

Transforming Tax System in Malaysia: Fiscal Federalism*

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1. Introduction

"Inequality: the Basis of society. We combined and put things in common to protect the weak against the strong" (Lord John Acton, 1848). How can we achieve the state of wellbeing in Malaysia as the same condition as Lord John Acton pronounced 170 years ago? Fiscal federalism is the path to derive the answer. Malaysia is a federal state (*Federal Constitution*, Article 1(1), 2019, p. 13), where federal (or national) government shares power and responsibility with its states.

Like in any other countries with a market-based economic system, the allocation of resources in Malaysia becomes efficient when Pareto optimal is attained in production possibilities frontier. Pareto optimal is the condition when no one can be better off without making other people worse off in the allocation of resources. The following illustrates an example. Two individuals X and Y are assumed to live in Federation of *Harapan* where a reallocation of resource for X does not affect Y at all is thus a situation where X has achieved the condition of Pareto optimal. The condition of Pareto efficiency is also adaptable for measuring utility of X and Y too. This means utility possibilities curve can substitute production possibilities frontier. Welfare economics stipulates—in a competitive market—X and Y have achieved Pareto optimal in utility when their marginal rate of transformation is equal to each individual's marginal rate of substitution. However, Pareto optimal in utility does not guarantee the outcome of fairness for assuring the highest state of economic welfare in the society. This weakness is correctable in order to ensure the attainment of the desirable situation, viz., fairness, when economic welfare is at the highest level where indifference utility possibilities curves of X and Y intersect. This desirable

situation is Pareto optimal for X's and Y's utility. Although this example is the simplified illustration of the society in reality, it is not an exaggeration to say that fiscal federalism is in fact the means to facilitate redistribution of income from the wealthy to the poor under the condition of Pareto optimal and fairness. Pareto optimal and fairness is a dual goal for the normative analysis in welfare economics.

Federalism is in fact *de jure* but it is practically *de facto* a centralized government tax system in Malaysia since independence. The *Federal Constitution* Part VII Chapter 1, Chapter 2 (pp. 89-101, pp. 187-189), Tenth Schedule (pp. 203-206) specify financial provision for national and state governments but the formation and the execution of fiscal policy was and still is practically centrally controlled by national government. The trade off between efficiency and fairness is not inevitable. Their conflict is avoidable if the condition for efficiency and fairness are harmonized according to the two fundamental theorems of welfare economics as elucidated in earlier paragraph. Pareto efficiency and fairness are desirable on one hand, and both are mutually inclusive and mutually reinforcing on other hand. The present state of affairs, with a centralized fiscal policy, still has not deliver the desirable wellbeing in terms of Pareto efficient and fairness for Malaysia's society.

Fiscal federalism is the subject matter that is contentious between *de facto* advocates and *de jure* proponents in both sides of the aisle. *Ceteris paribus*, the navigation on ethical, political, and a broader scope of social issues landscape is certainly a herculean task. But, constitutionally and also for enhancing the identity of the reborn homeland, the government and *rakyat* in Malaysia *Baru* are in need of a fiscal system that can foster their endeavors in securing not only desirable but also a higher welfare standard set up by efficiency, fairness,

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effectiveness, equity, and social justice. For this purpose, issues pertinent to fiscal federalism must be examined from both side of the equation, i.e., government revenue and government expenditure. Parliament is granted that authority by the Federal Constitution. Against this backdrop, this paper intends to examine how fiscal federalism can facilitate the desirable state of resource allocations that brings a better wellbeing in national and states level.

2. Centralization ratio of federal and state governments' expenditure

The scope of fiscal federalism is not necessarily definite. The conventional measurement is to compute the intensity of centralization of fiscal resources. Hence fiscal federalism varies across federal states. The intensity is defined as the ratio of national government's and state governments' expenditures except transfer made to other governmental units (Fisman and Gatti, 2002, p. 340, cited in Rosen and Gayer, 2014, pp. 499-500). Put differently, centralization ratio explains the extent of the federal government's authority has upon state governments' freedom in approving the priority of expenditures (Rosen and Gayer, op. cit., p. 499). The ratio is 8.70% and 7.42% in 2016, 2017, respectively (Table 2). For comparison, France, Canada, the US is 81%, 43%, and 48%, respectively, in early 2000s (Rosen and Gayer, op. cit. p. 499). Consolidated government revenues increased substantially in 2017 but consolidated state government revenues increased only a little more than 0.3%. Although this slight rise is from 2016 to 2017, undoubtedly in preceding years the degree of centralization was similar because the practice was repeated, so called precedent, every year by the previous coalition government, viz., Barisan Nasional—the most ardent advocate for centralization, since 1973. The record of fiscal policy shows that it is not an exaggeration to say the present state of practice in Malaysia is the extension of a highly centralized fiscal system. This problem was created *not because* of but was *in spite of* the federalism [guaranteed] by the Federal Constitution since the formation of Malaysia. Hence, in looking forward to consolidating the reborn Malaysia, the urgent need for transforming to a clear and a decentralized fiscal federalism in long horizon is undoubtedly of paramount importance for the struggle of achieving the sustained process of efficient, fair, equitable and just social economic progress.

Income redistribution using revenue (direct and indirect taxes) and expenditure (grant and transfer, development expenditure) is a powerful and an effective method for correcting disparity between states. This correction improves equitable income distribution. However, presently and previously in Malaysia, consolidated national and state governments financial positions have not caused concrete improvement in equitable income redistribution. This study

examines it by using the Gini coefficient—a metric for inequality—in Malaysia in 2017 and 2018 in terms of per capita gross domestic product (GDP) and population of 13 states and 3 Federal Territories. The value is 0.489 and 0.490 for 2017 and 2018, respectively. This metric has declined from 2017 but its magnitude is negligible. The degree of inequality is dependent on the mean and the variance of per capita GDP. Per capita income is directly influenced by the size of population in each state/Federal Territory. A better equitable income distribution, after income redistribution by fiscal policy, is of utmost importance for a multi-racial country. Otherwise, inter racial conflicts can be easily instigated, which disrupts the united harmonious society of pluralism. Standard deviation—the spread of per capita income from the mean—of per capital GDP in this calculation in 2017 and 2018 is RM204 and RM208, respectively. If we assume standard deviation can explain 25% of Gini index then the disparity gap can improve by about RM50 toward the mean. This correction means standard deviation is decreased to roughly RM154 and RM158 in 2017 and 2018, respectively. The amount that is required to add to the income redistribution is about RM 1,600 million per year in 2017 and 2018, respectively. The additional income re-transfer is equivalent to about 8% of Consolidated States Governments financial position in each corresponding year. While the size of additional transfer from national to state governments help to improve inequality but in reality it still does not help in reducing the centralization ratio significantly. Thus it is both urgent and imperative to completely re-examine how fiscal federalism can contribute and also what is the minimum amount of redistribution can help in strengthening decentralization. These efforts in turn will bring about desirable level of fairness, equitable, socially just, effective and efficient allocation of fiscal resources for the purpose of enhancing a better wellbeing of the society at large in coming years.

3. Fiscal federalism and decentralization of economic responsibility

The insistence for centralizing economic responsibility in national government rather than delegating a desirable larger portion of it to local governments was and still is entrenched by a small group of “elites” who are overwhelmingly self-interested in their own personal profit and political power. Without dispute, federal government is responsible for national defense, foreign affairs, building national infrastructure, international trade and commerce, money supply, currency and foreign exchange, immigration, postal, communications, broadcasting, air travel, social services, pension, delivery of other public goods and services of national nature. These activities are presently being categorized into operating expenditure and development expenditure. On the contrary,

decentralizing economic responsibility on social services (education and training, health, housing), the construction of infrastructure in a state level, public security in state level, and delivery of goods and service of local characteristics in state level is still contentious even though there is a redistribution of financial transfers from central government in the form of grants and transfers and development expenditures. Hence the crucial question to be answered is: How to divide economic responsibility between national and state governments that can provide a higher level of efficiency and fairness? The answer ought to encompass, at least, a socially just initiative in income redistribution that places resolute focus on cooperative or supportive relationship in the allocation of fiscal resources from national government to every state authority that consolidates Pareto efficiency and fairness for every Malaysian.

