1960, pp. 386-387.

[2] Where a federation is made up of a 'plural society', as this is the case in Malaysia, and where moreover the states are rather small in terms of population and size, educational administration on a regional basis would obviously serve little purpose.

also apply to the so-called 'community development programmes', designed to accelerate the social and economic development of the people by means of organised and government-assisted self-help efforts.

In the older federations member states have sometimes retained considerable powers in line with their traditional pattern of administration. In recent decades, however, there has been a growing centralisation of functions with the central governments. This trend has been explained mainly in terms of increasing expenditure needs in the fields of defence and social services.[1] In the newer federations serious attempts have been made to divide functions right from the start as far as possible according to what was thought to be the most efficient pattern. In most of the older federations, too, one finds instances where the division of functions has been adjusted by constitutional amendments to meet the demands of greater efficiency. As a result of these new developments we find in most of the existing federations, old and new, evidence of what is described as a move towards 'functional specialisation' between the federal and state governments.

b. *The Division of Resources*

As every function of the government is necessarily closely bound up with finance, the division of resources is a logical consequence of the division of functions. As mentioned above, earlier writers held that "the responsibility of raising revenue and the freedom of spending it ought to go hand in hand". However, this so-called 'principle of financial responsibility' is no longer upheld today.[2] In fact, it has become accepted practice in virtually all federations for the states to depend on federal grants for a considerable portion of their revenue. The abandonment of the 'principle of financial responsibility' has cleared the way for the principle of efficiency to become the main criterion for the division of resources.

If efficiency is the guiding principle for the division of resources then it has to be decided for each tax whether it would be handled more efficiently by the federal or by the state authorities. In general one may assume that taxes with an interstate basis are administered more competently by the centre. This applies mainly to customs duties (as the logical outcome of having a customs union and a common external tariff), excise duties (especially also because large interregional differentials in rates would lead to the awkward frontier smuggling problem) and probably also to inheritance taxes. On the other hand, taxes having a local base, such as land revenues; taxes on income from agricultural activities and mineral rights; licence, registration and entertainment fees; and secession and estate duties in respect of land ownership, are likely to be administered more efficiently by the states. Generally speaking, capital taxes in one form or the other may well qualify for state administration. At the same time, however, they are of limited significance to developing countries owing to the enormous practical difficulties in collecting them. For usually one does not find a much simpler pattern of property ownership in developing countries than in the advanced nations despite the fact that in the former the weight of capital taxation must fall on land ownership.

[1]Cf. Buchanan, J.M.: *The Public Finances*, p. 36.
[2]Cf. pp. 84-85.

In actual fact the division of resources in the existing federations does not follow any particular pattern and has usually been the outcome of some political compromise. A few examples may illustrate this. In the USA the state governments rely for the greater part of their revenue on commodity taxation. The taxes are either levied on the production, sale or consumption of a large number of goods and services. States sales taxes are also a feature in India, but generally they would seem difficult to collect in countries where retail business is still carried on under rather primitive and transitional conditions and where traders do not keep proper records of their transactions. In West Germany the 'Lander' (states) have been assigned inter alia the revenue collected from the property tax, the inheritance tax, the motor car and transportation taxes, and the taxes on beer and gambling. In addition, the states are entitled to 65% of the revenue from personal income and company taxes; 35% being the share belonging to the federal government. Other sources of income of the central government are customs and excise duties, the turnover tax and state monopolies.[1] In Nigeria and in the former Federation of Rhodesia and Nyasaland poll or personal taxes applying to all adult males (and women in some instances), licences, and property taxes in the urban areas fell solely under the jurisdiction of the territories concerned.[2] In the Federation of Rhodesia and Nyasaland the three territories also shared in the centrally collected income and profit tax. The federal government received 64%, Northern Rhodesia (Zambia) 17%, Southern Rhodesia 13% and Nyasaland (Malawi) 6% of the tax.

In respect of personal income and corporate taxation, there has been a steady trend towards centralisation in most of the older federations,[3] although, with regard to the personal income tax, many incomes, especially in the lower income brackets, have a purely local reference. This development has been partly the result of the administrative economies arising from a uniform pattern of taxation (imagine, e.g., the difficulties that would arise from a separate assessment by each state of companies with branches in various states and carrying out contracts all over the country). More important, however, has been the need for a more productive and elastic tax source which would enable the central government to carry out its increasing functions in the social and economic fields and which, at the same time, would place it in a position to exercise, through fiscal policy, a significant influence on the behaviour of the private sector with a view to ensuring stability and rapid growth. Personal income and corporate taxes (the revenue of which is likely to grow rapidly as development progresses), and to a lesser extent customs and excise duties are the most important instruments of fiscal policy in developing countries.

[1]Cf. Institut "Finanzen und Steuern": *Länderhaushalte 1952-1954,* Heft 49, Bonn, 1957, pp. 10-13.

[2]Cf. Due, J.F.: "Tropical African Contributions to Federal Finance", in *Canadian Journal of Economics and Political Science,* February 1964, Toronto, p. 53. For a resume of the allocation of resources in Nigeria cf. Due, J.F.: *Taxation and Economic Development in Tropical Africa,* Cambridge, Massachusetts, 1963, pp. 127-129. For more examples of the distribution of taxes in developing countries cf. Birch, A.H.: "Intergovernmental Relations in New Federations", in Hicks, U.K. and others: *op.cit.*, pp. 122-126.

[3]Cf., e.g., Singh, B.: *op.cit.*, pp. 101-106, Tripathy, R.N.: *op.cit.*, pp. 15-21, and Campbell, W.J.: *Australian State Public Finance,* Sydney, 1954, pp. 95-97.

A high degree of fiscal centralisation has also been a feature of most of the newer federations. In 1961—1962, for instance, 89% of the combined federal and territorial (state) revenue of the former Federation of Rhodesia and Nyasaland was collected centrally. The corresponding figure was 86% in the case of Nigeria, and 79.3% in the case of Malaysia (1964-1966).[1] In the new federations customs and excise duties and the various types of direct taxes are mostly collected centrally.

The case for a centralised administration of company taxation and for uniform rates throughout the federation is particularly strong in developing countries. Foreign investors are likely to feel more secure if their taxation is handled by the central authorities and it has rightly been argued that regional governments should be "deprived of the temptation to compete for overseas investment by lowering company taxes, or, alternatively, to exploit overseas companies who have made a major investment in the territory".[2] A strong case could also be made out for the centralisation of the personal income tax. Here the central government should retain control over the rates applicable on higher incomes and the scale of progression with a view to achieving a greater measure of social justice and equity throughout the country. Consequently efficiency should not be the exclusive guiding principle in deciding the division of resources. Other considerations affecting the wider interests of the nation can often also be relevant.

If all the major resources have been divided between the federal and state governments, there is always likely to remain a 'concurrent' zone of taxes which do not fall exclusively into the national or local category. Examples would be the road and motor car taxes which have bases extending beyond the boundaries of the individual states. An efficient exploitation of these taxes would require a close cooperation of all the governments concerned unless, of course, they are assigned by agreement to either the federal or the state governments. In any case, it would be unwise to leave open the question of which of the two layers of government should exploit a particular tax, as this may easily lead to duplication and unnecessary conflict. Where such uncertainty or overlapping of tax jurisdiction exists, Bhargava suggests that it may be desirable to have the federal administration collect it and to assign all or part of the proceeds to the states.[3] Needless to add, the scheme of division of resources must ensure that no state can tax the subjects of another state.

The difficulty in being more specific with regard to the rules for the division of tax resources according to the principle of efficiency increases if one further considers the great differences that often exist in the political and economic structures of federal states. What may suit one federation need not always suit another. In developing countries the question of the division of resources should be viewed in the light of the often more pressing problem of corruption and inefficiency in matters of tax administration and of large-scale tax evasion. A high degree of centralisation may be the only way to overcome these problems. Moreover, the need for simplicity and uniformity in matters of taxation in developing countries as well as the lack of trained personnel, all point to a more centralised system of taxation or

[1]Cf. Due, J.F.: "Tropical African Contributions to Federal Finance", *op.cit.*, pp. 53 and 58-59. The figure for Malaysia is calculated from Table 11.

[2]Birch, A.H.: "Inter-governmental Financial Relations in New Federations", in *op.cit.*, pp. 124-125.

[3]Cf. Bhargava, R.N.: *op.cit.*, p. 76.

at least to a more integrated federal/state system.

The division of resources obviously presupposes a certain measure of tax autonomy for the states, but with the growing centralisation of taxes the zone of this autonomy is constantly being diminished. One could easily conceive of the development of a system where *all* taxes are collected by the central government, or by the states as agents of the central government, and where the proceeds are then distributed according to a prearranged formula. The completely centralised system of tax collection would resemble that of unitary states and would be the logical outcome if the process of centralisation of taxes is carried on until it extends to all types of taxes. Such a scheme would probably be highly efficient, but it would have to rely rather heavily on the equally problematic system of intergovernmental adjustment for distributing the national tax yield among the various governments.

Whatever the outcome of the division of the responsibility for the collection of taxes—and there is reason to believe that efficiency of administration calls for a greater measure of centralisation—it is unlikely that each layer of government will collect exactly that amount of revenue required to discharge the functions allocated to it. The resulting maladjustment between functions and resources, or the issue of 'non-correspondence', poses the question of financial adjustment which is probably the most crucial one in federal finance.

3. *The Problem of Financial Adjustment*

a. *Horizontal and Vertical Imbalance*

In general, federal governments have more funds than functions and the states more functions than funds. The most productive and elastic tax sources, namely the income tax and import and excise duties—the two latter forming the most important sources of revenue in developing countries—are usually allocated to the federal government, whereas the states often assume, responsibility for the more costly and expanding functions such as education and health. This imbalance (or 'non-correspondence') can almost always be traced back to the initial division of functions and resources as laid down in the constitution.[1] The framers of the constitution were neither in a position to assign to the states tax powers and other sources of revenue which would exactly match their needs to fulfil their functions, nor were they able at that time to foresee changes, in later decades, in the whole tax structure such as the growing trend towards centralisation in the collection of taxes and the changing pattern of tax yields. Nor, indeed, could they anticipate the growing need especially for social services which often cannot be provided on a national scale. Moreover, new taxes are being introduced from time to time by both layers of government and tax bases are frequently changed. Similarly, new functions are constantly being assumed by both layers which affect their requirements for financial resources.

Two basic issues are involved in the fiscal imbalance between the centre and the states which need to be identified. First, there is the problem of 'horizontal' imbalance among the various states arising from differences in their fiscal capacities and from differences in the cost of fulfilling state responsibilities and duties. Second,

[1]Cf. Also Scott's reference to the problem of 'non-correspondence' in *op.cit.*, pp. 242-243.

there is the problem of 'vertical' imbalance between the two levels of government, i.e. between the federal government, on the one hand, and the states taken as a whole, on the other. The former gives rise to the complex question of equity and the need for interstate fiscal adjustments, provided—and to the extent—that the equalisation of interstate differences is an aim of the federal government's financial policy. On the other hand, vertical imbalance creates the problem of federal/state fiscal adjustment which requires that the states, irrespective of their regional financial differences, be provided with the means necessary to fulfil the functions assigned to them. Often both types of adjustment are carried out in one series of transfers. These transfers would normally assume the form of either unconditional or 'bloc' grants, as in Australia and Canada, or conditional grants, as in the USA, although other methods are also used.

b. *The Instruments of Adjustment and the Scope of Federal Grants*

There are three main methods by which fiscal imbalances between the federal and the state governments may be resolved:[1]

(i) Adjustment in the form of transfers of public funds (grants-in-aid) from the federal to the state treasuries;

(ii) Adjustment by changing the ratio of distribution under systems where tax yields are shared between the federal and the state governments; and

(iii) Adjustment by varying the number and/or composition of tax sources ('adjustment taxes') assigned to the states, thereby allowing for an increase (decrease) of the tax yield of the states.

Of these the first is of greatest practical significance, although the second one is also applied by a number of federations where the yield of some major sources of revenue is shared between the two layers of government.

The third method immediately raises the question of the availability of suitable taxes for the purpose of adjustment. Whether or not a tax is suited for that purpose depends largely on whether it yields regular and stable revenue and is thus insensitive to cyclical influences; for any fluctuation in the yield may easily upset the whole system of adjustment. The question of flexibility is another important criterion. Where the financial adjustment is to be effected by changes in the number and composition of the taxes assigned to the states, it would be an advantage if a few minor taxes were available which could easily be transferred from the federal to the state authorities, or *vice versa*, without cumbersome and time-consuming interference by the legislatures. On the other hand, these so-called 'adjustment taxes' have the defect that they are not really suited for the purpose of horizontal adjustment. This is so because it will be impractical to assign to some states more and to others less 'adjustment taxes' so as to ensure that the more or less subtle regional fiscal differences are exactly matched by the additional yield from these taxes.

[1]There are two other methods suitable mainly for bringing about horizontal equity. Firstly, the states may set their own tax rates, whereas the central government sets geographically discriminating rates. This method would, however, create administrative difficulties and would probably lead to geographical migration, or alleged migration, e.g., of company head offices, in order to reduce individual tax liability (cf. also p. 58). Secondly, the federal government can even out interstate inequalities through its own expenditure policy, especially by supporting development projects in the poorer states.

In view of the disadvantages attached to 'adjustment taxes', the preference given to the more flexible tax-sharing arrangements, percentage surcharges,[1] and adjustment grants is not suprising. As to federal/state tax-sharing arrangements, there are various possibilities. Both layers of government may share the yield of federal as well as state taxes on some predetermined basis. Tax sharing has been fairly common with regard to income taxes (e.g. in the Federal Republic of Germany, India and the former Central African Federation). A basis for sharing a tax could be the amount of tax which is deemed to be collected from a particular state (the 'principle of derivation'). Alternatively, taxes may also be shared on the basis of absolute amounts or percentages of a given tax yield without reference to the geographical origin. Under such an arrangement a percentage basis has the distinct advantage over a fixed sum in that it guarantees to the states a proportionate share if the tax yield rises as development progresses, and that the states share in increasing revenue in the event of an inflationary upward trend of prices, though it carries the risk of falling income during a slump. Another possible basis for tax-sharing may be compensation of pre-federation revenues in the case of federations by 'aggregation'.

There is an infinite number of bases for grants-in-aid from the federal government. All the various types of grants have their particular advantages and disadvantages. So many strings can be attached to them, and for so many purposes can they be used, that one rightly speaks of a federal grants policy. The 'normal' way for adjusting fiscal imbalances would be unconditional, or 'bloc' grants, although conditional or specific grants to which the states are usually not entitled under the constitution, have also been used for the purpose. The difference between these two types of grants is that unconditional grants are not tied to any particular objective, whereas conditional grants are tied to specific expenditures to be incurred by the recipient states.[2] With regard to the latter the federal government retains the right to ensure that the funds are actually used for the purpose for which they were allocated.[3] There is a third type of grant, which resembles the conditional grant, i.e. the *ad hoc* grant, which is paid to the states to tide over emergencies. However, the emergency nature of this grant clearly makes it unsuited for the purpose of financial adjustment.

Unconditional and conditional grants have their particular merits. The former allow the recipient states complete freedom in allocating the funds among the several possible expenditures. Conditional grants, on the other hand, usually

[1]Examples of percentage surcharges under which the states are permitted to add a percentage to the central tax for their own purpose are given on p. 75.

[2]If the conditions tied to conditional grants are defined in a rather general way, outlining broadly the policies to be followed, they actually resemble unconditional grants. If their conditions are more specific, they present an ideal means to direct and control the activities of the states in certain fields.

[3]A further distinction may be drawn between equalising, or variable ratio grants and matching, or constant-ratio grants. The former aim at equalising differences among the states in the availability of resources by overmatching the expenditure of the poorer states and undermatching that of the richer ones. The latter type of grant is based on the principle that the federal government would contribute a fixed amount of, say, 50% towards the total cost of a specific state service on condition that the state itself bears the remaining expenditure. These grants do not take into account the different stages of development of the various states and tend to increase differences rather than reduce them.

represent extraordinary income and are made in support of certain current state services, such as education, public transport, social security and public health, or large development projects such as the construction of roads and bridges, the development of new lands, and irrigation schemes.[1]

Logically, unconditional grants should form the major portion of any scheme of adjustment, the purpose of which is to make up for the deficiency in own resources for which the states cannot be held responsible. Such 'adjustment grants', made in 'general aid', would allow the states to retain a maximum of financial autonomy. Following the example of the Australian Commonwealth Grants Commission, additional special (unconditional) grants could be given to those states which experience temporary financial stringencies due to no fault of their own.[2] Such grants would then not only have a definite equalising effect but could also be used to compel the recipient states to improve their tax administration and budgetary arrangements.

Specific, or conditional grants provide the federal government with an opportunity to promote balanced economic development without interfering unduly with the autonomy of the states. With their help the centre can raise the standard of certain state services in the more backward states to that prevailing in the more advanced ones. Specific grants in support of state infrastructure projects may help, moreover, to increase the long-term economic prospects of the beneficiary states.

Critics have been concerned about the danger, inherent in conditional grants, that the federal government may use them to exert undue pressure on the states and that they tend to cause waste and extravagance in the spending policies of the states. Moreover, if the subsidised services are pushed up at the expense of other vital functions, this may create imbalance in the services provided by the states and thus increase interstate differences. On the other hand, safeguards against the abuse of conditional grants can successfully be introduced. Extravagance in state spending can be prevented, for instance, by putting an obligation on the state government that it should contribute a certain percentage to the total cost of the project which is being supported by the specific grant. Moreover, despite possible drawbacks, conditional grants also provide the central government with an effective means to overcome constitutional rigidities in all those cases where it wishes to improve the standard, or guarantee a certain minimum standard of some specific state service, or where it is desired to induce the states to introduce new services. They are equally useful where the federal government considers it desirable from the national point of view that two or more states should combine to carry out certain regional development projects, such as the construction of irrigation works and roads falling under the jurisdiction of the states.

The foregoing has given some indication of the various possibilities open to adjust fiscal imbalances. No system of adjustment is likely to employ merely one type of grant. In fact, a combination of tax-sharing arrangements and various conditional and unconditional grants is found in most federations, including Malay-

[1]For examples of conditional grants cf. Bhargava, R.N.: *op.cit.*, pp. 88-95, and Buchanan, J.M.: *The Public Finances*, pp. 493–499.

[2]A typical example are the grants from the State Reserve Fund in Malaysia. Cf. pp. 142 and 148–152.

sia. Where tax-sharing provides for fixed ratios of distribution and where conditional grants are made to assist the states in the implementation of certain services or investment programmes rather than for the purpose of balancing their budgets, the burden of adjustment will fall on the unconditional grants available. To qualify as a 'balancing grant', a grant should be unconditional and flexible and its rate of distribution should be either geared to an automatic device indicating the states' need for resources, or be determined annually by an independent authority.

The system of adjustment fills the 'fiscal gap' between the states' own sources of revenue and their need for resources to fulfil their constitutional functions. The size of this gap depends largely on the degree of tax autonomy enjoyed by the states.

c. *The Degree of Tax Autonomy of the States*

The process of tax centralisation considerably narrows down the degree of tax autonomy retained by the states. The logical outcome of such a continuing process of centralisation would be a system where *all* taxes are collected centrally and where the total tax yield is distributed between the federal and state governments according to a predetermined formula. In actual fact no such high degree of centralisation exists anywhere. Yet, it may be useful to study the implications of such a system and to compare it with other less integrated systems of tax autonomy.[1] Such a study will not only show the relative advantages and disadvantages of a completely centralised tax system but will also suggest a new approach to the whole complex of financial cooperation in a federation.

In this connection it is useful to distinguish between three models. In the first one the taxing and spending powers of each layer of government follow the general line of demarcation of subjects, thus making the distribution of political and fiscal sovereignty more or less congruent. The opposite of this model which, amounts to complete tax autonomy of the states, is the solution mentioned above where the states, though independent under the constitution, are completely dependent on the federal government for their income. In between these two extremes there are a great many compromise solutions allowing the states various degrees of tax autonomy.

(i) *Complete Tax Autonomy:* In a federation where the states may levy taxes at their own discretion, they will always be able to match resources to needs. This has one distinct advantage, namely there can be no conflicts between the state and federal authorities on matters of competency and on the question of financial adjustment. The drawback of complete tax autonomy is that it may lead to harmful duplication and overlapping of the state and federal tax systems. The whole tax structure of the country might become unnecessary complex and confused and the burden of taxation and the benefit of public expenditure may greatly differ from state to state. This may prevent a balanced geographical development of the country as a whole. Industries may gradually shift to those states where tax laws are least oppressive, thereby further enlarging the gulf between the more advanced and the backward regions. Obviously, where the states enjoy complete tax autonomy, the central government would neither have the power nor the means to equalise regional fiscal differences (horizontal adjustment). Nor, would it be able to carry

[1]In connection with the following discussion cf. also Haller, H.: *op.cit.*, pp. 266-272.

out a nation-wide fiscal policy, unless the states would be willing to co-operate with the federal government in this respect.

From the above it follows that the advantages of complete fiscal autonomy of the states and the avoidance of conflicts on the question of fiscal adjustment are dearly paid for.

(ii) *Complete Integration of the Tax System:* The other extreme would be a federation where the constituent states, though autonomous in discharging their functions and in managing their own financial affairs, are completely dependent for their revenue on transfers from the federal government'[1] In this model the central government collects all the taxes. This entails the distinct advantage that there is no scope for duplication and overlapping tax legislation. The system is, therefore, likely to be more efficient than any alternative scheme. At the same time the federal authorities would be able to make full use of taxation as a means to pursue objectives of national economic policy.

The disadvantage of this type of fiscal arrangement is that its success depends on whether a satisfactory formula can be found for the distribution of total revenue between the federal and the state governments. Unlike the government in a unitary state, the federal government cannot disburse the revenue at its own discretion, but must follow a formula which has been established in accordance with the provisions of the constitution. Generally speaking, a quota system need not be inferior to a scheme where the centrally collected revenue is distributed deliberately, provided the ratio of distribution is fixed in such a way that would ensure that the states obtain sufficient revenue to enable them to fulfil their functions, and provided the whole system remains flexible enough to be easily adjusted to changing circumstances.

(iii) *Compromise Models:* Between the above two models there is obviously a wide field for compromise, i.e. for schemes which tends to be either more centralised or grant a high degree of tax autonomy to the states. Tending to be rather centralised would be a system where all revenue is collected centrally and where grant to the states would not consist of a certain proportion of total revenue, but where a ratio of distribution is fixed for each type of tax. If the ratio for each tax was equal, or similar, there would be no advantage in adopting such a system because the final outcome would be the same as if a formula was applied to the total tax yield. The whole structure of distribution could be changed, however, if the revenue of certain types of taxes is distributed according to a predetermined ratio, whereas the revenue of certain other taxes are left entirely to the state governments. Such a system gives greater financial independence to the states than a system where all taxes are collected either centrally, or by the states as agents of the federal government, and where the distribution of total revenue is solely determined by a formula.

A useful alternative would be a system where all taxes are assigned either to the federal or the state governments with the exception of a single highly productive adjustment tax, the revenue of which would be distributed by the federal govern-

[1]A similar dependence on transfers (grants) is also found in unitary states where the central government has to support the various local authorities so as to enable them to perform their functions. In federations, too, local authorities and public and semi-public institutions look to the federal or state governments for financial support. However, whereas local authorities merely act as agents for the superior authority, the constituent states of a federation are assured, under the constitution, of a certain portion of the centrally collected revenue.

ment according to the needs of the states. This solution would minimise the possibility of dispute on the ratio of distribution and would meet with the demands of the states for as large a tax autonomy as possible. The drawback of such a scheme is that the yield of the taxes assigned to the two layers of government need not develop parallel and this may, in the course of time, lead to imbalances in the whole tax structure. To obviate such difficulty it would be advisable to have those taxes the revenue of which is likely to fluctuate easily, administered centrally and to have their yield distributed according to a formula. Admittedly, even then there remains the problem to forecast how the return from the individual tax sources will develop. This difficulty will be especially great if the tax revenue is easily affected by movements in the business cycle. We may add that the far-reaching fiscal independence that the states would enjoy under this scheme would naturally diminish the effectiveness of a federal fiscal policy.

Another solution, similar to that of distributing the total tax yield according to a predetermined ratio, would be a scheme which provides for percentage surcharges which the states are permitted to levy on some of the taxes which the central government collects within their area. Such percentage tax rates are, for instance, added by the communes of Switzerland on to cantonal income and capital taxes. Surcharges represent an additional source of revenue to the state governments. Their practical outcome would, however, be much the same as if the taxes in question, including the surcharge, would have been collected centrally from the start and if their yield was distributed acording to a fixed ratio. On the other hand, if the state governments were free to determine independently the percentage of the surcharge and if, moreover, they were free to levy such surcharges on all federal taxes, then such an arrangement would be almost equivalent to complete tax autonomy. Under this scheme, therefore, the degree of state autonomy (ranging, as it does, from almost complete tax centralisation to almost complete tax autonomy) is dependent, firstly, on the percentage of the surcharges and, secondly, on the type and number of taxes on which the states may levy surcharges independently.[1]

One could think of other ways and means to balance the financial requirements of both layers of government. A scheme, for instance, where the total tax yield is distributed according to a fixed long-term formula could be altered in such a way that the ratio of distribution is determined annually. However, the states may find such an arrangement unsatisfactory because they would not be assured of a stable and independent income. Again, another solution would be a system according to which both layers of government levy various types of taxes in their own spheres of jurisdiction, similar (and subject to the same drawbacks) to the case of complete tax autonomy. The difference would be that the type of taxes each layer may levy would have to be agreed upon between the federal and state governments. A periodic review of the arrangement and a possible shift of certain taxes from one layer of government to the other could ensure that such a system remains sufficiently flexible.

From the foregoing discussion of the various techniques available for settling

[1]Cf. Haller. H.: *op.cit.*, p. 271. Surcharges have also been a feature of the system of taxation of Nigeria and the former Federation of Rhodesia and Nyasaland. Cf. Due, J.F.: "Tropical African Contributions to Federal Finance", in *op.cit.*, p. 55.

fiscal imbalances in federations and of the three models representing the various degrees of tax autonomy, it has become clear that there is a great number of possibilities by which to adjust fiscal imbalances. Most of them will employ federal grants-in-aid in one form or the other. Which technique will actually be made use of depends on the relevant constitutional provisions which, in the case of the newer federations, are often modelled on the experience of the older ones. No method is likely to be completely satisfactory. Each one has its particular advantages and drawbacks.

The size of the adjustment operation will depend on the degree of tax autonomy enjoyed by the states. Where there is a large measure of tax concentration, as this would normally be the case in tight federations, the central government will have to pass on a comparatively large portion of its revenue to the states. Where, on the other hand, the states retain a large measure of tax autonomy, as this will invariably be the case in a loose federation, the financial adjustment between the federal and the state governments will involve only a relatively small portion of the centrally collected revenue.

d. *Federal/State Fiscal Relations under a Centralised System of Tax Administration*

The system under which the states enjoy full tax autonomy (model (i) above) prevents the central government from carrying out an effective fiscal policy. It is especially this aspect which led us to conclude that complete fiscal autonomy of the state is incompatible with the socio-economic functions that a government is nowadays expected to perform. Similarly, one would also have to discourage the adoption of all those compromise systems of taxation which tend to concede too large a degree of fiscal independence to the states.

On the other hand, there are a number of striking advantages attached to the completely integrated system of tax collection (model (ii) above.) It would allow for the greatest possible measure of uniformity, and hence efficiency, in the collection of taxes and would also permit federal government to make full use of the tax system to further the wider objectives of national economic policy. Such a system would not necessarily infringe upon the independence of states if constitutional provision was made for their participation in the centrally collected tax yield.

There remains the practical problem of finding a satisfactory formula for the distribution of total tax yield. This difficulty can, however, be resolved in spirit of cooperation between the federal and state governments and it is well to remember that the same difficulty is also experienced under any other system of federal finance, except for those which are tantamount to complete fiscal independence of the states. On the other hand, if a satisfactory solution to the problem of financial adjustment cannot be found and if, as a consequence, the states cannot properly carry out their functions, then the well-being of the people is likely to suffer more under a completely integrated system of tax collection than under a system under which the states have their own sources of revenue and are, thus, less dependent on transfers from the centre. The harm done by a persistent financial imbalance will, however, also depend on the relative importance of the socio-economic functions performed by the states. The more important these functions are the greater will the damage

tend to be, and *vice versa*.[1]

The trend towards a growing measure of centralisation in the collection of taxes supports the view that the integrated system might offer the ideal solution to the problem of tax collection in a federation.[2] This solution goes beyond that of distributing resources according to the principle of efficiency, or is rather its final inference. The integrated system of taxation would be in perfect harmony with the other features of modern cooperative federalism which is characterised by a close collaboration of the federal and state governments in all spheres of public life. In the era of cooperative federalism the states are required to sacrifice a certain amount of fiscal autonomy which, however, does not necessarily imply an abolition of the principles of federalism.[3]

In a country where taxes are collected centrally and where total revenue is distributed according to a predetermined formula, it would be desirable to protect the interests of the states against possible encroachments by the federal government which might result from its predominant position in the field of public finance and its first grip on the tax yield. Protection could be afforded to the states by means of:

(i) Constitutional safeguards. These would be the normal way of protecting the interests of the states.

(ii) The establishment of an independent body composed of fiscal and legal experts, which would advise the parties concerned on a just and impartial distribution of the total tax yield.

(iii) The establishment of an independent body, composed of competent representatives of the federal and state governments, which would decide on all matters connected with the distribution of total tax revenue and on incidental matters.

The first method is the one which is used in most federations, old and new. Where conflicts arise on any aspect of the federal/state financial adjustment and where these cannot be solved by negotiation, the supreme court of the country will normally be required to pass a judgement. This is, of course, completely in line with democratic principles, although there may be a danger that too much attention is given by a court of justice to purely legal matters and too little to economic and fiscal considerations. For this reason it is felt that the other two methods are more commendable. Especially the last solution would seem to be worth further exploration, because the control of the process of financial adjustment by mixed federal/state authority would place the states in a position to put forward their own views and to participate actively in all deliberations. The states would thus share the responsibility for decisions taken and need not take refuge in the purely negative approach of defending their rights against a too powerful central government. If the proposed

[1]We shall see later that, in view of the limited powers retained by the States of Malaya the orderly development of West Malaysia has been little affected by the failure of the system of adjustment to put state finances on a sound footing. Cf. p. 220.

[2]However, not all writers on federal finance share this view. Groves, e.g., is highly critical of such a proposition as "that the institution of aids (from central governments) is the sovereign remedy to bridge the gap resulting from the alleged fact that the administration of taxes should be centralised much more than responsibility for expenditures". Cf. Groves, H.M. "New Sources of Light on Inter-Governmental Fiscal Relations", in *National Tax Journal*, September 1952, Pennsylvania, p. 234.

[3]Haller, H.: *op.cit.*, pp. 274–275.

body was given the additional power to deal with and decide on all matters of federal/state financial relations, then such an arrangement would make it almost impossible for conflicts on fiscal matters to arise between the federal governments and the states.

The usefulness of an independent coordinating body, established along the lines suggested here, is not confined to the integrated system of tax collection. It is likely to prove equally advantageous under any other federal/state arrangement of collecting and sharing revenue. Nor need the authority advocated here be a permanent institution. It could also be thought of as an inter-governmental commission which would be set up whenever there is a need for it. What would speak in favour of a permanent body is that the accumulation of knowledge and experience is likely to be much easier in the case of a permanent body than in the case of a succession of newly created fiscal commissions.[1]

To put the scheme of centralised decision-making and shared responsibility into practice, politicians will have to overcome a great many psychological and administrative obstacles. The state governments, for instance, may initially be reluctant to accept such a scheme because they may fear that the outside world will get the impression that they have become subordinate to the centre by surrendering the important privilege of collecting taxes. On the other hand, the acceptance of the new approach might prove less difficult in the new federations where politicians are often quite susceptible to new ideas. The new approach may also have a profound influence on most of the other areas of federal/state relations. More inter-governmental institutions might be set up which will not only contribute toward increasing the cooperation of the two layers of government, but which will also raise the sense of responsibility of the states in respect of matters extending beyond their own borders.[2] Decisions made by these bodies would truly reflect the views of all regions. Difficult as it may be to implement the suggested new approach to the problem of federal/state financial relations, it remains a standard which federations might find advantageous to strive for in the course of time.

e. *The Problem of the Ratio of Distribution*

We shall now look into the question of how to determine a fair ratio of distribution for federal grants-in-aid and for federal/state tax-sharing arrangements. It will be recalled that formulae are relevant in the case of most of the schemes of taxation—stretching from those tending to be highly centralised to those giving almost full, but not complete tax autonomy to the states—which depend for financial adjustment on tax-sharing or on some form of balancing grant.

Formulae have probably more often been the outcome of political bargaining rather than of the application of scientific principles.[3] The share of the states in the

[1]Cf. Prest, A.R.: *op.cit.*, p. 155.

[2]Quite a number of such inter-governmental institutions have, in fact, been established in recent years particularly in the newer federations. For more details cf. Watts, R.L.: "Comment" (on Inter-governmental Financial Relations in New Federations), in Hicks, U.K. and others: *op.cit.*, pp. 138–142.

[3]Birch reports that in Canada where the provinces derive a very substantial portion of total revenue from federal subsidies, success in bargaining with the federal government is one of the main criteria by which provincial politicians are judged. Cf. Birch, A.H.: "Inter-governmental Financial Relations in New Federations", in *op.cit.*, p. 115.

centrally collected revenue should, obviously, have some definite, relationship to their actual requirements and the ability of the central government to part with a portion of its revenue. In practice, however, factors such as the political power of the states and their ability to convince the federal authorities of their needs have certainly also an important bearing on the question. In fact, one may assume that in most federations ratios of distribution have been the outcome of negotiations on the political plane or, where the constitution provides for some formula, of previous hard bargaining between the two layers of government.

A purely political approach to the question of the ratio of distribution is unsatisfactory from the point of view of the economist. He would like to see the application of some impartial scientific criterion for determining the 'need' of the states for federal grants. This criterion would have to be based mainly on the functions performed by the states and would also have to take into account differences in the tax capacities of the states. Both these factors are closely related to interstate differences in respect of population, geographical features and the general level of development. Only if all these aspects are taken into consideration, can the adjustment operation fulfil its objective with regard to federal/state (vertical) and interstate (horizontal) imbalances, provided the correction of the latter type of imbalance is a goal of government policy.[1]

The relevance of population as criterion is obvious because public expenditure benefits people and not governments or geographical areas. In fact, in a country where all the regions have reached more or less the same level of development, and where there are only minor interregional differences with respect to the distribution of wealth and income, the criterion of population alone may even suffice.[2] Such a situation might occur in some of the advanced federations. Small differences in the standard of certain state services may here easily be removed by means of special conditional grants. In the new developing federations, on the other hand, where one usually meets with considerable interstate divergencies in the availability of exploitable resources and the level of development, the other criteria mentioned above cannot be ignored.

The practical difficulty of finding a satisfactory standard for measuring the states' need for financial support from the centre is substantial, the more so as the criterion should be simple, clear and impartial, leaving little or no room for interstate jealousies or for political bargaining. Various indices have been suggested, such as local variations in the cost of performing state services and the ability of the states to finance them, or per capita state revenue and expenditure figures. However, whereas the former criterion is ambiguous if one tries to apply it in practice, the

[1]The Indian Nehru-Adarkar Report recommended that in allocating grants "the fullest consideration will have to be given to all relevant factors, including the size of the population, the wealth of natural resources, the existing backwardness of the areas concerned, the geographical density of population, the per capita income and wealth of the peoples of the Provinces, and their basic needs". Nehru, B.K. and Adarkar, B.P.: *Report on the Australian System of Federal Finance and its Applicability to Indian Conditions*, New Delhi, 1947, para. 83. Those countries which make use of conditional grants as a means of financial adjustment (as, e.g., the USA) will also have to employ other criteria such as assessed values, the number of school-age children, the number of hospital beds per thousand of population, road milage, etc., depending on the conditions attached to the grants.

[2]Cf. Sastri, K.V.S.: *op.cit.*, p. 132.

latter proves unreliable because of the possible inefficiency of the financial administration of some of the states, resulting in a waste of resources. Moreover, although the more advanced states may be able to tax more and to provide better services, the poorer states may be forced to tax more heavily in order to be able to maintain certain minimum standards of state services. The latter states may also have to provide certain services which need not be undertaken by the richer ones where the people may be able to provide these services themselves. Hence, there is not necessarily a direct relationship between the need for the states and their per capita state revenue and expenditure figures.[1]

In view of the above difficulties, per capita income figures are considered the most satisfactory standard for measuring the need of the states for financial relief from the federal government. The main reason for commending this criterion is that it is a simple and workable one which, simultaneously, indicates fairly reliably the degree of economic development of the various regions. This holds true of agricultural and industrial production as well as of the degree to which natural resources are being exploited. Where economic activity is higher, per capita income, too, will be higher, and *vice versa*. The defect of per capita income as an indicator of need is that it ignores differences in the cost of living and in the distribution of wealth. Where city-states are members of a federation as, for instance, Singapore during its membership of the Federation of Malaysia, they are likely to have much higher per capita incomes than the other states the economies of which are largely dependent on less remunerative agricultural activities. Yet, it would be wrong to judge the need for support of these city-states only from the point of view of per capita income. There may exist a small but very wealthy class of businessmen and professionals, whereas the actual need of the mass of the population may be even more pressing than in the other regions because of the high cost of living in the city.

A more fundamental drawback of per capita income is that developing federations with their poorly developed statistical services may be unable to establish reliable income figures for the various regions. National accounts data for the country as a whole are often based on crude estimates and a breakdown according to states would be nothing but guesswork. Yet, this difficulty is not so formidable that it could not be overcome in the course of time. Reliable statistical services are of utmost importance to any kind of development planning and bilateral and multilateral foreign technical aid has been successful in substantially improving these services in federations such as India and Malaysia.

