PENANG INSTITUTE
ISSUES
2025
08 DEC

ANALYSING PENANG, MALAYSIA AND THE REGION

Report of the Penang State-Federal Relations Select Committee 01/25

*By **YB Gooi Hsiao Loong** (Chairperson, presented in The Penang State Legislative Assembly)*

Executive Summary

- **Key Issues:** Malaysia's federal system is highly centralized, leaving states with limited powers and finances. Key state functions such as infrastructure, transport, education, health and welfare are largely administered and controlled by the federal government. The Federal Constitution's Ninth and Tenth Schedules concentrate legislative and fiscal authority at the center, giving the federal government almost all major tax sources (income tax, customs, excise, etc.) while states rely on narrow revenues like land taxes, forestry and fees. This over-centralisation has led to imbalances, states have meagre budgets, few autonomous powers, and heavily dependent on federal allocations.

- **Implications for Penang:** Over-centralisation undermines Penang's development and public service delivery. Penang's state revenue is small relative to its economic contribution. Even though Penang is a major contributor of federal tax revenues, it receives back annually in federal transfers a fraction of what it generates. The federal government collects more than 90% of the nation's total tax revenues, while the states collectively receive only around 2% of those funds back through federal transfers, a structure that underscores the extreme centralisation of Malaysia's fiscal system. Penang has struggled with under-funded mandates and federal controls even over basic local matters such as public transport which are decided far away in Putrajaya. Such constraints have resulted in delays in infrastructure projects, operating deficits, and constrained public services at the state and local level. Overall, **Penang's capacity to plan and invest for its people is stifled by the current federal–state arrangements.**

PENANG INSTITUTE CARRIES OUT RESEARCH ON PENANG. MALAYSIA AND THE REGION, FACILITATES INTELLECTUAL EXCHANGES, MAINTAINS A RESEARCH DATABANK AND DISSEMINATES RESEARCH FINDINGS TO ENRICH PUBLIC DISCOURSES. IT WAS FOUNDED IN 1997 AS SERI (SOCIO-ECONOMIC AND ENVIRONMENTAL RESEARCH INSTITUTE).

- **Recommendations:** The Select Committee calls for urgent reforms to restore the true spirit of federalism and ensure fairness for Penang and all states. Key demands include:

  (1) **A fairer fiscal deal** – a greater share of taxes collected in Penang should be returned to the state, alongside formula-based equalization transfers to poorer states (as done in Canada and Germany).

  (2) Legal and administrative devolution – amend laws and policies to devolve powers in key sectors (e.g. transportation, public works, housing, social welfare) so that Penang can manage its own development more effectively, in partnership with federal agencies.

  (3) **Enhanced state borrowing and revenue powers** – review and ease restrictive borrowing limits and allow states/local councils to raise funds (such as state bonds or a local sales tax) with proper safeguards.

  (4) **Institutional reforms** – establish a Federal–State Relations Commission to transparently negotiate powers, finances and dispute resolution, and reactivate mechanisms like the Federal-State Relations Select Committee in Parliament.

  (5) **Strengthening local governance** – restore elected local councils and empower local governments like MBPP to make decisions (e.g. in urban transport, planning) accountable to their residents. These reforms, taken together, will promote a more equitable, efficient, and collaborative federal system that benefits Penang and Malaysia as a whole.

Report of the Penang State-Federal Relations Select Committee 01/25

*By **YB Gooi Hsiao Loong** (Chairperson, presented in The Penang State Legislative Assembly)*

1. Introduction

1.1 Malaysia is a federation on paper, but in practice power and resources are highly centralized in federal hands. This report is written to address the urgent need for **principled federalism reform**, a need brought into sharp focus by Penang's push for greater autonomy and equitable treatment within the Federation. Decades of centralised control have produced structural inefficiencies and grievances, state governments have very limited revenue sources, constrained authority, and often find themselves pleading for funds or approvals from federal ministries for even routine matters. The Penang State Assembly's Select Committee on State-Federal Relations was tasked to investigate these issues and articulate reforms because the status quo is no longer sustainable for Penang's development. There is a growing consensus that empowering states will lead to better governance and outcomes. Indeed, policymakers, academics and civil society voices have rallied for a "**revival of the spirit of federalism**" – calling for a more balanced federation where **states are partners in nation-building, not mere subordinates**.