In a democratic country, the decision of establishing and of executing fiscal federalism, which is [guaranteed by the Federal Constitution], is politically doable. The task is not difficult because advantages are greater than disadvantages. Malaysian citizens or more specifically voters certainly support this political decision because it is constitutionally correct. In a simplified election form, political decision is influenced by voters who choose the best representative in their constituent who can maximize their utility while their choice is reciprocated by each candidate's desire to receive majority votes. Hence a candidate will undoubtedly position him or her in a situation where the majority votes are concentrated in the middle distribution of preferences so that it is also a situation where at the same time the best preference of voters could be satisfied. This voting behavior is called "the median voter theorem." Unanimous agreement in an election is extremely difficult, if not impossible (unless in a dictatorial regime where there is no democracy). Therefore, for the hypothetical Federation of Harapan, the outcome of the desirability for the amount of a public good (or a set of public goods) for two individuals X and Y with respect to each burden of tax share is the same as the mechanism of demand and supply curves that are constructed based on quantity and price in the competitive market. Graphically, the vertical axis is tax burden (in ratio of income) and the horizontal axis is the quantity of a public good both X and Y each desires to get. Then the actual quantity of a public good is determined by the intersection of the demand curve of X with that of Y. That point of equilibrium is the tax burden for X and Y, respectively. Even though the respective ratio in income share is mutually opposite (i.e., if X was high then Y was low, or vice versa). This mechanism is explained by Lindahl's hypothesis.

Fiscal federalism characterizes in Boadway's words (2017): "An important feature of federations is the extent of cooperation between levels of government. Much of the fiscal federalism literature emphasizes non-cooperative or competitive decision-making, and asks whether

intergovernmental competition is beneficial or not" (Boadway, 2017, p. 2). He then underlines:

"Tiebout (1956) had argued that competition among government, analogous to that among firms, contributed to efficient levels of public goods and taxation, and efficient allocations of population" (Boadway, op. cit., p. 2).

The advantages are, among other things, enhanced intergovernmental competition, the promotion of delivering goods and services that are innovative and creative to people who live in states or local regions. These are in fact public services that suit the taste of local people. The opponents are skeptical. They caution that fiscal federalism exacerbates efficiency and equitable distribution of public goods and services. Their warning is exaggerated, if not it was cooked up to fool all *rakyat*. Although disadvantages have merit but representatives in the federal level are able to mitigate, if not to eliminate them entirely. The theorems of welfare economics, viz., Pareto efficiency and fairness, can insulate disadvantages in fiscal federalism by the desirable income redistribution by means of shared responsibility in revenues and expenditure between national and local governments. The trade off is arguable but it is not an irremovable hindrance because Lindahl's model points out clearly that this is not a zero sum game but a positive one instead even though shared burden of tax in income ratio is different for every category of income brackets. This logic is justifiable because the utility of each citizen lies on the same indifferent curve of the utility function on one hand, whereas high proportion of citizen can achieve fairness in utilizing public goods and services provided by state governments through fiscal federalism on other hand.

The debate of advantages and disadvantages of fiscal federalism can go on indefinitely but the most important question to answer is: how to establish fiscal federalism that symbolizes the right of *Rakyat* in Federation Malaysia under the Federal Constitution, viz., government of, government by and government for the people. These are the Three Principles of the People. The constitutional right is unshakable and they ought to become the most important foundation of Malaysia *Baru* in navigating in a vast ocean where sometimes even a changeable weather influences high wind and waves along with huge storms are predictable but to a certain extent the degree of uncertainty varies from time to time. Looking forward, even the sail is rough in the voyage, the mindset of every *Rakyat* still desires to arrive at the destiny where fiscal federalism, based on the Three Principles of the People, is in place for the long lasting politic, economic and social progress engraved in pluralistic Malaysia.

4. Issues of welfare economics in fiscal federalism

(1) Market failure

Market failures cause inefficient allocation of resources. Market fails in the coordination of demand and supply because of market power (viz., monopoly and oligopoly), externality (positive and negative), and information failure (imperfect and asymmetry). Market power dictates prices of goods and services. Thus government ought to intervene to prohibit monopoly and oligopoly by setting price level (i.e., price ceiling and price floor) through legislations and/or regulations. Externality is an action by an individual or a group of people that affects another person or another group of people positively or negatively. This mechanism is also known as the spillover effect. The former relates to the relationship between personal marginal benefit-social marginal benefit and private marginal cost-social marginal cost. For example, education, health care and clean environment such as clean air, hygienic water and garbage free public spaces are notable areas where positive externality is generated.

In the case of education, every student's private marginal benefit is in equilibrium with his/her private marginal cost because that point is where the demand of education (determined by personal private marginal benefit) intersects with the supply (by personal marginal cost that equates with social marginal cost too). In this equilibrium state, social benefit is larger than social marginal benefit cost even the price for education has risen for accommodating larger beneficiaries in society at large. In a competitive market, a larger number of people will not choose to invest in education because the cost is higher. This situation defeats the positive outcome for the society at large that generated by more educated people. This is a market failure. In order to prevent this from happening, government ought to intervene by providing subsidy in education so that a larger number of people can attend schools at lower investment costs. The subsidy practically fills the gap between a lower tuition fee and the different between a market price (i.e., tuition fee) set by the intersection between social marginal benefit and social marginal cost (which has similar value as private marginal cost). Health care and mitigation of environmental problems function in similar way too. The former generates healthy people while the latter gives a cleaner environment for the society at large.

The problem of free rider is also a market failure. This problem especially prevails in pure public goods and services. A pure public good is non rivalrous and non excludable in consumption. Clean air is a pure public good because no one can deny another person or group of people from enjoying it. When an individual enjoys smoking cigarettes in public space, he or she is a free rider if there was no smoking restriction. Government can prevent a free rider from exploiting unavoidable property of non-rivalrous and non-excludability

in polluting clean air by using law for imposing punishment.

Information failures occur in two distinct different ways. Firstly, imperfect information occurs when institution and organization are not functioning satisfactory caused by the lower development level in a developing country. In an advanced country, the society also faces this type of problem because of institutional dysfunction and restriction of information access. As a consequence, this situation impedes information processing by the people at large. Secondly, asymmetric information occurs widely in "lemon market," insurance (life and property) market, labor market, banking and capital market. Hence government ought to correct market failures due to information failures. Intervention can come in the form of regulation, compliance, transparency, accountability and other related rules that are put in place to prohibit intentional actions in causing information failures.

(2) Market to support the poor does not exist

The assertion that market exists naturally for every good or service is not true. Income redistribution by reallocating taxes paid from a wealthier group of citizens to poorer people is one of the most acceptable means for helping the poor. This redistribution is the key channel for the purpose of transferring fiscal resources for improving living standards of poor beneficiaries. However, market does not exist for facilitating the transfer of income tax from richer people in the form of income subsidy for the poor. This study assumes that poverty in the poorer cohort in B40 is an externality to the society at large. There is no market to facilitate the redistribution of a portion of tax revenues to them. This problem is critically impairing poorer of the poor or it has caused those people who live in dismal economic situation to become increasingly stressful. Providing additional subsidy—the context of income redistribution—to support these financially vulnerable citizens is not only politically and economic viable but the decision is even socially just. In this regard, there is practically no economic agent who intends to act voluntarily in donating even RM10 to vulnerable people. A huge proportion of private donation is mainly attributed to philanthropists, private foundations, wealthy individuals, charitable organizations established by individuals, non-governmental organizations, community-based groups or social development groups created by like-minded individuals. But their altruistic efforts are still not able to influence the formation of supply curve because there is no such type of market for helping the poor. Therefore without a market then there is no "invisible hand" for coordinating income redistribution or financial support from the rich to the poor. The fate of Malaysia *Baru* on the new elevation where there is plentiful of efficient, fair and socially just progress lies in the hands of every citizen who cares, tolerates, just and enthusiastic in accomplishing the journey. This sail might be rough but it is certainly a politically and

practically doable navigation.