In view of the many corrections and adjustments that would be necessary to make the other possible indices of needless arbitrary, it would appear that the deficiencies of the standard of per capita income do not weigh so heavily as to justify discarding this simple and relatively easily established criterion. Together with the size of the population of the states, per capita income will furnish a fairly reliable picture of the states' real needs. Allowance should, however, also be made for the relative sparseness (or density) of the population because a sparsely populated state will, for instance, need more miles of road per head of population than a more

[1]Cf. Bhargava, R.N.: *op.cit.*, p. 87. Cf. also the discussion, on pp. 131–133, of interstate fiscal differences in West Malaysia and their relation to the economic development of the various states.

densely populated one. Similarly, the cost per head of social services tends to vary inversely with the density of population.

4. *Periodic Reviews of Federal/State Financial Relations and the Settlement of Conflicts*

a. *General Principles*

Clashes of interest between the federal and state governments over fiscal matters cannot always be prevented. This is not surprising because the financial provisions of the constitutions are often all but clear and because they do not always keep pace with new developments. Conflicts usually centre around the division of resources and the method employed, or the amount involved, in the intergovernmental financial adjustment. There may also be fields of overlapping jurisdiction in respect of functions and resources which require clarification. Where the conflict is about the legal interpretation of the constitution or ancillary financial legislation, the supreme court of the country would obviously be the final authority to be consulted. Supreme legal authorities exist in all federal countries and experience has shown that they have worked independently and fearlessly in almost all federations.

On the other hand, not all financial controversies originate from purely legal matters. This is especially so in the case of the intergovernmental financial adjustment where the relevant stipulations are often vague and need further interpretation. Here a great measure of flexibility would be desirable in view of the difficulty of establishing satisfactory criteria for determining the states' need for financial assistance. There is, moreover, a necessity for periodic reviews of the whole system of federal finance in order to adjust it to changing circumstances. Consideration will have to be given in this context to new theoretical knowledge and to past experience. All these matters have far-reaching economic and financial implications and are not really suited to be dealt with by lawyers alone. This is true also whenever new functions or new types of taxes have to be assigned to either the federal or the state governments.

It is clear, therefore, that not all controversies and fundamental decisions on the relationship between the central and state governments can be solved merely on the basis of legal considerations. What is really needed is an independent authority, or court (rather than a commission of enquiry appointed at certain intervals, because such a commission might be inappropriate to settle major questions of policy)[1], composed of legal and fiscal experts as well as economists, who would be empowered to pass judgement, or to arbitrate on any matter of federal/state financial relation referred to it. Determinations should be final and neither layer of government should have the right to reject or alter them, otherwise political bargaining will reappear. The exact composition of the authority would have to be determined by agreement between the federal and state governments. It should, however, comprise of experts in the field of public finance, national economic planning and state law, and should work independently, i.e. without any bias in favour of either the federal or state interests. Bhargava suggests that it would be a wise safeguard to provide that the chairman be a member of the country's supreme

[1]Cf. Hicks, U.K.: "Epilogue", in Hicks, U.K. and others: *op.cit.*, p. 165.

judicial authority and that the other members be appointed for life.[1]

In the course of reviewing, at regular intervals, federal and state finances from the point of view of efficiency and economy, and in the light of improved knowledge and understanding, the coordinating body would also have to examine the practice of fiscal adjustment in order to ascertain whether its working is satisfactory from the national point of view. This will include an examination of the aspect of horizontal adjustment in the light of the government's policy regarding interstate inequalities.

A body with such far-reaching powers does not yet exist anywhere. But periodical reviews of federal/state financial relations have been carried out in most developed and developing federations. Provision for regular reviews by special commissions of enquiry has, for instance, been made in India where a Finance Commission is appointed every five years to report inter alia on:[2]

(i) the distribution between the Union and the states of the net proceeds of taxes which are to be, or may be, divided between them...and the allocation between the states of the respective shares of such proceeds;

(ii) the principles which should govern the grants-in-aid to the states out of the Consolidated Fund of India; and

(iii) any other matter referred to the Commission by the President in the interest of sound finance.

In the former Central African Federation provision was made for official inquiry into the working of public finance at least every four years,[3] and also in Nigeria, to mention a third example, fiscal commissions have become a regular feature.

b. *The Australian Commonwealth Grants Commission*

We do not propose to analyse the various arrangements by which the older and newer federations have tried to coordinate federal/state financial relations.[4] Laudable efforts have been made by most of the newer federations to find some solution to the question of coordination not only of finances, but also of national economic planning, social services, etc. Most of the institutions established for the purpose of coordinating federal and state finances have been inspired by the model of the Australian prototypes, namely the Australian Commonwealth Grants Commission and the Loan Council. In the following paragraphs we shall discuss the most important functions of the former institution. The working of the Australian Loan Council will be described later in connection with the public debt and federalism.[5]

The Commonwealth Grants Commission was established under the Commonwealth Grants Commission Act of 1933 and is an independent and impartial body composed of three members. Its objective is to determine the amount of special grants made by the Commonwealth government to those states which have applied for them. More specifically, the objectives of the Commission are to inquire and to

[1]Cf. Bhargava, R.N.: *op.cit.*, p. 84.
[2]Cf. *ibid.*, p. 118.
[3]Cf. Garmany, J.W.: *op.cit.*, p. 55.
[4]For a detailed description of fiscal coordination and experience in the older federations cf. Singh, B.: *op.cit.*, Chapter V, pp. 92–115. Cf. also Watts, R.L.: *op.cit.*, pp. 138–142.
[5]Cf. pp. 159–161.

report on:[1]

(a) applications made by any state to the Commonwealth for grant by the Parliament of financial assistance in pursuance of Section 96 of the Constitution;[2]
(b) any matter relating to grants of financial assistance made in pursuance of that Section by the Parliament to any state, which are referred to the Commission by the Governor-General; and,
(c) any matters relating to the making of any grant of financial assistance by the Parliament to any state in pursuance of that Section, which are referred to the Commission by the Governor-General.

The Grants Commission examines applications for grants and, after thorough investigation of the financial position of the state concerned and of aspects such as economy in expenditure and the state's effort to increase its own revenue, makes recommendations to the Federal Government according to criteria such as the population figure of the state concerned and certain fluctuations in average wages. The main consideration has initially been compensation for disabilities arising from federation. From 1936 onward financial need has been adopted as the decisive criterion. The adoption of this indicator for the allocation of grants has been explained by the Commonwealth Grants Commission in the following terms:

"Special grants are justified when a State through financial stress from any cause is unable efficiently to discharge its functions as a member of the Federation, and should be determined by the amount of help found necessary to make it possible for the State, by reasonable effort, to function at a standard not appreciably below that of the other States."[3]

Whereas the principle of financial need has been applied during the last two decades as the basis of all decisions of the Commission, the methods to determine the actual needs of the states have been varied from time to time so as to give better effect to the principle.[4] The present method employed for calculating the total amount of grants to each claimant state (which was adopted for the first time in 1950) provides that the payment to the states be composed of two parts, known as the 'first part' and the 'second part', respectively, and that the following procedure be followed:

(a) A budget standard for the year of review is adopted on the basis of the accounts of non-claimant states for that year.
(b) On the basis of the accounts of a claimant state for the year of review, an assessment is made of the financial assistance which would have been required to enable that state to reach the budget standard adopted for that year; due allowance is being made for differences in the levels of certain revenues and expenditures.
(c) The amount thus assessed is then compared with any advance payment made to the claimant state under *(d)* below in the year of review. The difference, posi-

[1]Cf. Campbell, W.J.: *op.cit.*, p. 93.
[2]Section 96 of the Constitution makes provision for Parliament to "grant financial assistance to any State on such terms and conditions as the Parliament thinks fit". Commonwealth Bureau of Census and Statistics: *Year Book of the Commonwealth of Australia, No. 51, 1965,* Canberra, p. 19.
[3]Australia: *Third Report of the Commonwealth Grants Commission of Australia (1936)*, p. 75.
[4]For a detailed discussion of the methods which have been applied by the Commonwealth Grants Commission since 1936, cf. Singh, B.: Appendix *op.cit.*, B., pp. 134—141.

tive or negative, presents the first part of the grant recommended.

(d) A tentative estimate is then made of the assessed grant for the year of payment.

From this estimates an amount is deducted which, in the opinion of the Commission, is a reasonable margin of safety to cover the possibilities that:

(i) adjustments in respect of certain revenues and expenditures for the year of payment may later be found to differ substantially from those made for the year of review;

(ii) adjustments not made for the year of review in respect of levels of other revenues or expenditures may be found to be necessary when the year of payment becomes the year of review; and

(iii) unpredictable changes take place in the finances of a claimant state during the year of payment.

The balance left after providing for a margin of safety, is the 'second part' of the grant recommended. This second part, however, is an advance payment which is to be deducted, as described in *(c)* above, from the assessed grant for the year of payment when that year becomes the year of review.

(e) The total grant recommended is the 'second part', determined as explained in *(d)*, plus or minus the positive or negative 'first part' determined as explained in *(c)*.

The procedure, though rather involved, has worked very satisfactorily and the recommendations of the Commission have been adopted every year by the Commonwealth Parliament without alteration. Unfortunately, however, the Grants Commission has had only a limited influence on Commonwealth/state financial relations. The Commission has not been able to solve the problem of substantial interstate differences in the level of services rendered by the states and in the standard of living.[1] This is so because, firstly, the Commission's recommendations are limited to grants to claimant states or, expressed differently, it cannot recommend grants to those states which have not submitted claims. During the period of 1960—1964, for instance, only two states out of six—Western Australia and Tasmania—received special grants.[2] The states of New South Wales, Victoria and Queensland, on the other hand, have so far never applied for such grants. Secondly, the amounts involved in the grants recommended by the Commission are very small if compared with the total amount of grants allocated to the states. In 1963—1964 they amounted to only 2.2% of the amount of grants and to a mere 1.25% of the total receipts of the states.[3]

5. *Summary*

The most important finding of the foregoing discussion of federalism and an efficient fiscal administration has been the adoption of efficiency as the chief criterion for the division of functions and resources. The criterion should, however, not be the exclusive guiding principle. Other considerations affecting the wider interest of the national economy must also be taken into account. Historically the division of

[1]Cf. Commonwealth Bureau of Census and Statistics: *op.cit.*, tables p. 940.
[2]Cf. *ibid.*, tables pp. 918–919 and 921.
[3]Cf. *ibid.*, tables pp. 918 and 931.

functions and resources has in almost all cases depended on expendiency rather than on the application of any rational principle.

It is unlikely that both layers of government will collect exactly that amount of revenue required to discharge their respective responsibilities and duties. Fiscal imbalance ('non-correspondence') is a feature of all federations. In general it is found that the federal governments have more funds than functions and the states more functions than funds. Fiscal adjustment which includes both the adjustment of horizontal and vertical imbalances, is mostly effected by means of grants and tax-sharing arrangements whereby the size of the adjustment operation depends mainly on the degree of tax autonomy retained by the states. Unconditional grants as a means of adjustment do not interfere with the fiscal autonomy of the states. Conditional grants, on the other hand, enable the federal government to exercise control over the extent and quality of state services, and over state development expenditures. Such control may be desirable in the interest of nation-wide uniformity and equality. Where the system of adjustment is made up of a whole spectrum of tax-sharing arrangements and conditional grants, it will be necessary to have one or more powerful 'balancing grants' for adjusting marginal imbalances. In addition, it would be a great advantage if specific *ad hoc* grants were available to states suffering from temporary financial pressure through no fault of their own.

The success of any system of fiscal adjustment depends largely on the formulae chosen for the distribution of grants and allocations under tax-sharing arrangements. In determining the ratio of distribution, the size and density of the population and per capita income would appear to provide the most satisfactory criteria indicating the financial need of the states. Per capita income may be taken to be a fairly reliable indicator of the relative wealth or proverty of a state. As a general rule, the amount of federal aid should vary directly with the size of the population of the states and inversely with per capita income, whereby some allowance should be made for the relative sparseness of the population. The weighing of these factors will vary from country to country and requires periodic review to allow for changing circumstances.

Clashes of interest between the federal and state governments over fiscal matters and especially the system of adjustment cannot always be excluded. Conflicts other than purely legal ones should be arbitrated by an independent and impartial court or authority composed of legal and fiscal experts as well as economists. There should also be provision for regular reviews of federal/state financial relations by an independent body in order to adjust them to changing circumstances.

CHAPTER III

Fiscal Policy and Public Debt in Developing Federations

A. FEDERALISM AND FISCAL POLICY IN DEVELOPING COUNTRIES

The major objectives of the economic policies of underdeveloped countries have been mentioned earlier.[1] They culminate in the objective of rapid economic growth to which the other goals, such as full-employment, a reduction of the inequalities in income distribution and balanced growth, important though they are, are subordinate. Also in federations, where equality in opportunity, if not in wealth, is a popular demand, the goal of rapid development commands such a priority that there are instances where a policy of equalisation has to be set aside, for the benefit of growth.

Fiscal policy does not follow any independent objectives of its own. It is rather one of the most important instruments of general economic policy which can contribute significantly to promote rapid growth. In the following discussion we shall trace the opportunities of fiscal policy to promote growth and, at the same time, indicate where these opportunities are in conflict with the goal of interstate equality. Finally, we shall analyse the implications of a federal structure of government on the implementation of an effective fiscal policy, and indicate how developed and underdeveloped federations overcome possible complications in the design and implementation of policy due to the operation of various independent government administrations and fiscal systems.

1. *The Opportunities of Fiscal Policy in the Process of Economic Growth*

a. *The Major Problems of Economic Growth*

There are as many theories on how to achieve a satisfactory rate of growth as there are different interpretations of the nature of the process of growth. Most economists agree, however, that the low income—low investment vicious circle is at the root of the problem. It is argued, therefore, that the solution to the problem of growth in the backward countries lies mainly in raising their low level of investment.

Economic policy should, however, not only concentrate on aggregate investment in the form of fixed capital as the main generator of income and employment, but

[1] Cf. p. 24.

also on the composition of investments. It has been increasingly realised that investment in economic and social overheads and especially in human capital in the form of health and education, including vocational training, is a prerequisite of development and yields high dividends eventually. Since the amount and composition of aggregate investment is only one facet of the process of growth, the rate and pattern of saving being the other, the government will also have to promote saving in its various forms. In a country where a large sector of the economy remains non-monetised, where institutional facilities for savings and investments are inadequate, and where savings are frequently misdirected into undesirable channels, the obstacles which have to be overcome can be formidable.

The governments of developing countries are thus not only called upon to play a positive and stimulating role in almost all areas of economic activity, but the break-up of the vicious circle of low income—low rate of saving and, hence, low rate of investment, will necessarily be at the centre of policy making.[1] This suggests that the government, through a policy of vigorous monetary and fiscal management, should attempt to appropriate the largest possible slice of the national income for financing the various types of investments in both the public and private sector.

The process of structural adjustments, which is necessary if the flow of resources is partly to be diverted from consumption to investment, will not be a smooth and frictionless one. For, if the rate of capital formation is to become self-cumulative, it has to be substantial, which means that a correspondingly smaller proportion of a rising output will be available for current consumption.[2] In developing countries, the impact of a rise in money incomes generated by increased investment activities is likely to fall most heavily on locally manufactured and imported consumer goods and foodstuffs, the income elasticity of demand for which is usually high whereas their supply is limited. There is also the increased need for imported skills and capital goods for the development effort, as well as the difficulty of raising exports and substituting imports. All these factors work in the same direction and are responsible for the familiar pattern of inflationary pressure and balance of payments difficulties which are found in almost all developing countries. Economic policy, moreover, usually favours certain branches of economic activity more than others and this may easily lead to maladjustments among the various sectors of the economy. A typical example of this is the feature of a lagging agricultural sector.

The list of problems with which developing countries are faced need not be further enlarged, but it is important to state that monetary and fiscal policy, together with physical controls, where appropriate, are well suited to *(i)* bring about the desired increase in the rates of saving (usually at the expense of private consumption) and productive investment; and, to (*ii*) combat those difficulties which are invariably bound up with the pursuance of a policy of economic growth, i.e. inflationary pressure; balance of payments difficulties; an imbalance in the development of the various sectors of the economy; and, an unequal distribution among the members of the society of the burdens arising from the development effort.

[1]Heller, W.W.: "Fiscal Policies for Under-developed Countries", in Bird, R. and Oldman, O. ed.: *Readings on Taxation in Developing Countries,* Baltimore, 1964, pp. 4–7.

[2]Cf. Deshmukh, C.D.: *The Balance between Monetary Policy and other Instruments of Economic Policy in a Developing Economy,* lecture published by the Per Jacobsson Foundation, Washington, 1965, p. 18.

b. *The Instruments of Economic Policy and their Role in Stimulating Growth*

i. *Monetary Policy*

Although not always as effective as fiscal policy and physical controls, monetary measures are more flexible and easier to apply. In advanced countries monetary policy includes (*i*) the manipulation of the rate of interest and measures affecting the liquidity of the banking system, (*ii*) the control of international capital movements, (*iii*) measures affecting the lending activities of other (i.e. non-banking) financial institutions, and (*iv*) the control of capital issues. Unfortunately, these measures are often not suited to deal with the problems facing developing countries where an appropriate money supply is a necessary but not sufficient condition for economic growth.[1] The extent to which these countries will react to monetary measures will mainly depend on the level of their economic development. However, most underdeveloped countries still have a large traditional sector which is not susceptible to changes in the supply of money, and there are no excess capacities in the modern sector which could be brought into the production process if aggregate demand was raised.[2] Consequently, the expansion of credit with a view to raising the real national income would normally lead to outright inflation.

There are other more technical aspects which may obstruct the efficacy of monetary policy in developing countries. The absence of a near perfect capital market and the openness of the banking system are likely to make manipulations of the rate of interest, selective credit controls and open-market transactions less effective. Monetary measures may also fail in bringing about stability in the external account where pressure is due not only to an excess domestic demand but also to structural imbalances resulting from the policy of boosting industrialisation and the priority given to the large-scale importation of capital equipment.

It would appear, therefore, that the usefulness of monetary policy in attaining the major goals of general economic policy is rather limited in developing countries and that this deficiency puts greater emphasis on fiscal policy.[3]

ii. *Fiscal Policy*

The management of the economy by varying the size and the structure of taxation,

[1]For a detailed discussion of the reasons why an expansion of effective demand through deficit financing and a policy of cheap money fails to stimulate economic activities in developing countries, but tends to lead to inflation, cf. Rao, V.K.R.V.: "Investment, Income and the Multiplier in an Underdeveloped Economy", in Agarwala, A.N.: *The Economics of Underdevelopment*, Bombay, 1960, pp. 205–218. Cf. also Chelliah, Raja J.: *Fiscal Policy in Underdeveloped Countries*, London, 1960, pp. 30–38.

[2]The paradox in developing countries is that although there is an excessive pressure of population both on the countryside and in the towns, leading to open and disguised unemployment, the factor of production 'labour' remains in short supply because of the shortage of skilled personnel. Complementary factors of production that have to be imported, especially capital equipment and raw materials, also set narrow limits to an expansion of output.

[3]Despite the limitations mentioned, monetary policy has to play an important role in developing countries in the progressive institutionalisation of savings and investments and in the ensuing dispersion and differentiation of financial assets among all layers of the economy. The establishment of a modern and efficient banking mechanism, operating on the simple and objective criterion of maximum profit, would ensure a growing accumulation of financial assets and an efficient allocation of investible resources, and thus contribute more

public expenditure, public debt, and government funds, has the advantage that these measures operate more selectively and hence more effectively than monetary measures. The drawback is that their application is often rather cumbersome because of the slow working of the government machinery and the parliamentary approval needed if tax rates or the pattern of public expenditure are to be altered.

One may also argue that the availability of fiscal measures in itself is no guarantee for their satisfactory management in developing countries where politicians and administrators often lack the necessary know-how and integrity, and where the activity of the government is less effectively checked by a strong opposition and an influential press than is the case in the more advanced countries. Yet, these arguments relate to administrative defects. They cannot really question the potential of fiscal policy in developing countries as an instrument of national economic policy for (*i*) diverting the flow of resources from the consumption to the investment goods sector; (*ii*) encouraging the flow of investment into the most desirable channels; (*iii*) mitigating extreme income differences; and, (*iv*) combating structural imbalances in the economy resulting from the development policy itself.

An aspect which limits the usefulness of fiscal measures in developing countries has been mentioned under the previous subheading, namely the fact that an expansive monetary policy—and this includes a policy of sustained budget deficits—is unlikely to stimulate production. This is so because of the various bottle-necks—lack of skilled labour, capital equipment and raw materials—which are likely to be encountered once aggregate demand is raised. An increase of total aggregate demand in excess of the rise in real national income would probably soon lead to price rises.[1] The importance of this deficiency should not be overrated, however, because of the possibility offered by fiscal policy to raise the ratio of savings to national income and, thus, to make available a larger flow of resources for economic development in the public and private sector.

As to public sector investment, the amount of savings which has to be diverted from private individuals to the government will depend largely on the role the government plays in the economic development of the country; whether it confines itself to establishing the infrastructure, leaving directly productive investment to the private sector, or whether it wishes to participate in opening-up of resources and in the establishment of industries. Whatever the degree of government interference, one may safely assume that even if the government's programme of economic activities was interpreted restrictively, there would be a heavy demand for public funds which would invariably tend to exceed by far the amount of savings which the community would normally be able to accumulate.

This then justifies what has been termed 'compulsory saving', or 'socialisation of saving', i.e. the use of the proceeds of taxation to finance accelerated government investment expenditure. Compulsory saving has today become probably the most

---

indirectly towards development.

[1]Newlyn, on the other hand, points out that where a developing country experiences exceptional movements in export prices, it may offset the detrimental effects on the economy through a budgetary stabilisation policy. Cf. Newlyn, W.T.: "The Role of Fiscal and Monetary Policy", in Hicks, U.K. and others: *op.cit.*, p. 98. Silcock suggests that in Malaya taxation policy and a policy of budgetary surpluses have been used at times to offset the effects of booming rubber prices. Cf. Silcock, T.H. and Fisk, E.K., ed.: *op.cit.*, pp. 257—258.

popular method in developing countries for financing government development expenditure. Yet, it is not without disadvantage and it needs proper understanding and judgement to determine to what extent taxes can be raised in excess of what is needed for current government expenditure. For heavier taxation, as implied by a programme of compulsory saving, is likely to impinge upon the private sector with adverse effects on private saving and investment, and the supply and effectiveness of private entrepreneurship, and thus on economic growth in general.[1]

In their effort to raise funds for current and development expenditures, developing countries will initially at least largely rely on indirect taxes—import, export and excise duties.[2] This is so because the collection of indirect taxes usually presents less administrative difficulties than the raising of direct taxes which presupposes the existence of a fairly well developed monetised sector. However, with increasing economic development, direct taxation is bound to become a major source of revenue. Profits of public enterprises represent another potential source of saving. As far as these enterprises cannot be classified as public utilities, they should be managed along commercial principles not only to minimise possible detrimental effects on private enterprise, but also to allow them to increase their profits through rational pricing policies so as to generate funds for reinvestment and for the establishment of other public sector undertakings.

Besides the raising of revenue for public current and investment expenditure, taxation is potent instrument for regulating the investment activity of the private sector and for directing resources into the desired channels. The measures available to the treasury to encourage what it considers the desirable type of investment, at the right place and time, and to curb what it believes to be inessential investment, include a wide range of measures such as liberal allowances for depreciation, temporary exemption from taxation of profits earned by new enterprises (tax holidays), the exemption from taxation of reinvested earnings, tariff protection and preferential government buying of locally manufactured goods. Less frequent are outright subsidies to new industries. Where resources for certain desirable large-scale private sector investments have not been readily available, governments also frequently assist by supplying the whole or part of the capital requirements through state development corporations or investment banks.

Private saving is nowadays also frequently promoted through fiscal measures. Personal saving, can be encouraged, for instance, through tax allowances for life insurance premiums, or the exemption from tax of interest earned from government bonds or certain equity investments. Taxation of consumption would be a more

[1]Those who advocate compulsory saving (often for political rather than for sound economic reasons) easily overlook that compulsory saving, as in fact any kind of taxation, merely represents a transfer of funds from the private sector to the government and not an increase of total resources. Taxes are bound to reduce the taxpayer's real income. Whereas a reduction of the taxpayer's consumption is generally desired, any reduction of income will also reduce private saving, and probably proportionally more than consumption, Cf. United Nations, Department of Economic and Social Affairs: *Planning for Economic Development*, New York, 1963, p. 49.

[2]According to Adler, low income countries derive almost 30% of their total revenue from taxes on exports and imports while in advanced countries the comparable figure is 11.5%. Cf. Adler, J.H.: "Fiscal Policy in a Developing Country" in Bird R., and Oldman, O., ed.: *Readings on Taxation in Developing Countries*, Baltimore, 1964, p. 35.

indirect method to attain the same end.[1]

Where large inequalities of income and wealth exist, as it does in most developing countries, taxation policy is the most appropriate means to ensure a more equitable distribution of a rising national income. To what extent inequalities should be reduced will depend partly on the social outlook of those in power and partly on economic considerations. For the heavy taxation of the high income groups may inhibit their incentive to work and save. It does not necessarily contribute towards increasing the flow of aggregate saving since the wealthy would in any case have saved part of their surplus funds. On the other hand, the affluent classes of developing countries are often prone to indulging in conspicuous consumption and unproductive investment so that a steeply progressive income taxation may not only tend to reduce glaring inequalities of income and wealth and thus help to create healthier social conditions, but would also prevent resources from being deflected from productive investments. From an economic point of view progressive taxation of high income and wealth is justified up to a point where the weakening of incentives to effort and saving tend to reduce production and income.[2]

Finally, fiscal policy presents itself as a powerful weapon for the restoration of balance in those sectors of the economy which are likely to suffer from disequilibrium as a result of a policy of economic development. Most important can be the contribution to solving the vexatious problem of achieving viability in the balance of payments. Exports may be promoted by subsidies to reduce production cost or by tax rebates for export-intensive industries.

The levying of export duties on certain traditional export commodities, the foreign demand for which is insensitive to price changes, may help to prevent a loss of foreign exchange if the terms of trade tend to worsen. On the import side, fiscal policy may be an effective means to regulate the amount and pattern of imports. High import duties on non-essential and luxury commodities may not only save valuable foreign exchange, but also tend to encourage domestic saving. Tariffs as a means to protect infant industries have been used with varying success by almost all developing countries and only a few of them can afford to dispense with a selective tariff policy that discriminates in favour of capital goods and essential raw materials.

iii. *Physical Controls*

An optimum operation of monetary and fiscal measures presupposes an environment where the market is perfect, or nearly perfect, and where there is a free flow of factors of production. Under such conditions changes in the monetary and fiscal pattern will either raise the price incentive for desirable investment or the price disincentive for undesirable consumption. Even near perfect market conditions are often non-existent in developing economies. Consequently, where the price mechanism remains insusceptible to the influences of monetary and fiscal measures, the government may have to resort to physical controls in order to direct scarce resources into the desired channels and to avert serious imbalances in the national

[1]Cf. United Nations, Department of Economic and Social Affairs: *Planning for Economic Development*, New York, 1963, pp. 49 and 67–70.

[2]Cf. Heller, W.W.: *op.cit.*, p. 14.

economy.

Quantitative controls usually form an integral part of the import policy of developing countries because where capital goods, essential skills and raw materials have to be imported on a large scale to support development programmes and where the income elasticity of demand for imports is high, the government cannot risk allowing imports to be regulated by price considerations alone. Another typical example of physical controls would be price controls which often supplement monetary and fiscal measures in an attempt to stabilize prices. On the other hand, physical controls are not an unmixed blessing. Not only is a high level of expert knowledge and managerial skill required to draw up a workable and efficient system of controls, but its effective and impartial day-to-day implementation is a problem which puts great strain also on the administration of advanced countries.

2. *The Implications of a Federal Structure of Government for Fiscal Policy*

a. *Equality and the Allocation of Resources*

Fiscal policy does not follow any independent objectives of its own but rather derives its aims from the guidelines laid down in the country's general economic policy. Accordingly, the major implications of a federal structure of government for fiscal policy in developing countries should be basically the same as those which we met before when discussing the impact of federalism on the aims of a national economic policy and on public administration.[1] Here again the central issues are those of equality and efficiency.

Within the scope of fiscal policy the problem of equity presents itself mainly in two different respects, namely:

(i) the benefit of fiscal policy measures aiming at a diversion of resources from consumption to investment will usually not be the same for all the constituent states; and

(ii) the equalisation through taxation of extreme differences in the wealth and income of individuals will tend to reduce interstate inequalities.

The first point is obvious because the various fiscal measures which encourage the flow of private investment into channels considered most desirable from the point of view of national economic policy, will influence the actual investment activities taking place in the various states. Most fiscal measures—apart from direct subsidies to certain existing industries and where benefits accrue to companies holding monopoly positions in their field—do not by themselves differentiate in their application between the various states. Yet, they are likely to benefit some states more than others because entrepreneurs cannot afford to ignore the natural advantages which certain areas have over others. They will choose those localities for investments where returns are most promising. Consequently, although most fiscal measures are by themselves geographically 'neutral', they tend, in actual fact, to foster economic activities and the establishment of new industries in the more developed regions and in existing growth centres, and thus tend to aggravate interstate differences in the level and rate of development rather than mitigate them.

The second point is related to the progressive taxation by the federal government

[1] Cf. pp. 26–34.

of income and wealth, and luxury consumption, inasmuch as this mainly affects the rich who prefer to live in the more developed states. The equalisation effect of such taxation would be immediate. Yet, there are certain limits to the extent to which interstate differences can be equalised through the taxation of individuals because of the detrimental effects which such taxation might have on private saving and the supply of effort. There are also the practical administrative difficulties (e.g. corruption and tax evasion) which the taxation of the rich presents in developing countries. Any direct geographical discrimination in respect of tax rates was ruled out earlier because of legal difficulties and the danger of a shift of economic activities to those states where the tax burden was least.[1]

b. *Federalism and the Formulation and Implementation of Fiscal Policy*

The other major source of conflict between federalism and fiscal policy concerns the formulation and implementation of fiscal policy. For, if the federal government is to be responsible for a country's economic policy it should also have full control of the most important instruments of economic policy. It should have the right to wield monetary and fiscal weapons on a nation-wide basis and to make use of physical controls whenever this becomes necessary.

Monetary measures present little difficulty where all the units of a federation share a common currency and where its management is the joint responsibility of the federal treasury and the central bank. Physical controls, too, are usually no problem, especially where they are concerned with maintaining stability in the external account, because they would then be applied under the tariff legislation which would normally be a federal matter. This leaves us with fiscal policy the limitation of which, in a federal setting, are real both in developed and underdeveloped countries. For obvious reasons the effectiveness of fiscal measures is dependent on their uniform application throughout the country. This condition is not fulfilled in a country where more than one constitutionally independent fiscal system operates. The possibility of conflicting policies will be greater where the states enjoy a large measure of fiscal autonomy and less where the fiscal system tends to be more integrated.

As to a federal stabilisation policy, the larger the share of central government spending in total public expenditure, the greater its influence on the nation's aggregate demand and *vice versa*. This is significant for the advanced federations. It is of less importance to developing countries because of the limited effectiveness of a policy of cheap money and budgetary surpluses or deficits.

The extent to which the central government can use taxation as an instrument of economic policy depends largely on the extent to which it has a grip on total tax revenue. Ideal would be a tax system where all the revenue is centrally collected (model (ii), p. 74) because this would put the federal government in a position to raise a maximum amount of revenue and to distribute the burden of taxation among the people as equally as possible. Moreover, it could alter freely the composition of the whole tax system and the rates of individual taxes so as to suit the requirements of a given situation, or the wider objectives of policy, without prior consultations with the states. Where, however, tax sources have been divided

[1]Cf. p. 58.

between the two layers of government, it would be desirable from the point of view of an effective fiscal policy if the more powerful and flexible subjects were assigned to the central government. This is particularly important in respect of the key instruments of fiscal policy, namely the personal and company taxes as well as import duties which impinge directly on spending, saving and investment in the private sector.[1]

The looser the federal arrangements and, hence, the weaker the financial position of the central government, the less effective its fiscal policy is likely to be. A system under which the states enjoy more or less complete tax independence (model (i). p.73) would be inconsistent with the requirements of fiscal policy. However, this statement requires qualification because, where the central government lacks the power and the means to carry out an effective fiscal policy, a close federal/state cooperation in matters of taxation and public expenditure would still present an acceptable alternative.

A coordinated approach to the problem of fiscal policy can be found today in most of the advanced federations. In the new federations constitutional arrangements invariably require the states to cooperate with the central government in matters of economic and financial policy. Such provisions have often deliberately been written into the constitutions of these countries (often by foreign experts who were little influenced by local political considerations) because the need for a uniform national economic and financial policy was thought more significant than the possible advantages from a large degree of fiscal autonomy of the states. Other aspects which have also contributed towards a comparatively large degree of fiscal centralisation in developing federations and, hence, to the ability of the centre to carry out a dynamic fiscal policy, are the heavy reliance on customs duties, which by their very nature have to be administered centrally, and the need for simple and uniform standards in the collection of taxes in view of the shortage of skilled administrative staff.[2]

3. *Summary*

In the initial discussion of the problems of the process of economic growth and the major instruments of economic policy it was shown that in the effort to improve the standard of living of the people, the raising of the level of savings and investment is at the very centre of policy-making. In pursuit of this objective, monetary policy is more appropriate for monetizing and institutionalising the growth process but rather limited in other respects. Fiscal policy promises to enlarge and regulate the pattern of saving and to direct scarce capital resources into the desired channels. It can also help to maintain a viable external account and to combat structural imbalances resulting from the development effort. Lastly, physical controls can support monetary and fiscal measures whenever the market imperfections do not permit monetary and fiscal measures to operate effectively. Each of the three instruments of economic policy has its special merits. Yet, the economic problems of developing countries are usually of such a complex nature that they can be tackled

[1]Cf. Birch A.H.: "Intergovernmental Financial Relations in New Federations", in *op.cit.*, p. 120.

[2]Cf. Due, J.F.: "Tropical African Contributions to Federal Finance", in *op.cit.*, p. 59.

successfully only through the simultaneous and coordinated application of all three methods.

Interstate equity and the problem of uniformity in design and implementation of fiscal policy were the two outstanding issues in the then following discussion of the implications of a federal structure of government on fiscal policy in developing countries. Fiscal policy is an instrument of economic policy and does not follow any independent objectives. Normally, one would expect fiscal policy to assist in equalising interstate inequalities. In actual fact, however, it is more likely that with regard to investment promotion, fiscal measures work in the opposite direction. This is so because private investment will take place in those localities where circumstances are most favourable and where returns are likely to be greatest. Narrow limits are also set to the equalisation of interstate differences through the taxation of private persons. The reason for this is that the setting of geographically discriminating tax rates would be impracticable and that a strongly progressive taxation of income and wealth might have detrimental effects on private saving and effort. In developing countries taxes on income and wealth are, moreover, extremely difficult to administer.

As regards uniformity in the design and implementation of fiscal policy measures, loose federations would seem to be at a theoretical disadvantage which can be bridged, however, through close cooperation between both levels of government. The constitutions of the developing federations mostly provide for a high degree of fiscal concentration which facilitates the effectiveness of fiscal policy.

B. FEDERALISM AND THE PUBLIC DEBT IN DEVELOPING COUNTRIES

Finally, it is necessary to comment briefly on the implications of federalism on the problem of the public debt. The questions which need special attention in this context are, firstly how can one ensure that both layers of government as well as the financially stronger and weaker states, benefit equally from public borrowing; and, secondly, how can the federal government, being responsible for domestic and external monetary stability, ensure that total borrowing in the federation remains within the desirable limit? In this connection the experience of the Australian Loan Council is considered to be of particular relevance also to developing federations.

1. *Some General Characteristics of Public Debt*

Public finance is concerned with the transfer of purchasing power from the private to the public sector. The more common method of raising funds for the treasury is through taxation. Another method, which has gained increasing popularity in the last decades, is that of raising revenue through loans, both domestic and foreign. The fundamental difference between both methods is that a tax is a compulsory and outright reduction of a person's income or wealth, whereas a loan is a voluntary sacrifice. A loan is eventually repayable and interest is earned until its maturity.

Public debt may be described as deferred taxation because once a loan matures, it is redeemed from funds raised by taxation unless, of course, it is repaid from newly raised loans. This does not mean however that, objectively, posterity can be made to pay for the debts incurred by the present generations, because the actual sacrifice in consumption—and possibly also private investment—takes place at the time when the loan is raised. On maturity of a domestic loan there is neither a gain nor a loss of purchasing power for the community as a whole because there will be merely a transfer of money from one section of the community to another. Taxpayers will suffer a loss of purchasing power whereas bondholders will obtain an equal gain of purchasing power.

In respect of domestic loans one should distinguish between borrowing from the public, i.e. private individuals or institutional savers, and borrowing from the banking systems.[1] It is often impossible to clearly differentiate between these two alternatives, but the latter usually amounts to disguised money creation and, as such, has the same effects as the issuance of new legal tender. In countries where there are no under-utilized factors of production, or where a limit is set to economic expansion because of the lack of certain complementary factors of production, any excessive borrowing from the banking system is likely to lead to inflation.[2]

A loan raised within the country involves a transfer of wealth within the borrowing community which is at the same time also the lending community. An external loan involves a transfer of wealth from the lending to the borrowing community at the time the loan is made, and an opposite transfer when interest is paid and the principal repaid. Both types of transfer involve foreign exchange and a country having to repay a loan may face difficulties if foreign currency reserves are low. On the other hand, foreign loans may contribute much to the economic development of a backward country because, where incomes are low, economic growth may be retarded by the small volume of domestic savings. Borrowing from abroad may then become one of the main sources for financing development projects.