1.2 After the 2022 General Election, the new "Malaysia Madani" administration faced growing pressure from multiple states, not only Penang, but also Selangor, Johor, Sabah and Sarawak, demanding fairer fiscal treatment and greater autonomy. In June 2024, for example, the Penang government publicly urged the federal government to return 20% of tax revenue collected in Penang for the state's use. Johor quickly followed with its own demand for 30%, and Sabah and Sarawak have long asserted their 40% net revenue rights under the Malaysia Agreement 1963. These calls reflect a broader national recognition that over-centralisation is hindering regional development and straining the federal bargain.

1.3 This report, the first of a series planned, thus comes at a critical juncture. Produced by the Penang State Assembly's bipartisan Select Committee, taking into account research findings, fiscal data, comparative analyses, and input from experts, the report's goal is to propose concrete reforms that will empower Penang, and by extension other states without undermining national unity. The pages that follow examine the structural problems in the current federal–state setup (Section 4), illustrate how these problems specifically impact Penang (Section 5), and outline reforms needed (Section 6) along with recommendations for reform to the Federal Government (Section 7). We begin, in Sections 2 and 3, by briefly recounting the formation, mandate and activities of the Penang State-Federal Relations Select Committee.

2. Background of the Penang State-Federal Relations Select Committee

2.1 The Penang State-Federal Relations Select Committee was established to strengthen Penang's voice in Malaysia's federal system and to advocate institutional reforms. First formed in 2022 and reactivated by a unanimous motion of the Penang State Legislative Assembly on 22 May 2025, it is the first committee of its kind at the state level in Malaysia. The committee's creation reflects Penang's pioneering commitment to addressing federal–state imbalances through a structured, bipartisan approach.

2.2 **Mandate and Composition**: The Select Committee is a bipartisan committee comprising both government and opposition state assembly members. It is chaired by YB Gooi Hsiao Leung (State Assemblyman for Bukit Tengah). The committee's members include senior legislators from the ruling coalition – such as the Deputy Speaker (YB Azrul Mahathir Aziz) and assemblypersons for Machang Bubok (who spearheaded its reactivation), Komtar, and Seri Delima, as well as opposition representatives including the Opposition Leader (YB Muhammad Fauzi) and the assemblyman for Seberang Jaya. This multiparty composition ensures that Penang presents a united front on issues of state rights, transcending political divides. The committee's terms of reference are to examine federal policies and projects affecting Penang, scrutinize fiscal arrangements, and advocate for fairer federal-state relations. It also seeks to promote constructive cooperation with federal ministries and raise public awareness on the importance of decentralisation.

2.3 **Advisory Panel of Experts**: To support its work with research and policy guidance, the Select Committee appointed a panel of respected advisors. The expert advisory panel comprises: **Dato' Dr Ooi Kee Beng** (Executive Director, Penang Institute), **Dr Francis Loh Kok Wah** (Professor of Politics and scholar of Malaysian federalism), **Dato' Hamdan Abdul Majeed** (Managing Director, Think City), **Dato' Seri Farizan Darus** (CEO, Penang Infrastructure Corporation; former Penang State Secretary), **Dato' Seri Sr Hj Rozali bin Hj Mohamud** (former Mayor of MBSP), and **Dato' Ar. Yew Tung Seang** (former Mayor of MBPP). These advisors (from academia, policymakers along with experienced senior former officials) bring invaluable insight into the historical, legal, and economic aspects of federal–state relations. The committee's collaboration with such experts ensures that its recommendations are informed by evidence, best practices, and a broad range of perspectives.

2.4 **Stakeholder Engagements**: Since its formation, the Select Committee has conducted stakeholder engagements to gather views and evidence on reforms required to strengthen Malaysia's federal system and improve state-level governance. A notable event was the Roundtable Discussion on Federal–State Relations, jointly convened by the Select Committee and Penang Institute on 25 August 2025. The session brought together leading voices from government, academia, and policy institutions. Notable participants Dr Ooi Kee Beng (Executive Director, Penang Institute), Dr Tricia Yeoh (University of Nottingham Malaysia), Mr Stuart MacDonald (Guest researcher & Technical Director, Think City), Dato' Seri Farizan Darus (Penang Infrastructure Corporation), Mr Deisigan Shammugam (World Bank), Dato' Hamdan Abdul Majeed (Think City), Dr Francis Loh Kok Wah (Universiti Sains Malaysia), and senior representatives of the Penang State Government including YB

Dato' Zabidah Binti Safar (State Financial Officer). The roundtable, attended also by several members of the Penang State Assembly and local government heads, had deliberated on pathways toward fairer fiscal arrangements, institutional reforms, and stronger intergovernmental cooperation. The discussions have significantly informed the Committee's findings and recommendations.

