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From Fiscal Redistribution to Devolution of Power: Lessons from Elsewhere and Possible Pathways Forward

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By Mr Stuart MacDonald (Guest researcher & Technical Director, Think City)

Executive Summary

Malaysia's federal system remains one of the most centralised in the world, with nearly 95% of national tax revenue retained at the federal level. States are left dependent on discretionary transfers that are opaque, short-term, and rarely tied to performance. This not only restricts fiscal autonomy but also stifles innovation and undermines long-term planning. Many states now face rising financial stress, with debts collectively amounting to billions of Ringgit, while the reliance on annual allocations weakens both efficiency in resource use and efficacy in meeting the diverse needs of Malaysia's states.

International examples from Federal nations highlight the benefits of a different approach. In India, independent Finance Commissions have created transparent, performance-linked transfer systems while the Inter-State Council provides a standing platform for negotiation. Mexico's decentralisation reforms improved service delivery and democratic accountability, giving the National Conference of Governors a strong role in shaping national priorities. Brazil's model, meanwhile, combines significant state-level tax powers with the coordinating role of the Nacional Council for Fiscal Policy (CONFAZ), ensuring local fiscal incentives are balanced with equity. Together, these cases illustrate the importance of subsidiarity, where responsibilities are devolved to the level of government best positioned to deliver effectively.

For Malaysia, and particularly for Penang, this report suggests reform requires movement on four fronts at once. First, greater transparency is needed—publishing funding formulas and allocations, linking transfers to Malaysia Plans, and embedding performance monitoring would build accountability and trust. Second, modernising tax instruments such as the Capitation Grant, THAP, and the Ecological Fiscal Transfer would ensure that transfers reflect real costs, address inequities, and create stronger incentives for growth. Third, states must be given more scope to raise their own revenues, whether through targeted levies, tourism and congestion charges, or new development finance mechanisms, enabling them to expand fiscal space and mobilise private investment. Finally, movement towards a more co-operative federalism would see federal ministries work in structured partnerships with states on areas such as education, health, digital inclusion, agriculture, climate resilience, and welfare, aligning national funding and building local delivery capacity to maximise both efficiency and efficacy.

Reform along these lines would shift the state-federal relationship from one based on dependency to one of partnership. For the federal government, this offers improved efficiency in resource use, stronger legitimacy, and more sustainable outcomes given the challenges we face. For states like Penang, it opens the space to pioneer innovation in climate-smart governance, digital transformation, and inclusive growth. By embedding subsidiarity and cooperation at the heart of fiscal federalism, Malaysia can move beyond the middle-income trap and build a federation that is more equitable, resilient, and responsive to its citizens.

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Introduction[1]

Malaysia's federal system has been the foundation of its political and fiscal architecture since independence. Yet, as the economy diversifies, cities expand, and the challenges of climate adaptation, inequality, and technological disruption intensify, the centralised model shows signs of strain. States like Penang, with dynamic economies and highly urbanised populations, are both key drivers of national growth and sites where the consequences of fiscal and policy bottlenecks are most keenly felt.

This report, presented to Penang Select Committee on State-Federal Relations explores how Penang—and by extension other states—can recalibrate their relationship with the federal government to achieve a more balanced, effective, and resilient federation. It begins by laying out the fundamentals of Malaysia's federal structure, before examining the existing transfer mechanisms and dialogue platforms that can be reformed to shape how resources and responsibilities flow between Putrajaya and the states.

Drawing lessons from international case studies—including India, Mexico, and Brazil—each demonstrates pathways for managing fiscal federalism, decentralisation, and intergovernmental collaboration. These cases provide critical insights and learning into how Malaysia might adapt its own arrangements to suit its constitutional and political context.

Building on these lessons, the report sets out a series of possible pathways for reform, organised around four interconnected strategies to be pursued simultaneously:

1. Calling for transparency in the system – making federal transfers, decision making and responsibilities more visible and accountable.
2. Lobbying for tax reforms – modernising fiscal instruments, making them incentive and performance based to drive local and national economic growth.
3. Demanding revenue-raising powers – enabling states to capture value, innovate in financing, and diversify their fiscal bases.
4. Pursuing co-operative federalism – devolving responsibility where local delivery is more effective, removing inefficiency and improving efficacy by working collaboratively, building platforms for the devolution of power and responsibility.

The intention is not confrontation but partnership. By embracing the principle of subsidiarity—where decisions are taken as close as possible to the communities they affect—Malaysia can strengthen both its states and the federation as a whole. For Penang, this represents not just an opportunity to unlock new sources of revenue and capacity, but also to demonstrate how more responsive, accountable, and locally grounded governance can create a genuine win–win for federal and state governments alike.

[1] This paper was presented in slide format to the Penang Select Committee on State-Federal Relations on Monday, 25 August 2025 at Penang Institute.
[2] Ghani et al (2019) Fiscal Decentralisation And Economic Growth In Malaysia: A Market Preserving

Fundamentals

Malaysia is the most fiscally centralised federation in the world, with approximately 90–95% of total tax revenue retained by the Federal government. In practice, the system functions almost as a unitary system, and has become increasingly centralised over time (in 1963, the Federal government accounted for around 77% of total tax expenditure). As a result, state development largely depends on the discretion of the Federal government, since states rely heavily on federal transfers. This centralisation is accompanied by a severe lack of transparency in decision-making, allocation formulas, and the values allocated. Duplication in the system creates inefficiencies and a lack of performance-related incentives does little to encourage more efficient or effective use of funds.

The case for fiscal decentralisation arises from several challenges facing state governments. States rely heavily on natural resources such as hydrocarbons, land, agriculture, and forestry for revenue, which is unsustainable. This model cannot support Malaysia's national ambitions, advance its sustainable development commitments or unlock new engines of economic growth.

States struggle to balance their budgets, with some reportedly estimating collective state debts of around RM10 billion. Without reforms, states risk being trapped in a cycle of dependency, unable to innovate or invest in local growth. This also wastes significant energy and effort, as Putrajaya is often called upon to provide bailouts or emergency support when states' finances become overstretched.

Furthermore, the reliance on annual budgeting and federal discretion inhibits long-term planning. This short-termism prevents states from planning and sequencing major investments in infrastructure, climate adaptation, education, and social programmes, all of which require predictable funding streams over several years. Collectively, this can be argued to be limiting Malaysia's economic potential, making it more difficult to escape the "middle income trap".