The main advantage of a tax over a loan is that it does not leave behind the burdens of interest payments and of the ultimate redemption of the principal amount. On the other hand, it is much easier for a government to finance its expenditure from loans than from taxes because loans are not felt as a burden by the public. What is the limit to the amount that a government can raise by means of loans? No precise answer can be given to this question because, unlike the case with a private individual, the state has an almost unlimited capacity to raise loans. In the case of domestic loans, debtors and creditors are members of the same community and transactions connected with internal debt resolve themselves into a series of transfers of wealth within one and the same community. This means that from the point of view of the society as a whole there is no direct money burden, or direct money benefit, or an internal debt, for all money payments cancel out.[3]

[1]It is now increasingly recognised that a minor increase in the money supply of developing countries need not be inconsistent with price stability if there is (i) a corresponding increase in national output, (ii) an increase in the monetisation of the subsistence sector, or (iii) an increased demand for cash balances by individuals and firms.

[2]Since wages generally lag behind prices, inflation causes a redistribution of income in favour of businessmen who may gain windfall profits at the expense of wage-earners and those dependent on fixed money income. Cf. Dalton, H.: *op.cit.*, p. 135.

[3]Dalton, H.: *op.cit.*, pp. 180–181.

The limit set to the borrowing policy of the state originates from the indirect burden of a large public debt in terms of an increasing inequality of incomes. For, the proportion of taxes paid by the wealthier people towards servicing the debt is usually smaller than the proportion of public bonds held by them. In other words, the ordinary taxpayer normally has to bear the burden of the service whereas the major portion of interest payments accrues to the rich. This then tends to increase the large inequality of incomes which is a striking feature of many developing countries. There is also an important psychological reason for not allowing public debt to increase unduly, and more important, nor too rapidly. Because the real meaning of public debt is frequently misunderstood by the public and mistakenly taken to constitute a direct money burden towards some outside community, a growing public debt, even if it is quite sound from an economic point of view, may easily shake the people's confidence in the financial stability of the country. Another reason why public debt should be kept at a low figure is that an increase in the debt burden tends to reduce the freedom of action of the government. Moreover, since public loans are largely subscribed out of private savings they may easily adversely affect private investment activities.

The postulate not to create public debt lightly, applies particularly to 'dead-weight' public debt which, like debt for defence, does not yield any direct monetary benefit to the people. On the other hand, economists usually agree that it would be sound policy to finance from loans certain non-recurrent large-scale projects for which funds from the ordinary budget are not available, but which, over the years, would yield an income sufficient to cover the debt charges. Typical examples of investments productive of monetary revenue are public utilities and large production units, the establishment of which is considered vital from the national point of view. Once these enterprises reach the production stage, they should start paying interest and repaying the principal from their earnings. There is also some justification to finance large-scale infrastructure projects from public borrowing.

Public debt, which has reached unprecedented amounts in many of the industrial countries mainly as a result of the war effort, is nowadays also playing an increasing role in developing countries. These countries not only borrow substantially from bilateral and multilateral aid sources but are also becoming increasingly indebted internally. In general, however, per capita public debt is still rather low in developing countries as compared with some of the advanced countries.[1] Vast amounts are needed by the former countries for development purposes which cannot always be raised by current taxation alone. An increasing indebtedness need not, therefore, be a sign of economic weakness so long as this is supported by productive assets.

2. *The Need for Coordination in the Federal Approach to Public Debt*

In a federation the central government is usually in a much stronger position to

[1]Cf. p. 170, footnote 1). The volume of private savings which can be attracted through the sale of government bonds in developing countries is comparatively small because the total amount of savings outside the community of local entrepreneurs and businessmen (who are likely to use their savings for investment into their own business) is low. In addition, many developing countries experience strong inflationary pressure which undermines the establishment of a market for government securities.

raise loans internally and externally than the constituent states. This is so because of its higher credit standing which, in turn, is based on its greater financial capacity, Similarly, the states enjoying a strong financial position are likely to experience less difficulty in floating loans than the financially weaker ones which might be compelled to offer more attractive conditions to prospective bondholders.

Taking into account the dangers inherent in any undue rise in total public debt and the differences in the financial strength and prestige of the various governments, a sound debt administration in a federation would require that:

(i) there should be a central authority which ensures that the domestic and foreign borrowing of the federal and state governments remains within the desirable limit;

(ii) the state governments be placed in a position to:

—compete successfully with the federal government for loans on the domestic capital market, and

—obtain a fair share of the funds the nation is able to borrow from foreign sources;

(iii) the financially weaker states be put in a position where they can borrow on terms equal to those of the financially stronger ones.

Various schemes can be devised to achieve a satisfactory coordination of the debt policies of the various governments operating in a federation. These schemes would all aim at restricting to some extent the freedom of the states to negotiate loans independently inside and outside the country. Such restriction appears obvious in the case of foreign borrowing where a country suffers from balance of payments difficulties, and it is not surprising that in most developing federations the field of external borrowing has simply been left in the hands of the federal government.

As to domestic borrowing, coordination could take the form of a federal supervision of state borrowing, or of licencing arrangements for all federal and state borrowing through an independent authority. This authority which should, possibly, be composed of representatives of the federal and state governments, would have to cooperate closely with the federal and state treasuries, the central bank and particularly also the country's economic planning board because of the importance of public loans for the implementation of large-scale development projects. Where the demand for funds exceeds the available resources, priorities will have to be established in accordance with the long-term goals of the government's economic policy. Normally, these priorities should take into consideration the needs of all the various states. However, in a federation where the principle of interstate equality is found to be in conflict with the overriding goal of rapid growth, as this is probably the case in most developing federations, there is no guarantee that all the states will benefit equally from a centrally steered public debt policy. In fact, it is quite likely that the benefit of public borrowing will accrue primarily to those states which are already most advanced and which, accordingly, hold out the prospect of the best return for the funds invested.

A coordinated overall debt policy is also necessary in view of the effects of large-scale borrowing on the money and capital market and the possible adverse influence of extensive public borrowing on capital formation in the private sector.

The management of public debt, which has become an important aspect of anti-

cyclical policy in the advanced countries, has not yet assumed a corresponding significance in the developing countries. This is so mainly because the size of the domestic indebtedness is generally much smaller in the latter countries and because of the limitations of the effectiveness of variations in aggregate demand on employment and output in developing countries.

Machinery for the coordination of federal and state public debt does not exist in the United States, Canada and Switzerland where the states may borrow freely. In the United States there are, however, certain restrictions to state borrowing which originate from the legislation of the states themselves. Most of the new federations have solved the problem of coordination by some sort of federal dominance which is often enlarged by the constitutional power given to the federal government to make loans to the states.[1]

The rather successful Australian solution to the problem of public debt coordination deserves special attention. Under the Australian system both the Commonwealth and the states have given up their independent borrowing powers and submitted themselves to the control of an independent Loan Council, composed of representatives of both layers of government.[2]

3. *The Australian Loan Council*

In 1927 the federal and state governments of Australia entered into an agreement, known as the Financial Agreement,[3] the main objectives of which were to invoke the prestige of the Commonwealth as an added inducement to investors to lend for state purposes and to prevent a rise of interest rates due to interstate competition for funds in the domestic market and abroad. This agreement established the Australian Loan Council, consisting of representatives of the federal government and the states. Each state representative has one vote and the Commonwealth representative has two votes as well as a casting vote. The decision of the Council are final and binding upon the parties concerned. Since 1927, the Council has exercised control over all borrowing by the federal and state governments, except borrowing by the Commonwealth government for defence purposes.

The Council meets annually under the chairmanship of the Prime Minister of the Commonwealth, or another Minister nominated by him, to examine the loan programmes of the Commonwealth and the states and to determine the total amount to be borrowed during the year. With very few exceptions, all the loans for the Commonwealth and state governments are then raised by the federal government. The federal government is also responsible for all conversions, renewals, redemptions, and consolidations of the public debts of the Commonwealth and of the states.

With the approval of the Loan Council, a state may also borrow "outside Aus-

[1]Cf. Watts, R.L.: *op.cit.*, pp. 143–144.

[2]In the former Federation of Rhodesia and Nyasaland provision was also made for the establishment of a Loan Council, based on the Australian model, and composed of representatives of all four governments. Cf. Garmany, J.W.: *op.cit.*, p. 55.

[3]Details of the Financial Agreement are given in Commonwealth Bureau of Census and Statistics: *Year Book of the Commonwealth of Australia*, No. 37, 1951, Canberra, pp. 685—690. The full text of the agreement is reprinted in Campbell, W.J.: *op.cit.*, Appendix, pp. 284–300. Chapter XII, pp. 159–179, of the latter publication also gives a comprehensive account of the origin of the Loan Council and its working until the early fifties.

tralia in its own name, and may issue securities for the amount so borrowed. The Commonwealth then guarantees that the state will fulfil all its obligations to bondholders in respect of the money so borrowed and the money is deemed to be borrowed by the Commonwealth for and on behalf of the state."[1] Moreover, "subject to any maximum limits decided upon by the Loan Council for interest, brokerage, discount and other charges, the Commonwealth or any state may

(i) borrow within its own territory, for any purposes, money from any authorities, bodies, funds or institutions (including Savings Banks) constituted or established under Commonwealth or state law or practice;

(ii) borrow from the public by means of counter sales of securities; and

(iii) use any available public moneys.

However, any securities issued for money so borrowed or used must be Commonwealth securities on terms approved by the Loan Council".[2]

A substantial amount of loans has been raised by the Loan Council during the recent decades and it has been a special feature that with the rapid economic development of Australia after the Second World War, the incidence of borrowing has shifted from the foreign to the local market. The working of the Loan Council has been described as highly successful and "anarchy and chaos have given way to a planned borrowing programme, which has improved Australian credit in the foreign market also."[3] The decisions of the Council have always been unanimous.

We may add that the policy of the Loan Council has had far-reaching effects on the monetary situation in Australia and on her economic development in general. By varying the total amount of the country's public debt and determining the allocation of newly raised funds, the Council has been able to exert a strong influence particularly on the employment level of the states and on the allocation of public funds for investment. Less satisfactory, at least from the point of view of the states, has been the growing domination of the Council by the Commonwealth government. This development has been ascribed, on the one hand, to the fact that the allocation of votes within the Council is such that the Commonwealth needs the support of only two states for a majority decision and, on the other, to the power of the Commonwealth government over the loan market which stems from its effective control of the Commonwealth Banks. The latter aspect is said to have given the Commonwealth government a veto which it can exercise in respect of any decision of the Loan Council with which it disagrees.[4]

4. *Summary*

The discussion of the public debt administration in developing federations centred around two major questions. Firstly, how can it be assured that the federal government and the states as well as the financially stronger and weaker states derive equal benefits from public borrowing and, secondly, how can the federal government ensure that the total debt of the country remains within desirable

[1]Commonwealth Bureau of Census and Statistics; *Year Book of the Commonwealth of Australia*, No. 46, 1960, Canberra, p. 857.
[2]*Ibid.*, p. 857.
[3]Bhargava, R.N.: *op.cit.*, p. 141.
[4]Cf. Campbell, W.J.: *op.cit.*, pp. 169–170.

limits. The answer to both questions was that a satisfactory coordination of the activities of the various governments with regard to matters concerning the public debt can only be achieved by restricting to some extent the freedom of the states to negotiate loans independently inside and outside the country. Such a restriction seems obvious in the case of external borrowing the more so if the developing federation concerned suffers from balance-of-payments difficulties. As to domestic borrowing, coordination could take the form of federal supervision of state borrowing or of licencing arrangements for all federal and state borrowing through an independent body such as the Australian Loan Council.

In a developing federation where the demand for funds invariably exceeds the available resources, priorities for the allocation of the proceeds of loans will have to be established according to the long-term goals of the government's development policy. In these circumstances it is quite likely that the benefit from public borrowing will not be equally distributed among the various states.

PART TWO

The Working of Federal Finance in Malaysia

In Part One we dealt with problems of federal finance in developing countries mainly from a theoretical point of view. In Part Two we shall investigate the actual working of federal finance in one specific developing country, namely the Federation of Malaysia.

In the following discussion it is proposed, first, to analyse the problem of fiscal imbalance in Malaysia, its origin and its extent, and then to examine and assess the working of the system of adjustment in respect of the States of Malaya, on the one hand, and the Borneo States, on the other. We shall, thereafter, study the provisions of the Constitution regarding the flexibility and coordination of federal/state financial relations and finally look at the implications, if any, of Malaysia's federal structure of government on fiscal policy and public debt.

CHAPTER IV

The Problem of Fiscal Imbalance in Malaysia

In this chapter we shall then begin with an analysis of fiscal imbalance as it presents itself in Malaysia. Fiscal imbalance is a characteristic of all federations. Different functions and responsibilities are assigned, under the constitution, to the federal and the various state governments; so are sources of revenue. The latter may not correspond to the functions ('non-correspondence') so that the states may find themselves in a position where they have insufficient resources to meet their obligations. In these circumstances, the federal government, having been assigned the more productive and elastic tax sources, will have to support the states financially either by sharing with them certain tax sources or by means of grants.

Fiscal imbalance presents also a serious problem in Malaysia. However, not all the thirteen states face the same imbalance. With respect to the States of Malaya this divergency is mainly explained by the marked differences in the revenue capacities of the states and by the varying costs of fulfilling state functions. With regard to the Borneo States the difference is largely due to the fact that the constitutional arrangements under which the original eleven States of Malaya united, differed considerably from those under which Sabah and Sarawak joined Malaysia in 1963. Whereas the States of Malaya form a very tight union, with the Federal Government controlling almost all activities of public life and owning most of the more productive sources of revenue, the arrangements with the Borneo States are less tight, leaving the two states a greater measure of autonomy in respect of functions and resources.

A. THE ORIGIN OF FISCAL IMBALANCE IN MALAYSIA

The provisions governing federal/state financial relations as set out in the Federal Constitution evolved gradually since the end of the Second World War.[1] Prior to 1956 Federal control over state finances was very extensive. Up to then the revenue of the states consisted mainly of *ad hoc* allocations from the Central Government. A Committee set up in 1954 to make recommendations in this matter found that the prevailing system had not proved satisfactory. Accordingly, it endeavoured to evolve a system of revenue allocation which would not be subject to the 'annual

[1]The following account of the development of the financial relations between the Federal Government and the states is based on information supplied by the Ministry of Finance, Kuala Lumpur.

wrangle' for funds between the Centre and the states and recommended to increase that part of state revenue which would accrue directly to the state governments independently of any action on the part of the Federal Government. The recommendations of the Committee were embodied in Part III of the Fifth Schedule to the *Federation of Malaya Agreement*, 1948, and came into force on 1 January, 1956.

In 1957 the so-called Reid Commission again investigated the financial relations between the Federation and the states. The Commission concluded in its report[1] that the prevailing arrangements were still not satisfactory. There was, for instance, still too much room for disagreement about the amount of the capitation and development grants and about the way in which the deficits of the states were to be dealt with. Arguments on these questions were, moreover, expected to become more acute with the gradual replacement of official control in the states by democratic control. As long as the states had no full assurance as to the total income from grants which they could expect in future years and their deficits had to be met by the Federation each year, the states had little direct incentive to economize. It was, furthermore, difficult for them to plan ahead without a firm assurance of their financial resources.

As a result of the findings of the Reid Commission and the recommendations of a Working Party set up to consider the report of the Commission, the provisions governing federal/state financial relations were changed with a view to entitling the states to receive as of right:

(i) a capitation grant;
(ii) a state road grant;
(iii) the proceeds from certain taxes, fees and other sources of specified revenue which now form Part III of the Tenth Schedule to the Federal Constitution; and
(iv) not less than 10% of the export duty on tin produced in a state.

It was also decided to establish a State Reserve Fund for the benefit of those states which may find difficulty in balancing their budgets without further assistance. The Fund was initially also used for development purposes, a practice which was later discontinued on the recommendations of a Committee set up by the National Finance Council in 1960 to examine the procedure to be adopted for applications for grants from the State Reserve Fund.[2]

The latter Committee considered that a general review of the financial provisions of the Constitution should be undertaken at a later stage once the general pattern of state finances had emerged more clearly.[3] Such a general review has, however, not yet been undertaken.

The provisions of the Constitution governing the financial relations between the Federal Government and the Borneo States are mainly the outcome of the findings of an Inter-Governmental Committee which was set up in 1962 under the chairmanship of Lord Landsdowne[4] to follow up the report of the Cobbold Commission which had recommended that it would be in the best interest of Sabah and Sarawak

[1]The full title of the report is: *Report of the Federation of Malaya Constitutional Commission 1957*, Colonial Office, London, 1957.
[2]The report of this Committee has not been published.
[3]Information supplied by the Ministry of Finance, Kuala Lumpur.
[4]Cf. Malaya: *Malaysia Report of the Inter-Governmental Committee 1962*, Kuala Lumpur, 1963.

to federate with Malaya and Singapore.

1. *The Division of Functions*

a. *The Provisions of the Constitution*

Earlier it was pointed out that, according to the principle of efficiency, functions of an international character and those concerning the nation as a whole should fall under the jurisdiction of the central government, while those of a more regional nature should normally fall under the competency of the states.[1] Under the present heading we shall outline the division of functions as provided under the Constitution of Malaysia. This will be followed by an attempt to determine to what extent, if any, it may be said that the principle of efficiency has been followed in the division of functions between the Federal and state governments. We shall thus be able to comment on the degree of tightness of the Federation of Malaysia.

Articles 73-81 of Part VI of the Federal Constitution define the distribution of legislative and executive powers in Malaysia. In general the Federal Parliament may make laws for the whole or any part of the Federation, whereas the Legislature of a state may only make laws for the whole or any part of that state.[2] The Ninth Schedule of the Constitution contains the legislative lists—the Federal, States, and Concurrent Lists—which spceify in detail the subjects of legislative competence. The residuum of legislative powers belongs to the states.[3] These powers are, however, of little importance as the legislative lists are fairly comprehensive. Moreover, if state law is inconsistent with federal law, the federal law prevails.[4] This means that federal legislation on a subject contained in the Concurrent List, whether prior or subsequent to the state enactment, overrides state law.[5]

The following are the more important functions which fall within the jurisdiction of the Federal Government:

(Federal List)

External affairs; defence; internal security; civil and criminal law and procedure, and the administration of justice; federal citizenship and naturalisation; aliens.

Finance, including currency, legal tender and coinage; national savings and savings banks; loans to or borrowing by the states, public authorities and private enterprise; public debt of the Federation; banking; control of credit; foreign exchange; capital issues; and commodity exchanges.

Trade, commerce and industry, including the production, supply and distribution of goods; price control; food control; imports into, and exports from the Federation; industries, regulation of industrial undertakings; and subject to certain provisions of the State List development of mineral resources.

Shipping, navigation and fisheries, including ports and harbours.

[1]Cf. p. 65.
[2]Cf. Malaysia: *The Federal Constitution,* Article 73.
[3]Cf. *ibid.,* Article 77.
[4]Cf. *ibid.,* Article 75.
[5]Cf. Groves, H.E.: *op.cit.,* p. 133.

Communications and transport, including roads, bridges, ferries and other means of communication if declared to be federal by or under federal law; railways; airways; post and telecommunications; wireless, broadcasting and television.

Federal works and power, including water supplies, rivers and canals, except those wholly within one state or regulated by an agreement between all the states concerned; electricity; gas and gas works.

Surveys, inquiries and research, including scientific and technical research.

Education, including elementary, secondary, and university education; vocational and technical education; training of teachers.

Medicine and health, including sanitation in the Federal Capital.

Labour and social security, including trade unions; unemployment insurance; health insurance; widows', orphans' and old age pensions.

Newspapers; publications.

Co-operative societies.

The following subjects inter alia fall within the jurisdiction of the states:

(State Lists)

Muslim religious law.

Land, including land tenure; land improvement and soil conservation; permits and licences for prospecting for mines; mining leases; transfer of land; mortgages and leases.

Agriculture and forestry.

Local government.

Other services of a local character, such as markets and fairs, and licensing of theatres.

State works and waters; roads, bridges and ferries other than those in the Federal List.

Machinery of the State Government, including loans for state purposes; and public debt of the state.

To meet the special conditions of the Borneo States and Singapore when they joined the Federation of Malaya in 1963, certain matters in addition to those enumerated in the State List were left under the jurisdiction of these states *(Supplements to State Lists for Borneo States and Singapore)*. The Borneo States have retained inter alia certain rights under native law and customs, continue to control state ports and harbours, and administer museums and libraries. Sabah also controls its railways. Singapore, during its membership of the Federation, retained the control over a number of important matters such as education, health, labour and social security, factory legislation, and electricity and gas.

There remains the Concurrent List of subjects on which both the Federal and State Legislatures may make laws. These subjects include inter alia;

(Concurrent List)

Social welfare; animal husbandry; veterinary services; town and country

planning, except in the Federal Capital; and public health;

to which, in respect of the Borneo States, the following have been added:

(Supplement to Concurrent List for Borneo States)

Personal law; shipping under fifteen registered tons; maritime and estuarine fishing and fisheries; the production, distribution and supply of water power and of electricity generated by water power; agricultural and forestry research.

During Singapore's membership of the Federation the following matters were added inter alia to the Concurrent List for Singapore:

(Supplement to Concurrent List for Singapore)

Personal law; loans to, or borrowing by the state or its statutory authorities; imports into and exports from the Federation, but not bounties on exports; insurance; banking and money lending; industries; regulation of industrial undertakings; shipping and navigation.

The Constitution permits federal limitations on matters of state competence for a number of reasons, such as achieving uniformity in state laws, securing compliance with constitutional provisions and for the sake of administrative convenience and fiscal considerations.[1]

b. *The Division of Functions and the Principle of Efficiency*

Having outlined the division of functions, the next question is, to what extent has the principle of efficiency been applied in arriving at this division?

The Federal Government has been given not only all the powers which concern the nation as a whole (including external affairs, defence, internal security, the administration of law, and questions relating to citizenship), as well as exclusive jurisdiction over education and the more important social services, but also all those powers which are required to enforce a nation-wide policy of economic growth (including the control of currency and banking, production, exports and imports, industrial legislation and research, and transport and communications). The states merely control religious matters—the Rulers (Sultans) of the Malay States having a special responsibility for the Muslim religion which is the state religion of Malaysia—the various aspects of agriculture and forestry, certain aspects of mining, and local government. The latter subjects differ from state to state and it can be argued therefore—though perhaps not always convincing—that they are administered more efficiently on a regional level.

Federal law overrides state law in respect of all matters listed in the Concurrent List. This means that the Central Government may interfere with state legislation in matters such as social welfare, public health, animal husbandry, veterinary services and town and country planning, whenever it deems this to be necessary in the national interest. Looked at from the point of view of the states, this rule further restricts their independence. In the last analysis the states are not even fully autonomous in respect of agriculture, forestry and local government, as provided

[1]Cf. Groves, H.E.: *op.cit.*, pp. 135–137.

in the State List. This is so because of the provisions of the Concurrent List, and especially also because of the activities of federal or constitutional authorities, such as the Federal Land Development Authority, which opens up new lands for settlement; the National Land Council,[1] which is responsible for formulating a common policy to secure coordination in such fields as land use, mining, forestry and agriculture; and the National Council for Local Government,[2] which coordinates local authority legislation throughout Malaysia. All these bodies are practically fully controlled by the Federal Government. It should also be remembered that agricultural and forestry research, on which high hopes are set in connection with Malaysia's agricultural diversification programme, are federal matters.

There remain the somewhat wider powers left with the Borneo States, which include the control of ports and shipping and, in respect of Sabah, the coastal railway line between Kota Kinabalu (formerly Jesselton) and Melalap and Weston. There is also the expanded list of subjects on which both the Federal Government and the Borneo States may legislate and which includes fisheries, water supply, hydro-electric power as well as agricultural and forestry research.

The greater autonomy of the Borneo States is the result of the particular circumstances prevailing at the time of their joining Malaysia. Unlike the States of Malaya their interest in federating was not merely a political one. Good care was also taken of their special economic and financial interests. The greater constitutional powers of the Borneo States reflect, moreover, the fact that these territories do not form a natural geographical administrative union with the rest of Malaysia. This aspect alone would certainly justify a large measure of independence, the more so if one considers that Federal Government officials in Kuala Lumpur are often not familiar at all with local conditions in the Borneo territories. All this indicates that in the case of Malaysia one should avoid any too narrow interpretation of the principle of efficiency.

In respect of the States of Malaya one would almost doubt whether one is really allowed to speak of a federation at all. Granted that in developing federations the centre has to initiate and undertake, in the beginning, many of the economic activities which at a more advanced stage could easily be carried out by the states, the autonomy of the States of Malaya would, nevertheless, seem almost too limited to allow for an evaluation of the division of functions from the point of view of efficiency. This would to some extent also apply to the Borneo States although here the wider list of subjects assigned to them under the *Supplement to the State List for Borneo States* and *Supplement to Concurrent List for Borneo States* has given them a greater degree of autonomy which is justified if for nothing else but their geographical situation.

In respect of Singapore, the division of functions deviated to such an extent from that applicable to the other states forming Malaysia, that the question as to whether the division of powers followed the guiding principles of efficiency, must be asked anew. In addition to the subjects contained in the State List, Singapore retained a wide range of responsibilities including such important items as education, health, labour and social security, and labour and factory legislation. Together with the

[1]Cf. Malaysia: *The Federal Constitution,* Article 91.
[2]Cf. *ibid.,* Article 95A.

Federal Government it could, moreover, legislate on most of the matters important from the point of view of economic policy.

In view of its special position as an important international port and trading centre and its relatively high level of economic and administrative development, the retention of all these functions cannot be taken to contravene the postulate of efficiency. The case of Singapore rather stresses once more the need of interpreting the principle of efficiency as widely as possible, taking into consideration the degree of development of the state in question and the special conditions prevailing at the time of federating. When looking at the constitutional arrangements with Singapore one should also bear in mind that politicians on both sides of the Causeway were always aware that the integration of Singapore into Malaysia could not be achieved in a short period of time, but would necessarily be a long-term process demanding patience and adjustment on both sides.

c. *The Balance of Power between the Federal and the State Governments*

The peculiarity of the division of functions must be viewed against the historical and constitutional background of Malaysia, which was outlined earlier in Part One[1] and which can briefly be summarized as follows:

(*i*) From a geographical, historical, cultural and economic point of view, Malaysia falls into three distinct areas: West Malaysia comprising the eleven States of Malaya which form the 'core' of the Federation, and Sabah and Sarawak.

(*ii*) The eleven States of Malaya share the same historical development, have a similar demographic background and form a unit culturally and, to a large extent, also economically and administratively. Racial divergencies are not geographically based.

(*iii*) The desire of the Malays as a racial group to maintain their national identity was the main reason for preserving the status of the Malay Rulers as Heads of State and, hence, for adopting a federal constitution in 1957.

(*iv*) Once this need was met there was no further objection to the British desire to make Malaya a very tight federation. In fact, at the time of federating the states showed little or no interest in economic or financial matters. Consequently, under the Constitution of 1957, the Federal Government extended its influence into most of the vital areas of the country's political, economic and social life.

(*v*) The Borneo States differ in their historical, cultural and demographic background from the States of Malaya. Both are relatively less developed and have a predominantly tradition-bound population, scattered over a wide area. Their geographical distance from the mainland and the relatively poorly developed means of communications connecting them with each other and with the Malay Peninsula make them distinctively separate administrative units. To the Borneo States the formation of Malaysia meant the end of colonial rule; to the British it meant an opportunity to terminate their responsibilities towards the two territories.

(*vi*) In view of the disparities between East and West Malaysia, the fear of too

[1]Cf. p. 10 ff.

strong a control over domestic affairs from Kuala Lumpur, and a keen interest of the British to secure for the Borneo States a maximum of economic and financial advantages from federating, it was clear from the outset that the federal arrangements had to be looser than those uniting the States of Malaya.

(*vii*) Singapore's interest in joining Malaysia was mainly a political one, namely the prospect of gaining independence. Economically, federation meant joining a potentially large common market. On the other hand, since Singapore had to protect its special interests as an international trading centre and since, moreover, it was ahead of the other states in its economic and administrative development, there was an obvious desire to retain as much autonomy as possible.

The above points explain what has been evident from the discussion on the division of functions in Malaysia, namely, that the functions retained by the States of Malaya are so limited that one may almost question whether West Malaysia can be called a federation at all. In respect of Sabah and Sarawak the federal arrangements are less tight although also in their case the subjects assigned to them are in general considerably below the first level of governmental importance and rather typical for a unitary government running a poor, underdeveloped and tradition-bound economy. Only Singapore retained a number of far-reaching functions in the educational, social and economic fields and could thus secure a large measure of independence. The above also makes it clear why, under the Constitution of 1963, Malaysia is an 'assymmetrical' federation with the States of Malaya having been assigned less powers than the other member states.

2. *The Division of Resources*

a. *The Major Federal Sources of Revenue*

The distribution of resources reflects the predominant position of the Federal Government vis-a-vis all the thirteen states with regard to functions, and the fact that Malaysia resembles a three-unit grouping, with one of these units, Malaya, being subdivided into eleven parts.

The Federal Constitution draws a clear line between the rights of the Federal and the state governments to raise revenue. The states receive the proceeds from the taxes, fees and other sources of revenue specified in Part III of the Tenth Schedule in so far as they are collected, levied or raised within the states.[1] All other sources of revenue belong to the Federal Government which, as a matter of fact, collects practically all those direct and indirect taxes which in a modern society represent the major sources of government income. The following is a brief summary of the more important federal sources of revenue.

As may be seen from Table 7, indirect taxes, i.e. import, export and excise duties, represent the most important sources of revenue of the Federal Government. During the period 1960-63, they accounted for 53% and during the period 1964-66, for 45% of the total central government revenue in the case of Malaya and Malaysia, respectively. The yield from export duties has been fluctuating considerably from year to year and this source is likely to decrease in the years to come especially on

[1]Cf. Malaysia: *The Federal Constitution,* Article 110 (1).

Table 7:

FEDERAL GOVERNMENT ORDINARY REVENUE AND EXPENDITURE 1960-66

	MALAYA 1960—63		MALAYSIA 1964—66	
	Annual Average M$ million	% of Total Revenue	Annual Average M$ million	% of Total Revenue
ORDINARY BUDGET REVENUE				
1. Export Duties:				
Rubber	123	11.4	78	5.0
Tin	65	6.0	110	7.0
Iron Ore	6	0.6	18	1.1
Others	9	0.8	15	1.0
Sub-Total	(203)	(18.8)	(222)	(14.1)
2. Import Duties:				
Tobacco, Cigars, Cigarettes	106	9.8	131	8.4
Petroleum	71	6.6	30	1.9
Heavy and Fuel Oils	21	1.9	14	0.9
Malt Liquors	21	1.9	13	0.8
Spirits	19	1.8	26	1.7
Textiles	20	1.9	24	1.5
Sugar	21	1.9	28	1.8
Others	78	7.2	113	7.2
Sub-Total	(357)	(33.0)	(379)	(24.2)
3. Excise:				
Locally Grown Tobacco	2	0.2	1	0.1
Petroleum	1	0.1	78	5.0
Liquors	7	0.6	23	1.4
Others	5	0.5	7	0.5
Sub-Total	15	(1.4)	(109)	(7.0)
4. Road Transports	68	6.3	98	6.2
5. Income Tax	224	20.7	311	19.9
6. Other Tax Revenue	24	2.2	63	4.0
7. *TOTAL TAX REVENUE*	891	82.4	1,182	75.4
8. Commercial Undertakings:				
Ports	18	1.7	27	1.7
Telecommunications	38	3.5	66	4.2
Broadcasting and T.V.	1	0.1	3	0.2
Civil Aviation	–	–	–	–
Total Commercial Undertakings	57	5.3	96	6.1
9. Interest	56	5.2	56	3.6
10. Currency Profit	27	2.5	47	3.0
11. Miscellaneous including Lotteries	49	4.5	181	11.5
12. Special Receipts	1	0.1	6	0.4
13. Total Federal Revenue	1,081	100.0	1,568	100.0

Table 7 (continued):

FEDERAL GOVERNMENT ORDINARY REVENUE AND EXPENDITURE 1960-66

	MALAYA 1960—63		MALAYSIA 1964—66	
	Annual Average M$ million	% of Total Revenue	Annual Average M$ million	% of Total Revenue
ORDINARY BUDGET EXPENDITURE				
1. Defence and Security:				
Defence	85	8.2	197	11.7
Internal Security	93	9.0	169	10.1
Sub-Total	(178)	(17.2)	(366)	(21.8)
2. Economic and Social Services:				
Agriculture	12	1.1	18	1.1
Rural Development	9	0.9		
Commerce and Industry	3	0.3	n.a.	n.a.
Transport	6	0.6	92	5.5
Ports	15	1.4		
Telecommunications	22	2.1		
Public Works	31	3.0	32	1.9
Education	201	19.4	321	19.1
Information, Broadcasting T.V.	12	1.1	27	1.6
Medical and Health	81	7.8	119	7.1
Labour and Social Welfare	5	0.5	26	1.5
Lands and Mines	14	1.4	5	0.3
Sub-Total	(411)	(39.6)	(640)	(38.1)
3. Debt Charges	113	10.9	154	9.1
4. Pensions, etc.	68	6.6	64	3.8
5. Capital Contribution to International Institutions	8	0.8	n.a.	n.a.
6. Residual	79	7.6	175	10.4
Total 1—6	857	82.7	1,399	83.2
7. Allocations to States	76	7.3	138	8.2
8. Contributions to Statutory Funds:				
Development Fund	97	9.3	123	7.3
Others	7	0.7	22	1.3
Sub-Total	(104)	(10.0)	(145)	(8.6)
9. *TOTAL FEDERAL EXPENDITURE*	1,037	100.0	1,682	100.0
10. Total Recurrent Expenditure, i.e. Total 1–7	933	90. 0	1,537	91.4
11. Ordinary Budget Surplus/ Deficit	+44		−114	

Source: Malaysia *Official Year Books 1963—1965*, and information supplied by the Ministry of Finance, Kuala Lumpur.

account of the steadily falling rubber prices. The major export duties are those on rubber, tin and iron ore. The duty on rubber is progressively related to its price and is calculated according to a special formula. It may be as low as 4% and increase to almost 25% ad valorem. The export duty on tin is also related to the price of the metal. It is an ad valorem rate and during the past few years it amounted to approximately 16% of the value of net exports of tin metal and ore. The export duty on iron ore has been fixed at 15% ad valorem, subject to certain concessions. Other export duties, payable at the rate of 5% ad valorem, are those collected on coconut and oil palm products. Specific export duties are levied on the export of rubber planting material, and duties of 10% ad valorem are levied on most minerals and metals other than tin and iron.[1]

Import duties are among the most important sources of revenue in all developing countries. In Malaysia approximately one quarter of all federal revenue was derived from import duties during the period 1964-66. Table 7 reveals that the bulk of revenue from import duties was derived from tobacco products, petroleum and fuel oils, liquors and spirits, textiles and sugar. Excise duties have been playing an increasing role over the past years. This is so because of the increasing rate of domestic petroleum refining and the establishment of local factories for the production of liquors and spirits, and cigarettes. At the same time the increasing local production has had an adverse effect on the yield from import duties on these products.

The income tax, which is by far the most important direct tax, has been yielding increasing revenue over the past years and now accounts for almost 20% (1966: 21.7%) of total federal revenue. The rates of the personal income tax are fairly progressive and reach 50% in the case of income exceeding M$50,000 p.a. Tax allowances are being granted for married persons and for children. The corporate income tax has been raised successively and now amounts to a flat rate of 40% on profits.

Although the power for the collection of licence fees rests mainly with the state governments and local authorities, the Federal Government collects fees for wireless and television receivers as well as for motor cars. As may be seen from Table 7 the amount collected from road transport fees and licences is considerable. Other major items of federal revenue are the increasing surpluses from the operation of posts and telecommunications, and interest from government assets.

b. *The Tax Sources of the States*

The sources of revenue of the states are numerous although many of them are not very productive. They may be summarised as revenue from toddy shops; forests, lands and mines, and associated matters; various fees, including fees and receipts for specific services rendered by the state governments; court fees and entertainment duties; municipal revenues, unless they accrue directly to the municipalities concerned; fees for water supplies; and revenue from the sale of government property, including land. The latter does not strictly constitute a 'tax source', but is nevertheless an important item in the pattern of state income, because in Malaysia most

[1]Information on export duties obtained from Customs and Excise Department, Kuala Lumpur.

of the land not yet 'alienated' to individual ownership belongs to the states. In respect of a number of state sources of revenue Parliament may from time to time substitute other sources of revenue of substantially the same value.[1]

In addition to the sources of revenue mentioned each state receives at least 10% of the export duty on tin produced in that state ('principle of derivation'). In respect of the States of Malaya, Parliament may also provide for a portion of the export duty on minerals other than tin to be assigned to the state in which it was mined.[2] On the other hand, Parliament may, in certain instances, prohibit the states to levy royalties or similar charges on minerals, other than tin, although in the case of the Borneo States the Federal Parliament is entitled to restrict the levying of royalties only as far as these exceed 10% ad valorem.[3]

Parliament may by law assign to the States of Malaya the whole or any portion of the proceeds of any tax or fee raised or levied by the Federation, and assign to the states the responsibility of collecting for state purposes any tax or fee authorised by federal law.[4]

To support the development of the Borneo States, Part V of the Tenth Schedule of the Constitution provides for a number of additional important revenues to be retained by the two Borneo States. These are:

(i) Import and excise duties on petroleum products.

(ii) Export duty on timber and other forest produce.

(iii) So long as the royalty levied by the State on any mineral other than tin (but including mineral oils) does not amount to 10% ad valorem, export duty, on that mineral or such part of the export duty as makes the total of royalty and duty on exported minerals up to 10% ad valorem so calculated.

(iv) In case of Sabah, so long as medicine and health remain an item in the Concurrent List and expenses in respect of that item are borne by the State (i.e. until 1970), 30% of all customs revenue in addition to those sources of customs revenue common to all states.