3. The Penang Institute Report on "Enabling Decentralisation for Penang"

3.1 The decision to establish the Select Committee was informed in part by the Penang Institute's study in 2022, **"Enabling Decentralisation and Improving Federal–State Relations"**, which recommended creating institutional platforms to sustain long-term reform. The study was commissioned by the Penang State Government to provide an evidence-based foundation for renewed dialogue on federal–state reforms and to guide the State Assembly's subsequent decision to establish the Select Committee, against the backdrop of Penang's frustrations with over-centralisation and its limited fiscal capacity despite being one of Malaysia's most industrialised and globally connected states. The study also had a direct influence on the Select Committee's agenda and helped shape many of the proposals presented in this report. The Select Committee acknowledges Penang Institute's work as the intellectual and empirical foundation for Penang's ongoing pursuit of greater autonomy within the Malaysian federation.

4. Structural Problems of Over-Centralisation in Malaysia

4.1 Over-centralisation in Malaysia's federal system is rooted in the constitutional, fiscal, and administrative framework established since independence. The result is a legal imbalance, fiscal concentration, and administrative overreach by the centre, which collectively undermine the federation's spirit. Key structural problems include:

4.1.1 **Constitutional and Legal Centralisation**: The Federal Constitution's Ninth Schedule assigns the most significant matters to the Federal List, from education, finance, internal security, and healthcare to infrastructure and transport, while state jurisdictions are narrowly confined (e.g. land, forestry, local government). Critical public services and regulatory domains are thus centrally controlled. The result is a de facto unitary system. The abolition of elected local councils in 1965 (formalized by the Local Government Act 1976) removed a whole tier of autonomous government. In short, the legal framework provides few avenues for states to independently initiate or tailor policies for their region.

4.1.2 **Fiscal Centralisation and Imbalances:** The Constitution's Tenth Schedule grants the federal government virtually all major sources of revenue - income taxes, customs and excise duties, export/import taxes, sales and service tax, motor vehicle licenses, banking and finance licenses, etc. States are left with a short list of "residual" revenues, primarily land premiums, property rents, forestry yields, minor fees, and entertainment duties. Crucially, even natural resources such as oil and gas revenues are centralized. This division means the federal government collects about 90% of public revenues while state governments collectively raise barely 10%. Such imbalance leads to chronic vertical fiscal gaps where states must cover operating costs with limited income. All other funding (for hospitals, schools, roads, etc.) comes via federal ministries or ad hoc development allocations at Putrajaya's discretion. As a result, state budgets are structurally strained. Many states struggle to avoid operating deficits and cannot invest in development without federal approval and funding.

4.1.3 Penang's situation is illustrative whereby despite having a relatively strong economy, the state's own revenue sources are so constrained that it cannot finance large infrastructure (like mass transit) on its own. Moreover, borrowing constraints compound the problem. By law, states cannot borrow externally or issue bonds, and domestic borrowing requires federal consent. These rules, aimed at preventing subnational debt crises, nonetheless deny states the fiscal tools available in other federations (where subnational bonds finance local development). In Malaysia, a state like Penang cannot leverage future revenues to build, say, a new highway or rail line, it must depend on federal largesse or PPP models.

4.1.4 **Administrative Centralisation and Federal Dominance:** Apart from legal and fiscal frameworks, administrative practices and institutions in Malaysia reinforce central control. Malaysia's governance, shaped for over six decades by single-coalition rule, entrenched a top-down decision-making culture. Federal ministries operate state-level offices that implement national policy, for example, the Ministry of Education and Ministry of Health administer schools and hospitals through their state departments, and the Public Works Department (JKR) plans and delivers works via its state offices, often in coordination with state authorities. The civil service is largely a unified national service, and many senior state-level officers are federal secondments under federal service commissions. This has produced what observers describe as a "dual government" at the state level: a formal state administration alongside parallel federal administrative chains embedded within the state apparatus.

4.1.5 Over-centralisation is also evident in bodies meant to coordinate federal-state matters. The **National Finance Council**, for instance, is chaired by the Prime Minister to discuss state finances, but it has become largely ceremonial and **ineffective in securing a fair deal for states**. Federal dominance in such councils leaves little room for genuine negotiation. They often serve to **legitimize federal directives** rather than empower state initiatives. Similarly, the National Land Council or National Council for Local Government are dominated by federal ministers, even though these areas affect state jurisdiction. Furthermore, many federal grants and projects have been subject to political bias. In the past, opposition-led states saw development funds diverted to federally-controlled entities or delayed as a form of pressure. This undermines the **spirit of partnership** in the federation.