Fiscal decentralisation offers several advantages. It can provide stronger incentives for economic growth, as demonstrated in studies by Ghani et al. (2019[2], 2021[3]), and enable more responsive and accountable local governance. Decentralisation also allows states to develop tailored solutions to local problems, improving service delivery (efficiency and efficacy). Moreover, it can increase democratic engagement and public participation while promoting more efficient use of public resources, leading to lower administrative costs and reduced duplication.

However, decentralisation is not without risks. Effective implementation requires building state capacity and resources to manage finances properly. It also carries the potential to exacerbate existing inequalities between different states. Clear lines of responsibility and coordination are essential to ensure that decentralisation delivers its intended benefits without unintended negative consequences.

Existing transfer mechanisms

Federal-state financial transfers (excluding development transfers) in Malaysia operate through a mix of formula-based and discretionary mechanisms. The Capitation Grant is a mandated transfer based on population, with the formula last revised in 2002. The Pemberian Berdasarkan Tahap Pembangunan Ekonomi, Infrastruktur and Kesejahteraan Hidup (TAHAP) is discretionary, with allocations determined by factors such as population size, economic development, infrastructure gaps, welfare indicators, and the fiscal capacity of each state, though the exact formula is not published. The Ecological Fiscal Transfer (EFT) is also discretionary, with 70% of funding allocated according to the hectarage of protected areas in each state and 30% based on performance. The Road Maintenance Grant (MARRIS) is mandated and calculated using unpublished formulas that consider road length,

[2] Ghani et al (2019) Fiscal Decentralisation And Economic Growth In Malaysia: A Market Preserving Federalism Perspective, Jurnal Ekonomi Malaysia, 53(1), pp. 153-170

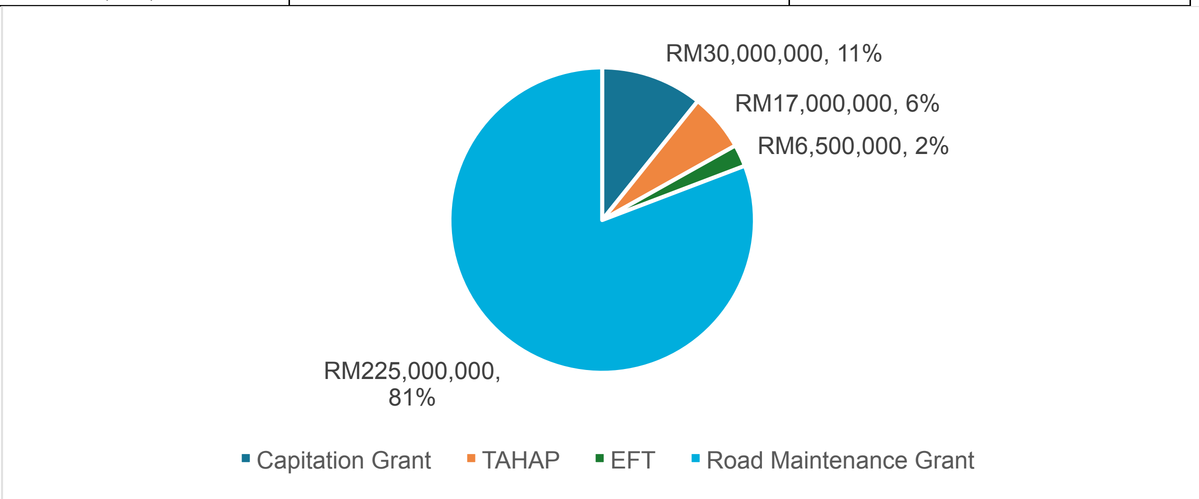
[3] Ghani et al (2021) Fiscal Decentralisation and Economic Growth Across States: New Evidence from Malaysia, Int. Journal of Economics and Management 15 (3): 463-477 (2021)

the proportion of federal, state, and local roads, and road conditions. Finally, Revenue Growth Grants are governed by the Revenue Growth Grants Acts of 1977 and 1980.

While these mechanisms may not be delivering optimum outcomes, they do exist. Reforming existing mechanisms is always going to be easier than inventing something new and we can learn from other Federal countries how reforms may produce a win-win situation for state and national development.

Figure 1 - Fiscal transfer mechanisms

Grant Type	Formula	Penang (Est. RM 2025)
Capitation Grant	Population based formula, last revised in 2002. Mandated.	RM 30 million (as per CM statement)
Pemberian Berdasarkan Tahap Pembangunan Ekonomi, Infrastruktur and Kesejahteraan Hidup (TAHAP)	Formula is not published, but allocations are based on: population size, level of economic development, infrastructure gap, welfare and social development indicators, fiscal need and capacity of the state. Discretionary.	~RM 16-18 million
Ecological Fiscal Transfer (EFT)	Allocated 70% based on the hectarage of protected areas in each state and 30% on performance. Discretionary.	~RM 4–9 million
Road Maintenance Grant	Formula is not published but based on road length, and the proportion of federal, state, and local roads and road condition. Mandated.	~RM 200–250 million
Revenue Growth Grants	Revenue Growth Grants as stated in Revenue Growth Grants Acts 1977 and its amendment in 1980	
TOTAL (Est.)		**~RM 252–311 million**



Existing dialogue mechanisms

The National Finance Council (NFC) is a high-level intergovernmental forum established under Article 108 of the Constitution, which allows the Prime Minister to summon meetings as deemed necessary or when three or more states request a meeting, with a minimum of one meeting per year. Despite its status, the NFC suffers from significant limitations. It lacks transparency and public accountability, as no minutes or reports are published, and its outcomes are purely advisory with no binding effect. Unlike fiscal commissions in countries such as India, Australia, or Germany, the NFC does not include technical experts, independent representatives, civil society actors, or public submissions in its deliberations. This absence of diverse and expert input undermines both the technocratic rigor and stakeholder ownership of fiscal reform.

The NFC can be reformed, it can draw lessons from elsewhere and strengthen state collective voice in shaping the nations development.

A range of other existing dialogue mechanisms would by default be strengthened with a National Finance Council committed to fiscal reform:

- National Land Council – Oversees land policy and administration at the federal level; coordinates land matters between federal and state governments.
- National Council for Local Government – Provides guidance on local government administration, policies, and coordination between federal and local authorities.
- Conference of Rulers – Comprises state monarchs; advises on constitutional matters, Islamic affairs, and appointments to key federal positions.
- National Water Council – Coordinates national water resource management and policy between federal and state levels.

