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Re-examining State Finances and Governance: The Challenge for Penang[1]

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Introduction

Malaysia embraces a federal system of government with a strong centre—so strong that some have dismissed it as a "flawed federation" (Holzhausen, 1974). No where is this more obvious than in the conduct of financial relations. The Centre has retained for itself all the major revenue sources, rights of undertaking expenditures and powers of borrowing. The states, on the other hand, have such limited revenue sources and borrowing powers that the system fosters a permanent dependency of the states on the Centre for development funds.

This has never been a major issue in the past because the Centre and the majority of the states have been under the control of a single political party. At any one time in the post-independence period no more than two states have been under opposition rule. And on such occasions, the Centre has not failed to use the opportunity to strike home the fact that states that vote opposition parties into power are likely to pay the price in terms of reduced and often delayed Federal fund disbursements[2]. The affected states have invariably been powerless to renegotiate the terms of disbursement because innumerable obstacles stand in their way.

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[2] See Loh (2008), for some recent examples.

In the 12th general election of 8 March 2008, the Barisan Nasional (BN) lost its two-thirds majority in parliament and control of five of the 13 states. This led to initial optimism that the old tactics of bullying a state by cutting down or delaying development allocations will no longer work. After all, the most developed states of Penang, Perak and Selangor were in opposition hands and any action that reduced economic growth in these key states would adversely affect the growth and economic performance of the national economy as a whole. Yet the early actions of the Central government do not demonstrate an appreciation of this fact; a series of measures were announced that appear to be designed to 'punish' opposition held states rather than foster joint development. For instance, the Entrepreneurial and Cooperative Development Ministry replayed a familiar tune from the past by ordering Mara, rather than the State Economic Development Corporations (SEDCs), to disburse funds for Federal projects under the Ministry (The Star, 27 April 2008). This deprived the states of revenue equivalent to 5% of the value of Federal projects implemented in the states.

Clearly, in Malaysia where a single party has controlled both federal and most state governments since independence, federal-state relations have been akin to intra-party relations. Some time will no doubt elapse before the former is recognized and treated as distinct from the latter. Until that time arrives, however, it is prudent for states such as Penang to optimize the internal resources available to it.

Levels of Government

The prevailing system of government in Malaysia is divided into three tiers: federal, state and local. In this paper, we will concern ourselves with the federal and state levels. The Federal constitution specifies the division of responsibilities with respect to expenditure, revenue-sharing and borrowing between the federal and state governments. The federal government controls a wide array of exclusive powers while shared powers are few, with federal law always taking precedence over state laws in case of inconsistencies.

While the Federation pays for federal responsibilities, the states must pay for their own responsibilities and, in the case of shared responsibilities, the Federation pays only if expenditures are related to federal commitments or state commitments undertaken in accord with federal policy and with Federal approval.

Under the constitution, the federal government enjoys exclusive powers to levy and collect all taxes and other forms of revenue except from a few minor sources assigned to the states. In fact, state revenues are limited to collections from import and excise duties on petroleum products (Terengganu, Sabah and Sarawak), export duties on timber and other forest products (for Sabah and Sarawak) and excise duties on toddy in all states. State revenues can be raised from forests, lands (quit rents, fees for TOL, grazing permits and conversion) and mines and entertainment taxes. Non-tax revenue include licenses and permits, royalties, service fees, profits from commercial undertakings (such as in water, gas, ports and harbors), land sales, rents on state properties; and non-revenue receipts include proceeds, dividends and interests and grants and reimbursements from the Federal government.

The state is only allowed to borrow from the Federal government or from a bank or other financial sources approved for that purpose by the Federal government for a period not exceeding 5 years. Furthermore, the Federal government prescribes the terms and conditions which will apply to all loans raised by the state or guaranteed by it. However, the state governments are constrained in their ability to guarantee loans. They can offer no such guarantees except with the approval of the Federal government and subject to conditions set by the latter (Ummikalsum, 1991).

Revenue, Expenditures and Deficits: An Overview

State revenue is divided into Operating and Development revenue. The former comprises largely of revenue raised within the State while the latter consists primarily of loans and grants from the Federal government to finance major development projects[3]. In a similar fashion, expenditures are classified as Operating and Development spending. Operating expenditures maintain existing infrastructure, services and facilities while development spending creates new infrastructure, services and facilities. In general, development expenditures are seen as contributing to increasing the productive capacity of the economy.

[3] It is odd that loans should be considered 'revenue'.

Table 1 shows these categories of revenue and expenditure for the 9 year period from 2000 to 2008 though the data for 2008 are only estimates. Table 2 shows the annual rates of growth of these categories between 2000 and 2004 and from 2005 to 2008[4].

Table 1: Total Revenue, Total Expenditures and the Budget Deficit, 2000-2008 (RM million)

	2000	2001	2002	2003	2004	2005	2006	2007	2008*
Operating Revenue	230.96	215.52	231.31	246.67	257.44	274.89	280.50	295.86	282.9
Development Revenue	161.01	132.34	100.13	102.54	105.8	163.22	75.43	152.28	162.53
Total Revenue	**391.97**	**347.86**	**331.44**	**349.21**	**363.24**	**438.11**	**355.93**	**448.14**	**445.43**
Operating Exp.	248.15	263.52	248.66	233.05	228.90	191.70	269.63	252.25	278.56
Development Exp.	179.58	112.55	93.84	79.99	98.42	106.04	110.67	129.39	162.53
Total Expenditure	**427.73**	**376.07**	**342.50**	**313.04**	**327.32**	**297.74**	**380.30**	**381.64**	**441.09**
Surplus/Shortfall in Operating Budget	-17.19	-48.0	-17.35	13.62	28.54	83.19	10.87	43.61	4.34
Surplus/Shortfall in Development Budget	**-18.57**	**19.79**	**6.29**	**22.55**	**7.38**	**57.18**	**-35.24**	**22.89**	**-**
Surplus/Deficit in Overall Budget	**-35.76**	**-28.21**	**-11.06**	**36.17**	**35.92**	**140.37**	**-24.37**	**66.50**	**4.34**

Sources: Report of the Auditor-General on the Accounts of the State of Penang, 1980 and 1990; Penang Financial Statement, 2001 and Penang State Budget, 2008.

