IJAPS, Vol. 22, No. 2, 1–18, 2026

# FISCAL FEDERALISM AND STATE FINANCIAL AUTONOMY: A DEPENDENCY THEORY ANALYSIS OF FEDERAL-STATE RELATIONS IN SABAH, MALAYSIA

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**Published online:** 28 August 2026

**To cite this article:** Jasni, N. S. S. and Dollah, R. 2026. Fiscal federalism and state financial autonomy: A dependency theory analysis of federal-state relations in Sabah, Malaysia. *International Journal of Asia Pacific Studies* 22 (2): 1–18. https://doi.org/10.21315/ijaps2026.22.2.1

**To link to this article:** https://doi.org/10.21315/ijaps2026.22.2.1

## ABSTRACT

*This study analyses the influence of fiscal federalism on Sabah's financial autonomy within Malaysia's federal framework, using dependency theory as a perspective. The study examines how Malaysia's centralised fiscal structure establishes a core-periphery dynamic that diminishes Sabah's financial autonomy and developmental prospects. Despite constitutional guarantees under the Malaysia Agreement 1963 (MA63), Sabah struggles to generate revenue and manage its resources. This is especially true when it comes to oil revenues, as it receives only 5% of Malaysia's total oil production despite contributing about 25% of the country's output. The research examines three key facets: Sabah's historical integration into Malaysia, the duties of MA63, and the development of intergovernmental budgetary arrangements. The research illustrates how structural dependencies sustain Sabah's fiscal limitations through comparative analysis with other federal systems and the application of dependency theory. This study advocates for extensive reforms, encompassing: the renegotiation of revenue-sharing formulae, augmentation of state-level taxing authority, implementation of transparent equalisation methods, and the establishment of independent fiscal commissions. These ideas seek to disrupt the cycle of dependency and create a fairer budgetary relationship between federal and state governments that honours the essence of MA63 and fosters sustainable development in Sabah.*

**Keywords:** Fiscal federalism, dependency theory, Sabah fiscal autonomy, Malaysia Agreement 1963, resource revenue sharing

## INTRODUCTION

The term fiscal federalism refers to the distribution of fiscal functions, expenditure tasks, and revenue-raising avenues across various tiers of government in a federal political system (Oates 1972; Bird 2000; Boadway and Shah 2009). It is based on the notion that public services and economic policies are best devised and provided at the government level closest to the citizenry, thus maximising allocative efficiency and contributing to better accountability. Another critical principle codified in fiscal federalism, decentralisation argues that if authority is transferred to subnational governments, they will be more responsive to local demands, create innovations in policy design and mitigate some of the top-heavy bureaucratic inefficiencies (Rodden et al. 2003; Shah 2007). However, to the extent that actual fiscal powers are concentrated at the top levels of government, subnational units, including states or provinces, face significant restrictions, which create disharmony between local concerns and the policy tools at their disposal to remedy them (Bird and Tarasov 2004).

Federalism is a form of political organisation in which a central authority and several semi-autonomous regional entities such as states, provinces, or regions share power. The government's duties administratively protect each of these entities (Elazar 1987; Hueglin and Fenna 2006; Watts 2008). A written constitution outlines the allocation of legislative, executive, and financial authority and functions under a functional federal system (Shah 2007; Bird and Vaillancourt 2006). Despite the praise for federalism for breaking down diversity into manageable units, permitting local autonomy and fostering policy innovation through horizontal competition and experimentation, the success of any federal design hinges on the nature of intergovernmental fiscal relations (Boadway and Watts 2004; Rodden and Wibbels 2010).

One crucial component of fiscal federalism is the distribution of taxing and spending authority. Subnational governments have the authority to impose taxes in decentralised or devolved systems and they keep a sizeable portion of the proceeds, which enables them to create policies that better suit regional preferences and systemic peculiarities (Oates 1972; Bird 2000). Centralised fiscal regimes, on the other hand, have a federal government that controls the majority of the revenue streams, including corporate taxes, income taxes, and resource revenues. It lessens subnational governments' fiscal autonomy, which could affect their ability to provide public services, be politically accountable and be economically efficient (Rodden et al. 2003; Boadway and Shah 2009; Calitz and Essop 2014).

Sabah, one of the East Malaysian states, provides a unique case study on the topic of federalism in practice, which rarely matches federalism in principle. This illustrates how Malaysia's concentration of fiscal powers has impeded Sabah's economic growth and weakened its capacity to effectively address regional development requirements (Dollah et al. 2018; Yeoh 2019). This tension has its origin in early history. Throughout the period of its transformation from a British protectorate to a Malaysian state, Sabah has gone through several administrative changes of differing degrees, each with the promise of greater autonomy and improved economic prospects (Baharuddin 2018). These ambitions were officially acknowledged during the formation of Malaysia.