5. Designing fiscal federalism

(1) Rationale

Taxes are necessary and unavoidable in any country because of the need to receive public goods and services. The crucial concern in taxation is fairness regarding the burden of tax. Fairness is different from equality if job descriptions were the same. In other words, a worker ought to receive a higher payroll because of more works than other workers who worked less in the same job category. This outcome is fair whereas workers were given equal opportunity, i.e., equality, for undertaking tasks. "If any one bears less than his fair share of the burden, some other person must suffer more than his share, and the alleviation to the one is not, *ceteris paribus*, so great a good to him, as the increased pressure upon the other is an evil. Equality of taxation, therefore, as a maxim of politics, means equality of sacrifice" (John Stuart Mill, 1866, p. 804). Hence a diligent worker has to sacrifice a portion of his or her income by the burden of higher income tax. The sacrifice is bigger if income was higher. Just like the burden of personal income tax and other indirect taxes, the allocation of revenue and expenditure also faces challenges from national and state governments especially from advocates who are most ardent for centralization against peers who insist in giving a higher allocation to the poorer state governments in order to improve equalization. The challenge is understandable but this does not mean parliamentarians ought to keep the *de facto* fiscal system that is highly centralized and quite easily being abused by special interest groups. Hence the justly correction is the *sine qua non* of fiscal federalism. Needless to say, the task is easier said than done. Legislation has to work out within the framework of the Federal Constitution with the minimum number of amendment or revision and/or adding new Article to ensure the legislature power in the oversight of revenue and expenditure under fiscal federalism.

(2) Fundamental approach at national level

For corporate and individual income taxes, beside tax fairness, the collection of tax revenues lies on at least two basic requirements, i.e., progressive and regressive tax rates. These principles must also give emphasis on the aspects of horizontal equity, vertical equity and generational equity. The role at national level is two-fold: first, they ought to ensure the consistency of these principles and requirements are in line with the Federal Constitution; second, they ought to make political decisions with regard to the range of income tax rates (corporate and personal incomes) assign to the lowest to the highest bracket progressively. In this regard, progressive tax rates are directly tied to vertical equity and horizontal equity. The former clearly means higher income group pays higher

taxes than people who earn lesser. The latter implies similar tax rate for people who are in the same income bracket. Practically, progressive tax rate means any taxpayer's marginal tax rate is higher than their average tax rate. Legislation can, like previously, delegate the operational aspect of tax collections to Inland Revenue Board. As explained, parliament ought to use these fundamental principles to define the degree of fairness and equality of taxpayers' tax burden. Otherwise, they are against the strong expectation of voters who have elected them.

For achieving a better level of fairness and equality in direct tax areas, real property gains tax (or capital gains tax) plays a crucial role in narrowing the gap between the rich and poor. This redistribution is also the means for enhancing generational equity. This direct tax is already put in place but tax rates and corresponding disposal period (i.e., the period from the time of purchase to the time of disposal) ought to revise upward. For example, 30% tax rate for less than three years, 20% for the fourth year, 15% for the fifth year, 5% for the 6th year and beyond, can be revised to 50% for less than 6 years, 40% for 7th year, 35% for 8th year, 30% for 9th year, 25% for 10th year, 15% for 11th year and beyond. Equally crucial, a higher tax rate for initial 6 years also prevents speculation in real estates while subsequent tax rates are for the purpose of enhancing generational equity in terms of redistributing capital gains tax to the same cohort of people who earned less and thus they can only own less or none at all in assets. At the same time, this design in fact lessens the disparity gap between the cohorts of next generation as they move up their social standings by motivation, hard work and dedication.

Presently, national government does not tax gift, wealth, estate, and inheritance. For these reasons, the disparity between "have" and "have not" is expanding along with economic growth because the rich make more in tangible and intangible assets as their income and assets expand faster and their asset values rise higher in economic growth. This is the classical case of "money makes more money." The "have not" are shaking their heads miserably by watching the rich people's game of "money makes more money." Do we want to become the silent audience? The answer is no. It is of utmost importance that Malaysia ought to put in place these instruments so that more resources are available for mitigating inequality—especially in vertical equity—and also for improving fairness by income redistribution. Also, it is worthy to note these taxes also bring about Pareto improvement in resource allocation between the rich and poor.

Stamp duty is also another area for revision. Property transfer is 1% for first RM100,000, it is subsequently increased to 2% and 3% for next RM400,000 and excess of RM500,000, respectively. These tax rates are disproportionate because richer people instead of paying higher duty, they are in fact paying relatively low average tax than the poorer people (whose

property transfers are most likely lie below RM100,000). Take property transfer of three individuals in the sequence of RM100,000, RM500,000, and RM2,000,000 as an example. The value of the second and of the third individual is 5 and 20 multiples of the first individual but their average tax rate is in the sequence of 1%, 1.8%, and 2.7%. The different is 1.8 and 2.7 multiples of the first individual. This experiment clearly shows present stamp duty generates larger vertical inequality. Hence these tax rates ought to be revised with progressively higher tax rates so that not only vertical equality is improved but also the enlarged tax revenue is used for improved income redistribution to the poorer citizens. If similar practice is also applied in gift, wealth, estate, and inheritance taxes, positive outcomes are realistic as demonstrated in earlier example.

Collection of indirect taxes such as sales and service tax, export duty, import duty and excise duty are the jurisdiction of Royal Malaysian Customs Department. Tax rates are reasonable but still have a sufficient space for improvement. Export duty is required especially for natural resources because it fills the differential between production costs and international market prices to prevent resource curse that drives up exchange rate, which in turn negatively affects manufacturing exports in price competitiveness. In import front, national government ought to narrow the range for import duty because this indirect tax inhibits stronger economic linkages or integration with the rest of the world. The inhibition comes in the form of loss economic welfare (smaller consumer and producer surpluses and also deadweight loss) caused by higher domestic prices after tax instead of allowing citizens to benefit from lower international prices. If taxes were unavoidable then there is a need to channel a share of tax revenues to research and development or equivalent activities that will strengthen labor productivity to offset the welfare loss. In this context, parliament ought to organize periodical dialogues with industrialists, business representatives, scholars and public intellectuals to set the priority of allocating resources in strengthening this area of policy actions.

To a certain extent, same argument applies to excise duty. However, taxes of demerit goods such as cigarette and alcohol—that create negative externality—can reduce the quantity by imposing higher prices for correcting market failures. This situation is similar to environmental problems. The consumption of demerit goods is reduced because marginal social benefit (less than marginal private benefit) intersects with marginal private cost (equals to marginal social cost) and marginal social cost by using a sin tax instrument. This situation theoretically generates welfare loss but the question is to ask what is the size of the reduction in healthcare expenditures contributed by a larger number of healthier citizens. This is not the debate on pro and con but it relates to the benefit derives from sin tax in terms of lower healthcare expenditure. Sin tax can create special interest groups thus to

avoid this negative outcome, national legislators can replace it by setting minimum prices for demerit goods. Skeptics might argue otherwise. But this method is applied not because of the source of revenue. Rather it can actually eliminate negative spill over, which in turn creates a greater good to the society at large where income redistribution improves efficiency and also enhances socially fair and just in reallocation of resources.

Luxury tax does not exist but it is lump into sales and service tax. Luxury cars and other extravagance goods are taxed by higher rates. However, these tax rates are not necessarily proportionate (similar to stamp duty). Therefore, instead of a different tax rate for a successive price bracket in present set up, a new luxury tax regime provides clearer and accountable tax charges from the perspective of using those revenues for income redistribution from the wealthier people to the poorer strata of citizens.