4.1.6 In summary, Malaysia's over-centralised system is characterized by a legal framework that favours the center, a fiscal system that starves states of funds, and administrative mechanisms that leave states subordinate. These structural issues are interlocking – limited finances constrain state capacities, while legal limits and federal oversight prevent states from expanding those capacities. The next section explores how these systemic problems have concretely affected the state of Penang, highlighting why reform is so critical from Penang's perspective.

5. How Over-Centralisation Undermines Penang

5.1 Penang, an economically vibrant but geographically small state, offers a clear case study of how over-centralisation can constrain subnational development. The state's experience over the past decades often under a different coalition than the federal government (notably 2008–2018 and 2020–2022) underscores how Malaysia's current federal–state arrangements can hamper development planning, strain state finances, and create governance challenges. Key effects on Penang includes :

5.1.1 **Fiscal Inequity and Outflow of Resources:** Penang contributes substantially to national coffers but receives only a fraction back through federal transfers, fostering a sense of injustice and under-investment. As noted in 2013, Penang's taxpayers and businesses paid about RM5.7 billion in federal taxes, yet the federal government's direct transfers to Penang (excluding capitation grant) were only RM162.7 million – a mere 2.85% of what Penang generated. This pattern persists until today, in which Penang continues to receive annually less than 3% of what Penang generates in federal taxes. In contrast, wealthier states like Selangor and Johor also face shortfalls, but poorer states often receive far more than they contribute. Consequently, Penang often **subsidises** other parts of Malaysia through the national fiscal system, albeit without a transparent, **formula-based revenue-sharing** framework, instead, the state must lobby annually for development allocations, which can be unpredictable. This vertical fiscal imbalance leaves many of Penang's development proposals under-funded. For context, Penang's development budget was about **RM326.76 million in 2023** (rising to RM374.72 million in 2024), far below the scale typically required for major infrastructure such as new public transport lines or comprehensive flood-mitigation projects envisioned under **Penang2030**.

5.1.2 **Constrained Budget and Services:** The state government's narrow revenue base (land premiums, quit rent, etc.) means Penang often struggles just to cover operating expenditures. Operating deficits have either forced austerity or delayed investments. Penang cannot introduce new taxes (e.g. a state sales tax or congestion charge) without federal approval, limiting its fiscal innovation. The state's inability to borrow freely is another choke point. Legally, Penang can only borrow from the federal government (or with federal consent), and only for development, not to cover operating costs. Even those development loans from federal sources are capped. This has meant that projects like affordable housing schemes or major roadworks can be delayed or scaled down if federal loans or guarantees aren't forthcoming. In short, Penang's fiscal autonomy is minimal and the state operates more like a local authority reliant on grants than a true subnational government with fiscal might.

5.1.3 **Underdevelopment of Critical Infrastructure:** Over-centralisation has directly delayed or derailed projects crucial to Penang's growth. In Peninsular Malaysia, urban rail and stage buses fall under federal law and the federal Land Public Transport Agency (APAD) within the Ministry of Transport, so major approvals, licensing and funding are centrally controlled. Penang's rail ambitions began with the monorail, which the federal government shelved in June 2008. A decade later, the state's LRT (Mutiara/MTP) line only obtained conditional federal approval in 2019, with federal funding and a groundbreaking following in 2023–2025. Meanwhile, buses in Penang are run by Rapid Penang, a subsidiary of Prasarana, the federal GLC. Service expansions and fare instruments (e.g., SBST, MY50/Mutiara Pass) are federal programmes, and terminals/routes require APAD licensing.

5.1.4 Large transport and infrastructure decisions beyond public transit systems are likewise federal. Expressways are regulated by LLM (Ministry of Works) and port development is overseen by the Penang Port Commission (a federal statutory body under MOT), which can lead to KL-centric decision-making that doesn't always align with state priorities. In housing and social amenities, federal agencies (e.g., PR1MA, JKR) control significant budgets and execution. In Penang, some PR1MA projects were cancelled or rationalised in recent years, while state-funded affordable housing remains constrained by state-level land and fiscal limits. The net effect is the absence of a fully empowered regional transport authority with statutory planning + operational powers, coupled with federal control of approvals, operators and funding, has contributed to slower delivery of mass public transit and other big-ticket infrastructure than local needs would warrant.