(v) For any year before 1974 and, if at the beginning of 1974 the Legislature of the State has power to make laws with respect to the carriage of passengers and goods by land, or with respect to motor vehicles, or licences connected with those vehicles, then during the continuance of that power, fees from such licences.

(vi) For any year before 1974, and if at the beginning of 1974 the Legislature of the State has power to make laws with respect to the registration of motor cars, then during the continuance of that power, fees from the registration of such vehicles.

(vii) State sales taxes.

(viii) Fees and dues from ports and harbours other than federal ports and harbours.

In respect of Singapore, the Constitution had been much less specific. Here the Constitution provided for a situation for two sovereignties to deal in the future

[1]Cf. Malaysia :*The Federal Constitution,* Article 110 (2).
[2]Cf. *ibid.,* Article 110 (3) and (3A), and Article 112C (3).
[3]Cf. *ibid.,* Articles 110 (3B) and 112C (4).
[4]Cf. *ibid.,* Article 110 (4) and Article 112C (3).

and at arms length[1]. The Federal Government and Singapore were to enter from time to time into agreements providing inter alia for the manner in which the revenue derived by the Federation from Singapore, or any part of that revenue, were to be collected and accounted for and how it was to be divided between the Federation and the State.[2] The tax sources assigned to the states under the Constitution (i.e. Part III of the Tenth Schedule) were also applicable to Singapore. They could be excluded or modified, however, by agreement between the Federal and the Singapore Governments.[3] Also subject to negotiation between both Governments was the inclusion of Singapore in a Common Market with the rest of the Federation and the laying down of conditions for the levying of import and export duties in relation to goods imported into or exported from Singapore.[4]

While Singapore was a member of Malaysia, its financial relations with the Central Government were specified in greater detail by the *Agreement between the Governments of the Federation of Malaya and Singapore on Common Market and Financial Arrangements* (cmd. No. 27 of 1963) which was the result of tough and prolonged discussion and bargaining between the two governments concerned. According to this agreement, Singapore retained all taxes under the State List, i.e. Part III of the Tenth Schedule of the Constitution, including the property tax. Most of the other taxes were to be paid into a special fund to be divided annually between the two governments in the proportion 60% to the Singapore Government and 40% to the Federal Government. The only exception in this regard was that customs duties and other charges collected in Singapore on goods to be exported from or imported into Malaysia outside Singapore, and income tax collected in Singapore and attributable to income derived from the States of Malaya, were both to be paid directly to the Federal Government.[5] The financial arrangements with Singapore were subject to a bi-annual review between both governments.

The flexibility of the financial relations between the Federal Government and Singapore reflected the rather loose degree of economic and financial integration which had prevailed between the Central Government and that State during 1963-1965. The agreement in force during that period had placed most of the taxes collected in Singapore outside the scheme of division of tax subjects. Taxes were collected centrally by the Singapore authorities and then divided between the State and the Federal Government according to a predetermined formula. The advantages of such a system of centralised tax collection have been explained earlier.[6] The system places heavy reliance on the ratio of distribution of total tax yield. Whether the formula eventually established was a satisfactory one, is hard to say in view of the short period of Singapore's membership in the Federation.

The financial agreement with Singapore was remarkable in many ways. Here was a case of a tax-sharing arrangement under which a state government retained its tax autonomy and where centralised tax collection was the responsibility of the

[1]Cf. Groves. H.E.: *op.cit.*, p. 146.
[2]Cf. Malaysia: *The Federal Constitution,* Article 112E (1) (a).
[3]Cf. *ibid.*, Article 112E (d).
[4]Cf. *ibid.*, Article 112E (c).
[5]Cf. *Malaysia—Agreement concluded between the Federation of Malaya, United Kingdom of Great Britain and Nothern Ireland, North Borneo, Sarawak and Singapore,* Kuala Lumpur. 1963, Annex J., Article 6, pp. 228–229.
[6]Cf. pp. 76–78.

Table 8:

SUMMARY OF STATE GOVERNMENT REVENUE 1964-65: STATES OF MALAYA, SABAH AND SARAWAK

- in M$ million -

	1964				1965[1]				1964/65[1]			
	Malaya	Sabah	Sarawak	Total for Malaysia	Malaya	Sabah	Sarawak	Total for Malaysia	Annual Average in % of Total Tax Revenue			
									Malaya	Sabah	Sarawak	Total for Malaysia
1. Tax Revenue												
Export Duty	–	1.2	1.2	2.4	–	1.0	1.1	2.1	–	4.5	5.8	1.6
Import Duty	–	3.2	4.6	7.8	–	5.7	4.6	10.3	–	16.5	23.2	6.8
Excise from Toddy	1.0	–	0.6	1.6	1.1	–	0.6	1.7	1.2	–	3.1	1.2
Royalties and Permits of Forest Products	26.0	15.9	7.6	49.5	26.1	16.3	6.7	49.1	29.4	60.3	36.1	36.5
Lands and Mines (mainly rents and licences)	28.1	1.7	2.5	32.3	32.8	2.0	2.6	37.4	34.4	6.9	12.9	25.8
Road Transport	–	1.5	1.2	2.7	–	2.1	1.3	3.4	–	6.7	6.3	2.3
Licences other than Road Transport	12.8	1.1	1.5	15.4	12.3	1.0	1.6	14.9	14.2	3.9	7.8	11.2
Entertainment Duty	12.5	0.3	0.9	13.7	12.7	0.4	1.0	14.1	14.2	1.2	4.8	10.3
Others	5.9	–	–	5.9	5.8	–	–	5.8	6.6	–	–	4.3
Sub-Total	(86.3)	(24.9)	(20.1)	(131.3)	(90.8)	(28.5)	(19.5)	(138.8)	100.0	100.0	100.0	100.0
2. Non-Tax Revenue												
Fees for Specific Services	7.7	1.5	0.4	9.6	8.6	1.5	0.4	10.5				
Commercial Undertakings	32.1	8.2	0.9	41.2	29.6	8.7	0.9	39.2				
Others	30.1	10.0	10.1	50.2	25.1	4.2	7.7	37.0				
Sub-Total	(69.9)	(19.7)	(11.4)	(101.0)	(63.3)	(14.4)	(9.0)	(86.7)				
Total Domestic Revenue	156.2	44.6	31.5	232.3	154.1	42.9	28.5	225.5				
3. Current Transfers (Grants and Allocations)	91.2	22.7	21.8	135.7	96.0	27.9	27.7	151.6				
Total Ordinary Revenue	247.4	67.3	53.3	368.0	250.1	70.8	56.2	377.1				
Total Ordinary Expenditure	265.9	78.3	70.3	414.5	280.9	72.7	53.8	407.4				
Surplus/Deficit	–18.5	–11.0	–17.0	–46.5	–30.8	–1.9	+2.4	–30.3				

[1] Returns from States and Estimates.

Source: *State Financial Statements*, and information supplied by the Ministry of Finance, Kuala Lumpur.

Table 9:

STATES OF MALAYA REVENUE AND EXPENDITURE 1958-68, ANNUAL AVERAGES

- in M$ 1,000 -

	1958–60		1961–63		1964–66		1967–68	
	Annual Average	% of Total	Annual Average	% of Total	Annual Average	% of Total	Annual Average (Est.)	% of Total
REVENUE								
1. Taxation								
Excise (mainly from Toddy)	8,154	4.2	9,043	3.8	2,511	0.9	420	0.1
Forests	15,386	7.9	20,232	8.5	27,877	10.2	33,613	11.2
Lands and Mines	25,005	12.9	27,157	11.5	31 512	11.5	40,388	13.5
Licences and Internal Revenue	28,852	14.9	34,694	14.7	27,555	10.0	26,697	9.0
Sub-Total	(77,397)	(39.9)	(91,126)	(38.5)	(89,455)	(32.6)	(101,118)	(33.8)
2. Receipts for and in Aid of Specific Services	12,746	6.6	10,992	4.6	14,682	5.4	17,907	6.0
3. Commercial Undertakings	16,388	8.5	22,298	9.4	34,661	12.7	45,222	15.1
4. Rent and Interest	5,533	2.8	9,175	3.8	10,193	3.7	11,064	3.7
5. Miscellaneous Sales and Receipts	12,780	6.6	14,486	6.3	23,939	8.7	24,578	8.2
6. Allocations and Grants	68,876	35.6	87,347	36.8	101,066	36.9	99,218	33.2
7. Receipts from Surplus Trust Funds	–	–	1,460	0.6	24	–	–	–
Total Revenue	193,720	100.0	236,884		274,020	100.0	299,107	100.0
EXPENDITURE								
1. Agriculture and Forestry	9,293	5.3	10,107	4.1	12,296	4.5	16,855	5.0
2. Public Works	62,947	36.0	53,224	21.8	60,310	22.1	72,433	21.7
3. Administrative Departments	102,813	58.7	181,347	74.1	199,922	73.4	245,236	73.3
Total Expenditure	175,053	100.0	244,678	100.0	272,528	100.0	334,524	100.0
Surplus/Deficit	+18,667		–7,794		+ 1,492		–35,417	

Source: *State Financial Statements,* and information supplied by the Department of Statistics, Kuala Lumpur.

state and not, as usual, that of the federal government. These extraordinary features were a sign of the political and financial strength of Singapore which, unlike the two Borneo States, was not dependent on the financial and administrative support of the Federal Government.[1] The fact that the arrangements were so loosed proved to be of great advantage when, in 1965, the ties between Malaysia and Singapore were cut. Both financial administrations could continue to function separately practically without any disruption.

Tables 8 and 9 show the composition of state tax revenue and its development during the period 1958-66. During 1964-65 royalties and permits on forest produce were the most important single source of state income, particularly also of the Borneo States where the timber trade is the most important economic activity. Income from forest produce accounted for 36.5% of all tax revenue of the thirteen states (Malaya: 29.4%, Sabah: 60.3%, Sarawak: 36.1%). Second in importance was the revenue from lands and mines (mainly rents and licences) which, during 1964-65, accounted for 25.8% of the total tax revenue of the thirteen states. During 1964-65 the States of Malaya obtained 34.4% of all their tax income from this source. Other important items of income are licences and entertainment duty. Sabah and Sarawak also obtain substantial amounts from export and import duties on various items which were retained by these states under the Constitution to support their economic development and to compensate them for certain additional constitutional functions. In 1964-65 export and import duties together amounted to 21% of the total tax revenue of Sabah and to 29% of the total tax revenue of Sarawak. Revenue from road transport, expressed as a percentage of total tax revenue, amounted to 6.7% in the case of Sabah and 6.3% in the case of Sarawak.

Tables 8 and 9 also reveal that tax revenue constitutes only a relatively small portion of the total income of the states. Table 10 breaks down the total ordinary budget income of the States of Malaya, Sabah and Sarawak according to tax revenue, non-tax revenue, and current transfers. The table clearly demonstrates the heavy dependence of the states on non-tax revenue and transfers (or grants and allocations) which together account for roughly two thirds of the total budget income of the states. Income from transfers will be discussed shortly in the context of the inter-governmental fiscal adjustment in Malaysia. As to non-tax revenue, this consists mainly of fees for specific services (e.g. drainage and irrigation fees, fees for ferries, court fees, marriage and divorce fees, cattle passes, etc.) which, during 1964-66 accounted for 5.4% of the total revenue of the States of Malaya (see Table 9); income from commercial undertakings (1964-66: 12.7%), representing mainly revenue from the supply of water; income from property (1964-66: 3.7%) comprising rents and interest from investments; and miscellaneous sales and receipts (1964-66: 8.7%) which include inter alia income from land and property sales.

c. *Comparison between the Federal and State Sources of Revenue*

The foregoing analysis of the federal and state sources of revenue has shown

[1]The financial strength of Singapore is evident from a comparison of its per capita total revenue with that of Malaysia (Federal plus combined state revenues). In 1963 (pre-federation) per capita total revenue amounted to M$265 (1966: M$286) in the case of Singapore and to M$180 (1966: M$215) in the case of Malaysia. *Source:* Table 11 and information supplied by the Chief Statistician, Singapore.

Table 10:
COMPOSITION OF STATE REVENUE 1958-66
- in M$ million -

	Tax Revenue and Licences	Non-Tax Revenue	Trans-fers	Total Revenue	% of Total Revenue: Tax Revenue and Licences	% of Total Revenue: Non-Tax Revenue	% of Total Revenue: Trans-fers
States of Malaya							
1958	70.3	48.0	67.1	185.4	37.9	25.9	36.2
1959	76.5	43.2	70.1	189.8	40.3	22.8	36.9
1960	85.3	51.1	69.5	205.9	41.4	24.8	33.8
1961	91.6	52.6	97.7	241.9	37.9	21.7	40.4
1962	95.3	61.3	77.5	234.1	40.7	26.2	33.1
1963	86.5	61.2	86.9	234.6	36.9	26.1	37.0
1964	88.2	69.5	91.2	248.9	35.4	27.9	36.7
1965	85.2	81.7	106.7	273.6	31.1	29.9	39.0
1966	95.0	99.3	105.3	299.6	31.7	33.1	35.2
Sabah							
1964	24.9	19.7	22.7	67.3	37.0	29.3	33.7
1965	29.0	15.3	30.6	74.9	38.8	20.4	40.8
1966	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sarawak							
1964	20.1	11.4	21.8	53.3	37.7	21.4	40.9
1965	22.5	9.4	28.5	60.4	37.3	15.5	47.2
1966	26.6	13.4	30.7	70.7	37.6	19.0	43.4

Source: *State Financial Statements*, and information supplied by the Ministry of Finance, Kuala Lumpur.

that all the major sources of income, particularly customs and excise duties and the income tax are under the jurisdiction of the Federal Government while the states have been left with a number of less productive tax sources. A glance at Table 11 reveals that the combined state budgets amount to only about one quarter of that of the Federal Budget. Between 1960 and 1965 the combined state revenue amounted to an average of 22.7% of the amount of the total Federal revenue. If we consider the figures for federal and state *tax* revenue only, the relation is even more unfavourable for the states. The combined tax revenue of all the states between 1960 and 1965 averaged only 10.8% of the total tax yield of the Federation.

The overwhelming predominance of the Centre in respect of public finance is a logical consequence of the preponderance of the Federal Government in the distribution of powers. It testifies to the relative insignificance of state action as compared with federal action. Indeed, the position of the states is almost comparable to that of semi-autonomous specialised public authorities in other countries. Only the two Borneo States, in line with their greater constitutional obligations, enjoy a somewhat higher degree of tax autonomy. Thus, in 1965, the total revenue of Sabah

Table 11:

COMPARISON BETWEEN FEDERAL AND COMBINED STATE BUDGET FIGURES
MALAYA 1960-63, MALAYSIA 1964-66

- in M$ million -

		Tax Revenue only			Total Revenue			Total Expenditure		
		Federal	States	States as % of Federal	Federal	States	States as % of Federal	Federal	States	States as % of Federal
Malaya	1960	881	85	9.7	1,030	206	20.0	856	193	22.6
	1961	876	92	10.5	1,052	242	23.0	939	251	26.7
	1962	880	95	10.8	1,090	234	21.5	1,072	238	22.2
	1963	920	86	9.4	1,149	235	20.5	1,277	245	19.2
Malaysia	1964	1,049	133	12.7	1,459	368	25.2	1,708	414	24.2
	1965	1,190	137	11.5	1,580	409	25.9	1,629	388	23.8
	1966	n.a.	n.a.	n.a.	1,655	455	27.5	1,713	443	25.9

Source: *Federal and State Financial Statements*, and information supplied by the Ministry of Finance, Kuala Lumpur.

and Sarawak together amounted to 8.5% (Sabah: 4.7% and Sarawak: 3.8%) of the total revenue of the Federal Government, whereas the combined total revenue of the remaining eleven States of Malaya amounted to only 17.3% of the amount of the Federal revenue.[1] In terms of per capita state revenue, the revenue of Sabah amounted to M$137.30 and that of Sarawak to M$67.80 compared with an average of M$32.80 for the States for Malaya in 1964/65.[2]

It is true that despite their relatively low tax capacity, some of the states are nevertheless comparatively wealthy because they own vast areas of unappropriated land. But this unemployed capital has still to be transformed, mainly through long-term agricultural and forestry development as well as land settlement schemes, into more economic assets. However, even if the states can increase their income from these sources in the long-run, most of the more productive resources will nevertheless continue to belong to the Centre. This means that also in future the overwhelming predominance of the Federal Government in respect of current and development expenditure remain unchanged.

d. *The Division of Resources and the Principle of Efficiency*

It remains to be examined to what extent the division of tax sources follows the principle of efficiency. Earlier it was suggested that, in general, taxes having an interstate basis should be administered by the centre and those having a regional basis, by the states.[3] This general rule should, however, be interpreted with the necessary flexibility and viewed against the background of the wider interests of the national economy (e.g. fiscal policy). Moreover, a system where most of the taxes are collected centrally and where the revenue is shared between the two layers of government according to tax sharing arrangements or by means of predetermined federal grants, would not necessarily be in conflict with the principle of efficiency. Examples of taxes which may be collected more competently by the federal government would be customs and excise duties, and taxes on income. Since these sources of revenue are also the most flexible and productive ones, they would enable the federal government to carry out an effective nation-wide fiscal policy.

The division of tax sources in Malaysia does not, in general, seem to be in conflict with the general considerations of efficiency. Export, import and excise duties are almost all collected by the Federal Government. Together they account for almost half (1964/66: 45.3%)[4] of the total federal revenue. Where certain portions of the yield of export duties have to be appropriated to the states (as, for instance, in the case of the export duties on tin and iron), the Federal Government still remains responsible for the administration of these duties. Only the Borneo States have retained responsibility for a number of duties, such as import and excise duties on petroleum products and export duties on timber and forest produce which compensate them for their additional functions under the Constitution. As regards export duties on forest products, these are suited for local administration since

[1]Percentages calculated from Tables 10 and 11.
[2]Cf. Table 17.
[3]Cf. p. 66.
[4]Cf. Table 7.

timber forms the backbone of the local economies in East Malaysia.

In the field of direct taxation the Federal Government has been assigned all the major tax sources with an interstate basis. This applies to the personal and corporate income taxes, which together yield about one-fifth (1964-66: 19.9%)[1] of the total revenue, and, in Malaya, to motor car licences and fees, the yield of which doubled over the past five years and which now account for approximately 6% of the federal income. Whether estate and stamp duties, and taxes on lotteries and betting should accrue to the federal or state governments is a matter which is hard to decide since they can also be taken to be regionally based. In Malaysia these sources of income belong to the Federation. On the other hand, it is obvious that income from service rendered by departments and organisations controlled by the Federal Government, such as Radio and Television Malaysia as well as the Telecommunications Department, should accrue to the Federal Treasury.

In respect of state tax sources, the guiding principle of efficiency also seems to have been largely adhered to. As a general rule it has been suggested that taxes having an essentially local base should be state administered. As examples were mentioned land revenues, taxes from agricultural activities and mineral rights, licence, registration and entertainment fees, as well as secession and estate duties in respect of land ownership. The main sources of state revenue in Malaysia—revenues from forests, lands and mines, municipalities and local authorities, as well as various local fees and entertainment duty—fit into this pattern very well. The administration by the states of income from forests, land and mines seems all the more justified if one thinks of the different conditions of land ownership and mining in the various states, and the fact that forests form the greater part of the unappropriated state lands. Many of the fees collected by the state are, furthermore, related to specific services performed by the states or subsidiary authorities (for instance water rates) and, accordingly, have a definite local base.

The high degree of tax concentration in the Federal Government is in itself not contrary to the principle of efficiency.[2] On the contrary, it is probably the best way of ensuring an efficient tax administration, uniformity of the tax legislation, and the avoidance of duplication and overlapping. It also ensures that the federal government can make the best use of the operation of public finance for the purpose of fiscal policy. The high degree of tax concentration in Malaysia is mainly a logical consequence of the overwhelming predominance of the Centre in every aspect of the economic life of the nation. However, even if there were no such preponderance of the Centre, it would still be questionable whether the states, in the face of the very acute shortage of qualified administrators, would be in a position to assume more responsibilities with regard to the administration of taxes. The administrative capability of some of the states is still rather limited.

With respect to Singapore, the Constitution did not provide for a division of resources in any real sense, for what we find here is rather a system under which taxes were collected by the Singapore Government and divided between the Federal

[1] Cf. Table 7.

[2] The high degree of tax concentration and the dependence of the states on federal transfers for a large portion of their total revenue show that there has been no intention in Malaysia to follow the 'principle of financial responsibility'. Cf. also pp. 48—49.

and Singapore Governments according to a predetermined formula. Although it is true that Part III of the Tenth Schedule of the Constitution, which defines the sources of revenue assigned to the states, also applied to Singapore, it is obvious that the more important state revenues specified in the State List such as those from forests, lands and mines were of no significance to Singapore with its limited land areas of 225 square miles. It follows that the question of whether taxes were divided between the Centre and Singapore according to the standard of efficiency is not really relevant. This, of course, does not mean that the centralised system of tax collection and the tax-sharing agreement in force between 1963-65 could not, over a longer period, have proved to work very satisfactorily.

This brings us to another point of interest, namely the avoidance of overlap in the division of functions and resources in the interest of an efficient working of the whole system of public administration. The danger of overlapping jurisdiction and duplication which has been a problem in many of the older federations, has so far been of little or no significance in Malaysia. With regard to the division of functions, there is a comparatively wide zone for concurrent legislation and a rather insignificant element of residuum legislative power. There is virtually no room for overlapping jurisdiction because in respect of the Concurrent List, federal legislation, whether prior or subsequent to the state enactment, overrides state law. With regard to the residuum of legislative powers this is clearly within the jurisdiction of the states.

Similarly, the danger of an overlap does not appear in relation to the division of resources inasmuch as the sources of revenue not especially enumerated in Part III of the Tenth Schedule of the Constitution, fall automatically under Federal competence. In practice, the collection of the major tax sources of the Federation, i.e. customs and excise duties and the income tax, is carried out by the Royal Customs and Excise Department and the Department of Inland Revenue which are both responsible to the Ministry of Finance. The Royal Customs and Excise Department also collects a certain amount of revenue for and on behalf of the states, notably excise on toddy. Separate revenue units collect the income tax in the States of Malaya, Sabah and Sarawak, but a pan-Malaysian Comptroller-General ensures that there is adequate coordination among the three units. The Department of Inland Revenue also collects the turnover tax, the payroll tax, as well as estate and stamp duties. Most of the other federal revenues are collected by the substantive Federal departments.

3. *Summary*

The following are the main findings regarding the division of functions and resources between the Centre and state governments in Malaysia:

(*i*) The Federal Government holds a predominant position in Malaysia with regard to functions and resources. The combined state budgets only come to approximately one quarter of the total Federal budget. The Federal Government extends its influence into all the vital areas of the country's economic and social life, and the states have been left with functions of secondary importance only. Similarly, almost all the more productive and flexible tax sources have been assigned to the Centre.

(*ii*) The Federal predominance in respect of functions and resources is less pronounced vis-a-vis the Borneo States than the States of Malaya which, at the time of the formation of the Federation of Malaya in 1957, were not opposed to the creation of a strongly centralised state for the sake of rapid economic development, provided the status and prestige of the Rulers was preserved. The Borneo States, on the other hand, control a number of additional sources of income which compensate them for their additional functions under the Constitution. Their wider powers and greater resources are largely the result of the special conditions prevailing at the time of their joining Malaysia and the fact that their socio-economic and financial interests were more strongly represented at that time.

(*iii*) The financial arrangements with Singapore were typical of the completely integrated (or 'centralised') system of tax collection; for, with a few exceptions, Singapore continued to collect all types of revenue within its boundaries and shared its revenue with the Federal Government according to a predetermined ratio of distribution. It was a special feature of the system that tax collection was the responsibility of the state and not that of the Federal Government. The special financial arrangements with Singapore—as, in fact, also the greater powers retained by the State—reflected the loose economic integration of Singapore with the rest of Malaysia which, in turn, was the result of its different economic interests, its political and financial strength and its high standard of administrative capacity.

(*iv*) The principle of efficiency has largely been followed in respect of both the division of functions and resources. This is true for the States of Malaya (provided one can still reconcile the overwhelming predominance of the Federal Government with the principles of federalism), and also for the Borneo States, if one considers that the latter's special circumstances call for a more liberal interpretation of the principle of efficiency. No room has been left for duplication and overlapping jurisdiction.

(*v*) Malaysia is a typical example of a federation with a high degree of tax concentration. This in itself is not contrary to the principle of efficiency because it guarantees the highest degree of coordination of federal finance and fiscal policy with a view to the nation's development effort.

B. THE EXTENT OF FISCAL IMBALANCE IN MALAYSIA

The problem of fiscal imbalance ('non-correspondence') usually originates from the fact that the central government controls most of the more productive and flexible tax sources, whereas the states, having dynamic and expanding functions, are left with less productive regional source of income. The yield of the latter rarely suffices to enable the states to fulfil their constitutional obligations. This type of fiscal imbalance is known as 'vertical', or federal/state imbalance and denotes the need of the states, taken as a whole, for financial support from the central government. Another type of fiscal imbalance, namely 'horizontal' imbalance, indicates the imbalance between the various states arising from their different fiscal capacities

and from the differences in the cost of fulfilling state functions at a certain minimum standard. It is the purpose of the next few paragraphs to determine the extent of vertical and horizontal imbalance as experienced in Malaysia. The next Chapter will then set out the provisions of the Constitution regarding these imbalances and analyse the practical functioning of the system of fiscal adjustment in Malaysia.

Table 12:

FISCAL IMBALANCE OF THE STATES OF MALAYSIA, 1964-65 ANNUAL AVERAGES

- in M$ million -

	States of Malaya		Sabah		Sarawak		States of Malaysia	
	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.
REVENUE								
Taxes, Licences etc.	86.7	31.7	27.0	35.8	21.3	34.3	135.0	25.2
Non-Tax Revenue	75.6	27.7	17.5	23.2	10.4	16.7	103.5	32.8
Total Domestic Revenue	162.3	59.4	44.5	59.0	31.7	51.0	238.4	58.0
"Fiscal Gap"	111.1	40.6	31.0	41.0	30.4	49.0	172.5	42.0
EXPENDITURE	273.4	100.0	75.5	100.0	62.1	100.0	411.0	100.0
Domestic Revenue per capita	M$22.20		M$85.90		M$37.80		M$25.40	

Source: Tables 8 and 10.

1. *Vertical Imbalance*

Within their limited fields of responsibility, to what extent are the state governments able to meet their commitments from their own sources of income? Tables 8 and 10 revealed that taxes collected locally account for only approximately one third of the total revenue of the states. Non-tax sources, i.e. mainly receipts for and in aid of specific services, revenue from commercial undertakings as well as rent and interest, account for approximately another quarter to one third of the total state revenue. Table 10 showed the development of tax and non-tax revenue for the States of Malaya during the period 1958-66, and for Sabah and Sarawak since 1964. During 1964-66 the 'domestic revenue', i.e. tax plus non-tax revenue, of the States of Malaya amounted on average to 63% of the amount of their total revenue. The corresponding figures for Sabah and Sarawak were 65% (1964-65) and 56%, respectively.

Table 12 relates the states' own sources of income, i.e. their 'domestic revenue' for the period 1964-65, to their expenditure figures. This enables us to determine their 'fiscal gap', i.e. the difference between their own sources of income and their

Table 13:

FISCAL IMBALANCE OF THE STATES OF MALAYA, 1964/65 ANNUAL AVERAGES

- in M$ million -

	Johore		Kedah		Kelantan		Malacca		Negri Sembilan		Pahang	
	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.
Total Domestic Revenue	31,035	71.7	11,065	50.2	7,536	49.2	4,314	49.3	11,822	61.6	19,784	84.7
"Fiscal Gap"	12,232	28.3	10,997	49.8	7,796	50.8	4,432	50.7	7,370	38.4	3,583	15.3
Expenditure	43,267	100.0	22,062	100.0	15,332	100.0	8,746	100.0	19,192	100.0	23,367	100.0
Domestic Revenue (tax ratio) per capita	M$ 25.50		M$ 12.70		M$ 11.80		M$ 11.20		M$ 24.60		M$ 49.60	
Suggested GDP per capita[1])	M$748.00		M$500.00		M$347.00		M$593.00		M$918.00		M$987.00	

	Penang		Perak		Perlis		Selangor		Trengganu	
	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.	Amount	% of Exp.
Total Domestic Revenue	8,752	66.2	30,725	63.1	904	25.2	34,135	70.4	4,529	25.5
"Fiscal Gap"	4,468	33.8	17,968	36.9	2,686	74.8	14,327	29.6	13,220	74.5
Expenditure	13,220	100.0	48,693	100.0	3,590	100.0	48,462	100.0	17,749	100.0
Domestic Revenue (tax ratio) per capita	M$ 12.30		M$ 19.90		M$ 8.10		M$ 25.90		M$ 12.70	
Suggested GDP per capita[1])	M$809.00		M$853.00		M$492.00		M$1,558.00		M$555.00	

[1]) See Footnote to Table 6.

Source: Table 16.

'need' for resources, expressed in terms of their expenditure figures. According to Table 12, the 'fiscal gap' during 1964-65 averaged 40.6% of the amount of the total expenditure of the States of Malaya. The 'fiscal gap' in the case of Sabah and Sarawak during the same period averaged 41.0% and 49.0% respectively.

2. *Horizontal Imbalance*

Table 13 shows the 'fiscal gap' for each of the eleven States of Malaya. It is evident that the financial imbalance of some of the states is greater than that of others. Whereas the domestic revenue of the states of Pahang, Johore and Selangor covers more than 70% of their total expenditure and that of Penang, Perak and Negri Sembilan more than 60%, the revenue of the remaining state covers less than 50% of their needs. The 'fiscal gap' in the case of Perlis and Trengganu amounts to approximately three quarters of their total expenditure on average.

The difference in the fiscal performance of the various states may be gauged from a comparison of their domestic revenue (tax ratios) per capita. Table 13 shows that this ranges from M$8.10 in the case of Perlis to M$49.60 in the case of Pahang. The comparison clearly indicates the relatively poor fiscal performance of the East Coast states of Kelantan and Trengganu and of the two Northern-most states of Perlis and Kedah, compared with the tin-rich and/or more industrialised states of Perak, Pahang, Selangor, Negri Sembilan and Johore. The small states of Penang and Malacca, too have comparatively low tax ratios per capita. Obviously, the different fiscal capacities of the States of Malaya are related to their varying degrees of development. From Table 13 it will be seen that the states having the lowest per capita gross domestic product (GDP) also tend to have the lowest tax ratio per capita, and *vice versa*.

Table 14 shows that the per capita revenue from the major state sources of revenue varies quite considerably among the States of Malaya. As regards revenue from toddy, not all states take equal advantage of this source. In fact, the sale of toddy is forbidden in some of the states (e.g. in Kelantan). Revenue from forests is highest in the large, forest-rich states of Pahang, Johore and Negri Sembilan which are comparatively well served by roads and from which forest produce are largely exported via Singapore and Port Swettenham. On the other hand, the small states of Malacca, Penang and Perlis, where agricultural activities concentrate on rice, rubber, palm oil, and coconuts, show little or no revenue from forests. This also applies to Selangor where virgin jungles have been replaced mainly by rubber plantations. As regards income from lands and mines, the land-rich states and those producing tin and iron are naturally best off. This is true also of revenue from licences and royalties which are highest in the states producing rubber, tin and iron. Water supply as a source of state revenue is highest in Selangor which is densely populated and where most of the secondary industry is situated. This state also profits greatly from premia on sales and grants of land.

As to the large difference in per capita domestic state revenue between the States of Malaya, on the one hand, and Sabah and Sarawak, on the other (see Table 12), this must be explained mainly in terms of the much wider field of taxable resources retained by the latter states. Thus Sabah collects large amounts from the export duty on timber and forest produce (1964: M$2.40 per capita), licences for motor

Table 14:

COMPARISON BETWEEN MAIN STATE SOURCES OF REVENUE, STATES OF MALAYA, 1964/65 AVERAGES

- Revenue per capita in M$ -

	Johore	Kedah	Kelantan	Malacca	N.Sembilan	Pahang	Penang	Perak	Perlis	Selangor	Trengganu
Excise (Toddy)	–.40	–.80	—	–.30	1.00	—	1.70	1.90	—	–.50	—
Forests	5.20	1.60	1.90	–.20	5.00	19.60	—	2.60	–.30	1.20	4.00
Land and Mines	6.80	2.00	2.20	3.80	5.40	6.80	–.50	3.00	1.60	4.00	2.40
Licences and Royalties	3.40	2.00	1.00	2.60	3.10	5.70	4.60	3.10	2.30	5.20	1.10
Water Supply	3.40	2.00	1.10	–.40	4.70	4.00	2.50	3.80	1.50	6.50	–.70
Premia on Land Sales and Grants	1.40	1.80	—	–.30	–.60	2.10	–.70	–.90	–.40	4.80	1.00
Total of above Sources of Revenue	20.60	10.20	6.20	7.60	19.80	38.20	10.00	15.30	6.10	22.20	9.20

Source: *State Financial Statements.*

vehicles (M$2.30 per capita), and import duty on petroleum (M$6.20 per capita), to which the States of Malaya are constitutionally not entitled. Sabah also obtains large royalties and fees for forest produce (1964: M$30.70 per capita compared with an average of M$2.70 per capita in the case of the States of Malaya)[1]. Sarawak, too, benefits greatly—though not to the same extent as Sabah—from export duties on timber and forest produce (1964: M$1.40 per capita), licences for motor vehicles (M$1.10 per capita), and import and excise duties on petroleum products (M$6.20 per capita). Royalties from the permits on forests constitute another major source of income (M$9.00 per capita)[2] in the case of Sarawak.

3. *Summary*

The following are the main findings in respect of fiscal imbalances as they exist in Malaysia: With regard to federal/state, or vertical imbalance, it was shown that the 'fiscal gap', i.e. the difference between the states' own domestic revenue and their requirements, amounts on average to 42% of the financial needs of all the thirteen states expressed in terms of their total expenditure figures. As to horizontal imbalance, there is a remarkable difference in the tax ratios of the eleven States of Malaya. These differences are related to their different aggregate tax capacities and are based mainly on differences in the exploitable natural resource endowments. There is also a considerable difference in the fiscal performance of the states comprising West and East Malaysia. The reason for this is the large revenue derived by the Borneo States from state forests and from the various additional sources which they have retained under the Constitution.

The way and extent to which intergovernmental fiscal imbalances are accommodated in Malaysia is the subject matter of the next Chapter.

[1]Figures calculated from *Sabah Financial Statements for the Year 1964*, and Table 14.
[2]Figures calculated from *Sarawak Financial Statements for the Year 1964*.

CHAPTER V

The System of Fiscal Adjustment in Malaysia and the Question of Flexibility and Coordination

The object of a system of fiscal adjustment may be regarded as twofold. Firstly, its purpose may be to fill the 'fiscal gap' between the states own sources of revenue and the means required to fulfil their constitutional obligations (vertical adjustment) and secondly, it may serve to equalise interstate fiscal differences (horizontal adjustment), provided such an equalisation is a federal aim and is economically feasible. Whereas a vertical imbalance arises from the 'non-correspondence' in the distribution of responsibilities and sources of revenue between the two layers of government, horizontal imbalance is the result of differences in the fiscal capacities of the states and/or in the costs of fulfilling state functions of a given standard.

The size of the adjustment operation depends mainly on the degree of tax concentration. In Malaysia most of the more productive sources of income belong to the National Government and this centralisation of tax sources has been a feature of the Federation from the outset. The combined revenue of all the thirteen states (including transfer payments) amounts to only approximately one quarter of the total revenue of the Federation (see Table 11).

There are three main methods for adjusting fiscal imbalances:

(i) federal grants;
(ii) changes in the ratio of distribution under tax-sharing arrangements; and
(iii) variations in the number and composition of tax sources assigned to the states.

Of these the first is of greatest practical importance although the second is also employed frequently. A typical example of a tax-sharing agreement were the financial arrangements between Singapore and the Federal Government when the former was a member of Malaysia. The third method is for a number of reasons difficult to apply in practice.

In the case of both grants and tax-sharing arrangements the ratio of distribution presents a major problem. Where formulae are fixed for long periods and cannot be changed at short notice, or where conditional grants form part of the scheme of adjustment, at least a portion of it should remain flexible in the sense that there should be one or more powerful marginal 'balancing grants' that are made unconditionally and that are linked to an automatic or impartial determination of the states' needs for additional resources. Long-term or persistent imbalances, on the other hand, which cannot be resolved by 'balancing grants' alone, would require basic changes in the pattern of resource distribution or of the formulae fixed under

that portion of the system of adjustment which is non-flexible in the short-run. Such changes should be initiated by an impartial body in the course of its regular reviews of federal/state financial relations.

In the present chapter we shall outline the method employed in Malaysia for bringing about short-term intergovernmental adjustments, and examine its effectiveness in attaining vertical as well as horizontal fiscal balance. At the same time we shall discuss the provisions contained in the Constitution of Malaysia for ensuring the flexibility and coordination of federal/state financial relations.

A. THE ROLE OF FEDERAL GRANTS AND ALLOCATIONS IN MALAYSIA'S SYSTEM OF FINANCIAL ADJUSTMENT

1. *Conditional Grants and Allocations under Tax-sharing Schemes*

In Malaysia the shifting of whole tax sources to the states would be a possible solution to bridge the large "fiscal gaps' experienced in the budgets of the states.[1] However, since the coming-into-force of the present Constitution there has been no change in the division of resources and it is unlikely that any change will be made in the foreseeable future. The financial needs of the states are met mainly through federal grants and allocations.