The formation of Malaysia resulted from a meticulously orchestrated legal and political procedure. On 9 July 1963, delegates convened in London to endorse the Malaysia Agreement 1963 (MA63), a seminal treaty that would alter the political dynamics of Southeast Asia (Great Britain et al. 1963). This agreement established the groundwork for forming a new federation by uniting four territories which are Malaya (now referred to as Peninsular Malaysia), Singapore, Sabah, and Sarawak. The MA63 initiated several significant legal modifications (Great Britain, Federation of Malaya, North Borneo, Sarawak, Singapore, and United Kingdom of Great Britain and Northern Ireland 1963). The Federation of Malaya required the implementation of new legislation to accommodate the future states, as the United Kingdom prepared to cede its colonial governance over these regions. The concerted legal actions resulted in the official formation of the Federation of Malaysia on 16 September 1963 (Baharuddin 2018; Abdullah 2024; Yeoh 2024).

Comprehending the distinctive status of Sabah and Sarawak was pivotal to the accord. The MA63 granted these states unique constitutional safeguards, acknowledging their specific attributes and requirements. These safeguards encompassed several essential domains which are the financial independence via specific grants and assurances, regulation of immigration, maintenance of official languages, and management of religious affairs (Great Britain, Federation of Malaya, North Borneo, Sarawak, Singapore, and United Kingdom of Great Britain and Northern Ireland 1963). The financial provisions were notably important, since they facilitated the maintenance of economic independence for these less developed republics while engaging in the larger federation (Abdullah and Mulia 2018; Baharuddin 2018). Upon Singapore's separation from Malaysia in 1965, Sabah and Sarawak continued to be part of the federation, mostly because of these constitutional assurances (Baharuddin 2018).

Samad (2024) in *Revisiting the Social Contract: The Malaysia-Borneo Perspectives* critiques the narrow framing of MA63 as only a legal instrument, arguing instead that it embodies an unfulfilled social contract between Sabah, Sarawak, and the federation. His analysis highlights that fiscal inequities are intertwined with broader questions of identity, representation, and trust in federal institutions, which earlier studies have largely overlooked. This perspective underscores that resolving fiscal dependency requires not only institutional reforms but also a rethinking of the social and political narratives underpinning Malaysian federalism. This shift in perspective highlights the need for more in-depth analysis of the political economy of federal-state relations, which remains underexplored in previous literature.

The meticulous attention to their distinct identities, geographical contexts, and developmental requirements under the MA63's stipulations facilitated their sustained involvement in the federal union (Baharuddin 2018). However, the centralisation of significant fiscal tools like corporate tax, income tax, and petroleum revenue has weakened Sabah's financial independence over decades (*Jesselton Times* 2024). Despite the oil and gas industry's significant contribution to the Malaysian economy, Sabah, a relatively large state compared to other Malaysian states, only receives a small share of the profits from this sector (*Jesselton Times* 2024).

According to the Commissioner of Law Revision, Malaysia (2006), in the Petroleum Development Act 1974 (PDA), it permits the discovery and extraction of petroleum by a company called Petronas. This transpired as a response to the Sabah State's decision to confer upon Petronas ownership, rights, powers, liberties, and exclusive privileges to oversee the management of consumption and development activities pertaining to petroleum and its derivatives. Section 4 of the PDA states:

> In return for ownership and rights, powers, freedoms and privileges conferred under this Act, the Corporation shall remit cash payments as mutually agreed upon by the relevant parties, the Federal Government, and any State Government. (The Commissioner of Law Revision, Malaysia 2006)

Based on the PDA, the Sabah State Government therefore on 14 June 1976 under the leadership of Harris Salleh had signed an agreement with the federal government and made an oil deal with Petronas (*Daily Express* 2014). Upon this, it is agreed that the Sabah State Government stipulates a 5% payment to the state government contingent upon the discovery of petroleum in state waters. This 5% of petroleum revenue is almost insignificant as Sabah is one of Malaysia's highest oil producers, accounting to 25% (Sabah Oil and Gas n.d.).

The insufficiency of the 5% royalty rate is a critical concern, since many in Sabah contend that it does not adequately represent the state's substantial contribution to the nation's petroleum wealth (Zawawi 2023). This fact notes that the centralisation of fiscal authority in Malaysia seriously impairs state autonomy and Sabah's excessive reliance on federal funds underscores the fiscal imbalance of power in Malaysia's federal system and how this impacts states' autonomy in establishing local policies. Apart from that, low oil royalties keep making Sabah's financial problems worse. The federal government makes most of the decisions on resource extraction and revenue distribution (Padlee and Yaakop 2024).

The federal government's absolute administrative authority clearly aids in policy implementation and the acquisition of oil revenues; yet it results in disparity in the distribution of oil income to state governments (Brosio 2003). Moreover, state leaders' persistent demands for greater control over resource management and a larger share of oil and gas revenue have led to political conflicts (Ismail and Yusoff 2022; Abdullah 2025). The 5% oil royalty payment from the federal government faced opposition from various political parties in Sabah, with calls for increased oil revenue particularly pronounced during general elections, such as the 1990 election when Joseph Pairin Kitingan advocated for a 50% oil royalty (Jomo and Chong 2002).