5.1.5 **Diluted Autonomy and Local Voice:** Important decisions affecting Penang are made federally with insufficient local input. For instance, Penang has no say in setting educational curricula or managing public hospitals in the state – those are centrally administered, leaving local communities unable to adapt services to Penang's unique context (such as its aging population needing more geriatric care facilities). Local government, which is closest to the people, remains unelected. Attempts by Penang (and Selangor) to lobby for restoring local council elections were blocked by federal law. This means Penangites cannot directly choose their mayors or councilors, and accountability for city-level issues is weakened. The lack of a formal federal-state dispute resolution mechanism forces Penang to resort to ad-hoc negotiations or, in extreme cases, legal action (as seen when state governments challenged federal decisions on oil royalties or water rights). Overall, Penang's ability to "shape its own destiny" is curtailed in the current setup, leading to frustration among state leaders and the public. It also fuels political frictions – any time Penang's government is of a different political coalition than the federal government, the state risks being treated unequally (as was the case from 2008–2018 and in 2020 - 2022, when Penang often alleged discrimination in fund allocations).

5.1.6 In summary, the impacts of over-centralisation on Penang are manifold. Financially, it drains resources and limits development spending. Economically, it slows critical infrastructure and growth initiatives. Politically, it marginalizes local voice and can breed center-state tensions. Despite Penang's strong economic performance and prudent governance (the state often ranks high in investment and budget management), these structural shackles prevent it from reaching its full potential. The next section outlines what reforms are needed to address these issues, drawing on successful models from other federations and proposals from experts, in order to empower Penang and improve Malaysia's federal balance.

6. What Reforms Are Needed: Lessons and Models for Decentralisation

6.1 To correct the imbalances detailed above, Malaysia needs comprehensive reforms that realign the federal–state relationship toward genuine partnership. These reforms span the legal, fiscal, and administrative domains. Penang's Select Committee, informed by comparative models and expert input, recommends a series of changes to empower states while maintaining national cohesion. Key reform areas include:

A1. Fiscal Federalism Reform – "Fair Share" for States: The core priority is to enhance state funding and revenue powers so that states have the means to fulfill their responsibilities. Malaysia can learn from federations that ensure more equitable fiscal balance:

A.2 Guaranteed Revenue Sharing: Unlike Malaysia's ad-hoc grants, some federations constitutionally allocate a share of national revenue to states. India, for example, uses a Finance Commission that regularly revises formulas – currently, 41% of net federal tax receipts are allocated to state governments on a formula basis. This gives Indian states a predictable share of income and other taxes to fund services. Malaysia should consider a similar fixed proportion or formula-based transfer of federal revenues (e.g. a percentage of income tax or GST) to all states, so that funding is more predictable and not politicized. Had such a system been in place, Penang would automatically receive funds commensurate with its population or needs, rather than the paltry 2–3% it gets currently.

A.3 Horizontal Equalisation Mechanism: A horizontal fiscal equalisation program can be introduced to reduce disparities between richer and poorer states in Malaysia. In Canada, for instance, the principle of equalisation is enshrined in the Constitution to ensure all provincial governments can provide comparable levels of public services at comparable tax rates . The federal government there provides unconditional Equalization payments to less affluent provinces, financed from general revenues. Germany likewise has the Länderfinanzausgleich system – an extensive transfer scheme where richer states and the federal center redistribute funds to poorer states to even out fiscal capacity. Malaysia could establish an Equalisation Fund under the National Finance Council that uses transparent criteria (such as population, poverty rate, cost of development indices) to top-up resources for states like Perlis, Kedah, Kelantan, Sabah, and Sarawak, while also addressing the concerns of net contributor states like Penang, Selangor, and Johor (which currently feel shortchanged). This would promote solidarity in the federation where every Malaysian citizen should enjoy a basic standard of services regardless of state, without over-burdening any single state.