From Table 10 it was evident that the states depend for a very substantial portion of their revenue on federal allocations and grants-in-aid. In 1964/65 the average for Malaya was 37.9% for Sabah 37.3% and for Sarawak 44.1%. However, in respect of the Borneo States not all grants originate from the Federal Treasury as may be seen from Table 15. During the period 1964/65 foreign grants accounted for 9.9% of Sabah's and 8.1% of Sarawak's total state income. The foreign grants obtained by the Borneo States represent mainly reimbursements from the British Treasury of salaries for officers employed under the Overseas Service Aid Scheme and compensation under a retirement scheme for British officers formerly employed in the two territories. If foreign grants are excluded, Federal grants still accounted for an average of 31.0% of the state income of Sabah and 36.2% of the state income of Sarawak during 1964/65.

Malaysia, then, mainly depends on federal grants and allocations to balance the books of the thirteen state treasuries. However, except for the capitation grant and the special grants to the Borneo States, none of these federal transfers can be classified as 'adjustment grants' in the sense that they are made unconditionally and for the sole purpose of 'general aid'. No grant qualifies as 'balancing grant' in the sense of what has been stated above, because none of them is linked to an automatic criterion indicating the financial need of the states.

A typical example of a conditional grant is the state road grant which compensates the states for costs actually incurred in maintaining state roads. The grant is made

[1]Article 110(4) provides that "Parliament may by law (a) assign to the States the whole or any portion of the proceeds of any tax or fee raised or levied by the Federation; and (b) assign to the States the responsibility of collecting for State purposes any tax or fee authorised by Federal law".

Table 15:

FEDERAL AND FOREIGN GRANTS TO THE BORNEO STATES

- in M$ million -

	Sabah				Sarawak			
	1964 M$	1965 M$	1964/65 Average of Total in %		1964 M$	1965 M$	1964/65 Average of Total in %	
			Grants	State Revenue			Grants	State Revenue
Federal Grants	21.3	23.2	75.8	31.0	18.1	23.0	81.7	36.2
Foreign Grants	1.4	7.4	24.2	9.9	3.7	5.5	18.3	8.1
Total Grants	22.7	30.6	100.0	40.9	21.8	28.5	100.0	44.3
Total State Revenue	67.3	74.9		100.0	53.3	60.4		100.0

Source: *State Financial Statements.*

to the states annually in respect of roads not directly maintained by the Federal Public Works Department. The grant is computed pragmatically and is based on the actual average cost per mile throughout Malaysia. Special rates were fixed for Sabah and Sarawak for the years 1964 and 1965.[1] Conditional grants have also been employed at irregular intervals to support the states in carrying out certain important services in the field of agriculture and rural development. Typical are grants for the maintenance of drainage and irrigation works, for fertilizer schemes, the construction of rural roads and bridges, for rural water supplies, the expansion of veterinary services, and in support of religious instructions in rural areas.

The development of the road grant, and of the other conditional grants (which are included under the item 'Others'), is shown in Table 16. However, in the case of the Borneo States the figures given for 'other' grants also include various other types of federal reimbursements. Whereas the road grant represents up to 20% of the total revenue of some states (1964/65 average for all states: 10%), the other conditional grants together accounted in 1964/65, for an average of only 1.2% of the combined revenue of all the States of Malaya.

Obviously, none of the abovementioned conditional grants is made solely for the purpose of balancing the budgets of the states. This is also true of the allocations in respect of the export duty on tin and other minerals under Article 110 (3) and (3A) of the Constitution. Following the principle of derivation, these allocations represent transfers under tax-sharing arrangements and partially compensate the tin and iron producing states for their having to forgo the right of levying export duties on these minerals themselves. As may be seen from Table 16, these allocations constitute a considerable portion of the total revenue of some of the States of

[1]The provisions governing the state road grant are set out in the Tenth Schedule, Part II and IV, Section 2(2), of the *Federal Constitution*.

Table 16:

SUMMARY OF STATE REVENUE AND EXPENDITURE, 1960–63 AND 1964–65, ANNUAL AVERAGES

- in M$ 1,000 -

A = Average amount per year during period

B = Percentage of Total State Revenue

	JOHORE				KEDAH				KELANTAN				MALACCA				NEGERI SEMBILAN				PAHANG			
	1960–63		1964–65		1960–63		1964–65		1960–63		1964–65		1960–63		1964–65		1960–63		1964–65		1960–63		1964–65	
	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %
REVENUE																								
Duties, Taxes, Licences	19,874	53.5	18,941	43.6	5,989	33.0	5,429	25.6	2,609	24.0	3,248	21.0	2,638	29.0	2,586	28.7	6,578	41.8	6,678	37.8	9,152	46.1	15,249	54.7
Other Income	7,741	20.8		27.9	3,882	21.4	5,636	26.5	2,364	21.8	4,288	27.6	1,197	13.2	1,728	19.2	3,360	21.3	5,124	29.0	4,162	20.9	4,535	16.2
Grants/Allocations																								
Capitation	5,556	14.9	5,457	12.6	4,559	25.1	4,558	21.5	3,772	34.7	3,772	24.4	2,916	32.0	2,915	32.3	3,208	20.4	3,208	18.1	3,002	15.1	3,002	10.7
Roads	2,897	.7.7	3,304	7.6	2,254	12.4	2,936	13.8	970	8.9	1,095	7.1	1,528	16.7	1,736	19.3	1,974	12.5	2,318	13.1	1,164	5.9	1,734	6.3
Tin, Iron, etc.	97	0.2	3,334[1]	7.7	140	0.8	785[1]	3.7	289	2.7	1,057[1]	6.8	7	0.1	17	0.2	97	0.6	141	0.8	531	2.7	3,074[1]	11.0
State Reserve Fund	—	—	—	—	—	—	1,350[2]	6.4	11[3]	0.1	1,836[4]	11.8	—	—	—	—	—	—	—	—	—	—	—	—
Others	1,106	2.9	292	0.6	1,329	7.3	542	2.5	854	7.8	204	1.3	821	9.0	29	0.3	534	3.4	216	1.2	1,846	9.3	301	1.1
Total Grants	9,556	25.7	12,387	28.5	8,282	45.6	10,171	47.9	5,896	54.2	7,964	51.4	5,272	57.8	4,697	52.1	5,813	36.9	5,883	33.2	6,543	33.0	8,111	29.1
Total Revenue	37,171	100.0	43,422	100.0	18,153		21,236	100.0	10,869	100.0	15,500	100.0	9,107	100.0	9,011	100.0	15,751	100.0	17,705	100.0	19,857	100.0	27,895	100.0
EXPENDITURE			43,267		19,540		22,062		11,455		15,332		8,978		8,746		15,466		19,192		18,339		23,367	
Surplus/Deficit	–2,148		+155		–1,387		– 826		–586		+168		+129		+265		+285		–1,487		+1,518		+4,528	

[1] Increase due to the introduction of duty on export of iron ore.

[2] Represents M$ 2,701,000 grant from State Reserve Fund in 1965.

[3] Represents M$ 45,000 grant from State Reserve Fund in 1960.

[4] Represents M$ 3,672,000 grant from State Reserve Fund in 1965.

Table 16: (Cont'd)

SUMMARY OF STATE REVENUE AND EXPENDITURE, 1960–63 AND 1964–65, ANNUAL AVERAGES

- in M$ 1,000 -

A = Average amount per year during period
B = Percentage of Total State Revenue

	PENANG				PERAK				PERLIS				SELANGOR				TRENGGANU				SABAH		SARAWAK	
	1960–63		1964–65		1960–63		1964–65		1960–63		1964–65		1960–63		1964–65		1960–63		1964–65		1964–65		1964–65	
	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %	A $	B %
REVENUE																								
Duties, Taxes, Licences	4,581	32.3	4,239	29.3	18,932	41.2	14,930	30.4	431	16.1	468	13.6	12,095	29.9	14,135	30.0	6,823[3]	45.7	2,889	19.4	26,965	37.9	21,325	37.5
Other Income	3,764	26.6	4,513	31.2	11,577	25.1	15,795	32.1	479	17.9	436	12.6	16,418	40.6	20,000	42.5	1,615	10.8	1,640	11.1	20,552	28.9	14,954	26.3
Grants/Allocations																								
Capitation	4,038	28.5	4,038	27.9	6,636	14.4	6,636	13.5	1,159	43.2	1,159	33.7	5,802	14.3	5,802	12.3	2,863	19.2	2,863	19.3	3,568	5.0	4,728	8.3
Roads	1,375	9.7	1,578	10.9	3,779	8.2	3,854	7.8	320	12.0	408	11.8	3,022	7.5	3,565	7.6	783	5.3	1,736	11.6	5,180	7.3	3,393	6.0
Tin, Iron, etc.	—	—	—	—	3,316	7.2	7,227	14.7	—	—	—	—	1,956	4.8	3,255	6.9	2,347	15.7	5,395[3]	36.3	—	—	127	0.2
State Reserve Fund	—	—	—	—	—	—	632[1]	1.3	—	—	913[2]	26.5	—	—	—	—	—	—	—	—	—	—	—	—
Others	407	2.9	100	0.7	1,740	3.9	83	0.2	289	10.8	60	1.8	1,177	2.9	355	0.7	495	3.3	343	2.3	14,839	20.9	12,302	21.7
Total Grants	5,820	41.1	5,716	39.5	15,471	33.7	18,432	37.5	1,768	66.0	2,540	73.8	11,957	29.5	12,977	27.5	6,488	43.5	10,337	69.5	23,587	33.2	20,550	36.2
Total Revenue	14,165	100.0	14,468	100.0	45,980	100.0	49,157	100.0	2,678	100.0	3,444	100.0	40,470	100.0	47,112	100.0	14,926	100.0	14,866	100.0	71,104	100.0	56,829	100.0
EXPENDITURE	14,730		13,220		47,601		48,693		3,001		3,590		37,131		48,462		16,274		17,749		72,450		61,038	
Surplus/Deficit	−565		−1,248		−1,621		+ 464		− 323		− 146		+3,339		−1,350		−1,348		−2,883		−1,346		−4,209	

[1] Represents M$ 1,264,000 grant from State Reserve Fund in 1965.
[2] Represents M$ 1,826,000 grant from State Reserve Fund in 1965.
[3] Royalties on iron formerly recorded under Duties, Taxes and Licences.

Source: *State Financial Statements.*

Table 17:

STATE DOMESTIC REVENUE, EXPORT DUTIES, CAPITATION GRANT AND TOTAL STATE REVENUE PER CAPITA OF THE STATE GOVERNMENTS, ANNUAL AVERAGES 1964/65

	Population 1965	Suggested GDP Per Capita [1]		State Domestic Revenue		Export Duty Tin, Iron, etc.		Capitation Grant		Total State Revenue excluding Capitation Grant		Total State Revenue including Capitation Grant	
	(in 1,000)	Per Capita M$	Malaya Average =100	Per Capita M$	Malaya Average =100	Per Capita M$	Malaya Average =100	Per Capita M$	Malaya Average =100	Per Capita M$	Malaya Average =100	Per Capita M$	Malaya Average =100
States of Malaya	8,036	856	100	22.20	100	3.00	100	5.40	100	27.40	100	32.80	100
Kelantan	637	347	41	11.80	53	1.70	57	5.90	109	18.40	67	24.30	74
Perlis	112	492	57	8.10	36	–	–	10.40	193	20.40	74	30.80	94
Kedah	874	500	58	12.70	57	0.90	30	5.20	96	19.10	70	24.30	74
Trengganu	356	555	65	12.70	57	15.20	507	8.00	148	33.80	123	41.80	127
Malacca	384	593	69	11.20	50	–	–	7.60	141	15.90	58	23.50	72
Johore	1,216	784	92	25.50	115	2.70	90	4.50	83	31.20	114	35.70	109
Penang	714	809	95	12.30	55	–	–	5.70	106	14.60	53	20.30	62
Perak	1,548	853	100	19.90	90	4.70	157	4.30	80	27.50	100	31.80	97
Negri Sembilan	480	918	107	24.60	111	0.30	10	6.70	124	30.20	110	36.90	113
Pahang	399	987	115	49.60	223	7.70	257	7.50	139	62.40	228	69.90	213
Selangor	1,316	1,558	182	25.90	117	2.50	83	4.40	82	31.40	115	35.80	109
Sabah	518	n.a.	n.a.	85.90	387	–	–	6.90	128	130.40	476	137.30	419
Sarawak	838	n.a.	n.a.	37.80	170	0.20	67	5.60	104	62.20	227	67.80	207
Malaysia	9,392	n.a.	n.a.	26.20	–	2.60	–	5.50	–	36.20	–	41.70	–

[1]) See Footnote to Table 6.

Source: Tables 3, 12 and 16.

Malaya. In 1964/65, for instance, they represented in the case of Trengganu 36.3% and in the case of Perak and Pahang 14.7% and 11.0%, respectively, of the total state income. The states of Johore, Kelantan and Selangor received between 6—8% of their total revenue from this source. The remaining states, in which minerals are not mined on a large scale, obtain little or no allocations from the export duty on minerals.

The allocations for export duty on tin and iron have contributed towards aggravating the striking difference in the revenue position of the various states of Malaya. As is evident from Table 17 most of the richer states such as Johore, Perak, Pahang and Selangor obtain large additional revenue from federal allocations for export duties, whereas the poorer states of Kelantan, Perlis, Kedah and Malacca benefit little or not at all from this source. Trengganu which is basically one of the poorest states, has temporarily obtained large financial allocations as a result of iron ore mined within its borders, but the export boom in iron ore is apparently subsiding owing to the gradual depletion of the mines.

The allocations made to the Borneo States under Part V of the Tenth Schedule of the Constitution in respect of export duties other than on tin (Section 3), as well as the allocation of 30% of customs revenue to Sabah (Section 4) also represent allotments under tax-sharing arrangements. They are based on the principle of derivation, form a regular source of income of these states and are designed to compensate them for certain additional constitutional functions. They do not represent adjustment grants in the sense that they are made in 'general aid', i.e. for the sole purpose of helping the states to balance their books. Nor, indeed, are they 'balancing grants' because the amounts are determined by inflexible formulae which are not, in any way, geared to the real financial needs of the states.

There are two other types of grants for which provision is made in the Constitution. Under Article 109 (3) of the Constitution the Federal Government may make grants to any state on such terms and conditions as may be provided by law. The purpose of this type of grant has not been specified, but it would appear that they are chiefly thought of as conditional grants to support certain state services. Article 103 foresees the creation of a Contingency Fund which may be used for advances to meet urgent and unforeseen needs for expenditure. As advances from the Fund are made on an *ad hoc* basis and for specific purposes only, they are of limited significance for the purpose of financial adjustment.

From the above it is clear that a large portion of the trarsfer component of state income consists of allocations under tax-sharing arrangements and of conditional grants to which the states are either constitutionally entitled or which are made by the Federal Government in support of certain state services. All these sources of revenue fall under the scheme of adjustment although none of them qualifies as an adjustment grant in the sense of being a grant made in 'general aid'.

Next our attention may be drawn to the provisions governing those federal grants which were specifically designed for the purpose of the intergovernmental fiscal adjustment, i.e. the capitation grant and the special grants to the Borneo States.

2. *The Major Adjustment Grants*

Part I of the Tenth Schedule of the Federal Constitution sets out the provisions

governing the capitation grant. The grant has operated every year since Independence and has been fixed on a sliding scale as follows:

(i) for the first 50,000 persons at the rate of M$15 per person;
(ii) for the next 200,000 persons at the rate of M$10 per person; and
(iii) for the remainder at the rate of M$4 per person, whereby the grant is based on the population of the state as determined at the last census taken before the beginning of the preceding financial year.[1]

Parliament may from time to time vary the rates of the capitation grant by law. However, if the effect of any such law is to reduce the grant, provision is to be made for ensuring that the amount of the grant received by a state in respect of any financial year is not less than 90% of the amount received by that state in the preceding financial year.[2] So far the rates of capitation grant have not been changed.

In addition to the capitation grant, Part IV of the Tenth Schedule of the Constitution provides for the following special grants to the Borneo States.[3]

(i) Sarawak

—a grant of M$5.8 million a year;
—a grant amounting to:
M$ 3.5 million for 1964
M$ 7.0 million for 1965
M$11.5 million for 1966
M$16.0 million for 1967
M$21.0 million for 1968

After 1968 the amount of the grant is to be fixed on a periodic basis by the Federal and State Governments. According to Article 112 D of the Constitution the review is to take place every five years, or such longer period as may be agreed upon. At the first review by the middle of 1968 with a view to 1969, the question of the grant itself cannot be raised but only the amount for the succeeding five years. A review as to the abolition of the grant cannot take place before 1973.

(ii) Sabah

The special grant for Sabah is governed by a rather complex formula. The amount of the grant is equal to two-fifths of the annual amount by which the net revenue derived by the Federation from Sabah (i.e. the revenue which accrues to the Federation, less the amounts received by the state in respect of allotments from that revenue) exceeds the hypothetical net amount of revenue which the Federation would have derived from Sabah in 1963 if the Malaysia Act[4] had been in effect for the whole of that year, and if no tax or fee were altered on or after Malaysia Day (i.e. the day of the creation of the Federation of Malaysia).[5]

[1]The last official census was taken in 1957. A new census is scheduled for 1970.
[2]Cf. Malaysia: *The Federal Constitution,* Article 109(2).
[3]For the origin of the specific grants to the Borneo States cf. Malaya: *Malaysia Report of the Inter-Governmental Committee* 1962, pp. 13–14.
[4]i.e. the *Malaysia Act* No. 26 of 1963 which amended the Constitution of the old Federation of Malaya so as to become the Constitution of the Federation of Malaysia.
[5]In actual fact the hypothetical figure amounts to M$42,023,693.30 (Information supplied by the Ministry of Finance, Kuala Lumpur).

The special grant for Sabah, too, is subject to periodic review which would normally take place every five years from the year 1969 onwards. If the Federal and State Governments agree on the alteration or abolition of the grant, or on another grant instead or in addition thereto, then the Constitution is to be modified accordingly by order of the King.

Before looking more closely at the actual working of the system of financial adjustment, it remains to outline the provisions governing grants from the State Reserve Fund. These grants have assumed great significance in recent years as instruments to assist states which have experienced extraordinary financial stringencies.

Article 109 (6) of the Constitution provides for the establishment of the State Reserve Fund and obliges the Federal Government to pay annually a certain amount of money into it. After consultation with the National Finance Council, the Federal Government may make grants from the Fund to any state for the purpose of development or, generally, to supplement its revenue. Grants from the Fund are not governed by any specific rules and have been made at irregular intervals mainly, though not exclusively, for the purpose of assisting states which have been unable to balance their budgets through no fault of their own.[1]

B. THE WORKING OF THE SYSTEM OF FINANCIAL ADJUSTMENT

Under ideal conditions a system of adjustment should enable the states to meet their obligations and to maintain their varied services at a uniform and high level. At the same time it should equalise interstate fiscal differences by transferring funds from the richer to the poorer states. A system of adjustment may merely aim at equalising differences in the tax and revenue capacities of the states and in the costs of fulfilling state services, or it may be designed simply to stimulate economic development in the backward areas by enabling them to introduce additional economic services and to embark on long-term development projects.

Ideally, too, a system of adjustment should put funds at the disposal of the states without attaching any strings thereto. The amount of such transfers should be determined annually by an automatic adjustment device or preferably, by an independent and impartial authority. In fixing the amount of adjustment transfers (or of formulae under tax-sharing agreements) the financial capacity of the central government and need of the states for assistance should be the chief criteria, whereby 'need' should take care of both the vertical and horizontal aspects of adjustment.

Since the term 'need' is ambiguous and does not lend itself to determine precisely the amount of federal grants required by the states, some standard figures may advantageously be employed indicating the amount of taxes and other revenues the states can be expected to raise, and the average cost of performing state func-

[1]No summary is provided for Section A, but the reader is referred to the summary on pp. 155-156 which also covers this Section.

tions. Alternatively, a simple standard, such as per capita income, could be used as a guide for the distribution among the states of federal financial assistance. States with similar overall conditions and having to fulfil more or less identical functions should obtain equal amounts. Differentiation is justified only to allow for differences among the states in the size of population, or to adjust differences in their fiscal capacities and in the cost of performing their functions at the desired level. Discrimination is also permissible where it is desired to equalise interstate differences in wealth and income, and in levels of general development.

The above presents an ideal system. It proceeds from the assumption that horizontal equalisation is a goal of federation and that its implementation is economically feasible as well. Both need not be the case, however. In a loose federation, the wealthier states may wish to enjoy full fiscal autonomy and may object to the idea of equalisation. Moreover, in view of the nature of the process of growth and the advantages of concentration it may be economically unwise, especially in developing countries, to carry out a policy of equalisation.

From the discussion of the aims of Malaysia's development policy in Part One,[1] it was clear that the Federal Government accepts in principle the obligation of treating all states equal. In fact, however, little attention has been given to the problem of bringing about a greater degree of equality among the eleven states of Malaya. The Northern and Eastern states are comparatively speaking more backward in their development than the states along the West Coast of the Malay Peninsula, but Federal development expenditure tends to favour projects in the West Coast states where such investments are more rewarding.

The position is, however, different with respect to the Borneo States. They were not only in a stronger bargaining position when joining Malaysia, but their political position vis-a-vis the Federal Government is also of such a nature that the latter can ill-afford to neglect their demand for a preferential treatment in financial matters.

The practice of fiscal adjustment as it operates in Malaysia also deviates in another important respect from the ideal solution outlined above. The system of adjustment largely consists of conditional grants and allocations under tax-sharing arrangements which are not related to the states' financial needs. Nor are the major unconditional adjustment grants geared to a device indicating the actual requirements of the states. The absence of such a relationship need not, however, be contrary to the ideal if there were, at the same time, a powerful marginal balancing grant. In Malaysia such a balancing grant is non-existent.

1. *The States of Malaya*

In view of the fact that the division of functions and resources differs substantially between East and West Malaysia and that, moreover, a number of additional powerful adjustment grants are available to the Borneo States, it is almost impossible to compare the financial systems of West and East Malaysia. It is, therefore, more appropriate to analyse the working of the system of fiscal adjustment separately for both parts of Malaysia.

[1]Cf. pp. 37–43.

a. *Conditional Grants and Allocations*

The most important feature of state government finance in West Malaysia is probably the extreme disparity in the revenue position of the various states. If one compares the two columns 'State Domestic Revenue' and 'Total State Revenue including Capitation Grant' given in Table 17 on a per capita basis, it will be noticed that the pattern of the disparity among the states is not much changed by the various grants and allocations. The total per capita revenue of the poorest state, namely Penang, still only amounts to 29% of that of the richest state, namely Pahang.

This is hardly surprising considering that none of these grants and allocations is related to the income position of the states nor, indeed, to their requirements of funds. In respect of the allocations of export duties on minerals (see column 'Export Duty on Tin, Iron, etc' of Table 17) there is no apparent relation between the amount of the allocations and the degree of wealth of a state, as expressed by the states' domestic revenue or by their per capita gross domestic product. Thus Perlis and Malacca, the gross domestic product and the state domestic revenue of which (both expressed on a per capita basis) is much below the Malayan average, received no such allocations, whereas two of the wealthiest states, Pahang and Selangor, received comparatively high allocations for export duties collected by the Federal Government. With respect to the state road grant the states having the most extensive network of roads benefit most.

Owing to the arbitrary way in which conditional grants and allocations have been augmenting the domestic revenue of the states, the working of the capitation grant assumes added significance. It was stated earlier that it is the only grant especially designed for the purpose of fiscal adjustment.

b. *The Capitation Grant*

Looking at the capitation grant, we find that its main characteristics are, firstly, that it is based on the population figures of the states (which is justified), and secondly, that it provides for a sliding scale which, it may be added, has remained unaltered since the grant was introduced in 1958[1]. The sliding scale was intended to favour the less populous states which, like the more populous ones, have to maintain a certain minimum administrative machinery as well as the households of the Rulers of the states. It was thought that the smaller states having only a few hundred thousand inhabitants, most of whom are poor, would not have enough tax-payers to support these administrative overheads that must be borne by the states under the existing political set-up. Reference to Table 17 shows, however, that this basic assumption is not correct since there is apparently no relation between the size of the population of the states and their wealth, expressed in terms of per capita gross domestic product and total state revenue, excluding the capitation grant. Some of the less populous states such as Pahang and Negri Sembilan are comparatively

[1]The capitation grant goes back to the recommendations of the so-called 'Himsworth Report', or *Report of the Committee appointed to review the Financial Provisions of the Federation of Malaya Agreement, 1948*, Kuala Lumpur, 1955. According to the recommendations of the Committee the grant was to be calculated on the basis of the adult population and varied within certain limits from year to year.

Table 18:

COST OF MAINTAINING STATE GOVERNMENTS AND THE ROLE OF THE CAPITATION GRANT IN MEETING THESE COSTS, 1962

	Population 1965 in 1000	Total State Expenditure M$1000	Cost of Maintaining Gvt.[1] M$1000	Cost of Maintaining Gvt. as % of Total Expenditure	Amount of Capitation Grant M$1000	Capitation Grant as % of Total Expenditure
Perlis	112	2,543	308	12.1	1,159	45.6
Trengganu	356	17,329	1,070	6.2	2,863	16.5
Malacca	384	8,101	558	6.9	2,915	36.0
Pahang	399	19,332	1,323	6.8	3,002	15.5
N.Sembilan	480	15,983	1,194	7.5	3,208	20.1
Kelantan	637	10,819	1,273	11.8	3,772	34.9
Penang	714	15,372	1,304	8.5	4,038	26.3
Kedah	874	20,308	1,794	8.8	4,559	22.4
Johore	1,216	37,465	2,322	6.2	5,457	14.6
Selangor	1,316	38,356	1,612	4.2	5,802	15.1
Perak	1,548	52,118	1,317	2.5	6,636	12.7

[1]Figures include costs of maintaining the households of the Rulers and the State Assemblies and Executives.

Source: *State Financial Statements.*

wealthy whereas some of the more populous ones, such as Kedah, are rather poor. The reason being that the wealth and thus the tax capacity of the individual states depends mainly on their natural resource endowment (mainly forests and minerals) rather than on the population size.

Table 18 compares the costs of maintaining the government machinery of the states (including expenditures for the maintenance of the households of the Rulers, and the State Assemblies and Executives) with the total expenditure of the states. The table also shows the extent to which the state's total expenditure is covered by the capitation grant. From the table it is evident that the cost of maintaining the state government machineries is not necessarily related to the size of the population although in the case of the two largest states in terms of population, namely Selangor and Perak, the cost of government is considerably below the average of 7.4% of total state expenditure for all the eleven states. The burden of maintaining the government machinery is highest for Perlis which has the smallest population. On the other hand, the capitation grant more than covers the cost of government in respect of all the states and it also meets a very substantial amount of the total expenditure of the less populous (but not necessarily poorest) states such as Perlis, Malacca and Kelantan.

The actual development of the capitation grant during the period 1960-65 may be deduced from Table 16 which also reveals that during 1964-65, for instance, the grant mainly supported the less populous states such as Perlis, Malacca and Trengganu, where it has provided approximately 34%, 32% and 19%, respectively, of the total revenue of these states. The corresponding figures for the most

populous states of Perak, Selangor and Johore during the same period amounted to between 12-14%.

Table 16 also shows that the capitation grant remained practically stationary for all states during 1960-65, whereas total revenue increased considerably during this period in respect of most of the States of Malaya. This indicates that the importance of the capitation grant as a source of income to the states is steadily declining. This development is welcomed by the Federal Treasury because the capitation grant has, by no means, always worked in favour of the poorer states. As may be seen from Table 17, some of the states receiving the highest per capita capitation grant as, for instance, Negri Sembilan and Pahang, belong to the wealthier states, whereas Kedah which, owing to its comparatively large population, received a relatively small amount, is among the poorest states both in terms of per capita gross domestic product and state domestic revenue. Only in the case of Perlis and to a smaller extent also in the case of Malacca and Kelantan which have comparatively small populations and hardly any natural resources, has the capitation grant fulfilled its original purpose, namely to discriminate by means of the sliding scale, in favour of the most needy states.

If the capitation grant has succeeded in slightly diminishing the difference in the revenue position of the States of Malaya (compare the last two major columns in Table 17), then this must be ascribed to the fact that in the case of the poorer states the grant represents a much higher percentage of their revenue than in the case of the richer states where its influence on total revenue is correspondingly less. With total per capita revenue of the four poorest states being approximately one-third of that of the richest state, and moreover, with functions being more or less the same for all the States of Malaya, it is hardly surprising that some states are chronically short of funds while others show considerable surpluses. It is also noteworthy in this connection that some of those states that suffered substantial deficits between 1960-65, such as Johore, Kedah and Perak, received comparatively low amounts in the form of the capitation grant whereas Pahang and also Malacca, which have showed substantial surpluses, received relatively high per capita capitation grants (see Table 16 and 17).

The failure of the capitation grant in bringing about a substantial improvement in the revenue distribution among the states of West Malaysia is, of course, mainly due to the fact that in a country such as Malaysia where the states differ considerably in their level of development and in their natural resource endowment, population figures alone are not a sufficient base for determining the financial need of the states and thus for fixing the amount of the most important adjustment grant. The capitation grant should rather be conceived as a genuine 'balancing grant' and should, as such, be geared to a more appropriate measure of the revenue needs of the states for federal financial assistance. These needs could be established by determining the difference between the revenue the states can reasonably be expected to raise if tax bases and rates as well as income distributions were considered equal among them, and the costs of meeting 'normal' state functions, whereby consideration should be given to the size of the population of each state, their rural/urban distribution, geographical features, their relative level of development, etc. Only after such a meaningful relationship has been established will it be possible

to reduce the striking difference in state income by way of an adjustment grant.

An equally satisfactory solution might be found by linking the capitation grant directly, but inversely, to per capita state income figures. With its rapidly improving statistical coverage and the expert assistance received from multilateral and bilateral aid sources it can be expected that the Federal Department of Statistics will soon be in a position to establish reliable income estimates for the various States of Malaya. An alternative might be the introduction of an additional balancing grant based either on an 'automatic' standard for determining the need of the states, such as per capita state income, or on the recommendations of an independent body established for that purpose which would have to find its own method for determining the financial need of the states.

There is little doubt that there is an urgent need for improving the present system of fiscal adjustment in West Malaysia if some of the poorer states are not to become a permanent burden to the Federal Government and if the sense of financial responsibility among the states is not to disintegrate eventually. With regard to the latter question it should be remembered that in view of the fact that equalisation is an objective of Federal Government policy in Malaysia—an objective which is confirmed by the intention of the sliding scale of the capitation grant—the poorer states are entitled to expect that at least some attempt be made to diminish extreme fiscal inequalities. A divergency between a declared policy objective and the actual fiscal practice of the Federal Government cannot but foster among the states a spirit of indifference in financial matters. Alternatively, if equalisation is considered too expensive and to stand in the way of rapid growth for the nation as a whole, it should be made clear to the states that, for the time being at least, they have to accept the existing inequality.

As things stand at the moment, a clash between the poorer states and the Federal Government may easily arise once the former become politically more self-aware and more interested in their own economic development. The financial differences during the last few years between the State Government of Kelantan and the Federation on the question of loans for development are a good example of the sort of disturbance that may one day undermine the spirit of cooperation prevailing thus far between the two layers of government.[1]

From the above it is clear that in respect of the States of Malaya the system of fiscal adjustment has been working unsatisfactorily both from the vertical and the horizontal viewpoints. The harm done by this to the sound development of the States of Malaya has, however, probably been less than one would expect because most states could so far still meet their deficits from accumulated assets. Moreover, the fiscal difficulties experienced by some of the states affect only their particular and rather narrow sphere of governmental activity and thus do not involve the supply of the more important socio-economic services to the people.

On the other hand, the strained financial position of a number of state governments, especially of Johore, Kedah, Perak, Perlis and Trengganu (see Table 19), has caused great concern to the Central Government. Their large and persistent deficits over the past years can in future no longer be financed from accumulated

[1]Cf. "Kelantan accepts loan terms", in *The Straits Times*, 22 December 1967, and "Sardon: I would be first to oppose new loan to PMIP", in *ibid.*, 18 May 1968.

state reserves. Moreover, bearing in mind that all the more productive and flexible sources of revenue belong to the Central Government, the scope for increasing state revenue to cope with rising recurrent state expenditure is limited in the short as well as long-run. Considerable reductions in the yield of some of the more important but rather unstable state sources of revenue such as premia on land sales and allotments in respect of export duties on minerals may easily aggravate the situation in no time.

It is not surprising, therefore, to find that the states are now looking increasingly to the Federal Government for extraordinary financial support in the form of Federal loans and reimbursements for state current and development expenditures.[1] The Federal Government, on the other hand, strongly objects to this attitude which fosters a spirit of financial indifference. It has reminded the states time and again to increase their own income and to be more careful in their expenditure policies.[2] Yet, it would appear that the Central authorities may not have fully realised the relationship between the financial difficulties of the states and the inefficiency of the system of intergovernmental financial adjustment which fails in bringing about an approximation of the extreme differences in the revenue position of the states and in meeting their growing requirements for funds. If the present system of adjustment remains unchanged for many more years and some of the states are allowed to become more and more dependent on the 'mercy' of the Federal Government, then the question may be posed whether a complete take-over of the affairs of the states by the centre would not eventually present a more efficient and satisfactory solution. As long as there is no powerful political opposition in Malaya which might have an interest in maintaining the sovereignty of the states, the adoption of a unitary structure in West Malaysia would probably meet with little resistance under the present circumstances. A solution to the problem of maintaining the prestige of the Sultans under a unitary constitution could probably also be found.

c. *Grants from the State Reserve Fund*

The special grants from the State Reserve Fund, which are presently employed to overcome the difficulties of some of the deficit states, can never-be a real substitute for an effective machinery of fiscal adjustment. A grant of the type available from the State Reserve Fund should be made only where it is necessary to overcome

[1]For 1968 eight West Malaysian states have budgeted for substantial deficits. Cf. "Selangor budgets for deficit but not to get aid", in *The Malay Mail*, 20 June 1968.

[2]In his 1967 Budget Speech the Minister of Finance said that "in the course of 1965 and 1966, the Federal Treasury had, on a number of occasions, no choice but to issue money from the State Reserve Fund to some States, a few of which had literally no money to pay even the current salaries and wages of their employees ... Some of these States can justify their request for assistance from the Federal Government ... There are, however, others which have shown little sense of financial responsibility and which think nothing of indulging in deficit financing without even knowing how their deficits are to be financed ... I should now like to state ... that the Federal Government will not consider any request for help from any State unless the Treasury is satisfied that the State concerned has practised the utmost economy and done everything it could to help itself by increasing its revenue to the maximum extent possible from the sources available to it." Budget Speech 1967 as published by the Department of Information: *Siaran Akhbar*, Kuala Lumpur, PEN: 1/67/332 (PARL), pp. 39–40.

purely temporary stringencies which cannot be taken care of by the ordinary scheme of adjustment. More precisely, grants from the State Reserve Funds are unsuited to act as major instrument of adjustment—and were in fact never intended to do so—because they are made on an *ad hoc* basis to states in deficit only and do not as such represent an assured source of income to the states. Since the investigation into the financial position of the states (which precedes the making of a grant) is limited to claimant states, there is always the possibility of financial mismanagement in the non-claimant states which can better 'afford' inefficiency and waste. In addition to these shortcomings it is a weakness of grants from the State Reserve Fund that the final decision on their amount rests with the Federal Government and not with an independent and impartial authority.

It follows that the fundamental imbalance in the financial affairs of the States of Malaya, stemming mainly from the inequality of state revenue, cannot in the last analysis be solved by the means of grants from the State Reserve Fund. All that they can do is to bridge temporary stringencies in the accounts of the states.

Article 109(6) of the Constitution provides that,

> "the Federation may from time to time, after consultation with the National Finance Council, make grants out of the State Reserve Fund to any State for the purposes of development or generally to supplement its revenue".

Table 19 shows the surpluses and deficits of the thirteen states forming Malaysia as well as the grants actually made from the State Reserve Fund since 1960.

For the years up to and including 1960 grants were made mainly in aid of certain development projects. No grants were made between 1961 and 1964. In 1965 and subsequent years, however, payments were made to cover deficits incurred by certain states in previous years. Although not reflected in Table 19, a few states also received advances against anticipated deficits in their budgets. From the table it is evident that so far only a few states, i.e. Kedah, Kelantan, Perak and Perlis, obtained grants from the State Reserve Fund. None of the other states have received grants to cover their deficits which in some cases were very substantial. In view of this seemingly arbitrary way of granting relief, we shall now look more closely into the procedure adopted by the Federal Government for making grants from the Fund.[1]

On recommendation of the National Finance Council[2] a Committee was set up in 1960 under the chairmanship of the Secretary of the Treasury, and comprising three members appointed by the Minister of Finance, five members appointed by the National Finance Council as representatives of the States, and a secretary appointed by the Treasury, to examine the procedure to be adopted for applications for grants from the State Reserve Fund. The Committee recommended that the State Reserve Fund should henceforth no longer be used to finance development projects of an ordinary and foreseen nature and that grants from it should be made only to states which find themselves in financial difficulties on current account. Moreover, it was decided to appoint another Committee which would be charged

[1]The following account of the method adopted to determine the amount of grants from the State Reserve Fund is based on information provided by the Ministry of Finance, Kuala Lumpur.

[2]The functions of the National Finance Council will be discussed on pp. 160–162.