Present tax regime for use taxes such as gasoline tax, highway toll, and public facility use fee are reasonable but subsidy from national government needs to be eliminated when investment amount is recovered. After that point, fees ought to be collected for each usage category so that its revenues is used for maintaining use of public infrastructures by every citizen comfortably, viz., a well defined users-pay principle that is transparent and fair. Parliament must work on this area in order to ensure results are achieved as anticipated.

(3) Rooms for improvement in proportional tax schemes

Employees Provident Fund (EPF) and unemployment insurance are taxes in the category of proportional equity. Legislators at national level have an obligation to ensure efficient, effective, and fair functioning of these institutions regardless of the choice of centralized fiscal system or fiscal federalism. In any case, this does not create a contentious debate between representatives and voters. Following paragraphs explain the details.

Practically, EPF is a force savings rather than a federal tax. Its performance has been satisfactorily for both employed and self-employed. However, it is worthy to say what is good today can certainly do better tomorrow if better management styles for operations and a higher quality of professional expertise to oversee investment portfolios in terms of the selection, monitoring, and the divestment are introduced. Although EPF is a federal statutory institution, for the purpose of monitoring, parliament certainly can ask for a quarterly operational report in the oversight committee in parliament. This committee can expand its mandates to ask business leaders, professionals, public intellectuals, scholars, representatives of unions to give suggestions for at least: one, how to improve the operational (with regard to Account I and Account II and other pertinent issues) and investment aspects; next, is the monthly payout for every beneficiary is appropriate for a decent living and also

whether the withdrawal age is consistent with legal retirement age and the prolonged longevity of each beneficiary. EPF is a force savings thus a prolong period of employment (in physically and mentally healthy condition) does not defeat the purpose as long as his/her payroll is affordable for a descent living. A larger pool of workers certainly facilitate a sustained economic growth whereas a beneficiary continuously receives a payroll does not lower the scale of private final consumption, which in fact has a positive feedback to growth too.

Unemployment insurance is a vital social safety net. In short, for a certain period (e.g., it ranges from 90 to 360 days in Japan), it provides a benefit of monetary value in cash and a certain type of unemployed individual can receive support such as re-training, job search matching or/and information sharing and other relevant benefits in order to be reemployed. Malaysia introduced unemployment insurance scheme this year. Similar to EPF, employees and employers share proportionally in paying insurance fee. Every month a worker pays 0.2% of salary whereas an employer pays 0.4%. The benefit of insured workers in unemployed period, he or she receives 30-80% of monthly salary as severance and also receives financial support for job search and re-training. There are still disagreements regarding the principle of proportional share in paying insurance fees as well as whether the scheme will deliver benefits as stipulated by the scheme. Behaviors like agree to disagree, disagree to agree, and refusal of burden sharing by employers due to cost happen quite common in a democratic country. Every citizen or worker/employer has the right to agree or to disagree or to refuse but from all dimensions the opponents do not have an alternative but to grudgingly accept the majority decision because the law is legislated in Parliament where elected representatives are obliged to fulfill responsibility to their voters. In spite of this political reality, all kind of complaints will still go on indefinitely. This shortcoming is inevitable but it is not catastrophic because in Winston Churchill's words: "No one pretends that democracy is perfect or all-wise. Indeed it has been said that democracy is the worst form of Government except for all those other forms that have been tried from time to time" (Churchill, 1947). Having said that, however, Malaysian citizens especially workers and employers will undoubtedly expect a practical and effective scheme. Therefore parliament certainly has to constantly play a crucial role in making certain the safety net provides care to *rakyat* who have lost their jobs.

(4) Fair and equitable income redistribution

Fiscal federalism, *res ipsa loquitur*, must at least focus on strengthening fiscal relation in a cooperative manner between national and state governments in tandem with efficient and fair redistribution of fiscal resources between them. The former is already stated in Section 3. The latter refers to the role of national government in undertaking fiscal equalization

between states. Every state is clearly obliged to provide public goods and services but the concern is none other than the financial capability of each state. Every state in our federation generates its own fiscal revenues but disparity between one another is unavoidable because of different economic capacity. National government has worked extremely hard to dilute the disparity between states and also between itself and state governments. In spite of dedicated efforts, centralization ratio remains high and Gini coefficient in terms of per capital GDP has yet to show impressive improvement. Hence, can every representative stay out of this spectrum of challenges in political economy? Running away is not a choice. *Rakyat* in general and voters in particular want a better tomorrow that is of the greater good to Malaysian society at large. Fiscal federalism is the *sine qua non*. Persistent let down and discontent of *rakyat* caused by national government insistence on *de facto* tax system will only create a disunited Malaysia Baru.

Necessary condition is already in place for the Federal Constitution has in principle guaranteed the administration of federal tax system. The shift to decentralizing national government by delegating a higher level of responsibility to state governments requires a politically acceptable sufficient condition, of which state governments, *rakyat* or voters are favorably anticipating positively. This study intends to suggest three areas that will launch fiscal federalism. These are: an improved method for equitable, fair and socially just redistribution of fiscal revenues from national to state governments; health and medical supports of proportional equity to every *rakyat*; support of B40 group by conditional cash transfer programs.

(a) Fiscal equalization

The first area deals with fiscal equalization between states because of two crucial problems. First, national and state governments consolidated financial position has a high centralization ratio. Second, different economic capacity in generating local fiscal revenues because of uneven economic endowments and development level in each state certainly requires additional transfer or redistribution from national government. The key principles are equitable, fair and socially just. Equally crucial, the effort of fiscal equalization has to produce Pareto improvement in resource reallocations from national to local governments. The second component in this area will resolve the challenge poses by the first component. This paper uses fiscal expenditures of State Governments in 2017 to demonstrate how fiscal equalization is logically doable.

Table 3 shows the result of this empirical example. Although the sample has only 13 states but financial expenditures from them were converted to a normally distributed sample by using T-score (mean is 5 and standard

deviation is 1). Then the gap between transformed value and actual expenditure in 2017 for each state is showed in the share of actual total expenditure. This share is multiplied by the computed total amount of additional fiscal resources (i.e., total value of 13 states) so as to determine the needed amount of additional redistribution from national government to each local government based on earlier calculated normally distributed spread (i.e., T-score). Additional redistributed fiscal resources are added to actual expenditure in 2017 produced a better and an even more appropriate fiscal position by this method of equalization. Total amount required to add more fiscal resources to local governments is RM122.66 billion, which raised total expenditure level in local governments to RM151.36 billion. This scale is significantly more desirable to *rakyat*. The total amount of additional transfer is about 6 times of that in 2017. The newly total amount of fiscal expenditure in this example shows centralization ratio has improved from 7.42% to 57.04%. The result shows fiscal equalization in fiscal federalism has strengthen decentralization from national to local governments. Equally important, transforming actual expenditures to a normal distributed spread actually ensures the redistribution enhances equality, fairness and socially just outcome in Malaysia *Baru*. Moreover, this method also logically promotes Pareto efficiency. That is a condition that should not be tampered with in this new redistribution. This new fiscal equalization does not interfere but it in fact assists in adding higher impact on the customary distribution of grants and transfers and development expenditures to state governments.

(b) Universal health care system

In the area of health and medical support to *rakyat*, universal health care (UHC) system does not exist in Malaysia yet. Although the intention is being strongly promoted by Ministry of Health and a wide spectrum of civil society organizations but the journey for establishing the proposed institution is still at present a long and winding one. Dzulkefly said: "We recognize that UHC is about equity and access to healthcare services for all, without them incurring catastrophic financial hardship" (The Star Online, 21 May 2019). He further stressed: "However, its out of pocket (OOP) expenditure stood at 38% in 2018 although the WHO recommends that the OOP expenditure should be at around 20%" (The Star Online, op. cit.). These statements exemplify the present unsatisfactory condition of health and medical support that requires urgent attention from parliamentarians in Malaysia *Baru*.