A.4 Enhancing State and Local Revenues: Another reform avenue is to widen the revenue options for state and local governments. Proposals discussed by the Select Committee include, allowing states to collect a modest consumption tax or SST within the state, or to surcharge the federal income tax (as some provinces do in other countries). Additionally, giving states a greater share of existing taxes for example, sharing a fixed percentage of personal income tax or corporate tax generated in the state would incentivize local growth efforts. Australia provides a useful model - its states receive all revenue from the national Goods and Services Tax (GST) which is then redistributed based on need by the Commonwealth Grants Commission. Malaysian states could similarly receive a share of a reintroduced GST or other broad tax, distributed with an equalization formula. At the local level, empowering municipal councils to levy specific taxes (like a city congestion charge, tourism tax, or increased property rates for luxury properties) can help cities like George Town fund urban infrastructure. Of course, any new tax powers should be introduced carefully to avoid double taxation, investor flight or undue hardship to its residents – but gradual devolution of revenue authority is key to long-term fiscal sustainability for states.

A.5 Relaxation of Borrowing Constraints with Oversight: To enable major development projects, states should be allowed more flexibility to borrow for capital investments. The federal government can maintain overall macro-prudence by setting guidelines (debt limits based on state GDP or revenue, for instance) and by requiring transparency, rather than an absolute ban on external borrowing. Many federations permit subnational borrowing under rules – e.g. Canada's provinces and U.S. states issue bonds for infrastructure, and India's states can borrow within limits set by a Fiscal Responsibility law. The Select Committee advocates for lifting the prohibition on external loans and working out a framework where states with sound finances can directly access development financing (such as infrastructure bonds or development bank loans). Federal guarantee mechanisms could be put in place for poorer states. The aim is to give states like Penang the agency to invest in their future without total dependency on federal budget decisions. Importantly, improved access to funding must go hand-in-hand with stronger state-level fiscal responsibility and project appraisal capacity – which brings us to administrative and governance reforms.

B.1 Administrative and Legislative Decentralisation: Alongside fiscal changes, there must be devolution of functions and strengthening of state capacities:

B.2 Transferring Certain Functions to State/Concurrent Control: The federal and state governments should review the Ninth Schedule's Legislative Lists, and, where appropriate, use Article 76A and sectoral legislation to extend state powers or create joint authority. Areas suitable for clearer state roles or co-governance include public transport management (with federal standards and funding retained), housing and town planning (Concurrent List), social welfare (Concurrent List), and aspects of environmental management where federal and state responsibilities intersect. Healthcare (medicine and health) remains a Federal List matter unless Parliament expressly extends state powers by law. For example, Penang could be empowered by federal legislation to plan and regulate intra-city public transport (land and sea) within a national framework set and funded by the Federation. This would enable more responsive local transit solutions. Similarly, states could take on preventive healthcare and local clinics, leaving tertiary hospitals under federal care but primary care attuned to local needs. Social welfare programs like poverty alleviation or senior care might be better administered by states who know their communities – with federal funding support. These shifts would implement the principle of subsidiarity – that matters ought to be handled by the lowest level of government competent to do so. By right-sizing responsibilities, the federal government can focus on national policy and equalisation, while states innovate in service delivery.

B.3 Reviving Local Democracy: Reforms should also encompass the third tier – local government. The restoration of local council elections is a long-standing promise and would greatly improve accountability for city management. Penang has been at the forefront of this call, even attempting to hold local elections via state enactment (which was struck down due to federal law conflict). Amending the Federal Constitution or the Local Government Act to allow state governments the option to conduct municipal elections would be a historic step to devolve political power to communities. Elected mayors and councilors in Penang's MBPP and MBSP could then make decisions with a direct mandate, ensuring that local issues – from waste collection to zoning – get the attention and legitimacy they deserve. This reform is about building a culture of participatory governance from the ground up, complementing fiscal and administrative decentralisation. It is also likely to improve service delivery, as local leaders would be directly answerable to ratepayers.

B.4 Civil Service and Institutional Adjustments: The Federal Constitution recognises both the federal and state public services (Art. 132), yet many operational functions today are executed through federal services and state-level federal offices. Malaysia could consider strengthening the state public service in selected sectors or, at minimum, empowering State Secretaries and departments with greater hiring and budgeting autonomy—implemented through the legal and regulatory frameworks that govern Service Commissions (Arts. 139, 144). The long-standing practice of federal departments running state-level operations warrants review. Similarly, greater delegation from the Public Services Commission for specified junior appointments in state departments could be provided by law or regulation, building state administrative capacity so that, as functions are devolved, the State has the manpower and expertise to carry them out effectively.