Case studies > India, Mexico, Brazil

Looking at the degree of fiscal centralisation across Federal nations, Malaysia is the most fiscally centralised in the world. This section develops case studies of nations slightly lower down the rankings, exploring the drivers and mechanisms of fiscal decentralisation in India, Mexico and Brazil.

Country	% of Total Tax Collected by Central Government
Malaysia	~90–95%
Russia	~85–90%
India	**~85%**
Mexico	**~80–85%**
Brazil	**~60–65%**
United States	~55–60%
Canada	~50–55%
Germany	~45–50%
Switzerland	~35–40%

Case Study: Fiscal Federalism and Decentralisation in India

India is a federal republic, constitutionally defined under Article 1. The broader framework of local empowerment in India was strengthened by the 73rd and 74th Constitutional Amendments (1992–1993), which, under the leadership of Minister Rajiv Gandhi, granted constitutional status to local governments and enabled limited local taxation powers. Although local taxation remains relatively weak in practice, these amendments were intended to enhance democratic participation at the grassroots level.

States in India possess constitutionally guaranteed powers, and they bear responsibility for major public services such as education, health, law and order, agriculture, and rural development. Over time, many states have advocated for greater fiscal autonomy, prompting reforms aimed at decentralisation and cooperative federalism.

Finance Commissions play a critical role in India's fiscal decentralisation. Established under Article 280 of the Constitution, Finance Commissions recommend how central taxes should be shared with states (vertical devolution) and how resources should be allocated among states (horizontal devolution). They also address broader financial relations and fiscal capacity issues. Horizontal devolution formulas typically account for factors such as population, area, forest cover, income, demographics, and tax collection. Importantly, India's Finance Commissions invite input from the public, institutions, and organizations to inform their recommendations.

From the 10th Commission (1995–2000) onwards, expert-led Commissions have increasingly supported greater tax devolution to states. A landmark moment came with the 14th Finance Commission (2015–2020), chaired by former Reserve Bank Governor Y.V. Reddy, which raised the states' share of the divisible tax pool from 32% to 42%, marking a key step in India's decentralisation path.

The Inter-State Council (ISC) serves as a constitutional mechanism to promote cooperative federalism and coordination between the Union and state governments. Established under Article 263, the ISC investigates and discusses matters of common interest between the Centre and states, or among states themselves, and can make recommendations for improved policy coordination. It also deliberates on disputes and aims to prevent conflicts before they escalate, functioning as a forum for preventive conflict resolution. The ISC's framework is reinforced by five Zonal Councils, each addressing region-specific issues to enhance inter-state cooperation.

India's Tax System and its GST Reform illustrate the evolution of fiscal federalism in practice. Prior to 2017, each state levied its own Value Added Tax (VAT) on intra-state sales, along with other levies such as entry tax, luxury tax, purchase tax, and entertainment tax. The Centre imposed Central Sales Tax (CST) on inter-state sales—collected by the originating state—along with central excise duty and service taxes. In 2017, India implemented a unified Goods and Services Tax (GST) system, a destination-based tax covering both goods and services. Under the dual GST model, both the Centre (CGST) and states (SGST) levy tax simultaneously on the same transaction. For example, a sale in Delhi subject to 18% GST is split evenly: 9% CGST to the Centre and 9% SGST to the Delhi state government. The GST Council, which oversees GST implementation, is weighted to reflect cooperative federalism, giving the Centre one-third of the vote and all states combined two-thirds.

Conclusion

India's experience demonstrates a structured approach to fiscal federalism that balances state autonomy with national coordination. Constitutional provisions, expert-led Finance Commissions, cooperative frameworks like the ISC, and major tax reforms (such as GST) collectively strengthen decentralisation while maintaining national cohesion. India's model underscores the importance of formal mechanisms, expert input, and institutional checks in promoting both fiscal autonomy and cooperative governance in a complex federal system.

Case Study: Fiscal Federalism and Decentralisation in Mexico

From the 1920s through the 1980s, Mexico was dominated by a highly centralised one-party system under the Institutional Revolutionary Party (PRI). Democratic reforms in the 1980s–2000s increased pressure to empower states and municipalities, creating incentives for decentralisation. The 1982 debt crisis imposed severe budget constraints on the federal government, prompting it to shift spending responsibilities downward, particularly in social sectors. Decentralisation served multiple purposes: it reduced the financial burden on the centre, strengthened the legitimacy and democratic accountability of local governments, promoted political pluralism, and curtailed the long-standing dominance of the federal government, reducing potential return to a one-party system.

In a vast and diverse country like Mexico, centralised governance was often ineffective in delivering services such as health, education, and local development. Decentralising spending responsibilities allowed local governments to tailor services to local needs, improving responsiveness, leveraging local knowledge, and enhancing service quality (subsidiarity).

Mexican states hold authority over education, health services, public safety and policing, infrastructure, and public works. A landmark reform in 1992 decentralised education, giving states responsibility for managing schools, hiring teachers, and allocating resources, with the aim of improving both quality and efficiency.

Mexico's state–federal relations are guided by a combination of constitutional provisions, sectoral agreements, and intergovernmental coordination mechanisms. The National Conference of Governors (CONAGO) is a political coordination body created to foster dialogue and collaboration among the 32 state governors and the federal government. CONAGO promotes intergovernmental coordination, federalism, and regional development, critically with the chairmanship rotating among state governors and thematic working groups addressing areas such as health, economy, and security.

The Fiscal Coordination Law (Ley de Coordinación Fiscal) is a key mechanism for addressing vertical fiscal imbalances. It provides states with access to national revenue through formal agreements (convenios) and distinguishes between ringfenced (aportaciones) and non-ringfenced (participaciones) funding streams. The law also incentivises states to improve their own tax collection; states that enhance efficiency in administering taxes such as payroll or vehicle ownership taxes may receive higher shares of participaciones.

Mexico's Value Added Tax (IVA or VAT), levied at 16% (8% in border areas), is collected federally by the Tax Administration Service (SAT) under the Ministry of Finance (SHCP). Approximately 10% of federal VAT revenues are allocated to the Fondo General de Participaciones (FGP), which in 2024 accounts for roughly 20% of net federal tax revenues (VAT and income tax). The FGP is distributed to states and municipalities based on a formula with three components: (1) Historical Share (~45%) reflecting each state's base-year share of participaciones, maintaining predictability; (2) Fiscal Effort Component (~30%) rewarding states that increase and modernize their own tax collection; and (3) Economic Activity and Population (~25%) reflecting each state's GDP contribution and population size, balancing fairness and economic relevance.