Notes: * Estimated

Operating revenue grew slowly between 2000-2004, recording an annual rate of growth of only 2.8% and this declined drastically to just about 1% growth in the 2005-2008 period. The annual rate of growth of operating expenditure, on the other hand, picked up from a negative 2% between 2000-2004 to a robust 13.3% growth in the 2005-2008 period.[5] Despite the fact that operating revenue growth edged ahead of operating expenditure in the first period, deficits were evident in the operating budget in 2000, 2001 and 2002. In the later period, when operating expenditure growth

[4] All rates of growth are continuously compounded rates.

[5] Note that the Operating expenditure figures shown here will not coincide with the figures published in the Financial Reports. This is because we have subtracted from the published figures the amounts that are transferred to Development revenue each year. If these transfers are not subtracted we will be unable to derive the overall budget deficit/surplus figures shown in the table above.

outpaced operating revenue growth, net surpluses were recorded. However, if operating expenditure maintains its rapid growth vis-à-vis operating revenue, the future may well see persistent deficits emerging in the operating budget.

Table 1: Annual Growth Rates of Revenue and Expenditure (%), 2000-2008

	2000-2004	2005-2008
Operating Revenue	*2.8*	*0.96*
Development Revenue	*-10.0*	*-0.14*
Total Revenue	***-1.9***	***0.55***
Operating Expenditure	*-2.0*	*13.3*
Development Expenditure	*-14.0*	*15.3*
Total Expenditure	***-6.5***	***14.0***

Source: Computed based on Table 1

A rule-of-thumb suggests that operating revenue must at least cover operating expenditures. In the case of Penang, after three years of operating deficits (2000-2002), operating revenue has exceeded operating expenditures from 2003 onwards. Although the surplus has averaged RM30 million per year, it has varied considerably in size and is unclear whether it is on a downward trend.

Turning to the Development budget, development revenue fell in both periods though the rate of decline in the second period was considerably slower. In a similar fashion, development expenditure that was falling at an even more dramatic rate than development revenue in the first period saw a hefty 15% rate of annual growth in the second period, well ahead of development revenue growth in this period.

The development budget maintained a surplus in all years except 2000 and 2006 and is expected to be balanced in 2008. In the early period, the surpluses were generated because development expenditure growth was declining at a faster pace that the decline of development revenue growth. In the later periods, surpluses were maintained despite the fact that development expenditures were growing at a more rapid rate in the face of declining growth in development revenue. If this trend persists, the development budget of the future will accumulate deficits again.

Looking at total revenue and expenditures, both components registered negative growth rates between 2000 and 2004, with expenditures falling at a more rapid rate than revenue. This helped reign in the size of the overall budget deficit in 2001 and 2002 and contributed to the surpluses in 2003 and 2004. In the subsequent period, both registered positive rates of growth with expenditures growing more rapidly than revenue. Despite this, the overall budget showed surpluses in all years except 2006 though surpluses seem to be shrinking since then.

It is interesting to note that between 2000 and 2003, the share of development expenditure in the total was shrinking from about 50% in 2000 to 26% in 2003. Since then it has shown an overall rising trend reaching about 37% in 2008. This suggests that the State budget surpluses of later years have been achieved largely by trimming operating expenditure rather than development expenditure—a positive development.

However, the generally favourable picture of Penang's budgetary health diminishes considerably when we appreciate how vulnerable it is to fluctuations in Federal funding. To illustrate, in 2000, Federal loans amounted to RM62.8 million. Had these not been forthcoming the overall budgetary deficit of the State would have more than doubled from RM35.8 million to RM98.6 million. Similarly, estimated Federal loans for 2008 amounted to RM97 million. If not for this, the estimated surplus of RM4.34 million would have turned into a hefty deficit of RM92.7 million. This vulnerability underscores the need for the State to be more dependent on its own sources of revenue given the reality of the prevailing political situation which suggests that Federal loans may not always be so freely forthcoming.

Sources of Revenue

State revenue, as previously discussed, is divided to operating and development revenue. Operating revenue is derived primarily from State sources while development revenue comprises curiously of federal loans, federal grants and, some amount classified as 'contribution to development funds' which is a transfer from the operating budget [6].

[6] Some portion of the operating expenditure is transferred to development revenue. This has the effect of lowering operating expenditure to amounts that are lower than the published figures. The published figures for development revenue, on the other hand, already incorporate these transferred amounts.

Operating Revenue

State operating revenue can be broken down into three major categories: tax revenue, non-tax receipts, and non-revenue receipts (Table 3). Of the three, non-tax receipts accounted for the biggest share in 2008, followed by tax revenue and non-revenue receipts. Each of these is discussed in turn.

Non-tax Receipts

Non-tax receipts consists of revenue from land sale, land applications and land ownership transfers (services payments), licenses and permits, dividends and income from investments, rentals and penalties. Together they accounted for 40% of all revenue in 2008.They recorded a high 9.1% growth rate in the 1980-1990 period but slowed down to 3.2% in the second ten-year period before recovering to 5.4% per annum growth between 2000 and 2008.

Within non-tax receipts, services payments, dividends from investments and receipts from the sale of goods (land) were the most important components in 2008. They accounted for 30%, 29.4% and 25.8% of non-tax revenues, respectively (see Appendix Table 1).

The growth of revenue from services payments appears to have remained stable over the period under consideration. Most of the incomes from services payments are derived from charges to register shifts in land ownership, land application fees, pawn registration fees and miscellaneous other sources (see Appendix Table 2). Of these, the fastest growing component has been revenue from registration of land ownership changes. Sadly, the revenue from Penang Hill railway was not only small but has also stagnated between 2000 and 2008.