C.1 New Cooperative Federalism Mechanisms: To implement and sustain the above reforms, Malaysia needs to strengthen platforms for federal-state dialogue and cooperation:

C.2 Federal-State Relations Commission: The Select Committee proposes the establishment of a permanent Federal–State Relations Commission at the national level. This independent commission would comprehensively review the workings of federalism – from legislative powers to fiscal transfers – and recommend adjustments over time. It should include representatives from all states (including opposition-led ones), federal representatives, and independent experts, to ensure balanced deliberation. Such a commission could institutionalize what has so far been an ad hoc, politically charged negotiation process. It would address long-standing state grievances, propose updates to the Federal Constitution where needed, and monitor the implementation of devolution initiatives. Crucially, it must tackle the core issues on revenue-sharing, borrowing limits, and equalising states' fiscal capacities and areas where the existing National Finance Council has fallen short. By making this commission a formal entity (possibly via an Act of Parliament), Malaysia signals that **federalism is an evolving partnership, not a static hierarchy.**

C.3 Inter-State Collaboration: States themselves should also collaborate and present united positions when appropriate. One idea arising from stakeholders engagement is an All-States Committee on Decentralisation, initiated by forward-looking states. Penang could lead by convening an informal alliance with other state governments (regardless of political affiliation) to share strategies and jointly lobby the federal government on common interests – for example, pressing for

higher federal allocations, or exchanging best practices in local governance. This “Inter-State Council” of Malaysia, so to speak, would strengthen the collective voice of the states, help build consensus for federalism reforms nationwide, and reinforce national unity by respecting diversity.
Strengthening Parliamentary Oversight: At the federal level, reviving the Parliamentary Select Committee on Federal-State Relations (which briefly existed in 2018) would provide oversight and follow-up on reform efforts. This committee, comprising MPs from all parties, could regularly call up federal ministries to account for how they engage with state governments, ensuring transparency in allocations and adherence to constitutional provisions. It would complement the work of the proposed Federal-State Commission by providing a political forum for grievances to be aired and resolved through Parliament.

6.2 The guiding philosophy behind the proposed reforms above is to **rebalance the federation**, empowering states such as Penang to manage local affairs and finances, while the **centre** focuses on redistribution, national standards, and shared national interests. When calibrated correctly, **decentralisation** delivers more responsive governance, makes states innovative and accountable, spurring healthy competition while keeping the federation strong. The next section sets out a summary of the Select Committee’s recommendations, as a roadmap for action.

7. Summary Recommendations of Select Committee

7.1 In light of the reforms required to strengthen the federation and empower states within the constitutional framework, the Select Committee on State-Federal Relations hereby presents a summary of actionable recommendations to the Penang State Government. These recommendations are put forward in the spirit of constructive dialogue and the national interest, and the Select Committee urges both the Penang State Government and the Federal Government to give them due and immediate consideration. The recommendations are as follows:

7.1(1) **Ensure Fair Fiscal Share for Penang:** Institute a just revenue-sharing arrangement whereby a significant portion of federal tax revenues originating from Penang is returned to the state. The state government has specifically called for at least 20% of the tax revenues collected in Penang to be allocated back to the state, in the form of increased grants or tax sharing. This will enable Penang to fund development projects and public services commensurate with its contribution to the nation. Additionally, it is recommended that the Federal Government publish transparent accounts of how much revenue is collected from each state and how much is spent in each state, to ensure accountability in federal allocations.

7.1(2) **Reform Federal–State Funding Formulas (Equalisation Mechanism):** Launch a comprehensive fiscal equalisation program to address the disparities among states. This should involve setting up a formula-based Equalisation Grant (or expanding the existing grant system) that takes into account states’ population, economic output, poverty levels, and development needs. The objective is to guarantee all states sufficient resources to provide basic services, while also acknowledging states like Penang that currently receive far less than their share of GDP contribution. International best practices, for example, Australia's horizontal fiscal equalisation administered by its Grants Commission and Canada's unconditional equalisation transfers — can be adapted to design a Malaysian mechanism that is entrenched in law, depoliticises state funding, and is reviewed regularly for fairness.

7.1(3) **Expand State Revenue and Borrowing Powers:** Amend laws and regulations to grant states greater financial autonomy. This should include broadening the tax base available to states, where constitutionally permissible—for example, enabling states (by federal law or constitutional amendment) to levy a modest state-level consumption/sales tax or to apply a carefully designed surcharge on selected federal taxes, with federal coordination, as well as adjusting state and local fees/levies to reflect local conditions. States should be permitted within prudent debt limits, to issue bonds or obtain development loans for infrastructure, under clear disclosure and risk-management rules. The Federal Government can facilitate this by establishing guarantee frameworks or matching-loan schemes for critical projects. Empowering states financially would reduce over-reliance on federal transfers and spur more effective, accountable local development initiatives.