Conclusion

Mexico's decentralisation experience demonstrates a pragmatic approach to balancing central authority with local autonomy. By combining constitutional frameworks, intergovernmental coordination (CONAGO), legal mechanisms (Fiscal Coordination Law), and formula-driven fiscal transfers, Mexico has strengthened state and municipal governance while ensuring accountability, responsiveness, and incentives for local fiscal effort. Decentralisation has enhanced both democratic legitimacy and service delivery in a complex, diverse, and fiscally constrained national context.

Case Study: Fiscal Federalism and Decentralisation in Brazil

Brazil is a federal presidential republic, and decentralisation intensified after the end of military rule (1964-1985), reflecting a desire to restore democratic governance at state and municipal levels. Post-dictatorship reforms aimed to empower subnational governments to manage local affairs more effectively while maintaining coordination with the federal government. Brazilian states are responsible for managing regional hospitals, specialized clinics, and healthcare networks, public secondary schools and technical education, as well as public security, including military and civil police and prison systems.

Brazil's fiscal system redistributes tax revenues to balance responsibilities across federal, state, and municipal levels. A central element is the ICMS (Imposto sobre Circulação de Mercadorias e Serviços), a value-added tax on goods, services, and interstate commerce. ICMS is collected by the states, which retain 75% of the revenue. From this portion, municipalities receive their shares based mainly on the Value Added Factor (VAF), which reflects where economic activity occurs—such as factories, logistics hubs, or retail centers. This gives municipalities a direct fiscal incentive to attract investment and stimulate local economic development.

The remaining 25% of ICMS revenue is redistributed to municipalities according to criteria defined by each state's legislation. These criteria often include factors such as population, education outcomes, health indicators, environmental performance, and municipal tax effort. This approach combines performance- and equity-based redistribution, ensuring that while municipalities compete to attract businesses, there is also a mechanism to support broader social and regional balance.

The IPI (Manufactured Goods Tax) redistributes 22.5% of revenues to states, and the IPVA (Motor Vehicle Tax) is split equally between states and municipalities. The federal government collects personal and corporate income taxes (IRPF and IRPJ) via the Receita Federal, redistributing 21.5% to states through the State Participation Fund (Fundo de Participação dos Estados – FPE) and 22.5% to municipalities via the Municipal Participation Fund (FPM), as established under Articles 157 and 159 of the Federal Constitution.

The National Council of Fiscal Policy (CONFAZ) is a key intergovernmental institution that coordinates fiscal policy among the federal government and Brazil's 26 states. CONFAZ primarily harmonises tax policy, particularly regarding ICMS, by approving interstate tax agreements ("convênios") and setting rules for tax incentives, exemptions, and benefits. Participation includes all state finance secretaries and representatives of the Ministry of Finance. For tax changes to be implemented, unanimous approval by all 27 members is required, giving each state a de facto veto. CONFAZ thus strengthens coordination in a fiscally decentralised system, manages vertical and horizontal fiscal imbalances, and provides a platform for negotiation that reduces disputes over tax issues; however progress can be easily stifled.

Conclusion

Brazil demonstrates a sophisticated model of fiscal federalism with post-dictatorship decentralisation empowering states and municipalities to manage key public services, while intergovernmental coordination via CONFAZ ensures harmonisation of tax policies and equitable distribution of resources. The ICMS and participation funds provide strong incentives for local economic development while addressing horizontal and vertical fiscal imbalances, illustrating how fiscal decentralisation and institutional coordination can coexist effectively in a large, diverse country.

Key learning

Malaysia can draw several lessons from India, Mexico, and Brazil in strengthening the collective voice of states, building platforms for negotiation, and developing performance-linked funding which can drive economic development and deliver national goals. India's Inter-State Council and GST Council provide states with formal decision-making powers, while Mexico's CONAGO, with a rotating state chairmanship, enables collective bargaining among governors. In Brazil, the National Council of Fiscal Policy (CONFAZ) requires unanimous state approval for tax changes, effectively giving states veto power.

These examples suggest that Malaysia could benefit from the reform of mechanisms where states and local governments can negotiate and participate meaningfully in fiscal decisions. Linking transfers to performance is also instructive: Mexico's Fiscal Coordination Law rewards states for improving tax collection, Brazil's ICMS gives municipalities incentives to attract economic activity, and India's Finance Commissions encourage fiscal effort and evidence-based allocations. For Malaysia, combining inclusive, expert-informed intergovernmental platforms with rotating leadership, weighted voting, performance-linked transfers, and proactive dispute resolution could create a more cooperative, transparent, and accountable federal fiscal system.

Possible pathways

State–federal relations in Malaysia are at a critical juncture. As Malaysia urbanises, decentralises services, and adapts to new economic and climate challenges, states such as Penang are increasingly at the frontline of delivery. Yet the current system remains highly centralised, with opaque fiscal arrangements, overlapping responsibilities, and limited space for local innovation. To ensure a more resilient, prosperous, and inclusive future, there is a need to reset the state–federal compact on the basis of transparency, fairness, and subsidiarity.

This section proposes a four-pronged strategy to advance a case for reform, with each element pursued simultaneously to maximise impact and demonstrate practical value:

1. Calling for transparency in the system – making federal transfers, decision making and responsibilities more visible and accountable.
2. Lobbying for tax reforms – modernising fiscal instruments, making them incentive and performance based to drive local and national economic growth.
3. Demanding revenue-raising powers – enabling states to capture value, innovate in financing, and diversify their fiscal bases.
4. Pursuing co-operative federalism – devolving responsibility where local delivery is more effective, removing inefficiency, improving efficacy by working collaboratively, building platforms for the devolution of power and responsibility.

Taken together, these measures would not only strengthen State level fiscal and policy autonomy but also provide the federal government with a stronger partner in driving national development. A more balanced state–federal relationship can create a genuine win–win scenario: federal ministries benefit from more efficient and locally responsive delivery, while States gain the flexibility and resources needed to realise their full economic and social potential.

1. Call for transparency in the system

A central reform priority should be to build greater transparency in the system. States should work collectively to demand clearer processes, including the publication of funding formulas and allocations, alongside regular, index-linked reviews. A collective voice would be harder to ignore, with perhaps a focus on reforming the role and functioning of the National Finance Council (NFC), with stronger commitments to transparency in its deliberations. Drawing lessons from India's Finance Commission, reforms should emphasize expert input and open engagement in fiscal decision-making.