Table 19:

SURPLUSES AND DEFICITS OF THE STATE GOVERNMENTS AND DEFICITS ACTUALLY COVERED BY GRANTS FROM THE STATE RESERVE FUND, 1960–65

- in M$ 1,000 -

	Amount of Surplus/Deficit + = Surplus — = Deficit						Amount of Grant from State Reserve Fund paid in respect of the year						Grant as % of Deficit Shown (Before the Application of Grant)					
	1960	1961	1962	1963	1964	1965	1960	1961	1962	1963	1964	1965	1960	1961	1962	1963	1964	1965
Johore	+1,526	–1,212	–1,463	–7,444	– 1,646	–1,956												
Kedah	– 121	– 340	–2,445	–2,641	– 865	(–3,488)[1] – 787			2,701[2]		2,819[4]	1,644[5]			110		326	47
Kelantan	+1,203	+ 344	– 577	–3,332	+ 179	(–3,516)[1] + 156	45		402[2]	3,269[2]		2,821[5]			72	98		80
Malacca	+1,019	– 357	+ 193	– 339	+ 381	+ 148												
N.Sembilan	+1,311	+ 4	– 270	+ 94	– 1,289	–1,684												
Pahang	+1,433	– 475	+2,723	+2,391	+ 1,656	+7,399												
Penang	+2,012	–3,388	–1,767	+ 886	+ 1,026	+1,470												
Perak	– 409	– 728	–4,087	– 1,259	– 2,756	(+2,419)[1] +3,683				1,264[2]						100		
Perlis	– 85	– 468	0	– 740	– 831	(–1,287)[1] + 539		176[2]		451[2]	993[2]	535[3]		38		61	119	42
Selangor	+3,741	– 87	+4,700	+4,999	– 2,158	– 543												
Trengganu	+ 985	–2,444	– 708	–3,225	– 1,163	–4,603												
Sabah					–11,005	+8,313												
Sarawak					–16,989	+8,570												

[1] Figures in brackets represent balance if the State had not received a grant from the State Reserve Fund.

[2] Grant actually paid in 1965.

[3] Grant actually paid in 1965/66

[4] Grant actually paid in 1967.

[5] Grant actually paid in 1968.

Source: Information supplied by the Ministry of Finance, Kuala Lumpur.

with the responsibility of advising the National Finance Council on the size of grants from the State Reserve Fund to states in deficit on current account. In making its recommendations the Committee which would consist of (i) two representatives from the Federal Treasury; (ii) two representatives from states not in deficit on current account, and (iii) the Accountant-General of Malaya, would have to scrutinize the accounts of the states in deficit and more precisely would have to:

—investigate the rates of taxes, fees and licences, bearing in mind the efficiency of revenue collection and arrears of revenue outstanding;
—probe into the levels of expenditure and particularly into expenditure on unproductive services;
—bear in mind that states may be inhibited from collecting the maximum revenue from land owing to federal development policies;
—bear in mind that some states are handicapped to increasing revenue by the existence of concessions which cannot be reassessed for rent purposes for long periods;
—bear in mind the potential revenues available by the imposition of additional premia on conversion of land under agricultural title to development purposes;
—bear in mind the disparity of potential revenue created by certain items in the List of Sources of Revenue assigned to the States contained in the Constitution;
—investigate the revenue produced from services of a commercial character and, in particular, the charges for water supplies:
—bear in mind the extent of subsidies given to local authorities and investigate the levels of assessments for rating purposes and the scales of fees and charges imposed within those local authorities;
—investigate very carefully the size and nature of available cash reserves and, in particular, the reserves held against appropriations to trust funds;
—investigate the liquidity of the states' reserves and caution states not to hold too large a proportion of such reserves in an unliquid form merely in order to escape calling on such reserves to meet deficits on current account;
—allow states to maintain a liquid reserve position amounting to 5% of annual revenue; and
—investigate the level of special expenditure and, in particular, development expenditure which should normally be provided from development funds.

Details about the methyd by which the Federal Government and the National Finance Council arrived at the amounts of grants made since 1965 have not been published. The Committee, having investigated the accounts of the deficit states in 1965 is, however, said to have found numerous instances where the financial position of the states as reflected in their Financial Statements was distorted. In the last few years the accounts of the states have, therefore, been systematically scrutinised as follows:

(i) In respect of receipts:
—by taking into account the state's overall financial position, including balances in their Trust and Loan Accounts and any arrears of revenue that remain uncollected;
—by including all receipts by the state whether they be in the form of

ordinary revenue, statutory grants, reimbursements, transfers or development revenue; and

—by excluding whatever grants or advances may have been received by the state from the State Reserve Fund.

(ii) In respect of payments;

—by including the total amounts spent by the state on both recurrent and capital expenditure.

(iii) The deficit is then determined by obtaining the difference between overall receipts and overall payments.

(iv) Any deficits accumulated from previous years which have already been examined for grants from the State Reserve Fund are not considered.

In other words, the deficit determined according to the above procedure is in respect of the year in question only. It does not include accumulated deficits carried forward by the state from previous years and shown as a debit in the state revenue account at the beginning of the year. The computation of a state's deficit also excludes any grant or advance from the State Reserve Fund that may have been received by the state during the year, thus ensuring that the deficit finally arrived at is a true amount representing the state's shortage of funds during the year in question. Apart from determining the states' actual deficit, the reasons which have led applicant states to be in deficit are also examined. In this connection it was also found necessary to investigate the financial position of the states as reflected in their Financial Statements for earlier years.

Table 19 shows that not all deficits given in the accounts of the states have been accepted as 'actual' deficits for the purpose of grants from the State Reserve Fund. In fact, out of the nine states in deficit in 1961 only Perlis was found to be eligible for assistance. In 1962 seven states showed a deficit in their accounts, but only two, Kedah and Kelantan, received special grants. For 1963 three states, Kelantan, Perak and Perlis, received such assistance, although four more states showed deficits in their books. Again, in 1964 nine states (including Sabah and Sarawak) were in deficit whereas only two of them, Kedah and Perlis, obtained relief from the State Reserve Fund. Finally, in 1965 seven states showed deficits before application of the grant, whereas only three of them, namely Kedah, Kelantan and Perlis received grants from the Fund. It may also be seen from Table 19 that the amounts of the grants do not always tally with the amounts of the deficit actually shown. The grants made to Kedah for 1962 and 1964 exceeded, for instance, the deficits shown in the State's accounts, whereas most of the other grants made for the period 1961-65 do not fully cover the deficits shown in the Financial Statements.

Figures for the accounts of the States of Malaya after 1965 are not available at the time of writing. It would be interesting to see in due course how the financial position of the states has developed since then and to follow up to what extent the Federation has found itself obliged to support them.[1]

[1]It is understood that the Ministry of Finance is now considering a proposal to introduce a bonus system which would entitle those states to an annual bonus the financial position of which is sound and which, in the opinion of the Federal Government, practice economy in their expenditures.

2. *The Borneo States*

The next question to be examined is whether the system of fiscal adjustment as it relates to the Borneo States has succeeded in equalising excessive differences in state income between the two states themselves and between them and the States of Malaya, and whether it enables them to meet their current expenditure.

The great disparity in per capita state revenue between Sabah and Sarawak and between these two states, on the one hand, and the rest of Malaysia, on the other, was noted earlier (see Table 12 and 17). So was mentioned the fact that a wider 'fiscal gap' has to be filled by Federal transfers in the case of Sarawak (1964-65: 49%) than in the case of Sabah (41.0%) and the States of Malaya (40.6%). There is, however, little common basis for comparing these figures. Whereas the States of Malaya have similar functions—which does not mean, however, that the costs of meeting these functions are also always the same—both Sabah and Sarawak enjoy much wider, although not always identical, powers under the Constitution. Similarly, there are important differences between the states of West and East Malaysia and between the two Borneo States themselves in the financial resources available to them. This is true not only of total domestic revenue but also of the type and amounts of allocations and grants under the system of adjustment.

All these differences make it virtually impossible to compare the financial structure of the States of Malaya with that of Sabah and Sarawak. Unless one could eliminate all the financial and administrative consequences of the disparity in the division of functions and resources, it will be futile to try to assess to what extent the Borneo States are really 'better off' than the States of Malaya with regard to their domestic revenue and constitutionally guaranteed Federal grants and allocations.

Easier to answer is the question whether the system of adjustment succeeds in putting the two East Malaysian states in a position to meet their current obligations (vertical adjustment). The answer is an affirmative one. Table 19 shows that both states had substantial deficits in 1964, and large surpluses in 1965 and 1966. The sudden improvement in their financial position was mainly due to the fact that, since 1965, Sabah has shared in the growth of federal revenue derived from that state, whereas the special grants to Sarawak increased by M$5.1 million in 1965 and M$3.7 million in 1966 (see Table 20). The financial position of both states is likely to remain satisfactory in the years to come. The federal revenue derived from Sabah is expected to continue to increase and thus also Sabah's share in it. The amount of the escalating grant to Sarawak will likewise expand under the relevant provision of the Constitution. On the other hand, current expenditure will also rise and the final outcome of the state budget will depend on the development of state expenditure in relation to state revenue.

Table 17 shows that the capitation grant works in favour of Sabah which has a smaller population than Sarawak. At the same time, however, Sabah has a higher per capita state income and a much higher per capita state revenue than Sarawak, which provides another example of the unsatisfactory working of the sliding scale of the capitation grant. According to Table 20, the amount of the grant has remained stable between 1964/66 and its importance in relation to the growing total state

Table 20:

THE ROLE OF GRANTS IN TOTAL REVENUE OF THE BORNEO STATES, 1964–66

- in M$ million -

	SABAH				SARAWAK			
	Amount			% of 1964/66 Total Revenue	Amount			% of 1964/66 Total Revenue
	1964	1965	1966		1964	1965	1966	
Grants								
Capitation	3.6	3.6	3.6	4.6	4.7	4.7	4.7	7.6
Roads	5.2	5.2	6.3	7.2	3.4	3.4	3.8	5.7
Tin/Iron etc.	—	—	—	—	0.1	0.1	—	—
Special Grants to Borneo States	—	5.0	8.1	5.6	8.5	13.6	17.3	21.3
(Annual Bal. Grant, Sarawak)	—	—	—	—	(5.3)	(6.3)	(5.8)	(9.4)
(Escalating Grant, Sarawak)	—	—	—	—	(3.2)	(7.3)	(11.5)	(11.9)
Other Grants	12.5	10.7	12.4	15.3	1.4	1.2	1.2	2.1
Total Grants	21.3	24.5	30.4	32.7	18.1	23.0	26.6	36.7
Total State Revenue	67.3	74.9	91.3	100.0	53.3	60.4	70.7	100.0

Source: *State Financial Statements.*

revenue is therefore decreasing from year to year. A similar trend was observed with regard to the States of Malaya.

The major difference between the systems of adjustment as applicable to the States of Malaya, on the one hand, and to Sabah and Sarawak, on the other, is that with regard to the latter states, the scheme of adjustment includes not only a variety of conditional grants and allocations as well as the capitation grant, but also other powerful adjustment grants which will increase in the course of time.

It is still too early to assess the efficiency of the system of adjustment as it applies to Sabah and Sarawak. At present it would appear that the system of adjustment works quite satisfactorily despite the fact that no link has been established between the major adjustment grants, on the one hand, and the states' need for assistance, on the other. Unfortunately, none of the special grants to the Borneo States has the quality of a 'balancing grant'. Nevertheless, since they are subject to review at regular intervals and a revision cannot take place without the agreement of the Borneo States, it will not be possible for the Federal Government to take any unilateral action in this connection.

At present there would appear to be no pressing need to determine the amount of the major adjustment grants on the basis of an automatic measure of the needs

of the states, since these grants result, in any case, in a preferential treatment of both states. This preference is desirable because of the relative backwardness of East Malaysia.[1] The preference which Sarawak enjoys over Sabah in the distribution of special adjustment grants (per capita average figures for the special grants amounted to M$15.70 during 1964/65 in the case of Sarawak and to M$12.00 in the case of Sabah),[2] also complies with the requirements of a horizontal interstate financial adjustment on the grounds that the economic development of Sarawak lags behind that of Sabah.

3. *Summary*

To conclude the analysis of the actual working of the system of adjustment as it relates to the States of Malaya, we may summarise the more important findings as follows:

(a) Owing to the rather arbitrary way in which the various types of conditional grants and Federal allocations are made to supplement the states' own domestic revenue, the main burden of fiscal adjustment falls on the capitation grant which is supplemented by special grants from the State Reserve Fund.

(b) The capitation grant fails to bring about a satisfactory vertical and horizontal adjustment, because it is not related to the states' actual 'need' for financial assistance. The capitation grant is not what we have called a 'balancing grant'.

(c) Special grants from the State Reserve Fund can merely overcome temporary imbalances in the accounts of applicant states.

(d) If one assumes that the equalisation of interstate fiscal differences is a genuine concern of Federal Government policy, then the working of the system of financial adjustment vis-a-vis the States of Malaya must be considered a failure. This is so because it solves neither the problem of extreme disparity in the revenue positions among the states, nor the chronic shortage of funds experienced by some of the states. In view of this, it is hardly surprising that some of the states have become rather indifferent with regard to maintaining sound financial standards and that they are increasingly looking to the Federal Government for financial support.

(e) Assuming again that the equalisation of fiscal differences is a goal of government policy, then it would be necessary to relate the conditions which govern the capitation grant to the needs of the states, or, alternatively, to introduce a new 'balancing grant'. The amount of the grant should be determined by an automatic standard or by an independent authority rather than by the Federal Government alone.

(f) The failure of the capitation grant to put state finances in West Malaysia on a sound footing proves that it is not sufficient to link the main instrument of adjustment merely to the population figures of the states. Regard must also be given to differences in the level of development, geographical differences, divergencies in the urban/rural distribution of the population, etc. All these differences would probably be reflected quite satisfactorily in the per capita state income figures.

[1]Cf. Malaya: *Malaysia Report of the Inter-Governmental Committee 1962*, pp. 14–15.
[2]The figures are calculated from the data given in Table 20.

(g) On the other hand, if the equalisation of fiscal differences among the states of West Malaysia is not an urgent concern of the Federal Government (and there would be sound economic considerations for not giving a policy of equalisation too high a priority), then the states would have to accept for the time being the existing fiscal differences, originating as they do from their different natural resource endowments and their different levels of development. In these circumstances it would serve the need for a greater financial responsibility if the poorer states were told that in the interest of the development of the nation as a whole they cannot, at present, expect any special financial support from the Federal Government.

(h) However, even if no substantial relief could be afforded to the poorer states at present, it would still be desirable to change the conditions of the capitation grant so that it would favour, at least to some extent, the really needy states.

(i) Fortunately, the failure of the system of adjustment in bringing about more healthy financial conditions among the States of Malaya has not seriously disturbed the overall development of West Malaysia; nor has it really affected the well-being of the people including those living in the poorer states. This is so because state functions are restricted to agriculture and forestry and other less important subjects.

With regard to the system of adjustment applicable to the Borneo States our main findings were as follows:

(a) The system of adjustment as it relates to the Borneo States has been working rather satisfactorily. This has been mainly due to the fact that since 1965 both states have been receiving substantial amounts of special adjustment grants in addition to the capitation grant to which all the states are entitled. Whether the system will continue to function satisfactorily without linking the major adjustment grants to an objective criterion for measuring the financial capacity of the states and their need for funds, will chiefly depend on the future development of the relation between state revenue and expenditure. If some fundamental imbalance should eventually develop in the financial position of the Borneo States, there is always the possibility of revising the amount of the special grants on one of the periodic reviews foreseen under the Consititution.

(b) In view of the preference enjoyed by the Borneo States with regard to Federal development expenditure and taking into account the transfer of considerable amounts annually from West Malaysia in aid of current state expenditure in East Malaysia, it is obvious that from a financial point of view federation has proved most advantageous to the Borneo States. At the same time it would appear that the more backward states of West Malaysia are the real 'step children' of the Federation having very little prospects for improving their position in the foreseeable future. They are paying the price for having neglected their economic and financial interests vis-a-vis the Centre at the time of the formation of the Federation of Malaya.

C. THE FLEXIBILITY AND COORDINATION OF FEDERAL/STATE FINANCIAL RELATIONS IN MALAYSIA

No financial system is set for ever. The functions of both layers of government as well as their requirements for funds are bound to change all the time. The yield from the sources of revenue assigned to each layer is subject to fluctuations in both the short and the long-run. In view of all these possible changes, a system of federal finance can remain efficient only if it is able to adapt itself timeously and without great disruption to varying conditions. Short-term fluctuations are probably best taken care of by the system of fiscal adjustment. Changes which affect the financial position of either layer of government structurally should be met by appropriate constitutional adjustments in the division of resources.

1. *The Flexibility of Federal/State Financial Relations*

a. *The Division of Resources and Federal Allocations*

The Federal Constitution clearly defines the tax sources available to the states. All those sources not specifically assigned to the states belong to the Federation. There is, however, some scope for changes in the present pattern of resource allocation and the following is an enumeration of the relevant provisions of the Constitution:

(*i*) Parliament may from time to time substitute for certain of the sources of revenue specified in the State List, or for any source of revenue so substituted, another source of revenue of substantially equal value;[1]

(*ii*) In respect of the Malay States, Parliament may increase the present allocation of 10% in respect of export duty on tin, to which these states are entitled;[2]

(*iii*) Parliament may provide that each of the Malay States receives a certain proportion of the export duty on minerals, other than tin, produced in the respective state;[3]

(*iv*) Parliament may assign to the Malay States the whole or any portion of the proceeds of any tax or fee raised or levied by the Federation;[4]

(*v*) The states may levy royalties or similar charges in respect of minerals, although Parliament has the power to prohibit or restrict the imposition of such charges;[5]

(*vi*) With regard to the Borneo States, some of the additional sources of revenue assigned to them under Part V of the Tenth Schedule of the Constitution, such as import and export duty on petroleum products and export duty on timber products, may be varied or substituted for by agreement between

[1]Cf. Malaysia: *The Federal Constitution,* Article 110(2).
[2]Cf. *ibid.,* Article 110(3).
[3]Cf. *ibid.,* Article 110(3A).
[4]Cf. *ibid.,* Article 110(4) (a).
[5]Cf. *ibid.,* Article 110(3B) and, regarding the special conditions for the Borneo States, Article 112C (4),

the Federal Government and the State Government concerned.[1]

The above list shows that there is considerable scope for altering the existing pattern of receipts of the states. Of particular importance is provision *(iv)* which permits the transfer to the states of the proceeds of any tax or fee deemed appropriate. The ultimate responsibility for changing the prevailing pattern of state revenue (except in the case of *(vi)* above) rests with Parliament.

Alterations under items (*ii*)—(*iv*) need to be initiated by the Federal Government which, in turn, has to consult the National Finance Council before proposing an action to Parliament. The States themselves have no direct say in these decisions. All they can do is to express their views through their representatives at the National Finance Council.

In contrast to these provisions which testify to the tightness of the Federal arrangements in West Malaysia, the Borneo States first have to agree to any alteration made in respect of some of their most important sources of revenue (item (*vi*) above). They have thus been given a status where they can eventually try to obtain, through direct negotiations with the Federal Government, more favourable conditions in respect of these revenues. We shall see shortly that the Borneo States also enjoy a similar privileged position in respect of changes of the provisions for the major adjustment grants.

b. *The Major Adjustment Grants*

A change in the substance and composition of the tax subjects or other assured sources of income of the states would be the most appropriate solution to any long-term imbalance in the relation between the states' needs and resources. Such a change is not always possible or appropriate, however, especially not where the process of tax centralisation has been carried far and where, accordingly, grants-in-aid represent a major portion of total state income. In these circumstances the main objective of the system of adjustment, namely to ensure that the states get sufficient funds to enable them to perform their functions, would include the obligation to balance short and long-term fluctuations in the functions/revenue relation of the states. To satisfy this need the system of adjustment has to be flexible in the sense that it should be possible to alter the bases or the amounts of the more important adjustment grants, including any 'balancing grant' where there is provision for such a grant.

In respect of the capitation grant the constitution provides that, within certain limits, Parliament may vary from time to time by law the rates of that grant.[2] Any such change requires the prior consultation of the National Finance Council.[3] The special grants to the Borneo States, too, may be altered or substituted for, but such alteration, or substitution, in contrast to variations of the capitation grant, needs the consent of both the Federal and the State Government concerned. Any agreement to this effect is made binding by royal decree.[4] This difference is important insofar as the conditions governing the special grants cannot be changed

[1] Cf. *ibid.*, Article 112D(5).
[2] Cf. *ibid.*, Article 109(2).
[3] Cf. *ibid.*, Article 108(4) (g).
[4] Cf. *ibid.*, *Article* 112D (1).

one-sidedly by the Central Government. The Constitution contains detailed provisions for the procedure to be followed when it is intended to alter the conditions of the grants.[1]

The above proves that under the Constitution of Malaysia there is sufficient scope for adapting the system of financial adjustment to changing circumstances. This, by the way, also held true of the former financial arrangements with Singapore which, it will be remembered, provided for the regulation of all financial matters by special agreement to be entered into by both governments from time to time. One may also mention the possibility of introducing new federal grants under Article 109(3) of the Constitution (which makes it possible, for instance, to introduce a new 'balancing grant') and the provision for temporary relief from the State Reserve Fund. Both add to the flexibility of the Malaysian system of intergovernmental financial adjustment.

Despite this adaptability, the method by which the provisions of the major adjustment grants can be changed cannot be considered really satisfactory, at least not from the point of view of the states. This is so, because as far as the States of Malaya are concerned, only the Federal Government can initiate such changes. In fact, the states have almost no say in the matter. This is true not only of changes in the conditions governing the capitation grant, but also of the way by which special grants from the State Reserve Fund are determined. All that the states can do is to express their views through their representatives on the National Finance Council. However, even if the Council should endorse the point of view of the states, the Central Government would merely be obliged to consider the recommendations of the Council. Nor is a regular review of federal/state financial relations by an independent body provided for under the Constitution from which the states could hope that a revision in their favour of the conditions governing the various allocations and grants under the scheme of adjustment could eventually emerge.

The states themselves may not fully realise the weakness of their financial position vis-a-vis the Federal Government. The fact that the States of Malaya are often felt to lack a certain self-awareness has been mentioned earlier. It is not the task of the economist to criticise the prevailing political structure of a country. In Malaysia it may be that for political and important economic reasons it would be desirable if at least West Malaysia would gradually move towards a unitary form of government. On the other hand, if politicians feel that fedcralism should, nevertheless, play a useful role in Malaya, a larger measure of responsible participation of the states in decisions vital to their independence would certainly be appropriate. In these circumstances there would then be a need for a review of the various aspects of federal/state financial relations in Malaya with a view to bringing about a more equal distribution of resources among the states and to assuring the state a larger measure of financial independence from the Federation.[2] Once these objectives have been achieved, federal/state financial relations and especially the system of adjustment should be reviewed by an independent authority at regular intervals.

[1]Cf. *ibid.*, *Article* 112D (2)–(5).

[2]The need for such a review has also been expressed by the Committee which, in 1960, examined the procedure to be adopted for applications for grants from the State Reserve Fund. Cf. p. 108.

Its recommendations should be binding on all parties concerned.

With regard to the Borneo States, changes in the present conditions of the special adjustment grants can be made only if agreement has been reached between the Central and the state governments. Under Article 112D of the Constitution the grants are subject to periodic review, the provisions of which were stated earlier.[1] This type of arrangements is obviously more satisfactory to the states than that applicable to the capitation grant, inasmuch as it makes the states partners to any decision taken. Yet, it is not ideal because there is always the possibility that too little consideration may be given in the negotiations between the two layers of government to the economic and fiscal aspects involved, and that political bargaining may dominate the scene. Only if the whole question of financial adjustment is isolated from politics and handled by an independent panel of experts, is it possible to arrive at a solution which will really meet the needs of the states.

The above remarks also apply to the now obsolete financial arrangements with Singapore. These arrangements were highly flexible inasmuch as they could be changed at any time by mutual agreement. Here, too, there was a considerable danger that any alteration to the prevailing provisions might have been the outcome of political rather than economic considerations.

2. *The Coordination of Federal Finance in Malaysia and the Provisions for the Settlement of Conflicts.*

Although the provisions of the Federal Constitution apparently leave no room for conflicts between the two layers of government, neither in respect of the division of functions and resources nor in respect of allocations and grants under the system of adjustment (the only exception being reviews under Article 112D of the Constitution concerning the special grants to the Borneo States), difficulties may nevertheless arise in the course of time from unforeseen circumstances.

To prevent open clashes it was suggested earlier[2] that there should be an independent authority, or special court (rather than commissions of enquiry), which would be empowered to pass judgement on, or to arbitrate, any matter of federal/state financial relations referred to it. The same authority should also review from time to time federal/state relations, and especially the working of the system of adjustment to ensure a continuous efficient working of the whole system of federal finance.

In Malaysia there exists no such independent institution. Nonetheless, with regard to the States of Malaya a certain amount of coordination of federal/state financial relations is brought about by the National Finance Council. Moreover, provision has been made under the Constitution for arbitration in the case of conflicts regarding the special grants to the Borneo States.

a. *The Role of the National Finance Council*

The National Finance Council consists of twelve persons, namely the Prime Minister, who presides at meetings, one other Minister designated by the Prime Minister and one representative of each state (except for Sabah and Sarawak)

[1] Cf. pp. 141—142.
[2] Cf. p. 81.

appointed by the Ruler or Governor. If the Prime Minister is not present at a meeting, he may be represented by another Minister who shall preside. The Council may be summoned by the Prime Minister at any time, or shall meet at the request of at least three states. There shall, however, be at least one meeting in every twelve months. The Council may deliberate on any matter of financial policy put to it. The Federal Government is obliged to consult it on the following matters:[1]

(*i*) the assignment to the states of the whole or any portion of the proceeds of any federal tax or fee;

(*ii*) any proposal to introduce a bill varying the rates of the capitation grant or affecting the receipt by a state of export duty on tin or other minerals produced in the state;

(*iii*) the making of grants by the Federation to the states;

(*iv*) the making of grants from the State Reserve Fund;

(*v*) the annual loan requirements of the Federation and the states and the exercise by the Federation and the states of their borrowing powers;

(*vi*) the making of loans to any of the states;

(*vii*) the making of development plans.

Of these, only items (*i*) to (*iv*) are of immediate interest here since they cover practically all possible changes in the existing division of resources, and in the system of intergovernmental financial adjustment as far as the States of Malaya are concerned.[2] Although the Federal Government is obliged to consult the Council before introducing a bill in Parliament varying the existing legislation, the Federal Government need not follow the advice of the Council. The fact that the National Finance Council has merely an advisory function and cannot force the Central Government to accept its recommendations, reduces its importance as an agency for coordinating federal/state financial relations. Another factor which also tends to weaken its significance is its limited competence regarding the financial relation between the Centre and the Borneo States.

The role of the National Finance Council regarding the adoption of guidelines for the making of grants from the State Reserve Fund has been mentioned earlier.[3] Otherwise the Council merely acts as a platform for the exchange of views between both layers of government. Yet, it may not be too difficult to reorganise the Council into a more effective coordinating unit. In the light of our foregoing discussion such a reorganisation would have to concentrate on the following major points:

(*a*) Depending on the role assigned to federalism in the country and particularly on whether or not a responsible participation of the states in major policy issues is to be encouraged, it may be considered desirable to charge the Council with wider supervisory functions with respect to Federal/state financial relations. In these circumstances there will be a need to improve the balance of representation of the two layers of government on the Council. The appointment of additional members on the strength of their expert knowledge on the legal, economic and

[1]Cf. Malaysia: *The Federal Constitution,* Articles 108 (4)–(5) and 109 (6).

[2]According to Article 112D (7) of the *Federal Constitution,* the Federal Government need not consult the National Finance Council regarding a review of the special grants to the Borneo States. The now obsolete Article 112E (6) provided for a similar exemption in the case of the financial arrangements with Singapore.

[3]Cf. pp. 148–152.

financial aspects involved in its deliberations may also be considered necessary.
(*b*) The Council, or a committee appointed by it, should be charged with examining at regular intervals all aspects of federal/state financial relations. Its recommendations, especially those concerning the intergovernmental financial adjustment, should be final and binding.
(*c*) The authority of the Council should be extended to include the Borneo States which should also be represented on it.

b. *The Constitutional Provisions for Arbitration*

Conflicts between the two layers of government can arise over a wide range of subjects. For conflicts of a purely legal nature the Supreme Court of the country concerned would be the competent authority. Controversies on financial matters which are not strictly legal in substance but can affect the well-being of the whole nation, such as on the question of fiscal adjustment, would call for settlement by arbitration by a special court or authority composed of legal, economic and financial experts.

In Malaysia there have, fortunately, been no conflicts about the financial provisions of the Constitution so far. Such conflicts are not likely to arise between the Federation and the States of Malaya because the sources of state income have been clearly defined in the Constitution and because any change in the relevant provisions is the sole responsibility of the Federal Government. If the Federation alters any of the provisions currently governing federal/state financial relations, then such action could be contested by the states only on purely legal grounds and the Federal Court in Kuala Lumpur would be the appropriate authority for settlement. Regarding the financial arrangements with Sabah and Sarawak conflicts can arise if, in the case of review of the special grants under Article 112D, agreement is not reached between the Federal and the state government concerned. In these circumstances the Constitution provides for the appointment of an independent assessor.[1] The recommendations of the assessor are binding on the governments concerned and shall be given effect as if they were the agreement of those governments.

No method for the appointment of the assessor is provided for in the Constitution, nor are there any indications as to the qualifications with which he would have to comply. This omission may have to be corrected later on. Groves suggests that the assessor need to be one of the highest competence in the economics of governmental finance and concludes that, in order to be as independent as possible, he should come from another state, or from an international body, such as the United Nations.[2] Although the latter suggestion seems somewhat far-fetched, there can be no doubt that independence and competence should be the outstanding qualifications of an assessor. Moreover, in view of the complexity of the matters usually involved in conflicts about the financial adjustment, the appointment of a special court of arbitration composed of several economic and financial experts may eventually prove even more appropriate.

[1]Cf. *The Federal Constitution,* Article 112D(6); cf. also Malaya: *Malaysia Report of the Inter-Governmental Committee 1962,* pp. 15–16.
[2]Cf. Groves, H.E.: *op.cit.,* p. 146.

A full evaluation of the provision for the appointment of an assessor can, of course, only be made once there have been a number of cases where an assessment was called for. The first review of the special grants to the Borneo States takes place in 1968 and an assessment may not be needed for many years thereafter.

The Constitution also provided for the appointment of an independent assessor in respect of the financial arrangements with Singapore.[1] His advice was to be sought if consensus on any of the matters subject to agreement could not be reached. The decision of the assessor was to be binding on both governments.

It is likely that the provision for assessment would have assumed great importance in the event that Singapore would have remained part of Malaysia. Not only did the arrangements between the Federation and Singapore, which were subject to agreement 'from time to time', lack the advantage of clearly defined guiding principles, but with the wide powers retained by Singapore and the conflicting interests of both governments regarding a number of important economic issues, disagreement on financial matters was almost bound to arise sooner or later.

3. *Summary*

Here is a brief summary of the discussion of the flexibility and coordination of federal/state financial relations in Malaysia.

In a federation the functions of both layers of government as well as their requirements for funds change in the course of time. It was found that the Constitution leaves enough scope if such structural financial adjustments should eventually become necessary in Malaysia. However, with regard to the States of Malaya alterations of the prevailing pattern of state sources of revenue can only be initiated by the Federal Government. This from the point of view of the states' rather unsatisfactory state of affairs does not apply to the Borneo States. Here the states have to agree to any proposed alteration.

Since the Constitution clearly defines the division of functions and resources, it is unlikely that any major conflict on financial matters will arise between the Federal and state governments. Moreover, coordination of federal finance is at least to some extent ensured by the operation of the National Finance Council on which serve representatives of both layers of government. Unfortunately, the Council can only advise on matters of federal finance relating to West Malaysia. With regard to possible future conflicts between the Federal Government and the Borneo States on the subject of the special grants, the Constitution provides for arbitration by an independent assessor.

[1]Cf. Malaysia: *The Federal Constitution,* Article 112E (1) (f) and (5).

CHAPTER VI

Federalism, Fiscal Policy and the Public Debt in Malaysia

A. FEDERALISM AND FISCAL POLICY IN MALAYSIA

Fiscal policy is one of the key instruments of economic policy which, in turn, is a major tool of the overall development policy of a developing country. Fiscal policy tries to implement, within its particular field, some of the wider objectives of the development policy as laid down in the development plan.

In Malaysia fiscal measures play an important role in the nation's development effort. The scope of fiscal policy and the implications of Malaysia's federal structure of government for its implementation are the subject of the following analysis, which is to be followed, in the second part of this Chapter, by a discussion of the relation between federalism and the public debt in Malaysia.

1. *The Limitations of Monetary and Fiscal Policy*

The limitations of an effective monetary policy and of an expansive fiscal policy in a developing economy arise mainly from the existence of a considerable non-monetised traditional sector, the absence of a sophisticated capital market, the 'openness' of the banking system and the structural imbalance between the supply of money and the availability of domestic and imported consumer goods. Most of these features are characteristic of the overall Malaysian economy. Moreover, Malaysia has a typical 'exposed economy' in the sense that she depends on two major products for the greater part of her exports, the fluctuating receipts of which determine, to a certain extent, the country's domestic money supply.

Another important factor which, until mid-1967, had a definite bearing on the effectiveness of an expansive monetary and fiscal policy as a means to stimulate the process of growth, was the currency union under which Malaysia, Singapore and Brunei shared a common currency. The union provided for the unrestricted flow of money and capital from one territory to the other, and made it impossible for its members to take expansive monetary measures independently. The currency union also restricted the ability of the participating countries to follow independent fiscal policies because consideration had always to be given to the possible effects of differences in the tax structure on the movement of capital and labour (which until 1967 was permitted to flow freely between the States of Malaya and Singapore), and the location of the headquarters of commercial houses and manufacturing enter-

prises.

With the introduction of separate currencies by Malaysia and Singapore in 1967, both countries have gained greater freedom in applying monetary and fiscal measures for the control of their respective economics. This does not mean, of course, that the other factors which tend to make a policy of monetary expansion ineffective in a developing country also ceased to operate. However, no longer need regard be had to the reaction of the other side of the Causeway to each measure taken. Monetary and fiscal policy may also gradually assume importance in Malaysia to avert possible inflationary pressure and balance of payments difficulties. These may eventually arise from structural imbalances caused by the vigorous development policy.

From the above it follows that monetary and fiscal policy measures affecting the money supply of the nation have not been of great significance so far in furthering Malaysia's economic development. Although this situation may change gradually, it is obvious that the main burden of implementing the government's economic policy vis-a-vis the private sector will still have to be borne chiefly by more traditional forms of fiscal policy, such as taxation and tariff policy.

2. *The Opportunities of Fiscal Policy*

Traditional fiscal measures have, in recent years, been employed increasingly in Malaysia's economic policy. When reviewing the more important fiscal measures in relation to their specific aims, we shall also attempt to answer the question of whether their application has been impeded, or is likely to be impeded, by the country's federal structure of government.

Any effective fiscal policy must be planned centrally and implemented at the desired standard throughout the country. In Malaysia one would anticipate little difficulty in this respect because of the Central Government's dominating position in the field of public finance. In general, the stronger the financial position of the federal government, the less are the states able to follow conflicting fiscal policies and the fewer obstacles are likely to be experienced by the federal authorities in giving effect to their policy.

a. *Investment in Manufacturing Industries*

The role of fiscal policy in Malaysia has probably been most significant in the field of manufacturing industry. It is the declared policy of the Government not to participate directly in production but to leave the industrial development of the country to private enterprise. In line with this policy the Government has been concentrating on the provision of the necessary infrastructural services and on the creation of a climate conducive to investment in secondary industry. Fiscal measures figure prominently among the various steps taken to create favourable conditions for the foreign and local investment.[1] They are mainly the following:

[1]Other facilities provided by the Government are the guarantee of foreign investment; the free transfer of capital and earnings within the Sterling Area and with a minimum control from or to countries outside the Sterling Area; the development of industrial estates; the provision of loans through the Malaysian Industrial Finance Ltd.; the training of management and supervisory personnel for local industry; and industrial research. Other stimuli provided for local industries are extensive 'purchase Malaysian goods' campaigns and preferential

(*i*) Under the *Investment Incentive Act, 1968* companies having been given 'pioneer status' are granted income tax relief for periods of two to five years,[1] as well as capital allowances and exemption from the payroll tax.

(*ii*) The Act provides also for the possibility of one-year extension of the tax relief period for firms establishing factories in an area declared by the Government as a 'development area'. The provision is designed to create a balanced development throughout the country by encouraging the expansion of industry in less developed areas. So far no region has as yet been declared a 'development area'.

(*iii*) Under the same Act, investment tax credits are granted to companies not qualifying for 'pioneer status'.

(*iv*) Moreover, under the *Investment Incentive Act* a variety of export incentives are available to companies resident in Malaysia and exporting a certain percentage of their products.

(*v*) Protective duties on imports may be granted by the Government on the advice of the Tariff Advisory Board.

(*vi*) Import duty exemption for machinery and in some deserving cases for raw materials for industrial development may also be granted.

What are the implications, if any, of federalism on the implementation of the above measures? The question is easily answered, for all incentives mentioned come under the jurisdiction of the Federal Government. This is so in respect of the pioneer industries legislation, which falls under the broader heading of income taxation, and also of protective duties and the exemptions from the payment of import duties which are clearly Federal matters.

Of interest is also the question of the effect of fiscal incentives to industry on the geographical distribution of new enterprises. Since privileges granted under the relevant legislation do not differentiate thus far between the various regions but are uniformly applicable throughout Malaysia, it is hardly surprising to find that most of the 'pioneer industries' are domiciled in the already fairly advanced West Coast states of West Malaysia. Out of a total of 151 pioneer industries by the end of 1967, 129 were located in West Malaysia and all of these, except one, in the Western coastal belt of the Malay Peninsula. Eleven 'pioneer industry' certificates were issued to manufacturers in Sabah and eleven in Sarawak. The pioneer industries of East Malaysia are all of comparatively small size.[2]

b. *The Promotion of Saving*

The mobilisation of as much resources as possible for saving is another major economic policy aim of developing countries. Saving in the private sector can be fostered inter alia by allowing rebates on company taxation for reinvested profits;

---

purchase instructions issued to all Government departments including the requirement that they should purchase locally made products provided their prices do not exceed those of equivalent imports by 10%.

[1]The company tax amounts to a flat rate of 40% on profits.