7.1(4) **Devolve Key Functional Responsibilities:** Initiate a controlled decentralisation of functions from federal to state governments (and where appropriate, to local authorities). It is proposed that immediate steps be taken to devolve powers in certain sectors such as public transport, housing, education, social welfare, health promotion, aligned with federal policy. For instance, Penang should be given authority to plan and regulate urban public transport routes and infrastructure, while federal agencies provide funding support. In social welfare, the state should administer poverty alleviation programs with federal funding transfers. Education and policing, while remaining largely federal, should involve state input through federal-state joint committees. Overall, decisions impacting local populations should involve the state in line with subsidiarity, with Penang piloting these devolutions to demonstrate gains in responsiveness and efficiency.

7.1(5) **Restore Democratic Local Government:** Amend federal law to reinstate local government elections or otherwise increase local accountability. The Federal Government should amend the Local Government Act 1976 (or enact enabling federal legislation) to permit the restoration of local elections in Penang, reversing the 1965 suspension and 1976 abolition of the "third vote." Short of immediate elections, the federal and state governments should agree on reforms that enhance local autonomy (e.g., in budgeting and planning) and broaden community representation. Penang's cities, George Town (MBPP) and Seberang Perai (MBSP), deserve governance that is directly accountable to their residents. This proposal aims to strengthen grassroots democracy and improve service delivery through local empowerment.

7.1(6) **Establish a Federal–State Relations Commission:** Create a permanent, statutory Federal–State Relations Commission at the national level as an independent body to oversee and continually reform the federal system. The proposed Commission to be formed shall have equal representation from the federation and the states, with guaranteed seats for Sabah and Sarawak (including from opposition-run states), and be tasked to review issues of legislative overlaps, fiscal transfers, economic planning, and intergovernmental disputes. It should report to Parliament annually and make binding or advisory recommendations on matters like updating the tax and revenue assignments (Tenth Schedule), reviewing grants, and arbitrating disputes over jurisdiction. This Commission would fill the current institutional void and ensure that federal–state relations are managed in a **transparent, rules-based** manner rather than **ad hoc politics**, toward **predictable, evidence-led governance.**

7.1(7) **Institutionalize Cooperative Federalism Practices:** The Federal Government should strengthen structured forums for intergovernmental cooperation. This includes reactivating the Parliamentary Federal-State Relations Select Committee (set up in 2018), and convening regular conferences between the Prime Minister and the Menteris Besar/ Chief Ministers of all states with clear mandate to resolve or expedite approvals for state projects or to coordinate disaster response responsibilities. The Federal Government's support for the establishment of an Inter-State Council (drawing on India's model) on decentralisation for states to deliberate and form common positions on national policies that affect them would signal a new era of partnership.

7.1(8) **Fairness and Non-Discrimination in Federal Allocations:** The Federal Government should institutionalise the principle of non-discrimination in allocating funds and projects. Every state, regardless of which party governs it, should receive development allocations based on transparent formula-driven criteria such as population, fiscal need, service gaps, and not based on political alignment. Penang experienced periods of discriminatory treatment in the past. To prevent this, the Federal Government should publish state-by-state spending breakdowns (operating and development) on a fixed schedule, and adopt multi-year, rolling allocation envelopes (e.g., five-year ceilings and indicative annual tranches) for each state. These measures would improve planning certainty, depoliticise development spending, and uphold the principles of justice, transparency, and consistency in federal–state relations.

8. Conclusion

The recommendations above encapsulate reforms that are deemed critical for a stronger federation. They are put forward not as ultimatums, but as the basis for negotiation and policy action. The Select Committee believes that meeting these reforms will benefit not only our state but Malaysia as a whole, paving the way for more balanced growth and improved governance nationwide.

Managing Editor:
Ooi Kee Beng

Editorial Team:
Tan Lee Ooi and Nur Fitriah (designer)

PENANG INSTITUTE
making ideas work

10 Brown Road
10350 George Town
Penang, Malaysia

Tel : (604) 228 3306
Web : penanginstitute.org
Email : issues@penanginstitute.org

© Copyright is held by the author or authors of each article.

The responsibility for facts and opinions in this publication rests exclusively with the authors and their interpretations do not necessarily reflect the views or policy of the publisher or its supporters.

No part of this publication may be reproduced in any form without permission.