The current reliance on annual budgets undermines long-term planning and creates inefficiencies. Given the scale of the demographic, technological and climate challenges we face, introducing multi-year settlements, aligned with Malaysia's development plan cycles (such as the 2026–2030 Malaysia Plan), would enable states to plan more strategically and allocate resources more effectively.

As a quid pro quo, reforms must strengthen accountability through the development and strengthening of performance-related measures. At present, limited outcome monitoring constrains both accountability and learning. Without systematic evaluation, inefficiencies are repeated and opportunities for improvement are lost. Embedding performance-linked transfers and evaluation mechanisms would set the stage for more competitive, outcomes-focused funding, ensuring that resources drive real improvements in both governance and service delivery.

2. Lobby for tax reform

Capitation grant

The capitation grant, currently a flat per capita transfer to all states, distributes equal amounts per resident regardless of differences in income levels, poverty, or the actual costs of service delivery. This formula produces wide variation, ranging from RM12.14 per person in Selangor to RM72 in Labuan, with Penang receiving just RM14.36. Such an approach disadvantages poorer, smaller, and geographically dispersed states like Kelantan, Penang, and Sabah. The grant has not been revised since the Capitation Grant Act of 2002, and if it had been inflation-linked, Penang's allocation in 2025 would be closer to RM84 million rather than the current RM30 million.

Reform should move towards a weighted population formula that takes into account demographic pressures—such as larger young or elderly populations—and higher service delivery costs. International examples demonstrate more equitable approaches: Australia applies horizontal fiscal equalisation, South Africa adjusts transfers through weighted population and poverty indexing, Germany uses a redistributive Länderfinanzausgleich system, and India's Finance Commission reviews allocation formulas every five years. These practices ensure that fiscal transfers reduce rather than entrench disparities across states.

Grants for Economic Development, Infrastructure, and Welfare-Based Development (TAHAP)

Pemberian Berdasarkan Tahap Pembangunan Ekonomi, Infrastruktur and Kesejahteraan Hidup (TAHAP) is a mechanism which channels funding for economic development, infrastructure, and welfare. Currently, the RM400 million allocated for state-led economic development is minuscule, and with no published formula or state-level allocation details, the system lacks transparency which undermines trust. Further, these funds are not ringfenced, limiting their targeted impact and making performance monitoring difficult. Shifting allocations to align with Malaysia Plan cycles of five years, while also introducing performance targets and annual public reporting, would enhance accountability, improve planning, and strengthen public confidence in the fiscal transfer system, allowing for a gradual ramping up of this as a funding mechanism for state led economic development.

Ecological Fiscal Transfer (EFT)

Malaysia's Ecological Fiscal Transfer (EFT) scheme, currently funded at RM200 million (around 2% of federal transfers), is widely viewed as inadequate, with conservationists calling for allocations closer to RM1 billion annually to meet national forest cover goals of 50%. The scheme's heavy reliance on land size as a criterion (50% weighting) disadvantages smaller states and those with unique but limited ecosystems. Reform should focus on making the EFT legally permanent, increasing transparency in how funds are allocated, and broadening the criteria to include climate adaptation benefits. Annual public reporting and evaluation would strengthen accountability and build public confidence, while shifting to multi-year allocations would allow states to plan effectively, but also leverage private finance through instruments such as climate bonds or sukuk.

Sales and Services Tax (SST)

The recent debate around the Sales and Services Tax (SST) highlights state level demands for a fairer share of locally generated revenues. For instance, Penang generated an estimated RM3.3 billion in SST in 2024, with projections of RM3.8 billion in 2025, yet its request to retain 20% (around RM760 million) was rejected. A more balanced proposal would be a growth-based formula: setting a baseline (e.g., RM3.8 billion) and allowing states to retain revenues collected above that threshold, at least for a fixed period such as the Malaysia Plan cycle. This approach creates a win-win scenario by incentivizing local economic growth, which in turn increases national revenue from SST, income tax, and duties. Crucially, any retained SST should be ringfenced for local economic development—such as skills training and local business development—to ensure funds directly contribute to economic growth. As with EFT and TAHAP, annual public reporting and transparent evaluation would maintain accountability and trust in the system.

Revenue Growth Grants

The Revenue Growth Grant mechanism, designed to reward states when federal revenue grows by more than 10% in a financial year, is outdated and underutilized. Capped at RM250 million since 2007, the distribution formula is split into three parts: RM50 million allocated through the original formula, RM100 million distributed based on each state's GDP share, and the remaining RM100 million allocated at ministerial discretion. In practice, the grant has rarely been triggered, with only two recent periods meeting the constitutional threshold—2018/2019 (+13.6%) and 2021/2022 (+25.9%). This limited activation underscores the need for reform to make the mechanism more relevant and impactful.

Reform should tie eligibility to state-level revenue growth rather than federal thresholds, creating a more consistent and predictable incentive for states. Such a mechanism could also be adapted to return a portion of Sales and Services Tax (SST) growth to states, rewarding them directly for contributing to national revenue expansion. By ringfencing these funds for local economic development—such as skills, innovation, and infrastructure—states would have both the resources and motivation to stimulate sustainable growth. Transparent reporting on how funds are spent and the outcomes achieved would build accountability, while ensuring the grant serves as a genuine win-win: incentivizing state-level growth while expanding the federal revenue base.

3. Demand revenue raising powers

Tourism taxes

Tourism-related taxes in Malaysia, currently split between the Federal Tourism Tax and local government fees, generate around RM20 million annually in Penang but are marked by duplication and inefficiency. Both tiers of government impose separate levies on visitors, creating unnecessary administrative burdens for operators and confusion for tourists. Reforming this system to allow tourism tax revenues to be retained locally would not only reduce duplication but also empower states and municipalities to better align tourism spending with local priorities and needs.

A reformed tourism tax model should focus on transparency and accountability, ensuring that revenues are ringfenced specifically for tourism development and conservation efforts. This would create a clear link between what visitors pay and the quality of services, infrastructure, and environmental protection they experience, fostering public trust and strengthening Malaysia's reputation as a sustainable tourism destination. For example, funds should be directed towards heritage site preservation, eco-tourism infrastructure, visitor amenities, cultural programming, and biodiversity conservation in protected areas.

Multi-year planning and public reporting of tourism tax revenues and outcomes would enable states to leverage these funds strategically, potentially attracting additional investment from private stakeholders. By streamlining the system and making it more transparent, Malaysia can transform tourism taxes from a fragmented and inefficient revenue stream into a targeted, performance-driven tool for local economic growth, cultural vibrancy, and environmental sustainability.