Table 3: Sources of Operating Revenue, 1980-2008

(RM Million)

	1980	1990	2000	2008*	*Growth 1980-90*	*Growth 1990-00*	*Growth 1980-00*	*Growth 2000-08*
Tax Revenue	**11.49**	**35.05**	**87.97**	**107.42**	***11.8***	***9.6***	***10.7***	***2.5***
Direct taxes	11.49	-	83.26	101.92			*10.4*	*2.6*
Indirect taxes	-	-	4.71	5.5			-	*2.0*
Non-Tax Receipts	**22.78**	**54.47**	**74.32**	**113.6**	***9.1***	***3.2***	***6.1***	***5.4***
Licences & permits	1.84	-	8.67	9.01			*8.1*	*0.5*
Services payments	2.1	-	14.9	34.05			*10.3*	*10.9*
Receipts from goods sold	9.27	-	25.88	29.31			*5.3*	*1.6*
Rentals	2.12	-	2.5	3.23			*0.8*	*3.3*
Dividends & Investments	6.98	-	19.38	33.41			*5.2*	*7.0*
Penalties& punishment	0.46	-	2.98	4.58			*9.8*	*5.5*
Non-revenue Receipts	**22.87**	**45.84**	**68.67**	**61.88**	***7.2***	***4.1***	***5.7***	***-1.3***
Returned expenditure	2.62	-	0.42	0.07			*-8.7*	*-20.1*
Receipts from Fed. Govt. agencies	20.25	-	68.25	61.82			*6.3*	*-1.2*
Total revenue	**57.14**	**135.36**	**230.96**	**282.9**	***9.0***	***5.5***	***7.2***	***2.6***

Sources: Appendix Table 1

Notes: * Estimated

The growth of returns from investments and dividends, on the other hand, has risen from 5.2% over the 20 year period (1980-2000) to 7.0% between 2000 and 2008. Dividends accrue largely from interest from fixed deposits and investments including dividend income from shares held in Telekom, Malaysian Airports Berhad and the Water Authority (PBA). (See Appendix Table 3.)

In sharp contrast to returns from investments, the growth of receipts from goods sold has dipped sharply from 5.3% between 1980 and 2000 to just 1.6% between 2000 and 2008 as has its share in total revenue from 16% to 10% (see Appendix Table 3). Income in this category consists largely of land premiums for ownership distribution and shifts in stipulation of land use. It is disconcerting that revenue from land sales, the only significant state resource, is dwindling both in terms of growth and its contribution to operating revenue. This suggests an urgent need to re-look at how this resource is being managed.

Tax Revenue

Tax revenue consists of two main items – quit rent and entertainment duties (indirect taxes) - that accounted for about 38% of all revenue in 2008. Tax revenue sources open to the State are few; as noted previously the Federal government has reserved for itself most of the lucrative sources of taxation. The only sources of tax revenue for the State are quit rents charged on land and entertainment levies.

The per annum growth of tax revenue appears to be slowing down rapidly— from 11.8% between 1980-90 to 9.6% between 1990-2000 and a mere 2.5% between 2000-2008. Consequently, although the share of tax receipts in total revenue recorded increases for 1980, 1990 and 2000, it has remained constant (at around 38%) for 2008 (Appendix Table 1). Even this was made possible only through the collection of arrears in the payment of quit rents.

Penang's tax base is narrower than those of resource-rich states like Sabah, Sarawak and Selangor where taxes on natural resources generate substantial state revenues. Given that land is limited in Penang and that the publicly held land bank is only around 12% of total land, the State is likely to face a serious shortfall in tax receipts in future years if serious attention is not paid to how land is managed.

Entertainment taxes contributed little to operating revenue and came largely via the cinemas in the State (Appendix Table 1)

Non-revenue Receipts

Non-revenue receipts consist largely of grants from the Federal government. These grants fall into three basic categories: tax sharing grants, general purpose grants and specific purpose grants. The first category refers to taxes imposed and collected by the Federal government with the receipts being returned back to the States in a specified proportion based on the origin of collection. These grants were important when export duties were imposed on tin, iron and other mineral ores. The structure, rate and proportion of sharing are determined by the Federal government though the States are free to spend their allocations without restrictions. Such grants are not relevant to Penang.

General purpose grants are given to states based on provisions in the Federal Constitution or by a formula determined by the Federal government. These include the capitation grant based on the state population, the revenue growth grant, state reserve fund grants and special grants (to Sabah, Sarawak, Selangor and Kedah only).

Finally, specific purpose grants are tied to a specific purpose such as the road grants, economic development grants, cost reimbursement grants, service charge grants and grants for religious schools and institutions.

In Penang, non-revenue receipts— more specifically, grants and other receipts from the Federal government, that accounted for the biggest chunk of the state's operating revenue in the past appears to be on the decline. For example, in 1980 it accounted for 40% of total revenue but by 2008 its share had declined to a mere 22% (Appendix Table 1).

Between 1980-90, non-revenue receipts grew strongly at 7.2% per year but slowed down to 4.1% over the succeeding 10 years before registering a negative 1.3% rate of growth between 2000-08. The main grants and receipts from the Federal government are detailed in Appendix Table 4. While per capita grants and grants for operating expenses have increased about 1.7 times and 1.6 times, respectively, between 2000 and 2008, no road grants are anticipated.

Clearly, Penang was not receiving big grants from the Federal government even when it was under Barisan control. This is evident from the fact that well before 2008 (when the State fell into opposition hands), federal funds as a proportion of operating revenue had been on the decline—from 35.4% in 1980 to 29.6% in 2000. Of course, it fell further to a mere 21.9% with the Opposition takeover of Penang in 2008 (Appendix Table 1).

The contribution of Federal funds to the State's revenues is likely to fall further in the immediate future. First, while Federal government payments to MPPP and MPSP were channeled through the State in 2000, the amounts allocated for both were not only reduced but were paid by by-passing the State in 2008. This explains the drastic reduction in funds in the ‘Others” category from RM18.1 million in 2000 to just RM2.0 million in 2008 (see Appendix Table 4).