[2]According to information supplied by the Federal Industrial Development Authority (FIDA), Kuala Lumpur, the distribution of 'pioneer industries' in West Malaysia as at the end of 1967 was as follows: Selangor: 79, Johore: 25, Perak: 11, Penang and Province Wellesley: 8, Negri Sembilan: 4, Malacca and Kelantan: 1 each.

by granting rebates on the personal income tax for life insurance premiums, for savings in the form of savings accounts, or investment into certain classes of securities; and by imposing consumption and import taxes. Little has so far been done in Malaysia to encourage saving by means of fiscal measures. A more sophisticated tax structure with these aims in view will most certainly be introduced in due time and it is important to note that steps in this direction are not likely to be impaired by Malaysia's federal structure because they would all come under federal tax legislation.

The use of the proceeds of taxation to finance public investment expenditure has been termed 'compulsory saving'[1]. Large funds are needed annually by the Federal Government and by the states for development purposes. Allocations from the Federal Consolidated Account (through which ordinary budget transactions are channelled) have accounted for a considerable portion of the total Federal development expenditure. They amounted to an annual average of M$97 million, or 30.3% of the Federal development expenditure during the period 1960-63, and to M$123 million, or 21.1% of the development expenditure for the period 1964-66.[2] Domestic and external loans represent the chief source of Federal development income.

The states, too, assign relatively large amounts from their ordinary budgets for development purposes. During the period 1964/66 these allotments amounted to an average (estimate) of M$95 million, or 41.1% of the combined state development expenditure.[3] However, state budgetary appropriations for development purposes cannot always be classified as genuine savings. This is so because of the substantial ordinary budget deficits shown by a number of states.[4] The gradual deterioration of the financial position of the states, the depletion of their reserves and, moreover, the limit set to the expansion of their domestic revenue certainly further diminish genuine savings of the states in future. More and more development expenditure of the states will have to be financed by means of loans outright reimbursements from the Federal Government. This means that the burden of accumulating 'compulsory savings' for development will shift increasingly to the Federal Government which owns all the more elastic and productive sources of revenue.

c. *The Harmonisation of Tax Rates and the Establishment of a Customs Union in Malaysia*

The harmonisation of tax rates and bases throughout the Federation of all those taxes falling under the competence of the Federal Government is another important aim of fiscal policy. In this connection, it will be recalled that the domestic tax structures of the two Borneo States differed considerably from that of the States

[1] Cf. pp. 89–90.
[2] Figures calculated from *Federal Financial Statements.*
[3] Figures calculated from the *State Financial Statements* and from information obtained from the Ministry of Finance, Kuala Lumpur.
[4] The State of Kedah, e.g., assigned in 1962: M$3.1 million, in 1963: M$1.5 million and in 1964: M$0.1 million from the ordinary budget to the State Development Fund. During the same period the Financial Statements of the state exhibit deficits of M$2.4 million in 1962, M$2.6 million in 1963 and M$0.9 million in 1964. The State of Perak assigned in 1962: M$9.8 million, in 1963: M$6.6 million and in 1964: M$3.3 million to the Development Fund and showed for the same years deficits amounting to M$4.1 million, M$1.3 million and M$2.8 million, respectively.

of Malaya at the time of federating, and even today East Malaysia continues to enjoy a privileged position in respect of certain taxes compared with the rest of the Federation.[1] Great strides have been made in the direction of harmonisation and successive Federal Budgets and amendments to the existing legislation have consolidated rates and provisions, especially those relating to the income tax.[2] Major steps in this regard are the enactment of the *Customs (Malaysia Common Tariff) Act*, 1966, and the *Income Tax Act*, No. 47, of 1967. The latter act applies uniform rates to the whole of Malaysia.

Since the effort towards harmonisation is directed towards taxes falling within the competence of the Central Government, there is obviously no scope for conflicting policies. This also holds true of the harmonisation effort in respect of customs duties both for revenue and protective purposes, and the endeavours to establish a common market within Malaysia, or more particularly between the States of Malaya, on the one hand, and Sabah and Sarawak, on the other. When federating with Malaya, the customs legislation of the two Borneo territories differed considerably from that of the Federation of Malaya. It has been necessary, therefore, for the full market integration of all the territories concerned to gradually establish a common Malaysian tariff vis-a-vis third countries and to abolish impediments to the free flow of goods within the country.[3]

Special provision has also been made for the application of the common Malaysian tariff, or part thereof, to the two free ports of Penang and Labuan (Sabah), so as to enable industries within the free port areas to take advantage of the market in the rest of Malaysia.

From the above it may be concluded that the federal structure of government does not in any way impede the endeavours to integrate the tax structure and the customs legislation of the various parts of Malaysia. This is so because of the fiscal predominance of the Centre which controls all the more important direct taxes and almost the whole of the customs legislation.[4] The fact that the customs legislation is a Federal responsibility is important also with a view to an effective foreign trade policy and the desired establishment of closer trade ties between the countries of South East Asia.

Constitutional difficulties are also unlikely to arise if the Federal Government had to interfere with the country's external dealings in the case of balance of payments difficulties. However, so far, fiscal policy measures as a means to ensure stability in the external account have been of little significance. Current and capital transactions between Malaysia and the Sterling Area are not subject to exchange control and

[1]Cf. The Economist Intelligence Unit: *Malaysia, Singapore, Brunei*, No. 1, 1968, London, p. 7.

[2]Cf. Bank Negara Malaysia: *Annual Report and Statement of Accounts 1966*, pp. 23–24, and *ibid.*, 1967, p. 29.

[3]Under the provisions of the *Malaysia Agreement* of 1963, a Tariff Advisory Board was set up to advise the Federal Government on the progressive establishment of a common market in Malaysia. The Board is charged with the responsibility of making commodity-by-commodity reviews and to recommend to the Government the imposition or alteration of customs duties. Cf. *Malaysia Agreement, op.cit.*, Annex J, Article 2(1), p. 226.

[4]The only exceptions are, in the case of the Borneo States, import and excise duties on petroleum products and export duty on timber and forest produce the yield of which belongs to the states. Cf. Malaysia: *The Federal Constitution*, Tenth Schedule, Part V, Section 1.

current payments to other countries can be made with a minimum of formality.

d. *Fiscal Policy and Social Justice*

As in so many developing countries there are also large differences in the distribution of income in Malaysia. In order to reduce the inequalities in the distribution of income and wealth the Government relies mainly on a fairly strong degree of progressiveness in income taxation and on estate duty. The income tax allows for generous exemption limits and personal reliefs. Rates range from 6% on the first M$2,500 of taxable income to 50% on the taxable income in excess of M$50,000 p.a. Life assurance premiums and contributions to provident funds may, within certain limits, be deducted from the taxable income.[1]

If one compares the rate structure of the income tax with that of other countries in the region it would appear that there is still some scope for raising the progressiveness by lowering the level of taxable income above which maximum marginal rates are applicable (see Table 21). On the other hand, regard must be had to the detrimental effects of a high income tax on foreign investment especially if other countries in the region apply more favourable rates. The time may also come when the Government finds it desirable to introduce some kind of property tax.

Table 21:

MAXIMUM MARGINAL RATES OF INCOME TAX IN SELECTED *ECAFE* COUNTRIES 1965/66

	Marginal rate in per cent	Level of taxable income above which applicable in US $
Burma	99	62,735
Ceylon	80	9,816
India	89.4	9,333
Japan	75	166,251
Korea, Rep. of	50	7,380
Malaysia	**50**	**16,340**
Laos	50	2,500
Philippines	60	127,551
Singapore	55	32,680
Thailand	50	19,203

Source: United Nations Economic Commission for Asia and the Far East: "Tax Potential and Economic Growth in the Countries of the ECAFE Region", in *Economic Bulletin for Asia and the Far East,* September 1966, Bangkok, p.46.

It is not proposed to enter into the various possibilities of bringing about a more just distribution of wealth and income in Malaysia, but it is clear that the major instruments to achieve this end fall within the jurisdiction of the Federal Government. The burden of income taxation falls mainly on the wealthier states whereby a certain amount of interstate, or horizontal adjustment is brought about.

[1]Information supplied by the Department of Inland Revenue, Kuala Lumpur.

3. *Summary*

Before turning to the next topic, public borrowing in Malaysia, the more important findings on the role of fiscal policy in Malaysia and the implications of federalism on its design and implementation may be summarised as follows:

(*i*) Various factors, but mainly the very fact that Malaysia has an underdeveloped economy are responsible for limiting the effectiveness of expansionary monetary and fiscal policy measures.

(*ii*) Traditional fiscal policy measures have, however, been playing an important role in Malaysia's development effort. They have been instrumental in directing resources for investment into the desired channels, in increasing savings of the public sector, in furthering the economic integration of Malaysia, and in promoting social justice in the country. The promotion of Malaysia's industrialisation through fiscal incentives has tended to further enhance the lead of the already well-developed West Coast states of Malaya over the other states of the Federation.

(*iii*) All the more important instruments of fiscal policy, especially the income tax and customs legislation, are federal subjects. The Federal Government has had no difficulty, therefore, in designing and implementing an effective fiscal policy.

(*iv*) The main contribution of fiscal policy to Malaysia's development effort has been the supply of substantial sums to meet public investment expenditure. A large portion of these funds has originated from surpluses in the ordinary budget of the Federal Government. The capacity of the states to save is very limited and an increasing portion of state development expenditure will, in future have to be borne by the Federation which owns all the more productive sources.

B. FEDERALISM AND THE PUBLIC DEBT IN MALAYSIA

Public borrowing has been playing a prominent role in the financing of development projects in Malaysia on both the federal and the state level. At the end of 1967, the total debt of the Federal Government stood at the substantial figure of M$3,525 million (see Table 22).[1] In the following discussion of federalism and public borrowing in Malaysia we shall mainly be concerned with the provisions governing federal/state relations regarding the raising and utilisation of public loans.

In Part One it was stated[2] that if the federal government and the states were allowed to freely borrow internally and externally a situation may easily arise where the nation's total debt gets out of control and eventually exceeds a total which

[1]Despite this large amount, Malaysia's public indebtedness is not too large by international standards. In 1966, the public debt of Malaysia (Federal Government only) as a percentage of total annual Government income amounted to approximately 181%. This compares with Egypt (1964): 73%, Ghana: 381%, India (Federal Government only—1967): 445%, Philippines (1967): 205%; and Australia (1967): 237%, Canada: 283%, West Germany (Federal Government and States): 64%, Japan (1967): 30%, United Kingdom: 268%, and USA (Federal Government only—1967): 228%. Cf. United Nations: *Statistical Yearbook 1967*, pp. 612–684.

[2]Cf. p. 96 ff.

endangers social justice and limits the freedom of action of the authorities. Moreover, since the federal government and the financially stronger states can obtain loans more easily than the financially weaker ones, the latter may be forced to offer more favourable conditions to prospective investors. It was suggested that coordination of public borrowing in a federation should be accomplished either through some sort of licencing arrangement by an independent authority or through federal supervision of state borrowing. The latter method was the one adopted by most developing federations where domestic resources are scarce and where the possibilities for borrowing abroad are restricted.

Under Article 111 of the Constitution no state shall borrow except from the Federation.[1] This holds true of domestic and forcign borrowing and is tantamount to a complete control of public borrowing by the Federal Government. In other words, it is the Federal Government which alone can contract loans at home and abroad and which is responsible for distributing among the states the resources so obtained. The question of coordination does not arise therefore. The only way the states can voice their views on the matter is through the National Finance Council which, under Article 108(4) (c) and (d) of the Constitution, has to be consulted by the Federal Government on the annual loan requirements of the states and on the making of loans to any of them. However, as we have already seen, the recommendations of the National Finance Council are not binding on the Federal Government.

There is one exception to what has been said in the previous paragraph, for Article 111 of the Constitution does not fully apply to the Borneo States.[2] These states may borrow within (but not outside) their own territories if the borrowing has the approval of Bank Negara Malaysia. This partial exemption of Sabah and Sarawak from the provisions of Article 111 is, however, at present of little significance because of the absence of a capital market in these territories. Moreover, through the Central Bank, the Federal Government can always exert an indirect control over the borrowing activities of the Borneo States.

During its membership of the Federation, Singapore, too, could borrow within its own boundaries if such borrowing had the approval of the Central Bank. With the consent of the Federal Government, Singapore could, moreover, also borrow outside its own borders.[3] This latter provision took into account Singapore's high international credit standing.

The almost complete control of public borrowing by the Federal Government probably best meets the requirements of Malaysia where domestic capital can be tapped only to a limited extent, and where the amount of foreign public borrowing depends mainly on the credit standing of the Federal Government rather than on that of any individual state.[4] The extent to which the country is able to obtain loans from bilateral and multilateral aid sources is, moreover, related to a variety

[1]Article 111 (2) of the Constitution provides that the states may borrow for a period not exceeding 12 months from a bank approved for that purpose by the Federal Government. This provision, of course, envisages only short-term borrowing to tide over temporary stringencies and does not constitute what is usually understood under the term 'public debt'.

[2]Cf. Malaysia: *The Federal Constitution,* Article 112B.

[3]Cf. *ibid.*

[4]In this connection the reader is reminded of the rather doubtful credit standing of some of the States of Malaya. Cf., e.g., footnote[2] to p. 148.

Table 22:

THE PUBLIC INDEBTEDNESS OF MALAYSIA, 1957-1967

in M$ million

As at end of year	Federal Government			States of Malaya				Sabah				Sarawak				States of Malaysia				Public Authorities' Foreign Indebtedness
	Foreign	Domestic	Total	Foreign	Domestic	Fed. Govt.	Total	Foreign	Domestic	Fed. Govt.	Total	Foreign	Domestic	Fed. Govt.	Total	Foreign	Domestic	Fed. Govt.	Total	
Malaya																				
1957	316	661	977	)				)				)				)				61
1958	308	773	1,081	)				)				)				)				61
1959	334	943	1,277	)				)				)				)				69
1960	360	1,106	1,466	)	See Column 1			)	Pre-Federation			)	Pre-Federation			)	Pre-Malaysia			77
1961	373	1,231	1,604	)				)				)				)				92
1962	395	1,379	1,774	)				)				)				)				121
1963	443	1,588	2,031	)				)				)				)				158
Malaysia																				
1964	438	1,780	2,218	—	—	114	114	21	26	—	47	21	4	3	28	42	30	117	189	178
1965	510	2,183	2,693	—	—	139	139	21	26	4	51	21	4	5	30	42	30	148	220	210
1966	501	2,511	3,011	—	—	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n,a.	n.a.	n.a.	n.a.	n.a.	n.a.	264	n.a.
1967	528	2,997	3,525	—	—	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	329	n.a.
Federal/State borrowing as % of Federal plus State indebtedness 1965=M$2,913 million=100%	92.4					4.8				1.8				1.0				7.6		

Source: Information supplied by the Ministry of Finance, Kuala Lumpur.

of political and economic aspects, both international and domestic, for which only the Federal Government can be responsible.

Federal control of public borrowing also has the potential advantage that it enables the central authorities to manage the nation's public debt according to the requirements of economic policy, once a more sophisticated capital market develops in the country. On the other hand, despite the advantages of an almost complete Federal control of public borrowing, the present arrangements further restrict the financial independence of the states. The cause of the states would probably be better served if the control over public borrowing was exercised by an independent authority on which both layers of government were represented. The National Finance Council could act as such an authority if it were reorganised along the lines suggested earlier.[1]

Table 22 shows the predominance of the Federal Government in the field of public debt. Its share in the total public debt of Malaysia outstanding as at the end of 1965 was 92.4%. The remainder, namely 4.8% were loans of the States of Malaya, 1.8% loans of Sabah, and 1.0% loans of Sarawak. In line with Article 111 of the Constitution the States of Malaya have no foreign loan commitments, while foreign loans outstanding for the two Borneo States were contracted before Federation. With regard to domestic borrowing, all the debt shown by the States of Malaya has been incurred vis-a-vis the Federation. The two Borneo States did not undertake any new domestic borrowing during the period 1964—1965, but both states have since obtained new loans from the Central Government.

The total indebtedness of Malaysia has increased considerably over the past years. This trend is likely to continue in the years to come in view of the large development expenditure envisaged under the First Malaysia Plan. During the period of 1966-1970 the Government hopes to raise about M$1,000 million in loans from external and M$1,025 million from domestic (non-bank) sources.[2]

The major holders of the nation's domestic debt have so far been the Federal and the state governments as well as government funds and agencies (which, in February 1962, together held 82% of the total debt), and to a lesser degree financial institutions (10%) and miscellaneous private investors (8%).[3]

The total debt of the Central Government of M$3,525 million outstanding as at the end of 1967 represented 37% of the country's gross national product. The servicing of the Federal Government's domestic debt amounted to M$141.3 million in 1967 which represents 7.6% of the current revenue for the year.[4] External Federal debt servicing at M$45.6 million was 2.5% of ordinary revenue and 1.2% of export earnings in 1967.[5]

We may add, that the figures shown in Table 22 under the heading 'Public Authorities' Foreign Indebtedness' constitute mainly external loans of the Central Electricity Board (1965: M$186 million), as well as loans of the Federal Land Development Authority (M$5 million), Bank Negara Malaysia (M$9 million) and

[1]Cf. p. 161.
[2]Cf. Malaysia: *First Malaysia Plan 1966–1970*, pp. 76–77.
[3]Information supplied by the Ministry of Finance, Kuala Lumpur.
[4]Cf. Bank Negara Malaysia: *Annual Report and Statement of Accounts 1967*, p. 41.
[5]Cf. *ibid.*, pp. 41–42.

the Malaysian Industrial Development Finance Ltd. (M$10 million).[1]

Finally, there is the question whether the distribution of loans from the Federal Government to the states conforms to the principle of equity. During 1964-65 the annual average amount of loans obtained from the Federal Government by the eleven States of Malaya amounted to M$24.3 million. The corresponding figure for Sabah was M$1.9 million and that for Sarawak M$381,000.[2] Expressed in per capita terms, the States of Malaya obtained approximately M$3.00 in the form of loans from the Federal Government, and Sabah and Sarawak M$3.70 and M$1.00. respectively.[3] A comparison of these figures and especially also of those for the individual States of Malaya (see last column of Table 6) for the purpose of assessing any deliberate government policy would be misleading, however. The reason is that loans are made at irregular intervals for individual projects, often involving very substantial amounts, rather than on a state basis. States may obtain no or only a few loans over many years, especially if they are small in size and population, and may then, all of a sudden, receive a comparatively large amount because of the availability of some large-scale project suitable for financing by Federal loans. Conclusions on the policy followed by the Federal Government in the distribution of loans to the individual states can therefore only be drawn from figures covering a considerable period of time.

To sum up: Public borrowing has been playing an important and increasing role in the financing of development projects both on the Federal and state level. However, the problem of coordination of public debt does not arise in Malaysia because of the almost complete control of public borrowing by the Federal Government.

[1]Information supplied by the Ministry of Finance, Kuala Lumpur.
[2]Figures extracted from *State Financial Statements*.
[3]Figures calculated from *State Financial Statements*.

CHAPTER VII

Summary and Conclusions

The study of the particular problems of federal finance in the developing economy of Malaysia against the background of the theory of federal finance as outlined in Part One of this book and the problems experienced by other federations old and new, has enabled us to draw a number of conclusions, the more important of which are summarised below:

1. Federalism as a political solution to unite people with different ethnical, cultural, linguistic and religious backgrounds and at different levels of socio-economic development, has come to play an important role in the world of today where small heterogeneous groups of people wish to unite without being too united. The desire to unite arises mainly from political and economic motives. Larger groupings can better represent their interests vis-a-vis the outside world, and are believed to be able to take advantage of economies of scale, and hence, to develop more rapidly than smaller ones.

At the root of forces of separation there is usually the fear of a minority of being overwhelmed by a majority. The desire of a weak group for protection against a more powerful one probably plays a greater role today than at the time of the formation of the older federations when divergencies in respect of race, language and the level of development were less pronounced. Moreover, the new federations have to cope with a number of additional problems, which often endanger their survival as democratic entities. These include poverty in the face of rising expectations, political instability and a poorly developed administration at a time when the state is expected to play a prominent role in bringing about rapid change.

2. Federalism is a compromise political solution based on a delicate balance of coalescing and conflicting forces, the relative strength of which determines the degree of tightness of the federation. There is no prototype federation and the circumstances prevailing at the time of the formation of a federation determine what type of federal arrangement is the most appropriate one. Federalism is no end in itself. On the contrary, forces are constantly at work which may change it in one direction or the other. It may tend to become looser, and even break up; or, it may tend towards a more or less unitary structure. Federalism should not be interpreted dogmatically, nor is it synonymous with good government. It can flourish only in a society where democratic practices are firmly established.

3. The motive for adopting a federal structure in the case of Malaya was mainly a racial and political one, namely the desire of the more numerous but economically weaker Malays to protect themselves against the dynamic, urban-oriented immi-

grant Chinese and Indian minorities. Though racial differences are not geographically based in Malaya, the retention of the Malay Rulers as a political institution was felt to offer a certain measure of protection to the Malay community.

Since the retention of the Sultans was probably the main motive for wishing to adopt a federal constitution, there was otherwise no opposition to the desire of the withdrawing British colonial power in the face of an armed Communist insurrection, to establish a strong centralised administration for the sake of rapid modernisation and development. In fact, the lack of interest of the Malay States in economic and financial matters resulted in a predominance of the Federal Government which is almost tantamount to the control exercised by the government of a unitary country.

4. When the Federation of Malaysia was formed in 1963, none of the parties favoured too tight a union. Not only were the three territories that federated with Malaya distinct geographical units, but there were also territorially based ethnical and historical differences as well as a desire among certain racial groups to obtain protection against foreign domination. Moreover, the various territories showed marked differences in their level of development. For Singapore and the Borneo States, federation also held out certain prospects of economic and financial gain. The interests of Singapore and the Borneo territories were duly taken care of with the result that the Federation of Malaysia became a much looser union than its predecessor. The integration of Singapore into the Federation had, in fact, made very little progress when that State separated from the Federation in 1965. The reasons for Singapore's secession were numerous, involving political as well as economic issues. Whereas conditions in West Malaysia seem to move in the direction of an ever increasing predominance of the Centre, the Borneo States have so far shown a strong desire for retaining as much independence from Kuala Lumpur as possible.

5. The adoption of a federal structure of government creates a number of far-reaching economic and administrative problems. There is especially a clash of interests between the desire of the states for equality in wealth and opportunity and the priority given by central policy makers to achieving rapid economic growth. In view of the so-called advantages of concentration—the attraction offered by existing growth centres and regions marked out by certain natural advantages for further large investments—even the advanced nations have already found it almost impossible to accomplish balanced geographical growth. Much less can developing countries afford to ignore the costs of a policy of equalising regional differences in terms of the level of development, if these are due to geographically bound divergencies in human and natural resources.

In a tight federation where the federal government would have both the power and the means to carry out a policy of equalisation, the demand for equality can, at the same time, be ignored more easily. In a loose federation, on the other hand, the rich states may be reluctant to foot the bill for the preferential treatment of the poorer states. Only where the latter are in a strong political bargaining position will they succeed in having equalisation accepted as a goal of federation.

6. Malaysia provides examples of all these variations. With regard to the States of Malaya the position of the Federal Government is so strong that it would probably not experience any serious difficulty if it wished to carry out a policy of equalisation.

However, despite the fact that equalisation is a goal of Federal economic policy, there are indications that the Federal Government is not willing to go very far in this direction. It is felt that such a policy would be economically unwise and financially too costly. In view of the far-reaching degree of political and economic integration of the States of Malaya and the predominance of the Federal Government there is probably little the poorer states of West Malaysia can do to improve their unfavourable position.

With regard to the Borneo States, on the other hand, we find a certain reluctance on the part of the Federal Government and politicians in West Malaysia to finance the accelerated development of these states. Yet, equalisation is actively pursued not only because this was the understanding at the time of the formation of Malaysia, but also because it is realised that the financial support which the Borneo States obtain from the Centre represents now, after the ending of the Indonesian Confrontation, probably the most important link which keeps the federal idea in East Malaysia alive. Expressed differently, the ever potent danger that the Borneo States could at some future date reconsider their attitude towards Malaysia, puts them in a position where they can insist on a policy of equality favouring them.

Equalisation would have meant financial sacrifice to Singapore which was the wealthiest of all the fourteen states that united in 1963. Singapore's interest was therefore clearly to retain as much financial independence as possible and to support the rest of Malaysia only to such an extent as was warranted by the advantages it would reap from federating in terms of greater security and an enlarged market for its products. The financial arrangements in force between the Federal Government and Singapore between 1963-65 largely recognised Singapore's special position and its desire for fiscal independence.

7. The other major problem created by the introduction of a federal structure of government concerns administrative efficiency. Administrative decentralisation following the lines laid down by the Federal Constitution need not necessarily be less efficient or more expensive than the more deliberately planned, but equally necessary decentralisation in a unitary country. The difficulties experienced by developing federations, including Malaysia, in setting up efficient administrative machineries originate probably less from their federal structure of government than from such factors as the scarcity of funds, the lack of qualified, experienced and devoted administrators at all levels, the absence of a well-developed system of communications, etc. All these difficulties are experienced by other developing countries as well.

8. In respect of development planning most of the newer federations have provided for a sufficient degree of centralisation to ensure coordinated planning and plan implementation. In Malaysia, uniformity of development planning is ensured not only by the constitutionally established predominance of the Federation in almost all aspects of the social and economic life of the nation, but also by special constitutional powers which empower the Federal Government to coordinate the development effort of the nation. Moreover, since the states depend largely on Federal grants and loans for the implementation of their own development schemes, they have little option but to cooperate with the central planning authority.

9. The most complex problem facing all federations, old and new, is that of fiscal

imbalance which presents itself in two distinct dimensions, namely vertical and horizontal imbalance. Vertical imbalance arises from the fact that resources are usually not distributed among the two layers of government according to their respective needs. Whereas the federal government often has more funds than it actually needs (because it controls all the more productive and flexible tax sources), the states frequently have insufficient resources to meet their obligations. Horizontal or interstate fiscal differences usually result from the different levels of development attained by the various states and the ensuing difference in their fiscal capacities, as well as from differences in the costs of meeting state responsibilities. As a general rule, the poorer states can be expected to have a lower fiscal capacity than the rich ones and it will be more expensive for them to provide services to the public at a certain minimum standard.

10. The problem of vertical imbalance is closely bound up with the way in which functions and resources are distributed among the two layers of government. Ideally, this distribution should follow the principle of efficiency which suggests that functions concerning the nation as a whole should fall within the jurisdiction of the centre, whereas those of a regional character should be administered by the states. With regard to resources, taxes having an interstate base should be administered by the federal government, and those having a more regional base by the states. However, the principle must not be interpreted too absolutely but rather against the specific and ever changing background of a particular federal setting.

In this connection, Malaysia provided us with examples of the need for a flexible interpretation of the criterion of efficiency. In respect of the Borneo States, which are separated from the mainland by hundreds of miles of sea, some of the functions which should normally fall under the jurisdiction of the centre are probably more effectively taken care of by the states. With regard to Singapore, the retention by that State of wide powers and resources must also be considered as 'efficient' in terms of the principle in view of Singapore's relatively high level of economic and administrative development and its special interests as a large seaport and international commercial centre.

In Malaysia the concentration of functions with the Federal Government has been carried so far that, in respect of the States of Malaya, one could almost question whether there is any justification to speak of a federation at all. Virtually all the functions of a unitary government administering a modern economy fall under the jurisdiction of the Federal authority. The powers retained by the states, on the other hand, are mainly those which are characteristic of an administration running a poor, underdeveloped and tradition-bound economy. The Borneo States were able to retain certain additional powers under the Constitution in the quest for rapid social and economic development, but these, too, are considerably below the first level of governmental importance.

11. The unequal distribution of powers is reflected in the way by which resources have been divided in Malaysia. Tax centralisation in the hands of the Federal Government is in itself not necessarily a sign of weakness of the states, provided the states are assured of a corresponding portion of the centrally collected revenue under tax-sharing arrangements or under a constitutionally guaranteed system of federal grants. Indeed, a highly centralised system of tax collection has a great num-

ber of advantages over a decentralised system. It has become a growing feature of the advanced federations and has been widely adopted by developing federations.

In Malaysia almost all the more important direct and indirect taxes belong to the Centre. Under the Constitution, the Federal Government is obliged to pass on to the states a small fraction of its revenue in the form of grants, and allocations in respect of certain revenues. The states share in the yield of the latter on the basis of the principle of derivation. The states, on the other hand, control various locally based sources of revenue to which, in the case of the Borneo States, a number of more productive revenue sources were added to compensate them for their wider functions. The effect of the division of resources is that the combined revenue of all the states, including federal transfers, amounts to only about one quarter of the total revenue collected by the Federation.

Since all the more productive sources of public revenue belong to the Federation it is not surprising to find that almost all the states suffer from a considerable degree of (vertical) fiscal imbalance. The 'fiscal gap' between the states' own domestic revenue and their expenditure ranges between 15-75% of their total expenditure.

12. The problem of equity in the context of federal finance arises from the fact that states differ in their fiscal capacities and in their need of resources to fulfil state functions. In Malaysia we find very substantial differences in the fiscal capacities of the states. On the Malay Peninsula the per capita domestic revenue of some of the states is three to six times higher than that of the poorest state. This difference is explained by the fact that the revenue of the states is mainly derived from forestry, and licences and royalties on land and mines which accrue chiefly to the states endowed with rich forest and mineral resources.

The extreme differences in the fiscal capacity of the states raises the question to what extent, if at all, the Federal Government should attempt to balance these differences. The 'pure' theory of federal finance strongly supports equalisation. In fact, the so-called 'principles of federal finance' advocate that the federal government should transfer funds from the richer to the poorer states until all interstate differences in the level of socio-economic development are completely evened out. The principles stand for the notion of geographically balanced growth.

This suggests a higher tax structure for the rich states. In practice, however, it may not be practical to follow this suggestion because tax legislation which discriminates between the various states is likely to be objectionable on legal-constitutional grounds. It may also foster smuggling and tax-evasion and cause industries to shift to areas which are less suited from an economic point of view. More important from the viewpoint of developing countries is that the doctrine of balanced geographical development may be in conflict with the aim of rapid growth for the nation as a whole. Investment in agriculture and industry will take place where it is most profitable. Investors will prefer those regions of a country which offer the greatest natural advantage in terms of the availability of factors of production, and the availability of ancillary services and a nearby market. Similarly, government investment in infrastructural services will also yield highest returns in those areas preferred by private investors.

13. From the above it follows that a policy of fiscal equalisation may be unwise and too costly for countries which have large backward areas and only a few growth

centres. In developing countries these growth centres are usually too weak to carry the additional burden which a policy of equalisation would impose on them. Moreover, equalisation may not be a federal aim at all. This is likely to be the case in loose federations where the rich states insist that revenues raised by the central government in their area, be returned to them according to the principle of derivation.

In a tight federation the popular demand for the equal treatment of all states may be more pronounced. Although in these circumstances the federal government will also have the power and the means to carry out a policy of fiscal equalisation, it can, at the same time, ignore such a demand more easily if it feels that this would be in the interest of the nation, bearing in mind the possible retarding effect of equalisation on economic growth.

It may be assumed that, in principle, Malaysia subscribes to the need of equalising interstate fiscal differences. The extent to which such differences should be balanced has, however, never been defined. An analysis of fiscal practice in Malaysia indicates that equalisation is, in fact, implemented vis-a-vis the Borneo States which benefit considerably from the large allocations and special grants from the Federal Government. No attempt is, however, made at bringing about a better income distribution among the States of Malaya. The contrast in the treatment of the states of West and East Malaysia is due to the fact that at the time of federating, the States of Malaya showed little interest in financial matters. The case of the Borneo States, on the other hand, was strongly represented in the negotiations preceding the formation of Malaysia. They were thus able to secure for themselves comparatively more favourable financial conditions.

14. Various methods are available to effect intergovernmental fiscal adjustments. Tax-sharing and federal grants are the most common ones. The extent of the adjustment operation depends on the degree of tax autonomy enjoyed by the states. Where use is made of conditional grants for the purpose of adjustment, the central government can influence the performance of certain state services. Such an influence may be desirable in the interest of uniform standards. The states may also be induced to take up new services. Normally, however, unconditional grants would bear the main burden of adjustment. Where the system of adjustment is made up of various grants and allocations the rates of distribution of which are fixed or cannot be changed easily, there should at least be one powerful 'balancing grant'. This should be based on a formula which is geared to an objective criterion indicating the states' need for additional funds.

15. In Malaysia the states are entitled to a variety of transfers from the Federal Treasury. Some of these represent allocations under tax-sharing agreements while others constitute conditional grants made in respect of certain state services. The main instrument of fiscal adjustment is, however, the capitation grant. The grant provides for a sliding scale, based on population figures, which is intended to give preferential treatment to the less populous and, hence, (as it was originally assumed) financially weaker states. The sliding scale nevertheless fails in bringing about a satisfactory degree of equality in the revenue distribution of the states. This is so because in a country like Malaysia where there are marked interstate differences in the natural resource endowment and in the level of development, population figures alone are an insufficient indicator of the need of the states for financial assistance.

Other factors influencing the need of the states, such as their level of development, geographical features and the urban/rural distribution of the population will also have to be taken into account. A fiscal adjustment based on per capita state income figures alone would probably come much closer to achieving both vertical and horizontal equality.

16. In view of the extreme income differences between the States of Malaya and the ambiguous attitude of the Federal Government to the question of equalisation, it is not surprising to find that some states are permanently in deficit, and that there is also a growing indifference among the states towards financial matters. The discontent of the poorer states on the Malay Peninsula is the more understandable if one thinks of the substantial Federal transfers to the Borneo States. The latter have been receiving large and increasing amounts of special grants to which the other states are not entitled. Nevertheless, the special grants to the Borneo States are also not related to the actual needs of these states. This state of affairs may lead to conflict with the Federal Government at some later date. Any disagreement between the Centre and the Borneo States on the special grants can, however, be resolved at one of the regular reviews provided for under the Constitution.

Even if a policy of equalisation vis-a-vis the States of Malaya commands a low priority at present, the system of fiscal adjustment applicable to these states needs urgent revision with a view to alleviating the extreme income differentials. Without greater equality in this respect the standard of financial responsibility of the states is bound to suffer. A revision of the conditions of the capitation grant or, alternatively, the introduction of a new 'balancing grant' could solve the problem. Since the States of Malaya have no right to demand a review of their financial position under the Constitution, it would be up to the Federal Government to initiate the necessary steps in this regard.

17. Grants from the State Reserve Fund are made on an *ad hoc* basis and cannot solve the problem of extreme horizontal fiscal imbalance as experienced on the Malay Peninsula. They can do no more than bridge temporary stringencies of the states. Moreover, as long as the extreme revenue differentials between the states are allowed to persist, it is unlikely that any other device aimed at inducing the states to exercise greater economy in their financial dealings will succeed.

18. Fortunately, the damage done so far by the failure of the system of adjustment in bringing about more healthy conditions in the financial position of the States of Malaya may not have been too great. During the past years most of the states have still been able to finance their deficits by drawing on accumulated reserves. Moreover, most of the essential services to the nation fall under the competence of the Federal Government and are thus not affected by the financial difficulties of the states. The degree to which the welfare of the people is impaired by a defective system of fiscal adjustment tends to vary directly with the size of the unresolved imbalance and the socio-economic importance of the functions performed by the states.

19. No financial system is set for ever and circumstances in a federation always change. The constitution should, therefore, provide for a maximum amount of flexibility in all aspects of federal/state financial relations. Whereas short-term imbalances in the functions/resources relationship of the states should be taken care

of by the system of fiscal adjustment, long-term imbalances may require appropriate constitutional changes in the prevailing pattern of resource distribution. Moreover, to meet changing conditions and to ensure a high degree of efficiency, the whole system of federal finance should be subject to periodic review by some independent and impartial authority. Where open conflict arises between the federal and a state government on some financial matter, such conflict should be arbitrated by a court or body on which there should serve experts in the field of law, economics and financial administration.

In Malaysia it was found that the Constitution provides for a sufficient measure of flexibility in the federal/state financial relations. However, with regard to the States of Malaya a change in the present fiscal set-up can be initiated only by the Federal Government. Provision for periodic reviews exist only in respect of the conditions governing the special grants to the Borneo States. Such reviews are carried out by the Federal Government and the state concerned. Both governments must agree before any change may become effective. This is a more satisfactory solution from the point of view of the states, although the danger cannot be excluded that a purely economic and financial issue may become the object of political bargaining.

If no agreement is reached between the parties concerned, the Constitution provides for arbitration by an independent assessor. No method for the appointment of the assessor is provided for in the Constitution, however, and this omission may have to be corrected at a later date.

A similar arrangement was also foreseen in the case of Singapore when this State was still a part of Malaysia. The financial agreement with Singapore provided for the greatest amount of flexibility and for arbitration if disagreement were to arise between the Federal and the State governments.

20. The need for a body which could effectively coordinate and review federal/state financial relations from time to time may become more urgent in future, especially if the states should eventually become political and economically more self-aware. The National Finance Council, which so far acts merely as an advisory body to the Federal Government, could be reorganised and given wider responsibilities in the field of federal finance. These wider responsibilities should also cover the Borneo States. It would depend on the role assigned to federalism in Malaysia whether or not the states should be given the right to actively participate in the Council's deliberations and thus share in thc responsibility for decisions taken by it.

21. Fiscal policy aims at implementing some of the wider aims of national economic policy. Loose federations would seem to be at a disadvantage with regard to the uniformity of the design and implementation of fiscal measures. Although tight federations would accordingly be in a better position, the fact remains that the scope for expansionary monetary and fiscal measures is very limited in developing countries irrespective of the form of government. These countries are therefore obliged to rely mainly on the more traditional fiscal instruments to attain rapid and stable economic development.

In Malaysia, traditional fiscal methods have played an important role in the nation's development effort particularly in promoting investment in secondary industries and savings for public sector investments. Fiscal measures also play a

major role in the endeavour to integrate the various parts of the Federation economically and to promote social justice. It was noted that all the spheres in which fiscal policy can be instrumental in achieving the wider aims of socio-economic policy, are federal responsibilities. There is thus no need in Malaysia to overcome constitutional rigidities in order to implement a nation-wide fiscal policy. All the major instruments of fiscal policy, especially income tax and customs duties, are Federal matters.