Shifting transit behaviours

Introducing new local revenue raising streams such as an e-hailing surcharge, a workplace parking levy, and a congestion charge in George Town could play a critical role in complementing the significant federal and state investment in Penang's LRT. These mechanisms would generate dedicated, predictable revenues that can be ringfenced for public transport improvements, especially addressing the "first–last mile" problem that determines whether commuters actually shift from cars to public transport. Without solving this connectivity gap, the full benefits of the multibillion-ringgit LRT project may not be realised, as residents and visitors will still face barriers in accessing stations efficiently.

An e-hailing surcharge of RM0.50 per trip—already implemented in places like Vancouver (CAD 0.30 congestion fee per ride) and Lagos (10% tax per ride)—could generate an estimated RM3 million annually in Penang. If ringfenced, this revenue could fund micro-mobility infrastructure, feeder bus services, or digital demand-responsive transport (DRT), reducing reliance on private vehicles while integrating e-hailing into the broader mobility system. The Local Government Act 1976 (Sections 101 and 102) provides the legal basis for service charges, though effective implementation would require coordination with JPJ, APAD, and the Ministry of Transport.

A workplace parking levy (~RM21 million annually), could be particularly impactful if applied around transit-oriented developments (TODs) linked to the LRT. This mechanism, successfully trialled in cities such as Nottingham (UK), encourages modal shift by disincentivising car commuting, while simultaneously providing revenue for local councils to reinvest in sustainable transport infrastructure. The levy could be legally grounded in Section 101 of the Local Government Act and ringfenced to improve connectivity between workplaces and nearby LRT stations, ensuring higher ridership and better return on the LRT investment.

Finally, a George Town congestion charge could raise as much as RM120 million annually, reflecting the city's ranking as Malaysia's most congested urban area (TomTom Traffic Index). If designed well—with exemptions or discounts for residents, small businesses, and low-income groups—this charge could manage traffic demand while generating substantial funds for public transport enhancements such as DRT services, bike lanes, and pedestrian-friendly upgrades. By linking congestion revenue to visible improvements in mobility, Penang could strengthen public support for both the LRT and broader transport reforms.

Property-related tax reforms

Introducing property-related tax reforms could provide Penang with the tools to build a more climate-friendly and economically resilient city, while aligning with the state's significant public investment in the LRT and broader urban sustainability goals. These measures could generate new, predictable revenues that can be ringfenced for green infrastructure, urban renewal, and sustainable mobility, helping to ensure that growth linked to infrastructure investment benefits the community as a whole rather than speculative interests.

An Urban Green Infrastructure Fee (UGIF) (~RM12.5 million annually), would apply a small levy on developers—particularly for transit-oriented development (TOD) projects in urban areas. Funds would be earmarked for the maintenance and expansion of parks, tree planting, and green corridors, directly supporting Penang's Low Carbon City Framework. This fee would ensure that urban growth contributes to climate resilience, while enhancing liveability and property values in TOD zones.

A vacant property tax, (potentially generating ~RM57 million annually) would address Penang's estimated 53,000 unoccupied residential units that exacerbate affordability pressures by driving speculation and leaving housing stock underutilised. A levy on properties left vacant for more than six months—enabled under the Local Government Act 1976 (Act 171)—could discourage landlordism, promote more efficient use of housing, and stabilise the property market. Revenues could be directed to affordable housing, climate-smart retrofitting, and neighbourhood revitalisation, reinforcing equitable urban growth.

A Land Value Tax (LVT) pilot (~RM20 million annually), would modernise the outdated quit rent system by tying taxation to actual land values. Applied as a split-rate assessment within an LRT "Value Capture Zone," the tax would discourage land hoarding, promote higher-density development, and capture some of the value uplift created by public investment in the LRT and related infrastructure. This approach would ensure that private gains from public investment are partially reinvested in climate-smart urban development and transport integration.

Finally, Business Improvement Districts (BIDs), (~RM10 million annually), could formalise local partnerships for urban upgrading. While current pilot initiatives have relied on grants, legislative amendments to the Local Government Act could create a framework for businesses within designated districts to pool resources for street greening, waste management, and mobility enhancements. BIDs would enable shared responsibility for maintaining vibrant, climate-friendly urban spaces, particularly around the LRT corridor.

Together, these reforms would shift Penang's property market towards sustainability, reduce speculation, and ensure that urban development contributes directly to climate goals. By linking property-related revenues to visible green and mobility improvements, the state can align fiscal reform with public expectations and strengthen the long-term success of the LRT as the backbone of a low-carbon city.

Penang Development Bank

The most transformative reform for state finances and long-term economic growth in Malaysia—particularly for Penang—would be the establishment of state-owned banking or financial institutions with development mandates. State Economic Development Corporations (SEDCs) could seek Development Financial Institution (DFI) licenses, enabling them to operate similarly to the Sabah Development Bank (established in 1978) and the Development Bank of Sarawak (DBOS, established in 2018). While DBOS is not licensed by Bank Negara Malaysia under the Financial Services Act 2013, it demonstrates how states can still mobilise and manage capital for infrastructure, housing, and industrial projects outside of the traditional federal financial framework.

For Penang, a Penang Development Bank could become the financial engine behind the proposed Penang International Financial Centre (PIFC), serving as its core tenant and executing arm. By leveraging windfall land premiums from mega-projects like Silicon Island (PSI) and aligning with emerging financial zones such as Johor's Forest City Special Financial Zone, Penang could capitalise a state-led bank to fund its strategic priorities. Such an institution could focus on climate finance (e.g., green bonds, sukuk, and carbon credit markets), municipal finance vehicles, and infrastructure-led growth. This would reduce reliance on federal transfers, give Penang greater autonomy in long-term planning, and unlock access to private capital for sustainability-focused projects.

The implications go beyond Penang. A state-level banking model, if replicated, could reshape Malaysia's fiscal federalism by enabling states to take a more active role in financing and executing development. Restrictions such as Article 111(2) of the Federal Constitution, which limits states from borrowing without federal approval, currently constrain state financial innovation. However, using development banks as intermediaries offers a creative pathway to mobilise local resources without breaching constitutional limits.

In essence, the creation of a Penang Development Bank would be a game changer, positioning the state not only to finance the expansion of its public transport system, green infrastructure, and housing agenda, but also to drive innovation in climate finance and regional investment. It would allow Penang—and other reform-minded states—to become active participants in Malaysia's economic transformation, reducing over-centralisation and accelerating state-led growth.