Another component of receipts from Federal agencies is the ‘service charge for Federal projects’. This refers to the 5% charge levied on Federal projects implemented in Penang using State personnel. Although receipts from this source was projected to increase from RM7.31 million to RM10 million between 2000 and 2008, it is likely to fall in the future. This is because a familiar mechanism used by the Federal government to deny opposition-held states of vital funds is to channel the implementation and monitoring of Federal projects in the state through Federal agencies. This tactic deprives the states of the receipts from the 5% service levy chargeable on Federal projects. This was evident in the case of Sabah and Kelantan –when the former fell to the opposition PBS party and the latter was controlled by PAS. While grants to these states, guaranteed under the Federal constitution, were given directly to the state governments, development funds allocated under the Sixth Malaysia Plan (1991-95) were redirected through the Federal government-controlled Federal Development Offices that were set up in these states to administer the funds (Loh, 2009).

Development Revenue

The share of Development revenue in total revenue fell from 41.4% in 2000 to 38.5% in 2008. The main sources of development revenue are evident from Table 4.

The main source of development revenue was Federal loans; it is therefore a gross misnomer to call it ‘revenue’! The loans went to the Water Authority and financed the Jelutong Expressway. It accounted for 60% of all development ‘revenue’ in 2008, up from the 39% share in 2000. Federal grants for development, on the other hand, accounted for only 8% of development funds although this was a larger share relative to the 2000 figure.

Table 4: Sources of Development Revenue

Sources of Estimated Income	2000 (RM million)	%	2008* (RM million)	%	*Growth 2000-08 (%)*
Federal loans to Penang Water Authority and for building of expressway	62.70	38.9	97.00	59.7	*5.6*
Returned loans	7.42	4.6	-	-	-
Monthly installment from the selling of low-price houses	7.89	4.9	5.10	3.1	*-5.3*
Lease receipts (rental paid by PBA)	-	-	7.60	4.7	-
Contribution from consolidated state funds	72.50	45.0	-	-	-
Contribution to development funds (transferred from operating expenditure)	-	-	40.00	24.6	-
Sale of low-cost houses	1.78	1.1	-	-	
Federal grants based on economic development, infrastructure and security of life stage (capitation grants from federal government)	8.72	5.4	12.83	7.9	*4.9*
Total of Estimated Income	**161.01**	**100.0**	**162.53**	**100.0**	***-0.12***

Sources: Penang State Financial Statement, 2001 and Penang State Budget, 2008.

Note: *Estimate

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State revenue sources accounted for only RM52.7 million (or 32%) of development funds in 2008. Of this, one quarter (or RM40 million) was in effect transferred from the operating budget. Thus, Federal loans (rather than grants) and funds reassigned from the operating budget financed most of the State development in 2008.

The Nature of Expenditures

As indicated previously, expenditures can be divided into operating and development expenditures. While the former supports existing goods and services the latter creates new goods and services.

Operating Expenditure

Three components took up the bulk operating expenditures in 2008: fixed contributions, charges and payments, emoluments and supplies and services. Each of these is discussed in turn.

Fixed Contributions, Charges and Payments

This component accounted for nearly 40% of operating expenditures in 2008 despite the fact that it recorded a negative rate of growth between 2000 and 2008 (Table 5). It had used up 65% of operating spending in 2000.

A detailed examination of the spending reveals that the 81% of the expenditure was undertaken by the State Treasury department and disbursed as state grants (see Appendix Table 6). Of the RM86.2 million set aside under state grants, RM40 million represents the transfer made to development revenue. The rest was made up of assessment payments to MPPP and MPSP for state buildings, medical expenses for existing and retired state officers and so forth.

Another 17% was disbursed as state grants by the Chief Minister's office and this includes payments made to the state museum, Penang library, Majlis Sukan Negeri and similar entities.

Table 5: Operating Expenditure (RM million)

	1990	2000	2008*	*Growth 1990-2000 (%)*	*Growth 2000-2008 (%)*	*Share of Total in 2008(%)*
Emoluments (corresponding to higher salary for civil servants)	31.87	50.47	115.88	*4.7*	*10.9*	*36.4*
Supplies and services (management, rentals, transportation and trips, office rentals, utility cost, post and raw materials)	19.35	32.87	68.65	*5.4*	*9.6*	*21.6*
Asset acquisitions (equipments and appliances for government departments)	1.17	2.60	2.02	*8.3*	*-3.1*	*0.6*
Fixed contributions and charges/payments (state debt, gifts, annual contributions to local authorities, other contributions and assistance)	54.06	161.52	126.92	*11.6*	*-3.0*	*39.8*
Other expenditures (refunding)	0.91	0.68	5.09	*-2.9*	*28.6*	*1.6*
Total	**107.36**	**248.14**	**318.56**	***8.7***	***3.2***	***100.0***

Sources: Appendix Table 5

Note: *Estimate

Emoluments

Emoluments took up about 36% of the Operating expenditure in 2008 relative to the 20% in 2000. The annual rate of growth of emoluments increased from nearly 5% between 1990 and 2000 to about 11% in the 2000-2008 period. The nation wide reorganization of departments and the creation of additional posts in 2008 and salary revisions account for this rapid expansion. The offices involved in the expansion are the Chief Minister's Office and Secretariat, the five district and land offices and the State religious department (see Appendix Table 7). The salary bill more than doubled in the Chief Minister's Office and Secretariat, each of the five district and land offices and the State religious department. The bill in the State Mufti's office saw an over four-fold increase.

However, the biggest chunk of emoluments in 2008 (62.4%) was paid out by four departments: the Chief Minister's Office and Secretariat, the Public Works

Department, the State Treasury and the State Agriculture Department. The comparable share in 2000 was 59%.

Supplies and Services

Expenditures on supplies and services took up 22% of operating spending in 2008, substantially higher than the 13% share in 2000. It also recorded an almost 10% growth rate per annum between 2000 and 2008. Details on these expenditures are shown in Appendix Table 8.

The Chief Minister' Office and Secretariat incurred 48% of all spending in this category in 2008 and payments for 'professional services' constituted the bulk of the spending. A large part of these payments are allocations for programmes of the various committees established under each executive council member. The size of this item ballooned more than two-and-a-half times relative to the 2000 figure.