Malaysia was ranked 57th in Human Development Index (HDI) in 2017. HDI is a "statistical metric being used for measuring a country's overall achievement in its social and economic dimensions (UNDP, 1990, p. 109). UNDP defines "this index is a composite of three crucial indicators, viz., life expectancy at birth (i.e., life expectancy index), knowledge

accumulated over expected years of schooling and means year of schooling (i.e., education index), and a decent standard of living (i.e., GNI—gross national income—per capita in US Dollar purchasing power parity—PPP)" (UNDP, op. cit., p.109). Between 2009 and 2017, although Malaysia spent quite a higher GDP share in education but the shares in health and social welfare were quite lower when compared with other countries that were ranked higher in HDI (Lau, 2019, p. 10). In sailing to a healthier and a more secure living environment, Malaysia crucially requires relentless efforts in overcoming high tides in the sea of health and social welfare. Without any doubt, this is an important policy issue. By and large, a higher per capita income raises people's aspiration to pursuit stronger physical and mental health, which in turn lengthens their longevity.

UHC is the ground floor of enhanced health and medical care. It ought to allow all citizens to receive health and medical assistance in the case of illness (physically and mentally), injury, and other threats to health. Also, private insurance schemes in reality can add force to health and medical care for every *rakyat* is equally important. This part is especially encouraging for those *rakyat* who are affordable. For UHC, every beneficiary is obliged to pay the insurance premium in order to acquire the entitlement of receiving assistance. On the other hand, affordable persons can concurrently buy additional insurance from private insurance entities. Hence private insurance schemes sit on the second floor above UHC—the ground floor.

UHC is a mutual assistance among members. In the nutshell, UHC performs the provision of health and medical assistance to members from the pooling of insurance premium. The premium can be determined proportionately to income brackets. This method strengthens both vertical and horizontal equity. Wealthier people might not want to associate with UHC because they are affordable. However, in the context of operational efficiency, it is not necessary to ask and wait. Instead, legislate UHC as a compulsory insurance for every *rakyat* without solicitation. In order to prevent inefficient troubles with *rakyat*, the legislation can include an "Op-out" clause for wealthier citizens. If there was no formal submission of "Op-out" forms then insurance payment is still mandatory. Intuitively, skeptics will certainly argue UHC will not work. This logic is not well founded. There was no UHC in Malaysia in last six decades. Therefore, it is not an exaggeration at all in objecting that baseless logic.

Effective, efficient, and fair operation of UHC is really not complicated. But this system must not be centrally managed because of at least two reasons. Firstly, Federation of Malaysia is not an authoritarian state and thus centrally based information storing and processing are costly and ineffective. Digital economy and the emerging Industry 4.0 are classical illustrations. They clearly show every connectivity is

decentralized and the system overall does not perform well with command by the center and then reaction from subordinates or branches. Secondly, in reality, one must not assume utility or preference is uniform in every state. Because of differences in utility in every state, tastes and choices for food, type of exercises, work and leisure activities are different. Hence the condition of physical and mental health, the type of illness, and other unanticipated health threats vary in every state. These local specifics demand prompt responses and quick effective treatments. Hence the delegation of operational responsibility is crucial. These two elements indeed are mutually reinforcing.

First and foremost, legislation has to enact a law for establishing UHC. This law also must clearly spell out the do and don't so that it ensures the sound operation of UHC. This must be consistent to the goal for the enhancement of every *rakyat's* health. Unlike private insurance schemes, UHC ought to have the minimum coverage encompassing treatments for physical and mental health, illness and other threats to human health. These provisions ought to be equal for every beneficiary regardless of premium cost with respect to different income brackets. Equally important, prudence and due diligence in approving claims are crucial keys to prevent deficit between premium income and expenditures (insurance payout and administrative cost). If deficit has arisen then financial injections from national government is unavoidable. But this situation creates unnecessary fiscal burden. This problem is preventable. We can initially assume insurance premium is pooled into three categories, viz., insurance payout, operational expenses, and investments for expanding financial values of the collected insurance premiums. Using a portion of the second category to activities that promotes the awareness of good physical and mental health are certainly helpful in reducing cases of insurance payouts in UHC scheme. The effective functioning of this aspect will certainly strengthen the higher returns from the third category over a longer horizon. Later on as the operational aspect of the scheme is functioning, parliamentarians can improve the core accordingly if deemed necessary to accommodate changes in reality.

For the purpose of decentralization and the adjustment of different local preferences in life styles, state governments ought to play a central role in the sound management of UHC especially with respect to stable financial management, efficient implementation of health and medical assistances. By law, local governments must ensure appropriate but efficient and effective execution matters relating to membership (acquisition, disqualification, prevention and avoidance of moral hazard), collection of UHC premiums, planning, execution and monitoring of health services and other health and medical assistance projects under the auspices of UHC. Each state must take initiative to organize periodical events in promoting the share of experiences relating to the task and responsibility with other states and national stakeholders.

These events of experience sharing will give additional force to strengthen health and medical support in UHC.

(c) Support of B40

The third area, the support of B40 group requires assistance from national government but the implementation ought to be delegated to state governments because B40 is characterized by the economic conditions that negatively influence their life significantly. Many people stuck in poverty because of its vicious cycle. Poor children or youths are unaffordable to attend school not in spite of free tuition fee but it is because they need to spare their time to assist families in doing house errands of which their parents could not attend to. Their parents are concerned of how to secure minimum income for providing food. There is also a substantial portion of youth who have to undertake miscellaneous works for compensating household subsistence income. Sadly the scale of this compensation is insufficient to offset economic dismal. Because many poor children or youth are not educated thus employability in formal sector is outrageously low. Inhabitants in B40 are not affordable to pay health and medical care thus their health condition is not reasonably acceptable. This problem compounded with insufficient education have drawn down labor productivity, consequently they are persistently trapped in low income. Quite a fraction of even poorer B40 lives in subsistence because of this vicious cycle.

This peculiarity requires special attention from government in their locality. Hence, state governments must take the responsibility in working together with national authority to mitigate the share of B40 group vis-à-vis two other higher income groups. The result of this alleviation will reflect, at least, in the forms of a better income bracket, affordable and respectable education attainment, healthier, and buoyant living standard along with their upward social mobility. Poverty is a negative externality. Hence if there was no positive intervention from government, negative aspects certainly exacerbate higher cost to the society at large. Hence, mitigation, if not at least prevention, is less costly but effective and socially just for improving equity and fairness because the results give equal opportunity to people in escaping from economic consternation.

Market is almost non-existence for coordinating financial supply to the poor who inevitably require certain minimum income to float above relative poverty line in order to receive a respected dignity in their living. Income share of B40 in 2016 is about 16.4% in 2016. Their mean household income is RM2,848 whereas median household income is RM3,000. B40 earn less than RM3,860, and this group is estimated to have 1.13 million households and about 4.63 million people. Presently, national government is providing financial subsidy in a variety of scale in accordance to several income brackets. This aid is important but not sustainable because financial burden is

quite difficult to become lighter. Put differently, the aid is like “pedaling a bicycle,” when the pedaling is stopped then recipients fall back to dire economic condition. If averagely each household received RM100 per month, the monthly cost is RM113 million, and annually the sum is RM1,356 billion. This amount is larger than annual expenditures in several states. It is unavoidable to utilize fiscal resources, which is a form of income redistribution, to support this poor group of citizens. But the scarcity of fiscal revenues also needs to place important emphasis in other areas too. Hence the competition of the scarcity is intense and thus not necessarily efficient and sufficiently just in our society.

In order to create better results in B40, the proposed fiscal federalism is more effective because local governments are more appropriate than national authority in undertaking the task. This approach by no mean implies the assistance does not require fiscal resources. Instead this paper strongly recommends using national fiscal resources for tasking state governments to assist B40 in their local districts. This method is effective because local administrators have a clearer understanding of the core problems engulfing poor citizens. Furthermore, this method will become even more efficient and equitable by introducing “conditional cash transfer (CCT)” to qualified recipients. The World Bank defines CCT as “programs provide cash payments to poor households that meet certain behavioral requirements, generally related to children’s health care and education” (The World Bank, 2019). Adapting this method to support B40 is not difficult. The key issues are how to make sure that the assistance is delivered more effectively, more efficiently and fair in the framework of fiscal federalism.