4. Pursue co-operative Federalism

With an estimated RM2–3 billion in federal spending flowing into the state each year, there is scope to work more closely with federal ministries to devolve responsibilities and funding in areas where local delivery would be more effective. Rather than seeking broad constitutional changes, Penang can build pragmatic partnerships through Memoranda of Understanding (MoUs) that set out shared objectives, performance benchmarks, and accountability mechanisms, drawing on precedents from other states and countries.

By embracing subsidiarity and cooperative federalism, Penang can make the case that devolving powers and funding in selected areas not only improves service delivery and accountability but also reduces the administrative burden on the Federal government. This approach would demonstrate that state-led initiatives can be a complement—not a competitor—to federal priorities, helping Malaysia as a whole to build a more responsive, efficient, and equitable governance system.

Education

Expanding technical education in Penang offers a clear example of how cooperative federalism can be applied in practice. While full fiscal devolution is unlikely in the short to medium term, what may be immediately feasible is partial curricular devolution, where Penang could work with the Ministry of Education (MoE) to adapt technical and vocational training (TVET) to the state's labour market. For example, Penang's advanced manufacturing and engineering clusters require a steady pipeline of engineers, technicians, and digital specialists. Tailoring curricula to these needs would help bridge the gap between education and industry, strengthening Penang's position as a hub for high-value industries.

There are already models to build on. Selangor, for instance, has taken proactive steps in aligning TVET with industry demand, experimenting with curriculum design, strengthening data systems, and investing in infrastructure to support training delivery. Penang could pursue a similar path by working through state–federal partnership agreements or MoUs with the MoE. This approach emphasises collaboration, not confrontation, by demonstrating that states can complement federal priorities through context-specific innovations.

The scale of funding underscores the opportunity. In 2024, Malaysia allocated RM6.8 billion for TVET nationwide. If distributed proportionately, Penang's share could amount to roughly RM380 million across its six colleges. Redirecting even part of this investment into state-led initiatives—such as demand-driven training, curriculum adaptation, and stronger links with local employers—would maximise returns on federal spending while giving Penang a decisive role in shaping its talent pipeline.

Health

Preventative health care represents a promising area where Penang could collaborate with the Federal government to devolve responsibilities and improve outcomes. Health is already a concurrent list subject under the Federal Constitution, but the rising costs of healthcare, particularly linked to non-communicable diseases (NCDs), make a stronger role for states both timely and necessary. By devolving preventative healthcare budgets to the state level, Penang could better integrate public health interventions with local policies in transport, housing, and urban planning—areas where lifestyle and environmental factors have a direct bearing on health. The benefits would extend beyond health outcomes, contributing to improved labour market productivity and long-term economic gains.

The scale of resources underscores the opportunity. In 2022, Malaysia spent RM5.2 billion on preventive care, equivalent to 6.6% of the Ministry of Health's total expenditure. If allocated proportionally, Penang's share would be in the region of RM300 million annually. Redirecting part of this to state-managed initiatives would allow for programmes that are more responsive to Penang's unique demographic and health context, which is shaped by its highly urbanised environment, ageing population, and disproportionately high rates of NCDs such as obesity, high cholesterol, hypertension, and diabetes.

A possible institutional vehicle could be the creation of a Penang Preventive Health Authority (PPHA). Such a body could take the lead in localising health promotion, disease prevention, and community wellness efforts. It could design integrated strategies that link food security and urban farming with healthy diets, embed physical activity in transport, housing and planning, and build partnerships with local employers to promote workplace wellness. By tailoring initiatives to Penang's realities—where car dependency, sedentary lifestyles, and dietary risks compound health challenges—the PPHA could deliver more impactful and cost-effective interventions than a centralised model can provide.

This approach would not replace federal oversight but rather complement it through cooperative federalism, with MoUs between the Ministry of Health and Penang setting clear roles, reporting frameworks, and accountability measures. By piloting devolved preventative care responsibilities, Penang could demonstrate how state-led innovation can help Malaysia contain spiralling healthcare costs while improving quality of life for its citizens.

Digital

The digital sector is another area where cooperative federalism could unlock greater efficiency and impact for Penang. At present, the Ministry of Communications and Multimedia (K-KOMM) commands a sizeable annual budget of around RM2.5 billion, of which Penang's estimated share is about RM140 million. Yet, despite this significant federal spending, digital governance in Penang remains fragmented and often inefficient due to overlapping roles and duplication. For instance, Digital Penang, a state agency, currently plays more of a soft influence role without the structural authority to coordinate federal and state initiatives effectively. Meanwhile, agencies such as MDEC (Malaysia Digital Economy Corporation) continue to operate programmes that overlap with Digital Penang's efforts, leading to redundancy and a lack of local tailoring.

A devolved model could address these inefficiencies by giving Penang greater responsibility over specific functions while maintaining federal oversight on national strategy, regulation, and consistency. Areas well-suited for localisation include Community Internet Centres (Pusat Internet), which could be better managed at the state level to address Penang's unique urban-rural digital divide; digital literacy campaigns, which require cultural and linguistic tailoring to reach different communities; and digital inclusion programmes targeted at marginalised groups, such as the elderly or low-income households.

Beyond inclusion, Penang could also take on a greater role in supporting the digital economy, nurturing startups and talent platforms, and developing smart city infrastructure. With devolved authority, Penang could design and operate local digital platforms for transport, energy management, and health systems, aligning them with its broader development agenda, including climate goals and the new LRT project. This approach would not only reduce duplication but also improve responsiveness, innovation, and accountability in programme delivery.

By shifting from overlapping federal-state structures to a coordinated, subsidiarity-based framework, Malaysia could ensure that digital investments yield stronger returns, while Penang becomes a testbed for more localised, future-ready governance.

Agriculture & Food Security

Agriculture and food security present another strong case for cooperative federalism, particularly given Penang's inherent strengths in technology and innovation. The Ministry of Agriculture and Food Security (KPKM) manages a sizeable annual budget of around RM6.4 billion, with Penang's estimated share at roughly RM380 million. Yet, agriculture is a shared responsibility sector, and many of the functions that determine success—urban land use, infrastructure planning, and technology deployment—fall squarely within state jurisdiction. This makes Penang well-positioned to co-develop solutions with federal agencies in ways that leverage its competitive advantages.

One area is urban and peri-urban agriculture, where Penang's dense urban form and planning authority provide natural synergies. A relatively modest budget could fund initiatives that align with the City Competitiveness Master Plan, enabling rooftop farming, vertical agriculture, and community-based food hubs. These efforts would reduce dependency on imports while improving food resilience in line with Penang's urban growth patterns.