The Irrigation and Drainage Department accounted for another 16% of the payments with much of it going towards maintenance works. The payment for 'professional services" in the State Treasury also saw a spectacular seven-fold increase between 2000 and 2008 and represents largely expenditures on training and upgrading courses for staff. In contrast, the maintenance bill for Public Works actually declined by some RM0.76 million between the two periods.

Development Expenditure

Table 6 gives the details of development spending by the various Departments in the State.

Table 6 Development Expenditure by Departments

Department/Office	2000		2008*	
	RM million	%	RM million	%
State Agriculture Department	1.64	0.9	4.00	2.5
State Forestry Department	0.80	0.4	3.00	1.8
State Department of Veterinary Services	1.10	0.6	2.00	1.2
Penang State Chief Minister's Officeand Secretariat	111.46	62.1	117.90	72.5
Penang Botanical Gardens	0.70	0.4	1.00	0.6
Public Works Department of Penang	35.08	19.5	10.00	6.2
State Religious Department	5.01	2.8	5.00	3.1
State Department of Irrigation and Drainage	10.00	5.6	10.00	6.2
State Treasury Department	13.80	7.7	9.63	5.9
Total Development Expenditure	**179.59**	**100.0**	**162.53**	**100.0**

Sources: Penang State Budget, 2000 and 2008.

Note: *Estimate

The biggest expenditure appears under the State Chief Minister's Office and Secretariat; about 73% of development spending occurred via this Office in 2008. This is explained by the fact that development expenditure is financed either by using State revenue directly or through Federal loans. For instance, out of RM 117.90 million spending estimated in 2008, the RM97 million, financed through Federal loans, were credited to the State Chief Minister's Office and Secretariat for disbursement to the relevant projects departments. Thus, all State agencies have to borrow through the State Chief Minister's Office and Secretariat. Furthermore, spending on land acquisitions to build committee halls, roads and the like, financed through State revenues, also appear under the e Chief Minister's Office and Secretariat.

To illustrate, in 2008, RM90 million was allocated to the Water Authority, RM14 million went towards land acquisition to build the Jelutong Expressway and other projects and RM3.74 million was spent on low cost housing.

Apart from the above, most development spending took the form of public works and financing Drainage and Irrigation.

It is sad to note that the development allocation for the Botanical Gardens – an important attraction in eco-tourism— was small (RM0.7 million) in 2000 and increased by only RM0.3 million in 2008

Summary and Policy Recommendations

State finance is constrained by the asymmetry of power between state and federal governments in Malaysia, with the latter controlling most revenue sources. Despite the fact that the state managed to maintain small surpluses in most years since 1980, the fact remains that Federal government funding, either by way of grants or loans, has been one of the important sources of funding.. While in the past this over dependence on the Centre might not have been an issue, a Penang ruled by an opposition party can no longer feel as secure as it has been before. The Federal government has a history of using the availability of Federal funds as an instrument of pressuring opposition-held states; it is therefore prudent for the State to become as self-reliant as possible by maximizing States sources of receipts and decreasing unnecessary expenditures or leakages. In the longer-run, in concert with other opposition-held states, it should also seek a review of the Federal-state financial arrangements that reduces the present dependency on the Centre.

On the revenue side, of the three major sources– tax revenue, non-tax revenue and non-receipts revenue (mainly federal loans and grants)—tax revenue, as percentage of total revenue, has almost doubled from 20% in 1980 to 38% in 2000, and thereafter stayed constant at 38% in 2008. Non tax-revenue has hovered at about 40% between 1980 and 2008. Most significantly, non-revenue receipts has almost halved from 40% to 22% in the same period. This percentage is likely to further decrease with the State falling to an opposition party and the reduction of the 5% service fee received by State from the Federal government as the latter starts to use more Federal (rather than State) agencies to implement development projects in Penang.

Quit rent forms the largest component of tax revenue; there has been no major revision of the rates over the past decade and the substantial increase in revenue from this source noted for 2008 was the result of better collection of arrears. As quit rents are a major revenue source, the rates should be regularly reviewed to keep pace with inflation or rise in property prices. It is noteworthy that the rate of growth of receipts from quit rents was 2.6% per annum, between 2000 and 2008, considerably lower than the 4.3% growth of the Penang House Price Index (PHPI) during the comparable period[7]. There is therefore considerable scope and justification for judicious increases in the quit rent rates. Given the mounting arrears, the efficiency of collection of quit rents should also be reviewed.

The second largest source of revenue is non-tax revenue, the major component being service payments, followed by receipts from land sales and income from dividends and investments. Income from service payments is made up primarily of payment for land ownership transfer.

One potential source of revenue is for the State to consider appropriating a substantial, if not the entire proportion, of the increase in land value upon its conversion from one use to another. To illustrate, assume that an owner of a piece of land that is gazetted for agricultural use applies for the land to be converted to housing or commercial use. Upon the conversion being approved, the value per square foot of the land will increase substantially without any additional effort on the part of the owner. Presently, this increase is entirely appropriated the owner. It is suggested that the State appropriates this increase in value (or a substantial part of it). A similar principle should apply for reclaimed land as well.

The State should also consider introducing a property transfer charge on a sliding scale such that properties that are held for shorter periods are taxed at higher rates; this would be a source of revenue and also discourage excessive speculation in property investments that normally result in property asset bubble.

[7] PHPI data were obtained from SERI.

The second important source of non-tax revenue is receipts from land sale. The Penang State government owns only about 12% of total land in the state. Past practices of conversion of lease hold land into free hold land have been less than desirable and have deprived the State of an important source of revenue. This administration must give serious thought on how to manage this revenue source more effectively. In particular, it should review the policy of conversion of leasehold to freehold land. (Please see Appendix A)

The third crucial source of non-tax revenue is income from dividends and investments, much of this derived from interest on fixed deposits and investment income from PBA and other privatized entities. The State treasury should review its investment portfolio to consider partial investments in government bonds and securities based on its cash flow needs to enhance yields. Performance of State corporations like the PBA and others should be monitored regularly with a view towards improving their returns.