The proposed CCT can work in fiscal federalism in two layers. The first layer is to set aside the fund for supporting CCT in a statutory agency, which is independent from direct administration of central government. The financial source can be allocated from tax revenues under the administrative scope of national government (e.g., Ministry of Finance). The decision in determining which channel or tax must it derives from might be controversial but political decision based on effective, efficient, equitable, fair and socially just in order to make society at large better off is an acceptable rationale to large majority of people. What does an individual has to gain in refusing the decision? It is wrong to assume no resistance but there will certainly has a group of opponents but this group is minority. This is not lack of respect because they will eventually give support instead of rhetorically say “I told you so,” if CCT programs ware successful over time.

The launch of CCT scheme will face a few obstacles. The most important one is pertained to the source of financial resources. The fastest track comprises two sources. The first one is to use a portion of total expenditure after fiscal equalized tax revenues. Next one is to use a portion of tax

revenues collected from sin and luxury taxes. In order to determine the contribution from the first track, legislators must determine the financial size requires for implementing CCT scheme. Data in 2016 is instructive. The highest income per household is RM3860 whereas the lowest value is not known but we take RM980 (the relative poverty line) as the bottom. The gap is RM2,880 per household per month. Because there are 1.13 million households in B40 and thus the amount of fund requires in filling the gap is about RM39 billion per year. This amount is about 24% of total expenditure by the state governments after fiscal equalization. It is a political suicide if national and state governments decided to cover the whole.

Thus this study suggests the following. The first track focuses on a realistic but practical means by the contribution of national and state governments. Specifically, parliament can decide by law to mandatory allocate 2% of total fiscal resources based on fiscal equalized revenues. Using earlier empirical example in 2017 to illustrate, the amount is RM3.2 billion. In order to pool a larger fund, the second track can source additional fund from revenues collected from sin tax and luxury tax. For the purpose of transparency, accountability and predictability, 2% of tax revenue from these two categories is not only appropriate but it is also similar magnitude with respect to the first track.

The second issue is pertinent and it relates to what is the reasonable amount that is fair and socially just in supporting B40 households. Parliament can categorize households’ monthly income to 5 categories that are consistent to achieving proportional equity—after the CCT supports—in B40. It is not too ambitious but instead it is more realistic to provide averagely RM20 per month per household (i.e., RM240 per year). Hence total fund requires per year is about RM3.25 billion, almost equivalent to 2% of total fiscal expenditure in states in 2017. Additional fund allocated from sin and luxury taxes can be used as administrative and extra supports to B40, or part of it can be carried forward to the subsequent year.

This study aims to demonstrate how to distribute the pool of financial resources allocated from 2% of fiscal expenditure from national and state governments. The calculated total amount is RM3.2 billion, which is reallocated to every state according to figures shown in the first column from the right of Table 4. These figures are derived by: weighted average of total expenditure after transfer adjustment (from Table 3) with respect to T-score (adjusted expenditure in a normal distribution) in 2017; each result is then divided by the total in the third column from right to obtain each respective share; it is then multiply by the total sum required to support B40, viz., RM3.2 billion or RM3,200 million. The gap between the highest and the lowest is about RM72 million, not a large figure to be alarmed about. The number of households in B40 is not evenly spread in every state. Therefore the allocated amount in one state might be either more than the actual requirement

or less than the required sum. The differential between states is cancelled off by transferring surplus of one state to fill up the deficiency in another state. Figure 1 illustrates this equalizing approach. Supporting B40 by fiscal resources pools from both national and state government expenditures is equitable, fair and socially just. CCT as the approach is practical, transparent, accountable and fair in assisting B40 to at least be able to acquire basic human needs without which their meager livings will persist.

Poverty is not a new problem. National government had intervened to correct this miserable situation but has yet to eliminate it entirely. Hence, presently it still is providing financial support to B40. Here are a few instances. If an individual in B40 is eligible, he/she can receive RM112 in social protection insurance payment. Also, when an individual in B40 was diagnosed with critical illness, he/she is able to receive unrepeatable treatment up to RM8,000. At the same time, Bank Negara is giving special financial assistance to people in B40 to acquire affordable homes. Single Malaysians can apply from Micro-Homes (RM100), whereas stamp duty for first time home purchaser is exempted. The assistances are specific but it is still early to carry out practical review of their effectiveness. Social economic problems in B40 are multi-dimensional. Therefore, added emphasis on these problems and the urgency to attain convincing results are vital to keep the momentum of continuous assistance.

Present support schemes focus on who are eligible in B40. Eligibility or qualification is no doubt important but the probability of realizing predicted results might not necessarily high. Supporters certainly assert the limitation is inevitable if there was no better alternative. However, not everyone, especially taxpayers, must assume aid certainly will deliver intended results because operational plans are generally formulated based on “known knowledge,” hence consequently they are expected to be executed as planned (with necessarily adjustments when deemed required) in order to achieve good results. This “if-then” hypothesis does not function as intended whenever there is “unknown known” knowledge that engulfs the depressed living of B40. Life is in fact full of uncertainties. There are even more unknowns, unpredictable and unexpected events posing critical challenges to B40, at least especially to the lower B40 in moving up to a higher income within the group. Hence the effectiveness of the financial support for B40 requires objective assessment of results instead of based on the execution per se. Giving support per se does not guarantee improvement but adapting CCT mechanism can certainly strengthen the effectiveness.

CCT is a unique mechanism for improving the living of targeted beneficiaries in B40. This mechanism uses a specific behavioral condition—which has positive spill over effect—for verifying whether a targeted beneficiary has achieved the specific result as anticipated. The result is specifically

determined by the assistance plan prior to its actual implementation. In other words, targeted beneficiaries must abide by the specific behavioral condition in order to qualify for receiving the financial aid. The degree of achievement ranges from 0% to 100%. Therefore, financial disbursement to targeted beneficiaries can be divided into several categories.

Here are several elements that are useful specific behavioral conditions for the CCT mechanism. For example, children’s school attendance rate, children’s and adults’ health condition, parents’ subsistence income per week, voluntary contribution rate, and visible and fair behavioral actions. If the financial assistance to a household is assumed to be RM200 per household in a month, then each household is entitled to RM50 assistance per week. If children in a household would have achieved 100% school attendance rate, the family receives RM50. For 80%, 70%, 60% then the financial support is RM40, RM30, RM20, respectively. Financial assistance is zero for children’s school attendance rate less than 60%. This conditional assistance not only encourages children to attend school, which in turn enhances their literacy rate in primary and middle school level (i.e., compulsory education). Similar *modus operandi* is applicable to other behavioral conditions listed above. In this manner, CCT is more effective than the conventional unconditional cash transfer scheme. Some supporters might contend there is still a relatively high possibility the latter will produce effective results. This view certainly has its merit and thus there is no compulsion for agreeing to disagree. However, this paper underlines the former is even more effective for at least two reasons, viz., specific behavioral conditions are clearer and easier for measuring effectiveness and CCT helps to save financial resources that can be reallocated to other areas of concern in B40. Elimination of poverty and it enhances the wellbeing of citizens in B40 are not only a difficult task for national and state governments but it is neither a pleasant one for every individuals in Malaysia too. The result may fall short of the intended goal but the endeavor in elevating a few millions people to a decent and dignified livelihood is the immovable obligation.

Ignoring poorer of the poor or abject poverty in B40 is also morally unacceptable. Extending our hands—co-responsibility at national, state and local levels—to them is of utmost priority for achieving a more inclusive, equitable, fair and socially just society. Building Malaysia *Baru* where poverty alleviation requires every citizen’s resolute commitment in the provision of basic needs such as food, education, health and sanitation, hygienic water and clean air to B40 group. Otherwise, achieving the status of advanced country where everyone lives in effective, efficient, fair, equitable and socially just society is simply a wish that might not come true (Lau, 2013, pp. 4-5).

