

Executive Summary

Federal Transfers and Fiscal Capacity in Malaysia: Evidence on Equalisation Across States

Malaysia's federated fiscal system is under increasing scrutiny for being highly centralised. The Constitution gives the federal government comprehensive revenue-raising powers while heavily restricting states from taxing and borrowing. The federal government's application of these powers further concentrates power in the centre, creating a large financial shortfall between what state governments need to meet their expenditure responsibilities and what they can raise on their own.

Transfers of revenue from federal to state governments are a federation design feature intended to address financial gaps: both revenue and expenditure shortfalls for all states and to reflect differences in circumstances between the states. They should compensate for the legal limits on state revenue-raising powers, while at the same time provide extra support to states that have less ability to raise revenue and have higher economic development needs.

Whether federal transfers in Malaysia perform the second 'equalisation' function - allocating more funds to less developed states with lower revenue-raising capacity - has received little examination. Federal transfers are mostly designed around specific activities (or political and historical reasons) not fiscal capacity or need. Allocations between states in Malaysia have not been empirically assessed against equalisation objectives.

Without effective equalisation, differences in fiscal capacity can translate into persistent disparities in expenditure and unequal access to public services across regions. This goes against the spirit of federation, which aims to pool resources and coordinate regulation to advance the livelihoods of all Malaysians equally. Revenue sharing that neglects equalisation imperatives worsens inequality between states and can undermine democratic functioning.

This paper addresses a critical evidence gap by examining whether the distribution of federal transfers promotes equalisation. It empirically assesses the allocation of transfers per capita by state against various indicators of fiscal capacity and fiscal resources, including economic size, household incomes, and economic structure. For outcomes to be consistent with equalisation, states with lower fiscal capacity should receive a higher share of transfers.

Assessed against these alternative measures, there is no consistent or clear evidence that federal transfers are systematically aligned with differences in fiscal capacity across states. States with weaker underlying revenue-raising potential do not consistently receive higher levels of support. More notably, transfers exhibit a counterintuitive relationship with realised fiscal resources, with higher-revenue states often receiving higher transfers.

From an equalisation perspective, this finding is partly driven by how fiscal flows are recorded, where components of federal transfers are embedded within state revenue accounts, which causes the distinction between a state's own fiscal resources and federal support becomes blurred.

Despite little evidence of targeting, federal transfers do reduce overall fiscal disparities across states. The variation in fiscal between states narrows following transfers, indicating that the system does have a moderating effect a broad-based distribution of transfers that does not systematically prioritise states with weaker fiscal capacity. Although the disparities are reduced in aggregate terms, the significant difference in fiscal resources remains across states.

These findings suggest that Malaysia's intergovernmental transfer system functions more as a mechanism of general fiscal support rather than one that targets equalisation objectives. Transfers play a critical role in sustaining state finances, but their current design does not consistently align with differences in fiscal capacity across states. Strengthening the equalisation role of transfers would require clearer alignment with underlying fiscal capacity, alongside greater transparency in how transfers are defined and recorded. A shift towards a more consistent and rules-based allocation framework may be needed to ensure that the system supports more balanced and equitable regional development.