Finally, as noted previously, receipts from Federal government agencies have been declining. In the longer term, the State, in co-operation with other opposition held states, must seek to change the existing Federal-State arrangements that allow them access to so very few sources of self-funding. Some renegotiation of the revenue-sharing arrangements becomes imperative. While this may have been unimaginable previously, with four[8] opposition states working in concert towards a common objective, now may be the most opportune moment to attempt this.

Renegotiating tax sharing arrangements is an area that has been suggested before but has remained fruitless because of the poor bargaining power of just one or two opposition-held states (Umikalsum1991). With five states (and Sabah possibly throwing its indirect support to any change that will grant it more control over state resources), it is worth revisiting this suggestion. The idea is to extend the current revenue sharing mechanism with respect to mineral resource taxes (which benefits only mineral rich states) to taxes on income and sales. Such an arrangement will ensure all states get a share of the taxes raised in their respective jurisdictions and,

[8] At the time of writing the position of Perak is unclear.

more importantly, the revenue obtained will have a direct relationship with the level of economic activity in the respective states.

Another area that can be revisited is the basis on which grants are given. For example, the size of the capitation grant is determined by population size while the revenue growth grants are based on population and the GDP. A more meaningful method of giving grants should take into account the tax base of the state; states limited revenue bases should receive higher transfers from the Centre (Abdul Rahim, 2000; Wilson and Sulaiman, 1997).

Turning to expenditures, it has been rising at a faster rate than revenue especially between 2005 and 2008. The largest percentage rise is in supply of services expenditure which went from 18% of total operating expenditure in 1990 to 22% in 2008. It was growing at about 7.3% per annum, much faster than the inflation rate. In particular, attention should be focused on why professional services in the Chief Minister's office (22%) and State Treasury office (8%) are high, and the category of minor maintenance in Department of Irrigation and Drainage (12%) and the Chief Minister's office (9%) are also high. The State should begin to set yearly operational targets to control or reduce this category of expenditure and appoint appropriate state organizations, possibly with participation of independent public individuals or organizations, to monitor this process. The introduction of competitive and open bidding by this administration is a step in the right direction.

Fixed contributions and charges at 50% of total operating expenditure in 1990 form the largest category; though it has declined percentage wise from 65% in 2000 to about 40% in 2008.

Emoluments form the second largest category of operating expenditure; it has fluctuated between 30% of total operating expenditure in 1990 down to 20.3% in 2000 and rising again to 36% in 2008. Emoluments have risen on average at a rate of 11% between 2000 and 2008. The departments with the highest emolument expenses are the Chief Minister and Secretariat Office (22%), Public Works Departmenet (21%) and State Department of Irrigation and Drainage (11%).

Development expenditure should be regarded as investments for generating future income. In 2008, $97 million or 60% of development revenue were federal loans for PBA and highway expenses, $53 million (33%) from state sources and the remaining $13 million were federal grants. Seventy three per cent (73%) of development expenditure was absorbed by the Chief Minister's office. The other 3 departments with substantial development expenditures are the Drainage and Irrigation, Public Works Department and the State Treasury, with each absorbing 6% of total development expenditure.

The office with the lowest development expenditure is the Penang Botanical Garden with a paltry $1 million (0.6%) of total development expenditure. The Botanical Garden and the Penang Hill are among the jewels of eco-tourism spots in the state. Since eco-tourism is crucial to Penang's economy, serious considerations and planning must be given to develop and upgrade these two sites to become star attractions for both tourists and local residents. Substantial improvements and sustained maintenance of these facilities can be followed by modest charges so that they not only become self-sustaining but generate a small surplus to the State coffers. (Please see Appendix B.)

This paper is an initial attempt to examine state finance with the objective of enhancing state financial capacity. It is recommended that the Penang State government make publicly and easily available, through print and website, audited financial data in order to make its finances transparent and also to encourage more research and suggestions from the public.

To conclude, the message is very clear: the State needs to trim wasteful expenditure, maximize collections from existing revenue sources, look for new sources of revenue, and plug leakages in spending.

Appendix Table 1: Sources of State Revenue, 1980-2008

Revenue	***1980***		***1990***		***2000***		***2008****	
	RM million	%	RM million	%	RM million	%	RM million	%
Tax Revenue	**11.49**	**20.11**	**35.05**	**25.89**	**87.97**	**38.10**	**107.42**	**37.97**
Direct Taxes (quit rent)	11.49	20.11	-	-	83.26	36.00	101.92	36.03
Indirect Taxes (entertainment duties)	-	-	-	-	4.71	2.00	5.5	1.94
Non-Tax Receipts	**22.78**	**39.87**	**54.47**	**40.24**	**74.32**	**32.20**	**113.6**	**40.16**
Licenses and Permits (alcohol manufacturers, pawn shops, import and export of fauna, production of stone materials, Water Enactment, public entertainment)	1.84	3.22	-	-	8.67	3.80	9.01	3.18
Services Payment (Land application, land ownership transfer)	2.1	3.68	-	-	14.9	6.50	34.05	12.04
Receipts from Goods Sold (land premium for ownership distribution, shifting in stipulation)	9.27	16.22	-	-	25.88	11.20	29.31	10.36
Rentals (government furniture, houses and buildings)	2.12	3.71	-	-	2.5	1.10	3.23	1.14
Dividends and Investments (interest from fixed deposit)	6.98	12.22	-	-	19.38	8.40	33.41	11.81
Penalties and Punishment (notice and penalty for late land taxes, breaking of contracts)	0.46	0.81	-	-	2.98	1.30	4.58	1.62
Non-Revenue Receipts	**22.87**	**40.02**	**45.84**	**33.87**	**68.67**	**29.70**	**61.88**	**21.87**
Returned Expenditure (refund from previous year surplus expenses)	2.62	4.59	-	-	0.42	0.20	0.07	0.02
Receipts from Government Agencies (receipts from federal government, road grants & population grants)	20.25	35.44	-	-	68.25	29.60	61.82	21.85
Total Revenue	**57.14**	**100.0**	**135.36**	**100.0**	**230.96**	**100.0**	**282.9**	**100.0**

Sources: Report of the Auditor-General on the Accounts of the State of Penang, 1980 and 1990;

Penang Financial Statement, 2001 and Penang State Budget, 2008.