6. Conclusion

The proposed fiscal federalism is a new initiative that deserves serious consideration by the legislation. Since the formation of Malaysia, maintaining in the comfort zone with less political troubles is to practice a highly centralized tax system, which has become the precedent for majority of legislators. National government has persistently taken advantage of that mentality, which consequently has brought about a fiscal expenditure that has been less efficient, less fairness and lower equity, less just, and less efficient in utilizing fiscal expenditures for more than half a century. Fiscal policy influences economic performance in a country. It especially focuses on demand side with policy approaches from fiscal revenues and expenditures. Fiscal federalism is a tax system that focuses on shared responsibility between national and local governments or cooperative relation between national and state governments in managing tax revenues and expenditures.

This study stresses the urgency of transforming the present centralized tax system to the decentralized one because the Federal Constitution specifies Malaysia is a federation. In spite of the Federation Constitution, tax system was and still is practically a centralized system. Fiscal federalism is a powerful tool to strengthen social wellbeing in Malaysia *Baru* based on efficiency, fairness, equity, and socially just redistribution of fiscal resources from national to state governments. Equally important, this result reduces the intensity of centralization ratio between national and state governments. This transformation will not only enhance economic efficiency but also promote better vertical equity, horizontal equity, generational equity, and proportional equity by direct taxes (income tax, real property gains tax, stamp duty) and also by indirect taxes (sales and service tax, export duty, import duty, excise tax, sin and luxury tax). The paper also proposes the needs to improve EPF (a force saving scheme), unemployment insurance, universal health care, conditional cash transfer scheme for supporting B40—the lowest income group. Fiscal resources equalization by fiscal federalism improves efficiency in fiscal reallocation from national to state governments, which in turn brings about a higher level of fairness in redistribution. Therefore these efforts produce Pareto optimal in efficiency and fairness.

The establishment of a tax system for fiscal federalism is not a difficult task but it requires a strong political commitment in the legislation. The transformation will face challenges in the new landscape where terrain has pockets of uncertainties. The navigation requires concerted efforts from all stakeholders and it also demands extra prudence too. “The care of the health, of the fortune, of the rank and reputation of the individual, the objects upon which his comfort and happiness in this life are supposed principally to depend, is considered as the proper business of that virtue which is commonly called Prudence.....The prudent man always studies seriously and

earnestly to understand whatever he professes to understand, and not merely to persuade other people that he understands it; and though his talents may not always be very brilliant, they are always perfectly genuine” (Adam Smith, 1759, p. 192, cited in Lau, op. cit., p. 17).

The proposed federal tax system ought to be well planned, professionally and effectively executed along with regular check follow with better actions by the legislative and executive branches as well as by taxpayers and users. This is the framework of PDCA—plan, do, check and action. The demand of resources is huge, if not unlimited, but the supply is constrained in reality. As such, national government must decide policy priorities based on the cost and effectiveness under a hard budget constrain. Especially both execution and legislation branches ought to clearly explain the aim, anticipated outcome, and detailed operational aspects of every policy to the public with transparency and accountability. “Ask not what your country can do for you, ask what you can do for your country” (John F. Kennedy, 20 January 1961). This statement is true not only to the *rakyat*’s representatives but to all Malaysians. This paper fervently hopes Malaysia *Baru* will navigate with confident in the elevated landscape where every *rakyat* will have a better wellbeing in not a distantly far horizon.

No one wants to dispute that globalization means economy openness. This process at least implies to the extent of borderless economy. The supporters insist that economy openness or free trade pushes up competitiveness but they have not examined its shadow sufficiently. The shadow comprises situation where government losses room for maneuvering policy intervention to support vulnerable citizens who are unable to surf along with globalization waves. Put differently, while government encourages free trade on one hand, it losses the control of policy that add misery to vulnerable people who live in the sovereign territory on other hand. Rodrick (2007) shows that the nation state, democratic politics and deep integration are in a triangular relation but these ideals also create a “trilemma” in political economy. Openness brings about deep economic integration. Democratic politics promote policies that support free trade and enhanced competitiveness in international market place. However, nation state is the foundation for democratic politics but it is against immoral and unethical competition that produces a large share of the have not that defeats the greater good of fairness and equality within the sovereign territory. Hence two elements can be mutually inclusive but not three. Democratic politics enhances deep integration and vice versa but nation state does not respond to deep economic integration because it is obliged to support a large group of vulnerable citizens—both before and after intense competition in global markets. Nation state and democratic politics are also mutually inclusive if deep economic integration is not included.

The reality in and outside our homeland poses many difficult challenges to 32 million people. This paper does not cover every details of fiscal federalism but it has at least highlighted its core essence in order to generate greater awareness of the need for transformation in the new terrain flourishes with tons of *harapan* in *Malaysia Baru*. Last but not least, fiscal federalism is the *de jure* and not the *de facto* centralized tax system. Ben Bradlee, who was closed to J.

Kennedy, and then he was the VP of Washington Post said, "Today is good, tomorrow is better." This inspires me to make the following statement. "Malaysia is good today, tomorrow it is the Better Malaysia" (Lau, op. cit., p. 17).

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Table 1 Sources of Revenue Assigned to States

1	Revenue from toddy shops.
2	Revenue from lands mines and forests.
3	Revenue from licenses other than those connected with water supplies and services, mechanically propelled vehicles, electrical installations and registration of businesses
4	Entertainments duty.
5	Fees in courts other than federal courts.
6	Fees and receipts in respect of specific services rendered by departments of the State Governments.
7	Revenue of town boards, town councils, rural boards, local councils and similar local authorities other than: (a) municipalities established under any municipal Ordinance; (b) those town boards, town councils, rural boards, local councils and similar local authorities which have power under written law to retain their revenue and control the spending thereof.
8	Receipts in respect of raw water.
9	Rents on State property.
10	Interest on State balances.
11	Receipts from land sales and sales of State property.
12	Fines and forfeitures in courts other than federal courts.
13	Zakat, Fitrah and Baituhmal and similar Islamic religious revenue.
14	Treasure trove.

Source: *Federal Constitution*, Tenth Schedule Part III, PP. 204-205

Table 2 Comparison of Consolidated Federal and State Governments Financial Position (million RM)

	2016	2017	2018
(A) Consolidated federal government financial position*	225,550	265,362	279,019
(B) Consolidated state governments financial position*	19,631	19,692	n/a
Intensity of centralization ((B)/[A])	8.70%	7.42%	

* includes grant and transfer, development expenditure

Source: Ministry of Finance, *Public Sector Finance*, pp. 93-94 (retrieved from <https://www.treasury.gov.my/pdf/economy/er/1718/chapter4.pdf>).

Table 3 Calculation of fiscal equalization based on actual expenditures in 2017 (Billion RM)

	A	B	C	D			
	2017	Z - score	T - score	Share with respect to 2017 total	C x 2017 (=additional transfer)	Total expenditure after transfer adjustment =(2017+D)	
Sarawak	6.90	2.71	7.71	0.0373	2.43	9.33	Sarawak
Sabah	3.90	1.16	6.16	0.1039	6.75	10.65	Sabah
Selangor	2.80	0.59	5.59	0.1284	8.34	11.14	Selangor
Terengganu	2.10	0.22	5.22	0.1439	9.35	11.45	Terengganu
Johor	1.60	-0.04	4.96	0.1550	10.07	11.67	Johor
Perak	1.10	-0.30	4.70	0.1661	10.80	11.90	Perak
Penang	0.80	-0.45	4.55	0.1728	11.23	12.03	Penang
Kedah	0.60	-0.55	4.45	0.1772	11.52	12.12	Kedah
Kelantan	0.60	-0.55	4.45	0.1772	11.52	12.12	Kelantan
Pahang	0.50	-0.61	4.39	0.1794	11.66	12.16	Pahang
N. Sembilan	0.40	-0.66	4.34	0.1817	11.81	12.21	N. Sembilan
Melaka	0.30	-0.71	4.29	0.1839	11.95	12.25	Melaka
Perlis	0.10	-0.81	4.19	0.1883	12.24	12.34	Perlis
Average	1.67		5.00				
Std. dev.	1.93		1.00				
Var.	3.71		1.00				
Total	21.70		64.99		129.66	151.36	

1. Multiple between 2017 (actual expenditures) and adjusted fiscal expenditure is about 6.0 (redistributed values=129.66/21.7).