22. Fiscal measures designed to promote industrialisation can to a certain extent influence the regional distribution of private investments. In Malaysia, no serious attempt has been made so far to induce private investors to invest in some of the less developed states. In fact, the vast majority of the newly established 'pioneer industries' are located in the already fairly industrialised West Coast states of the Malay Peninsula.

23. Finally, attention was given to the public debt which is assuming ever in creasing proportions in developing countries. The difficulty experienced by federations in this context is that the financially weaker states may be at a disadvantage when competing with the wealthier states and the federal government for domestic and foreign loans. There is, moreover, the danger of an uncontrolled expansion of the public debt in a federation.

Following the example of other developing federations, public borrowing in Malaysia has been restricted to the Federal Government. Only the Borneo States have the right to borrow within their own borders provided they first obtain the approval of the Central Bank. Singapore, formerly, could also borrow within its own borders and from external sources, subject to certain restrictions. These wider powers signified Singapore's high financial standing and its special position in Malaysia.

24. Political, economic and social forces are not stagnant in Malaysia. It may be too early to establish any definite trend in the development of federalism in Malaysia. Nevertheless, it would not be surprising if in the long run the present rather weak forces of federalism in West Malaysia were to permit a replacement of the present tight federal set-up by a unitary type of political structure. With regard to Sabah and Sarawak, the trend would appear to be in the opposite direction. Both states wish to retain a maximum of autonomy. The further development of Federal/state fiscal relations are likely to play a major if not decisive role in determining the future course of federalism in both West and East Malaysia.

Bibliography

Bibliography

Bibliography

1. Publications Dealing with Federalism, Public Finance, Federal Finance and Development in General

Adarkar, B.P.: *The Principles and Problems of Federal Finance,* London, 1933.

Australia: *Third Report of the Commonwealth Grants Commission of Australia (1936),* Canberra.

Australia: *Sixteenth Report of the Commonwealth Grants Commission of Australia (1949),* Canberra.

Bauer, P.T. and Yamey, B.S.: *The Economics of Underdeveloped Countries,* Cambridge, 1960.

Beloff, M.: "The Federal Solution in its Application to Europe, Asia and Africa", in *Political Studies,* June 1953, Oxford.

Bhargava, R.N.: *The Theory and Working of Union Finance in India,* London, 1956 (reprinted Allahabad, 1965).

Bhargava, R.N.: "The Theory of Federal Finance", in *The Economic Journal,* March 1953, London.

Binns, K.J.: *Federal Financial Relations in Canada and Australia,* Report prepared for the Government of Tasmania, Hobart, 1948.

Birch, A.H.: *Federalism, Finance and Social Legislation in Canada, Australia, and the United States,* Oxford, 1957.

Bird, R. and Oldman, O. ed.: *Readings on Taxation in Developing Countries,* Baltimore, 1964.

Buchanan, J.M.: "Federalism and Fiscal Equity", in *American Economic Review,* September 1950, Wisconsin.

Buchanan, J.M.: *The Public Finances,* Homewood, Illinois, 1960.

Buchanan, J.M.: *Public Principles of Public Debt,* Homewood, Illinois, 1958.

Buchanan, J.M.: "The Pure Theory of Government Finance", in *The Journal of Political Economy,* December 1949, Chicago.

Campbell, W.J.: *Australian State Public Finance,* Sydney, 1954.

Chand Gyan: *The Essentials of Federal Finance,* London, 1930.

Chelliah, Raja J.: *Fiscal Policy in Underdeveloped Countries,* London, 1960.

Clark, C.: *Taxmanship—Principles and Proposals for the Reform of Taxation,* London, 1964.

Commonwealth Bureau of Census and Statistics: *Year Books of the Commonwealth of Australia,* No. 37, 1951; No. 46, 1960; No. 51. 1965.

Council of State Governments (USA): *Federal Grants-in-Aid,* Report of the Committee on Federal Grants-in-Aid, 1949.

Crockett, J.P.: *The Federal Tax System of the United States,* New York, 1955.

Dalton, H.: *Principles of Public Finance,* London, 1964.
Deshmukh, C.D.: *The Balance between Monetary Policy and other Instruments of Economic Policy in a Developing Economy,* lecture published by the Per Jacobsson Foundation, Washington, 1965.
Due, J.F.: *Taxation and Economic Development in Tropical Africa,* Cambridge, Massachusetts, 1963.
Due, J.F.: "Tropical African Contributions to Federal Finance", in *Canadian Journal of Economics and Political Science,* February 1964, Toronto.
Dvorin, E.P.: "Emergent Federalism in Central Africa.", in Carter, G.M. and Brown W.O. ed.: *Transition in Africa: Studies in Political Adaptation,* Boston, 1958.
Garmany, J.W.: "Revenue Allocations in a Federal State", in *South African Journal of Economics,* Vol. 30, 1962, Johannesburg.
Germany, Federal Republic of: *Grundgesetz für die Bundesrepublik Deutschland vom 23. Mai 1949.*
Germany Reports: *Public Finance,* published by the Press and Information Office of the Federal Government, Wiesbaden, 1964.
Groves, H.M.: "New Sources of Light on Intergovernmental Fiscal Relations", in *National Tax Journal,* September 1952, Pennsylvania.
Haller, H.: *Finanzpolitik,* Tübingen, 1965.
Hazelwood, A. and Henderson, P.D.: "Nyasaland - The Economics of Federation", in *Bulletin of the Oxford University Institute of Statistics,* Vol. 22, No. 1, Oxford.
Heller, J. and Kauffman K.M.: *Tax Incentives for Industry in Less Developed Countries,* Cambridge, Massachusetts, 1963.
Hicks, J.R.: *Essays in World Economics,* Oxford, 1959.
Hicks, J.R. and U.K.: *Report on Finance and Taxation in Jamaica,* Kingston, 1955.
Hicks, U.K.: *Development from Below,* Oxford, 1961.
Hicks, U.K.: "National and Local Finance", in *The Economic Journal,* December 1946, London.
Hicks, U.K.: *Public Finance,* Cambridge, 1959.
Hicks, U.K. and others: *Federalism and Economic Growth in Underdeveloped Countries,* London, 1963.
Hirschman, A.O.: *The Strategy of Economic Development,* New Haven, 1958.
India: Ministry of Finance, Department of Economic Affairs: *Indian Tax Reform—Report of a Survey by Nicholas Kaldor,* New Delhi, 1956.
Institut "Finanzen und Steuern": *Finanzausgleich,* Heft 17, Bonn, undated.
Institut "Finanzen und Steuern": *Länderhaushalte 1952-1954,* Heft 49, Bonn, 1957.
International Bank for Reconstruction and Development: *World Bank Atlas of Per Capita Product and Population,* Washington, DC., 1967.
International Labour Organisation: *Employment and Economic Growth,* Geneva, 1964.
MacMahon, A.W.: *Federalism Mature and Emergent,* New York, 1955.
Maxwell, J.A.: *The Fiscal Impact of Federalism in USA,* Cambridge, Massachusetts, 1946.
Musgrave, R.A.: *The Theory of Public Finance,* New York, 1959.
Myrdal, G.: *Beyond the Welfare State: Economic Planning in the Welfare States and*

its International Implications, New Haven, 1960.
Mydral, G.: *Economic Theory and Underdeveloped Regions,* London, 1957.
Nehru, B.K. and Adarkar, B.P.: *Report on the Australian System of Federal Finance and its Applicability to Indian Conditions,* New Delhi, 1947.
New Delhi National Council of Applied Economic Research: *Taxation and Foreign Investment,* Bombay, 1955.
Nigeria: *Report of the Commission on Revenue Allocation,* Lagos, 1951.
Onslow, C. ed.: *Asian Economic Development,* Singapore, 1965.
van Philips, P.A.M.: *Public Finance and Less Developed Economy,* The Hague, 1957.
Pigou, A.C.: *A Study in Public Finance,* London, 1928.
Prest, A.R.: *Public Finance in Underdeveloped Countries,* London, 1963.
Rao, V.K.R.V.: "Investment, Income and the Multiplier in an Underdeveloped Economy", in Agarwala, A.N.: *The Economics of Underdevelopment,* Bombay, 1960.
Report of the Advisory Commission on the Review of the Constitution of Rhodesia and Nyasaland, London, H.M.S.O., 1960.
Riker, W.H.: *Federalism, Origin Operation Significance,* Boston and Toronto, 1964.
The Role of Direct and Indirect Taxes in the Federal Revenue System, A Conference Report of the National Bureau of Economic Research and the Brookings Institution, Princeton, 1964.
Schriftenreihe des Bundesministeriums der Finanzen: *Probleme einer Neuordnung der Haushaltswirtschaft bei Bund und Ländern,* Heft 8, Bonn, undated.
Scott, A.: "The Economic Goals of Federal Finance", in *Public Finance,* Vol. XIX, No. 3, 1964.
Singh, Baljit: *Federal Finance and Underdeveloped Economy,* Bombay, 1952.
Spencer, J. and Screeney, Th.: "The Fiscal Problems of Less Developed Countries" in *Finance and Development,* December 1965, Washington.
Tan Wai, U.: "Taxation Problems and Policies of Underdeveloped Countries" in *IMF Staff Papers,* November 1962, Washington.
Tinbergen, J.: *Central Planning,* New Haven and London, 1964.
Tripathy, R.N.: *Federal Finance in a Developing Economy,* Calcutta, 1960.
United Nations: *Monthly Bulletins of Statistics,* New York.
United Nations: *Statistical Yearbook 1967,* New York, 1968.
United Nations: *The United Nations Development Decade, Proposals for Action,* New York, 1962.
United Nations, Department of Economic and Social Affairs: *Planning for Economic Development,* New York, 1963.
United Nations, Economic and Social Council Fiscal Commission: *Corporate Tax Problems,* New York, 1953.
United Nations, Economic Commission for Africa: "Public Finance in African Countries", in *Economic Bulletin for Africa,* June 1961, Addis Ababa.
United Nations, Economic Commission for Asia and the Far East: "A Decade of Development Planning and Implementation in the ECAFE Region", in *Economic Bulletin for Asia and the Far East,* December 1961, Bangkok.
United Nations, Economic Commission for Asia and the Far East: "Administrative Machinery for Planning in the ECAFE Region", in *Economic Bulletin for Asia*

and the Far East, December 1966, Bangkok.
United Nations, Economic Commission for Asia and the Far East: "Design of Fiscal Policy for Increasing Government Saving", in *Economic Bulletin for Asia and the Far East,* December 1962, Bangkok.
United Nations, Economic Commission for Asia and the Far East: *Programming Techniques for Economic Development,* Bangkok ,1960.
United Nations, Economic Commission for Asia and the Far East: "Public Finance in the Postwar Period", in *Economic Survey of Asia and the Far East 1960,* Bangkok, 1961.
United Nations, Economic Commission for Asia and the Far East: "Tax Potential and Economic Growth in the Countries of the ECAFE Region", in *Economic Bulletin for Asia and the Far East,* September 1966, Bangkok.
United Nations, Economic Commission for Asia and the Far East: "Taxation and Economic Development in Asian Countries", in *Economic Bulletin for Asia and the Far East,* November 1953, Bangkok.
United Nations, Technical Assistance Administration: *Taxes and Fiscal Policy in Underdeveloped Countries,* New York, 1954.
United Nations, Technical Assistance Programme: *Decentralisation for National and Local Development,* New York, 1962.
United Nations, Technical Assistance Programme: *A Handbook of Public Administration,* New York, 1961.
United Nations, Technical Assistance Programme: *Seminar on Central Services to Local Authorities,* New York, 1964.
Wallich, H.C. and Adler, J.H.: *Public Finance in a Developing Country,* Cambridge, Massachusetts, 1951.
Waterson, A.: *Development Planning—Lessons of Experience,* Baltimore, 1965.
Wheare, K.C.: *Federal Government,* London, 1963.

II. Publications Dealing with Malaysia in General and the Working of Public Finance in Malaysia

Bank Negara Malaysia: *Annual Reports and Statements of Accounts,* Kuala Lumpur.
Bank Negara Malaysia: *Review of Economic Conditions* (monthly), Kuala Lumpur.
The Chief Statistician: *Monthly Digests of Statistics,* Singapore.
Department of Information: *Malaysia in Brief,* Kuala Lumpur, 1963 and 1967.
Department of Information: *Siaran Akhbar* (Press Releases), Kuala Lumpur.
Department of Statistics: *Annual Bulletins of Statistics Malaysia,* Kuala Lumpur.
Department of Statistics: *Annual Bulletins of Statistics Sabah,* Kuala Lumpur.
Department of Statistics: *Malaysia, an Economic and Functional Classification of Central Government Budget Estimates 1965, Kuala Lumpur.*
Department of Statistics: *Monthly Statistical Bulletins of the States of Malaya,* Kuala Lumpur.
Department of Statistics: *National Accounts of West Malaysia 1955-1964,* Kuala Lumpur, 1967.
Department of Statistics: *States of Malaya, an Economic and Functional Classification of Government Transactions 1963,* Kuala Lumpur, 1965.

The Economist Intelligence Unit: *Malaysia, Singapore, Brunei* (Quarterly), London.

Groves, H.E.: *The Constitution of Malaysia,* Singapore, 1964.

The Malay Mail (daily), Kuala Lumpur.

Malaya: *Agreement between the Governments of the Federation of Malaya and Singapore on Common Market and Financial Arrangements* (cmd. No. 27 of 1963), Kuala Lumpur, 1963.

Malaya: *Currency Act,* 1960 (Act No. 27 of 1960), Kuala Lumpur, 1960.

Malaya: *The Development Fund Ordinance,* 1958 (No. 18 of 1958), as amended, Kuala Lumpur.

Malaya: *The Federation of Malaya Agreement, 1948,* as amended, Kuala Lumpur, reprinted 1956.

Malaya: *Federation of Malaya Constitutional Proposals 1957,* Kuala Lumpur, 1957.

Malaya: *The Finance Ordinance, 1956* (No. 57 of 1956), Kuala Lumpur, 1957.

Malaya: *The Financial Procedure Ordinance, 1957* (No. 62 of 1957), Kuala Lumpur, 1958.

Malaya: *Malaysia Report of the Inter-Governmental Committee 1962,* Kuala Lumpur, 1963.

Malaya: *Report on the Economic Aspects of Malaysia,* by a Mission of the International Bank for Reconstruction and Development (Rueff Report), Kuala Lumpur, 1963.

Malaya: *Second Five-Year Plan 1961-1965,* Kuala Lumpur, 1961.

Malaysia—Agreement concluded between the Federation of Malaya, United Kingdom of Great Britain and Nothern Ireland, North Borneo, Sarawak and Singapore, Kuala Lumpur, 1963.

Malaysia: *Budget Speeches of the Minister of Finance, Tun Tan Siew Sin* (annually), Kuala Lumpur.

Malaysia: *Development Estimates,* Kuala Lumpur.

Malaysia: *The Federal Constitution,* Kuala Lumpur. 1964.

Malaysia: *Federal Financial Statements,* Kuala Lumpur.

Malaysia: *Finance Act, 1965* (Act No. 2 of 1965), Kuala Lumpur, 1965.

Malaysia: *First Malaysia Plan 1966-1970,* Kuala Lumpur, 1966.

Malaysia: *Income Tax Laws (Malaysia) (Amendment) Act,* No. 75 of 1965, Kuala Lumpur.

Malaysia: *Investment Incentives Act, 1968,* No.13, Kuala Lumpur, 1968.

Malaysia: *Official Year Books,* Kuala Lumpur.

Malaysia: *Pioneer Industries (Relief from Income Tax) Ordinance, 1958* (Ordinance No. 31 of 1958), Kuala Lumpur, Reprint No. 6 of 1966.

Malaysia: *State Financial Statements,* Kuala Lumpur.

Malaysia: *Supply Acts* (annually) and *Supplementary Supply Acts,* Kuala Lumpur.

Ministry of Culture: *Singapore Facts and Figures,* Singapore, 1966.

Ratnam, K.J.: *Communalism and the Political Process in Malaya,* Kuala Lumpur, 1965.

Report of the Commission of Enquiry, North Borneo and Sarawak, Knebworth House, Hertfordshire, 1962.

Report of the Committee appointed to review the Financial Provisions of the Federation

of Malaya Agreement, 1948, Kuala Lumpur, 1955.

Reports of the Board of Commissioners of Currency, Malaya and British Borneo, Kuala Lumpur.

Silcock, T.H. and Fisk, E.K. ed.: *The Political Economy of Independent Malaya,* Canberra, 1963.

Singapore: *Year Books,* Singapore.

The Straits Times (daily), Kuala Lumpur.

United Kingdom, Colonial Office: *Malayan Union and Singapore: A Statement of Policy on Future Constitution,* (cmd. 6724), London, 1964.

United Kingdom, Colonial Office: *Report of the Federation of Malaya Constitutional Commission 1957,* London, 1957.

United Nations, Commissioner for Technical Assistance, Department of Economic and Social Affairs: *Report on the National Accounts of the Federation of Malaya 1955-1960* (prepared by Dorothy Walters), New York, 1963.

Index

Adarkar, B. P., 48 n, 51 n, 57 n, 63, 79 n

Adjustment grants, *see under* grants

Adjustment taxes, *see under* taxation

Adler, J. H., 90 n

Administration, efficient:
  and decentralised decision-making, 29-30, 177
  and federalism, 8, 29-34, 44, 177
  see also financial administration in a federation

Administrative norms of federal finance, 63-64

Allocations under tax-sharing arrangements, *see under* taxation

Arabian Emirates, Federation of, 4 n

Arbitration of conflicts:
  Borneo States, 162-163, 163, 182
  general principles, 2, 77, 81-82, 85, 162, 181
  Singapore, 163, 183
  see also coordination of federal/state financial relations

Australia, 2 n, 4

Australian Commonwealth Grants Commission, 82-84

Australian Loan Council, 99-100

Austria, 4 n

Balanced geographical growth, *see under* equity

Bhargava, R. N., 2 n, 30 n, 47, 51 n, 52 n, 65 n, 68 n, 72 n, 80 n, 82 n, 100 n

Birch, A. H., 3 n, 49 n, 67 n, 68 n, 78 n, 94 n

Borneo States:
  administration of, 21, 31
  federal development/economic policy vis-a-vis: 26-27, 38-43, 45, 143
  fiscal capacities of, 131-133, 153
  motives for joining Malaysia, 7, 15-18, 22-23, 113-114, 175-176
  see also capitations grant, division of functions, division of resources, special grants to the Borneo States, *and* state road grant

British interests in federation, *see under* Malaysia *and* Malaya

Brunei, failure of federation with Malaysia 19-20

Buchanan, J. M., 52 n, 53, 53 n, 58 n, 65 n, 66 n, 72 n

Campbell, W. J., 67 n, 83 n, 99 n, 100 n

Canada, 4, 8, 78 n, 99

Capitation grant, provisions and working of:
  in Borneo States, 136, 153-154, 180
  its failure, 145-148, 155-156, 180-181
  in States of Malaya, 108, 136, 140, 144-148, 155-156, 158, 180-181

Carnell, F. G., 4 n, 5 n, 6 n, 8 n, 30 n, 32

Central African Federation, *see* Rhodesia and Nyasaland

Centralisation as feature of federalism, 3, 66, 177, 178

Centralised system of tax administration, 67-69, 74, 76-78, 93-94, 95, 119, 125, 126, 127-128, 134, 158, 178, 179

Ceylon, 24 n

Chelliah, Raja J., 88 n

Chinese population group in Malaysia, 11-13, 15-16, 175-176

City-States as members of federations, 47, 80-81

Communism 11, 12, 22, 175-176

Company tax, *see* income tax

Concurrent zone of functions and resources, 68, 109, 110-111, 127

Conflicts, settlement of, *see under* arbitration of conflicts

Constitution of Malaysia, origin and nature, 13, 15, 18-19

Constitutions of States of Malaya, 19

Cooperative federalism, 4, 77

Coordination of federal/state financial relations:
  general principles, 77-78, 81-82, 85, 94, 135, 160
  in Malaysia, 127, 128, 149, 160-162, 163, 170, 182
  see also arbitration of conflicts *and* National Finance Council

Currency union, Malayan, 14-15, 164-165

Customs duties:
  in general, 66, 69, 90, 91, 94
  in Malaysia, 114-117, 118, 125, 127, 133, 136, 157, 166, 167, 168, 170
  see also fiscal policy

Customs union in Malaysia, 119, 167-168

Dalton, H., 51 n, 54 n, 55 n, 56 n, 57-58 n, 96 n

Deshmukh, C. D., 87 n

Development planning in Malaysia 43-44, 45
  see also federalism, and development planning

Division of functions:
  general principles, 2, 64-66, 178
  in Malaysia, 109-113, 114, 128, 178
  and the principle of efficiency, 65-66, 84-85, 111-113, 128-129, 178

Division of resources:
  general principles, 66-69, 127, 178
  in Malaysia, 114-127, 135, 157-158, 178-179
  and the principle of efficiency, 66-69, 77, 84-85, 125-127, 128-129, 178

Dualistic federalism, 68, 75

Due, J. F., 67 n, 68 n, 75 n, 94 n

Economic development and the role of the government, 8-9, 23-25, 86-87

Economic growth:
and federalism, 23-24, 26-28, 44-45, 59-61, 62-63, 175, 179-180
problems of, 86-89
the process of, 25-26

Economic motives for formation of Malaya and Malaysia, 13-14, 15-18, 22-23, 113-114, 175-177, 179-180

Economic policy:
aims vis-a-vis Borneo States, 38-41, 43, 179-180
aims in general, 25
aims in Malaysia, 37-43, 143, 179-180
aims vis-a-vis States of Malaya, 38-43, 143, 155, 179-180
and federal finance, 46-47, 59-61
implications of federalism on effectiveness, 25-26, 26-27, 32-34, 45, 59-61, 176
instruments of, 88-92

Economies of scale as motive for federating, 6-7, 175

Efficiency, *see under* administration, division of functions, division of resources *and* principle of efficiency

Equalisation, *see* equity *and* financial adjustment

Equity, the problem of interstate:
and balanced geographical growth, 27-29, 44-45, 60-61, 62-63, 72, 73-74, 176, 179
in the context of federal finance, 47, 179
and federalism:
in general, 24-26, 44-45, 59-61, 62, 176,
in Malaysia, 38-43, 45, 107 ff, 131-133, 147-148, 176-177, 178-180
its origin:
in general, 25-26, 47-48, 51-53, 176, 177-178
in Malaysia, 107-149
and the theory of federal finance, 48-63, 179
see also financial adjustment *and* fiscal policy

Export duties, *see* customs duties

Federal finance:
aims, 47
definition, i-ii, 46-47

Federal grants *see* grants

Federalism:
its aims, 9, 59-60, 63, 134, 143
balance of forces, 5-7, 9, 27, 61-62, 175
conditions for, 8, 9
and decentralised decision-making, 29-30, 177
definition, 1, 2 n, 21-22
and democracy, 2, 8, 175
and development planning, 30-34, 43-44, 44-45,
and economic growth, 23, 27-28, 44-45, 60-61, 62-63, 175, 179-180
and economies of scale, 6-7, 175
failure of, 5
its merits, 4-5, 9, 175
motives for amalgamation and separation, 5-7, 7-9, 22, 175
and nationalism, 5-7
its nature, 1 ff, 4, 7, 21, 22, 23, 175
see also administration, equity, financial administration in a federation, Malaya, Malaysia *and* public debt

Federalism by aggregation 4, 71

Federalism by devolution, 4

Federation of Malaya Agreement, 11, 108

Financial adjustment:
fiscal gap in Malaysia, 129-131, 133, 134, 135, 153, 178-179
horizontal and vertical imbalance, nature and policy vis-a-vis:
in general, 58-59, 60-61, 61-63, 66, 73, 74, 76, 79-81, 82, 84-85, 128-129, 134, 142-143, 147-148,158
in Malaysia, 128-133, 147-148, 155-156, 161-162, 179-181
origin, 46-48, 51-53, 69-70, 134, 177-178
instruments to carry out adjustment operations:
in general, 58-59, 70-73, 134-138, 142, 180
in Malaysia, 77, 135ff, 180-181
and ratio of distribution (formulae), 74-77, 78-81, 85, 135, 136, 140, 143, 146-147, 155-156
size of operation, 73-76
see also capitation grant, equity, grants, special grants to the Borneo States, State Reserve Fund *and* taxation

Financial administration in a federation, 63-84, 126-127

Fiscal adjustment, *see* financial adjustment

Fiscal equity, *see* equity

Fiscal policy (in general and in Malaysia):
aims and opportunities:
in general, 76, 86, 88-91, 92, 94, 134, 143, 164, 182
in Malaysia, 125, 128, 164-167, 183
and interstate equity, 74, 92-93, 94-95
formulation and implementation of policy in a federation, 76, 93-94, 95, 125, 126, 128, 183
implications of federalism on its effectiveness 92-95, 168, 170
and investment, 88-89, 90, 94-95, 165-166, 170, 183
instruments of 88-89, 182
limitations of, 89, 93, 94-95, 164-165, 170, 183
and (compulsory) saving, 89-90, 166-167, 170, 183
and social justice, 90-91, 92-93, 95, 169-170, 182-183
see also customs duties, grants, income tax *and* monetary policy

Flexibility of constitutional and financial arrangements:
in general, 76, 81, 135, 182
in Malaysia, 157-160, 163, 182
see also coordination of federal/state financial relations

France, 56

Friedrich, C. J., 4 n

Garmany, J. W., 32 n, 82 n, 99 n

Germany, 4 n, 67, 71

Government, its role in economic development, 23

Grants:
ad hoc grants, 71, 84, 140
adjustment grants:
in general, 70, 71-73, 84, 134-135, 158
in Malaysia, 136, 140, 146, 153-154

balancing grants:
in general, 73, 84, 135, 158, 159, 180
in Malaysia, 136, 140, 146, 154, 155
conditional:
in general, 71-73, 79, 84, 180
in Malaysia, 42, 135-141, 153-154, 155, 180-181
equalising (variable ratio) grants, 71 n
matching (constant ratio) grants, 71 n
policy, 24, 70, 71-73, 74 n, 76, 180
unconditional, 71-73, 84, 180
see also Australian Commonwealth Grants Commission, capitation grant, equity, financial adjustment, special grants to the Borneo States, State Reserve Fund *and* state road grant

Groves, H. E., 11 n, 18 n, 109 n, 111 n, 119 n, 162 n

Groves, H. M. 77 n

Haller, H., 53 n, 73 n, 75 n, 77 n

Harmonisation of tax rates in Malaysia, 167-168

Heller, W. W., 87 n, 91 n

Hicks, J. R., 25

Hicks, U. K., 53 n, 81 n,

Horizontal imbalance *see under* financial adjustment

Import duties, *see* customs duties

Income tax:
in general, 67-68, 69, 90-91, 94, 95
in Malaysia, 117, 122-123, 126, 127, 165, 167, 169, 170
see also fiscal policy

India, 4, 4 n, 32 n, 33 n, 64, 66, 71, 79 n, 82

Indian population group in Malaysia, 12-13, 175-176

Indonesia, 5, 18, 21

Industrialisation policy in Malaysia, 41-42, 165

Italy, 28

Japanese occupation, 11, 15

Keynes, J. M., i, ii

Lee Kuan Yew, 16, 20

Malaya, Federation of:
British interests in federation, 10-11, 13-14
federal tradition, 10
federalism as solution, 10-14, 22
motives for federating, 11-14, 175-176
nature of federal solution, 11, 175-176
see also States of Malaya

Malays as racial group:
political aims, 10-14, 15-16, 17, 20, 21-22, 113, 175-176
special rights, 10-11, 14, 17, 21

Malaysia, Federation of:
aims of development/economic policy, 37-43, 45, 59 n, 176-177
balance of power, 21, 113-114, 122-125, 128, 177, 179
British interests in federation, 7, 15-18, 113-114, 175-176
failure of federation with Brunei and Singapore, 19-21, 176
federalism as solution, 7, 10, 14-19, 22, 113-115, 175-176
framework of economy, 34-37, 37-38, 164
future of federalism, 21, 148, 159-160, 176, 176-177, 183
motives for federating, 15-18, 22-23, 175-176
nature of federal solution, 18, 114, 178
see also Borneo States, customs union, division of functions, division of resources, equity, fiscal policy, harmonisation of tax rates, industrialisation policy, public debt, Singapore *and* States of Malaya

Monetary policy:
in general, 86-88, 93, 94
in Malaysia, 164-165, 170

Musgrave, R. A., 53 n

National Finance Council, 151, 161-162, 158-159, 160-162, 163, 171, 173, 182
see also coordination of federal/state financial relations

Need, the criterion of, *see* financial adjustment, and ratio of distribution

Nehru, B. K., 79 n

Newlyn, W. T., 89 n

Niculescu, B. M., 21 n, 23 n

Nigeria, 4, 4 n, 5, 6 n, 33 n, 65, 67, 68, 75, 82

Non-correspondence of functions and resources, 69, 128, 134
see also equity

Onslow, C., 24 n

Pakistan, 5, 9, 24 n

Per capita income and the rate of distribution, 79-81, 85, 146-147, 155-156, 180

Personal tax, *see* income tax

Philippines, 18, 21

Physical controls, 88, 91-92, 93, 94

Pigou, A. C., 51 n, 56 n

Pioneer industries in Malaysia 165-166, 183

Plural society 8, 13, 65

Prest, A. R., 4 n, 33 n, 78 n

Principle of derivation, 27, 71, 136, 178-179

Principle of efficiency, 49, 65-69, 125, 178
see also under division of functions *and* division of resources

Principles of public and federal finance:
principle of federal finance, 50-57, 61-62,
principle of financial responsibility, 48-49, 66-67
principle of maximum aggregate welfare, 51 n
principle of maximum social advantage, 51 n
principle of public expenditure, 51, 55-56, 62
principle of taxation, 51, 54-55, 62
principles of public finance, 50-51, 51-53, 61-63, 178-179

their validity: 57-61, 178-179
see also theory of public and federal finance

Public debt:
implications of federalism, 95-99, 100-101, 170, 173-174, 183
principles and characteristics, 95-97
in Malaysia, 161, 170, 170-174, 182-183
see also Australian Loan Council

Quasi-federations, 4

Racialism in Malaysia, 12, 17, 20

Rahman, Tunku Abdul, 16, 20

Rao, V. K. R. V., 88 n

Ratnam, K. J., 11 n

Reviews of federal/state financial relations:
vis-a-vis Borneo States, 154, 159, 159 n, 163, 181
general principles, 81-82, 134, 181
role of National Finance Council, 162
vis-a-vis Singapore, 161
vis-a-vis States of Malaya, 159, 159 n, 163, 182

Rhodesia and Nyasaland, Federation of, 5, 8, 67, 68, 70, 75, 82, 99 n

Riker, W. H., 4 n

Sabah *see under* Borneo States

Sarawak *see under* Borneo States

Sastri, K. V. S., 49 n, 79 n

Savings, promotion of, 166

Scott, A., 26 n, 34, 58 n, 61 n, 69 n

Silcock, T. H., 13 n, 15 n, 89 n

Singapore:
failure of federation with Malaysia, 19-21, 176
financial relations with Malaysia, 119-122, 126-127, 128, 134, 159, 163, 171, 176-177, 182
industrialisation, 32
motives for joining Malaysia, 7, 15-18, 23, 114, 175-176, 176-177
see also division of functions *and* division of resources

Singh, B., 63, 64 n, 67 n, 82 n, 83 n

Social justice, 68, 169

South America, failure of federalism, 5

Special grants to the Borneo States, 136, 141-142, 154-155, 156, 159, 163, 181

State Reserve Fund, grants from, 108, 142, 148, 153-155, 159, 161-162, 181

State road grant, 108, 136

States of Malaya:
development planning of, 43-44, 44, 60 n
federal development/economic policy vis-a-vis 38-43, 45, 143, 155-156, 176-177
fiscal capacities of, 131-133, 147-148, 155-156, 179-181
interstate differences, 39, 41-43, 131-133, 140, 143-148, 152
political self-awareness, 32, 147, 159
tax capacities, 122
see also division of functions *and* division of resources

Surcharges on taxes, 70-71, 75

Switzerland, 4, 8, 75, 99

Taxation/Tax (in general and in Malaysia):
adjustment taxes, 70, 71, 74, 134
administration, 126-127
definition, 54
tax autonomy, degree of, 68-69, 73-78, 180
tax discrimination, 58, 62, 92, 179
tax efforts of States of Malaya, 131
tax sharing and allocations under tax-sharing arrangements:
in general, 70, 73, 134-136, 180.
in Malaysia, 126, 127, 134-135, 135-141, 143, 148, 153-154, 155, 157, 179, 180
theory of 54-55
see also customs duties *and* income tax

Theory of (public and) federal finance, 48-63, 179
theory of public expenditure, 55-57
theory of taxation, 54-55
its validity, 57-61, 63, 179
see also equity *and* principles of public and federal finance

Tripathy, R. N., 57 n, 60, 60-61 n, 67 n

United States of America, 2 n, 4, 67, 79 n, 99

Vertical imbalance *see under* financial adjustment

Watts, R. L., 78 n, 82 n, 99 n

West Indies, Federation of, 4 n, 6 n, 7, 33 n, 65

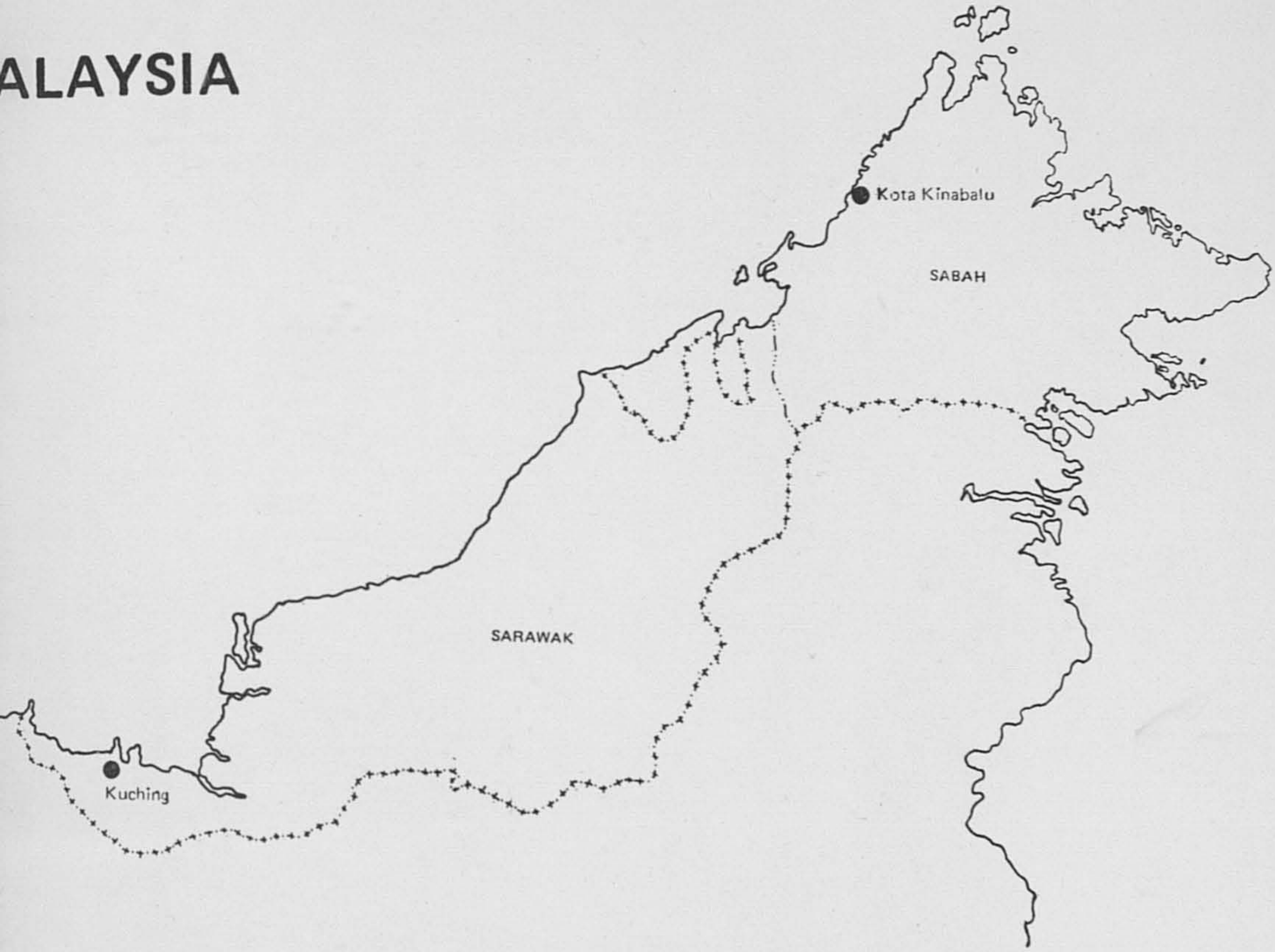
Wheare, K. C., 2 n, 4, 8 n

MAP OF



SOUTH CHINA

ALAYSIA



ALSO PUBLISHED BY
Penerbit Universiti Malaya

CHENG SIOK-HWA
The Rice Industry of Burma

J. I. PURCAL
Rice Economy
A Case Study of Four Villages in West Malaysia

C.N. WILLIAMS AND Y.C. HSU
Oil Palm Cultivation in Malaya

YIP YAT HOONG
The Development of the Tin Mining Industry of Malaya

DAVID LIM
Supply Responses of Primary Producers
(Forthcoming)

ALLAN CHEW
The Malaysian Balance of Payments
(Forthcoming)

For Malaysia and Singapore only: M$12.50
Overseas Price: US$8.00

PENERBIT
UNIVERSITI MALAYA