Penang is also uniquely placed to lead in agritech and innovation pilots, given its thriving electronics and technology ecosystem, especially the emerging Sedusun Tech Valley. By positioning itself as

Malaysia's testbed for smart agriculture technologies—from IoT-enabled farms to AI-driven crop monitoring—Penang can demonstrate how technology clusters can spill over into food security and rural development. This approach could integrate agricultural innovation with Penang's broader industrial strategy, creating both economic and social dividends.

Further, local food security planning requires a strong grounding in local knowledge, something state authorities are far better positioned to manage. Penang could localise efforts to identify vulnerable supply chains, diversify food sources, and prepare for climate-induced shocks, while coordinating with federal frameworks. Similarly, agri-microenterprise and cooperative development could be used to "level up" Seberang Perai, helping smallholders and cooperatives access new markets, technology, and financing.

Through these measures, Penang can move from being a secondary player in federal agricultural policy to becoming a driver of agritech and local food security solutions, setting a model for how subsidiarity can add value in practice.

Environment & Climate

The environment and climate agenda is an area where Penang can work more cooperatively with federal agencies while also leveraging its own local strategies, particularly the Penang Nature-Based Climate Adaptation Programme (PNBCAP). The Ministry of Natural Resources and Environmental Sustainability (NRES) oversees a sizeable RM7 billion annual budget, with Penang's estimated share at around RM350 million. Yet while states already control over land matters, most of the funding, policy tools, and technical expertise remain centrally controlled. This creates both a dependency and an opportunity: Penang can advocate for a subsidiarity-based model that decentralises delivery where it makes sense, while still aligning with national frameworks such as the Malaysia National Adaptation Plan (MyNAP).

One priority is urban nature and green infrastructure, where the local governments (MBPP and MBSP) are best placed to plan and manage interventions such as mangrove restoration, green corridors, flood-resilient parks, and coastal buffers. With proper fiscal devolution, these councils could embed adaptation measures directly into urban development plans, aligning with both climate objectives and Penang's Low Carbon City Framework.

Another area is renewable energy siting and deployment. While energy policy remains under the Ministry of Energy Transition and Water Transformation (MinETWT), states control land use and permitting, making them critical partners in identifying viable sites for solar and other renewable projects. With stronger fiscal instruments—such as access to a state development bank or climate-linked financing—Penang could play a catalytic role in mobilising private investment, blending state land powers with federal energy targets.

By linking federal resources with Penang's own priorities, the state can demonstrate how subsidiarity strengthens not only environmental outcomes but also economic resilience and climate finance access. This cooperative model would enhance Penang's position as a national leader in urban climate adaptation and green growth, while helping Malaysia meet its wider sustainability goals.

Social welfare

Social welfare is another area where cooperative federalism and subsidiarity could deliver major efficiency gains. The Ministry of Women, Family and Community Development (MWFCD) currently channels about RM3 billion annually through the Department of Social Welfare (JKM), with Penang's estimated share at ~RM150 million.

The existing model is heavily centralised, with budgeting and programme design controlled in Putrajaya, leaving little room for local tailoring. Much of the federal focus is on cash transfers—often one-off payments—rather than investment in care infrastructure, community services, or early childhood development. This transactional approach means that social welfare is too often about disbursement rather than measurable outcomes. By contrast, a devolved system could shift the emphasis toward needs-based and outcome-driven delivery, building local accountability and improving long-term resilience.

While social welfare sits on the Concurrent List, allowing states to run their own schemes, the reality is a patchwork of overlapping programmes. In Penang, for instance, state-led initiatives like i-Sejahtera operate alongside federal transfers, creating duplication and inefficiencies that confuse beneficiaries and dilute impact.

Penang has already demonstrated its capacity to step up during crises, such as Covid-19, by mobilising quickly and filling service gaps. A state-led model could formalise this responsiveness, integrating household income, health status, employment, and housing insecurity into eligibility systems. This would allow for more holistic interventions, working in partnership with the private sector (beyond GLIC's) on initiatives such as a Penang Living Wage framework, ensuring social transfers directly support pathways out of poverty.

Devolving greater control of social welfare to the state would also enable smarter resource allocation, allowing Penang to invest in community-based care systems, early learning, and targeted services for vulnerable groups. Federal–state cooperation in this field would not replace national programmes but could make them far more efficient, equitable, and locally relevant.

A model of co-operative federalism

A more co-operative federalism model would allow Penang to take on greater responsibility in areas where local delivery is more efficient, while ensuring the federal government achieves national policy goals more effectively. Across a number of areas, cooperative devolution reduces inefficiencies, strengthens trust, and creates fiscal space for the federal government. Penang gains the flexibility to deliver services suited to its dense, urbanised, high-tech economy, while Putrajaya benefits from improved outcomes, reduced duplication, and stronger local buy-in to national priorities.

Conclusion and Next Steps

Malaysia stands at a crossroads in its federal evolution. The current model of fiscal centralisation has delivered stability, but it is no longer fit for purpose in an economy that must innovate, adapt to climate realities, and meet rising expectations for equity and resilience. A pathway forward requires moving beyond dependency to a more balanced, dynamic, and cooperative federation—one that values efficiency in the use of public resources, efficacy in service delivery, and subsidiarity in decision-making.

The lessons from India, Mexico, and Brazil make clear that reform is both possible and transformative when pursued deliberately. For Malaysia, and for Penang in particular, the task is urgent but achievable. The four-pronged agenda outlined in this report—calling for transparency, lobbying for tax reform, demanding revenue-raising powers, and pursuing co-operative federalism—must be advanced not sequentially but simultaneously, each reinforcing the other.

The next steps are therefore clear:

- Build consensus among states to strengthen collective voice, particularly through reform of the National Finance Council and other intergovernmental platforms.
- Push for legislative and administrative reforms to modernise outdated fiscal instruments and link them transparently to Malaysia Plan cycles.
- Develop state-level pilots, in areas such as tourism taxes, climate finance, welfare and preventive health, that demonstrate the efficacy of devolved responsibilities.
- Negotiate structured federal–state partnerships through memoranda of understanding in sectors where local delivery is demonstrably more efficient and responsive.

If Malaysia seizes this moment, it can reshape state–federal relations into a partnership that unlocks new sources of growth, strengthens public trust, and delivers on the promise of sustainable development. For Penang, pioneering these reforms would not only secure its own fiscal resilience but also provide a model for how Malaysia can escape the middle-income trap and become a federation that truly works for all its citizens.