Note: *2008 data are estimates

Appendix Table 2: Components of Services Payments

	2000		2008*	
	RM million		**RM million**	
Land application	2.54	17.0	5.00	14.7
Preparation & registration of land grants	1.31	8.8	2.25	6.6
Registration of shifting the land ownership	3.99	26.8	13.00	38.2
Pawn registration	1.60	10.7	3.97	11.7
Caveat registration	-	-	2.70	7.9
Penang Hill railway fare	2.11	14.2	2.00	5.9
Others	3.35	22.5	5.13	15.1
Total Services Payment	**14.90**	**100.0**	**34.05**	**100.0**

Sources: Penang Financial Statement, 2001 and Penang State Budget, 2008.

Note: *2008 data are estimates

Appendix Table 3: Components of Dividends and Receipts from Investments

	2000		2008*	
	RM million	**%**	**RM million**	**%**
Dividends from shares in listed companies	-	-	10.50	31.4
Interest from money balance in the bank-Current account	0.34	1.8	0.50	1.5
Interest from fixed deposit	12.76	65.8	22.00	65.8
Interest and receipts from loans	5.41	27.9	-	-
Others	0.87	4.5	0.41	1.2
Total Dividend and Receipts from Investment	**19.38**	**100.0**	**33.41**	**100.0**

Sources: Penang Financial Statement, 2001 and Penang State Budget, 2008.

Note: *2008 data are estimates

Appendix Table 4: Components of Receipts from Government Agencies

	2000		2008*	
	RM million	**%**	**RM million**	**%**
Grants based on population	13.63	20.0	22.60	36.6
Grants for State roads	18.62	27.3	-	-
Service charge for Federal projects	7.31	10.7	10.00	16.2
Additional revenues	3.72	5.5	16.18	26.2
Grants for Operating expenses	6.83	10.0	11.00	17.8
Others	18.14	26.6	2.04	3.3
Total Receipts from Government Agencies	**68.25**	**100.0**	**61.82**	**100.0**

Sources: Penang Financial Statement, 2001 and Penang State Budget, 2008.

Note: *2008 data are estimates

Appendix Table 5: Components of Operating Expenditure, 1990-2008

	1990		**2000**		**2008***	
	RM million	**%**	**RM million**	**%**	**RM million**	**%**
Emoluments (corresponding to higher salary for civil servants)	31.87	29.7	50.47	20.3	115.88	36.4
Supply and services (management, rentals, transportation and trips, office rentals, utility cost, post and raw materials)	19.35	18.0	32.87	13.2	68.65	21.6
Asset acquisition (equipments and appliances for government departments)	1.17	1.1	2.60	1.0	2.02	0.6
Fixed contributions and charges/payments (state debt, gifts, surrenders to state government, annual contribution to local authorities, other contribution and assistances)	54.06	50.4	161.52	65.1	126.92	39.8
Other expenditures (refunds)	0.91	0.8	0.68	0.3	5.09	1.6
Total Operating Expenditure	**107.36**	**100.0**	**248.14**	**100.0%**	**318.56**	**100.0**

Sources: Report of the Auditor-General on the Accounts of the State of Penang, 1990; Penang Financial Statement, 2001 and Penang State Budget, 2008.

Note: * 2008 data are estimates

Appendix Table 6: Components of Fixed Contribution and Charges/Payments

	2000		2008*	
	RM million	%	RM million	%
Penang State Chief Minister and Secretariat Office (general administrative: in-state contribution)	**23.81**	**14.7**	**21.63**	**17.0**
Scholarship, donation and study loan	0.86	0.5	0.90	0.7
State grants	22.95	14.2	20.65	16.3
Rewards	-	-	0.09	0.1
State Treasury Department (management: in-state contribution)	**135.93**	**84.2**	**102.48**	**80.8**
State grants,	111.79	69.2	86.15	67.9
Insurance claim and compensation	0.004	0.002	3.00	2.4
Dividends, interest and other State debts (Low cost houses, PBA projects)	19.30	11.9	5.25	4.1
Pension to Governor and DUN members	3.01	1.9	4.64	3.7
Rewards	1.83	1.1	3.44	2.7
State Welfare Department (outside services: in-state contribution)	**1.78**	**1.1**	**2.78**	**2.2**
State grants	1.78	1.1	2.78	2.2
Total Expenditure	**161.52**	**100**	**126.89**	**100**

Sources: Penang Financial Statement, 2001 and Penang State Budget, 2008.

Note: *2008 data are estimates

Appendix Table 7: Components of Emoluments Expenditure by Departments

Department/Office	2000		2008*	
	RM million	%	RM million	%
Penang State Chief Minister and Secretariat Office	11.99	23.8	24.89	21.5
Public Works Department of Penang	11.01	21.8	24.48	21.1
State Department of Irrigation and Drainage	4.89	9.7	12.46	10.8
State Treasury Department	2.06	4.1	10.41	9.0
State Agriculture Department	2.69	5.3	5.31	4.6
State Religious Department	1.91	3.8	4.31	3.7
District and Land Office of North Seberang Perai	1.55	3.1	3.58	3.1
District and Land Office of Central Seberang Perai	1.64	3.3	3.46	3.0
District and Land Office of South West	1.31	2.6	3.07	2.7
District and Land Office of South Seberang Perai	1.26	2.5	2.74	2.4
District and Land Office of North East	1.26	2.5	2.67	2.3
Office of Land and Mines	2.09	4.1	3.28	2.8
State Syariah Court	0.91	1.8	3.06	2.6
State Department of Veterinary Services	1.30	2.6	2.80	2.4
State Department of Town and Country Planning	0.86	1.7	2.33	2.0
Penang Botanical Gardens	1.07	2.1	2.22	1.9
State Forestry Department	0.89	1.8	1.62	1.4
State Welfare Department	0.62	1.2	1.19	1.0
State Mufti Office	0.22	0.4	0.94	0.8
His Excellency The Head of State Penang Office	0.39	0.8	0.74	0.6
Toddy Department	0.28	0.6	-	-
Water Supply Department	0.24	0.5	0.28	0.2
Total Emoluments Expenditure	**50.44**	**100.0**	**115.84**	**100.0**

Sources: Report of the Auditor-General on the Accounts of the State of Penang, 1990; Penang Financial Statement, 2001 and Penang State Budget, 2008.