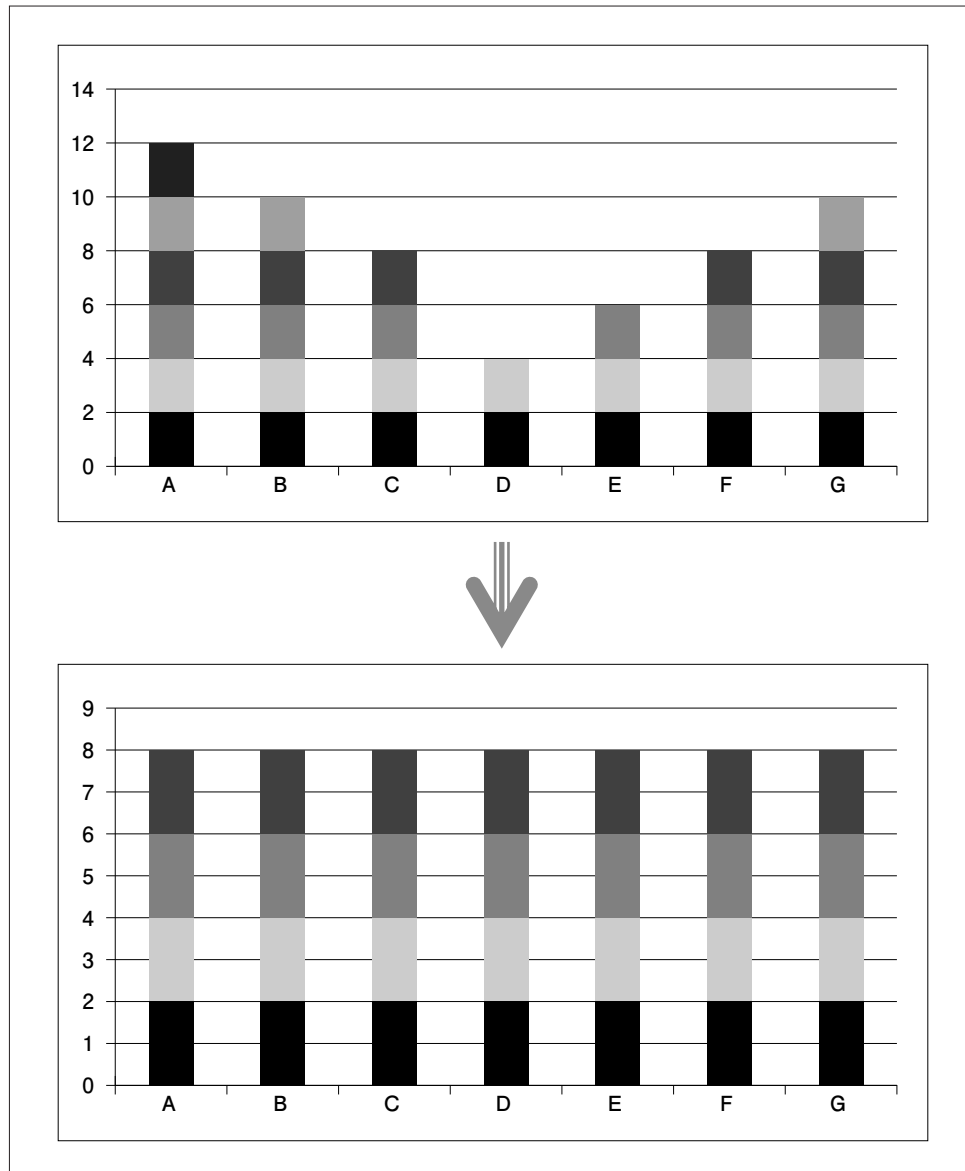
2. Post redistributed State Governments new expenditure position increased from 7.42% (Table 2) to 57.04%.

Table 4 Allocation of contribution from national and state governments for CCT in B40

	Weighted average of total expenditure after transfer adjustment (with respect to T-score (adjusted expenditure) in 2017	Total expenditure after transfer adjustment in 2017-Weighted average, RM Million	(A) Share (state expenditure/total)	Resources contributed from national and state governments (A*3,200 mil) RM Million
	1.33			3,200
Sarawak		7,995	0.0596	190.83
Sabah		9,325	0.0695	222.56
Selangor		9,812	0.0732	234.19
Terengganu		10,123	0.0755	241.60
Johor		10,344	0.0772	246.89
Perak		10,566	0.0788	252.17
Penang		10,699	0.0798	255.35
Kedah		10,787	0.0805	257.46
Kelantan		10,787	0.0805	257.46
Pahang		10,832	0.0808	258.52
N. Sembilan		10,876	0.0811	259.58
Melaka		10,920	0.0814	260.64
Perlis		11,009	0.0821	262.75
Total		134,075	1	3,200

Source: computed by author from Table 3

Figure 1 Filling the gaps from surpluses (based on distributed scale in Table 4)



Note: the number of households in B40 is not evenly distributed in every state.

Source: compiled by author based on a hypothetical condition.

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Abstract

The Federal Constitution specifies Malaysia is a federation. But the formulation and the execution of fiscal expenditure were and still are practically controlled by national government. It is constitutionally right for enhancing the identity of the reborn homeland where the government and rakyat in Malaysia Baru are in need of a fiscal system that can foster their endeavors in securing not only a desirable but also a higher welfare standard set up by efficiency, fairness, effectiveness, equity, and social justice. Fiscal Federalism is the path to derive the answer. Against this backdrop, this paper intends to examine how fiscal federalism can facilitate the desirable state of resource allocations that brings better wellbeing in national and states level.

In a democratic country, the decision of establishing and of executing fiscal federalism, which is [guaranteed by the Federal Constitution], is politically doable. The proposed fiscal federalism is a new initiative that deserves serious consideration by the legislation. Fiscal policy influences economic performance in a country. It especially focuses on demand side with policy approaches from fiscal revenues and expenditures. Fiscal federalism is a tax system that focuses on shared responsibility between national and local governments or cooperative relation between national and state governments in managing tax revenues and expenditures.

This study shows federal federalism could reduce centralization ratio, i.e., ratio of consolidated state governments financial position with respect to national's. The calculated result shows it improved from 7.4% to 57.4% in 2017 by fiscal equalization. Market failure persists in a market-based economic system. Therefore, government ought to intervene to correct it by the principles of progressive, regressive, and proportional taxes on the one hand, and vertical equity, horizontal equity, and generational equity on the other hand. Furthermore, fiscal equalization leads to more efficient, more efficient, a higher fairness, and it also enhances equity and social justice.

This study stresses in spite of the federation constitution, tax system was and still is practically a centralized system since the formation of Malaysia. Fiscal federalism is a powerful tool to strengthen social wellbeing in Malaysia *Baru*. This paper also proposes the needs to improve employees provident fund (EPF, a force saving scheme), unemployment insurance, universal health care, conditional cash transfer scheme for supporting B40—lowest income group. Fiscal resources equalization by fiscal federalism improves efficiency in fiscal reallocation from national to state governments, which in turn brings about a higher level of fairness in redistribution. Therefore these efforts produce Pareto optimal in efficiency and fairness.

The reality in and outside our homeland poses many difficult challenges to 32 million people. This paper has highlighted the core essence in order to generate greater awareness of the need for positive changes in the new terrain flourishes with tons of *harapan* in Malaysia *Baru*. Finally, just as importantly, this study emphasizes fiscal federalism is the *de jure* and not the *de facto* centralized tax system.