Note: * 2008 data are estimates

Appendix Table 8: Components of Supplies and Services

Department/Office	2000		2008*	
	RM million	%	RM million	%
Penang State Chief Minister and Secretariat Office (general administrative: in-state contribution)	**15.43**	**46.9%**	**32.69**	**47.6**
Professional services and others	5.65	17.2	14.75	21.5
Travelling and lodging	1.39	4.2	2.47	3.6
Communication and utility	1.74	5.3	3.25	4.7
Rentals	1.05	3.2	3.96	5.8
Minor maintenance	4.41	13.4	6.45	9.4
Others	1.19	3.6	1.81	2.6
State Department of Irrigation and Drainage	**6.16**	**18.7**	**11.00**	**16.0**
Professional services and others	0.06	0.2	0.34	0.5
Travelling and lodging	0.13	0.4	0.27	0.4
Communication and utility	0.75	2.3	1.41	2.1
Rentals	0.16	0.5	0.48	0.7
Minor maintenance	4.66	14.2	8.04	11.7
Others	0.40	1.2	0.46	0.7
Public Works Department of Penang	**3.96**	**12.0**	**4.05**	**5.9**
Professional services and others	0.31	0.9	0.50	0.7
Travelling and lodging	0.23	0.7	0.34	0.5
Communication and utility	0.36	1.1	0.60	0.9
Rentals	0.002	0.0	0.08	0.1
Minor maintenance	2.71	8.2	1.95	2.8
Others	0.35	1.1	0.58	0.8
State Treasury Department	**1.15**	**3.5**	**6.20**	**9.0**
Professional services and others	0.77	2.3	5.62	8.2
Travelling and lodging	0.06	0.2	0.16	0.2
Communication and utility	0.03	0.1	0.08	0.1
Rentals	-	-	0.02	0.0
Minor maintenance	0.20	0.6	0.11	0.2
Others	0.09	0.3	0.21	0.3
Other Departments	**6.17**	**18.8**	**14.71**	**21.4%**
Total Expenditure	**32.87**	**100%**	**68.65**	**100**

Sources: Penang Financial Statement, 2001 and Penang State Budget, 2008.

Note: * 2008 data are estimates

Appendix A

Ideas on Enhancing Revenue from Proper Management of State Land

As the analysis shows, revenue from land sale forms about 10% of State revenue, with another 12% from land application and land ownership transfers. Hence a judicious management of land matters can enhance this important source of revenue.

The State should enact and implement new and transparent policies for land management.

We suggest the following ideas for discussion and consideration.

1) When agricultural or recreational land is converted to development land, the value of the land immediately rises with the benefit going to the land-owner, without any contribution on his/her part. The State can enact a policy whereby the rise in land value from conversion reverts to the State as is practiced in some countries. This will form a huge source of revenue for the State. As a rough illustration, one acre of agricultural land in the Tanjong Bunga area converted to development land could yield $8.7 million (assuming $200 psf x 43,560 sq ft). One hundred acres of such conversion would yield $870 million - equivalent to 3 years present State budget. Private individuals and developers should base the viability of their projects on such market rates rather than from windfall gains.

2) All land reclamation should be carried out by the State and the benefits accrue to the State. In the past, the Penang State has lost billions of dollars of revenue by allowing private companies or individuals to benefit from land reclamation and conversion of reclaimed land to freehold land. This practice should be terminated. There are legal opinions to support that reclaimed land cannot be converted into freehold land

3) Presently there are numerous bungalows and buildings in Penang Hill that are not properly maintained and therefore have violated the conditions of the leases. The State should take action to repossess these buildings and re-develop them into recreational bungalows in line with a proper master plan to develop Penang Hill into an eco-friendly and sustainable site that can generate revenue for the State and for the enjoyment of its citizens and tourists.

4) The State should seriously reconsider its policies of converting leasehold land into free hold land when the lease expires. By keeping its leasehold status, the State can benefit from revenue and also keep the cost of land from escalating.

Appendix B – Proposal to Improve Penang Botanical Garden

The Penang Botanical Garden and the Penang Hill, pristine, luxuriant tropical jungles in the island are the jewels in the Pearl of the Orient (if this term can still be justifiably used). However, their state of neglect is obvious to any casual observer. This is also reflected in the development budget allocated to the Botanical Garden – a paltry $1 million for 2008.

We propose the following measures to develop the Botanical Garden to one that is worthy of its status.

1) Set up an advisory committee consisting of highly qualified professionals with experience to provide vision, direction, guidance, and assistance to the staff of the Botanical Garden to re-develop the Garden. (The Singapore Botanical Garden can be an example to consider.) This committee can also include some representative users to provide feedback and input on policies.

2) The State to increase the budget for the Garden and to upgrade staff skills.

3) Upgrade the Garden incrementally. Begin by selecting one or two sites to develop and beautify, e.g., an orchid garden, or a cacti greenhouse, or a Japanese garden. Invest maximum effort to develop it. Once the first site is successfully completed, move on to the next.

4) Raise public funds by appealing to the citizens of Penang for donations – big and small. For example, propose to philanthropists to sponsor individual sites in the Garden that can be named after that philanthropist. E.g. XX Lee Rose Garden, YY Yap Japanese Garden etc.

5) For smaller donations, any one giving more than say $5,000 (as an example), can have his/her name in a plaque in the Garden. The State can consider match- funding smaller donations.

6) Once people see visible progress, the State can consider charging modest entrance fees for local users (this can be fine tuned with discount for regular users, children and elders) and higher fees for foreign tourists. We believe people are willing to pay for quality services and facilities. This serves as a source of revenue for the State.

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