Oates' (1972) theory of fiscal federalism advocates for granting subnational governments the authority to make fiscal decisions. This allows for policies that are more suited to local requirements, which benefits the general welfare. Increased resource efficiency, greater responsiveness to local preferences and greater innovation in the delivery of public services are all potential benefits of fiscal decentralisation. But in Sabah, these potential advantages are still a long way off. Despite Sabah's potential for economic growth, it remains structurally dependent on federal funds and transfers. Such reliance necessitates a more thorough examination of the political economy and power dynamics underlying both non-formalised and constitutionally codified activities (Institute for Democracy and Economic Affairs [IDEAS] 2022; Yeoh 2024).

Recent empirical analyses (Ismail and Yusoff 2022; Jody and Yusoff 2023) demonstrate that anti-federal sentiment in Sabah is deeply rooted in perceived fiscal injustice and unfulfilled constitutional promises, suggesting that legalistic solutions alone have limited efficacy. These findings highlight the need to examine how regional discontent translates into electoral and political pressures at the federal level. Similarly, the Sabah 2020 state election (Welsh et al. 2021) shows how local political mobilisation and coalition strategies have increased Sabah's leverage in national politics, challenging assumptions of passive dependency. These works underscore that Malaysia's federalism is not static but shaped by ongoing negotiation and conflict. This highlights the need for a deeper exploration of how political mobilisation is transforming the nature of fiscal federalism in Malaysia.

In comparative terms, Croissant (2022) argues that Malaysia's competitive authoritarian context constrains meaningful institutional reforms, helping to explain why federal–state relations remain heavily centralised despite decades of criticism. Meanwhile, Yeoh (2024) observes that recent political instability and the emergence of the "Madani" agenda have created pressures on the federal government to revisit state–federal fiscal relations, opening windows of opportunity for reform that have been underexplored in prior literature.

Utilising dependency theory as the theoretical framework, this study seeks to analyse how fiscal federalism in Malaysia undermines Sabah's fiscal autonomy. Applying dependency theory to the Malaysian context, the underlying argument is that the country's centralised fiscal system, despite rhetorical gestures about decentralisation and regional inclusiveness, establishes the conditions that a core-periphery framework anticipates. This study also elaborates on structural constraints in Sabah by analysing three aspects: the history of Sabah's inclusion in Malaysia, the obligations encapsulated in MA63, and the development of intergovernmental fiscal arrangements since the formation of Malaysia. The discussion will then turn to possible reforms, from legal amendments in revenue-sharing formulas to enhanced capacity-building efforts at the state level, which could strengthen Sabah's fiscal independence and break the shackles of dependency.

This study addresses these gaps by integrating institutional, political, and comparative insights to offer a more grounded analysis of Sabah's fiscal dependency and reform prospects, informed by empirical realities rather than normative assumptions. While the literature has highlighted the legal, fiscal, and political dimensions of Sabah's dependency, this study adopts dependency theory as its central analytical framework to interpret these dynamics within a broader core–periphery paradigm, as discussed in the following section.

## METHODS

This study adopts a qualitative, conceptual approach, using dependency theory as the primary analytical framework to examine Sabah's fiscal dependency within Malaysia's centralised federal system. The research focuses on historical, constitutional, and institutional factors that sustain this dependency, with particular emphasis on fiscal arrangements, legal constraints, and governance structures.

The comparative analysis includes a study of fiscal federalism in Canada, Australia, and Nigeria, three federations with resource-rich regions that have formalised fiscal arrangements. These cases were selected based on their resource-based economies and established intergovernmental fiscal frameworks, which provide valuable insights for reforming Malaysia's fiscal system. The comparative approach draws lessons on how other federations manage fiscal equity and autonomy, with the aim of suggesting potential reforms for Sabah's fiscal governance.

The study is based on secondary data sources, including constitutional provisions, federal budgets, auditor-general reports, and public finance statistics. These materials provide a comprehensive view of the historical evolution of fiscal federalism in Malaysia and its impact on Sabah's autonomy. The analysis also incorporates scholarly literature on fiscal federalism and dependency theory, drawing from both classical and contemporary sources.

Given the conceptual nature of this study, primary data collection through interviews or fieldwork is outside the scope of the study. The comparative component is illustrative, focusing on key aspects such as resource-sharing models, fiscal autonomy indicators and governance structures in the selected federations. By comparing Malaysia's situation with these international examples, the study seeks to identify best practices and offer actionable recommendations for strengthening Sabah's fiscal autonomy.

## Dependency Theory

Dependency theory emerged in the mid-twentieth century as a critique of modernisation theories that posited path-dependent routes to development. Developed by Latin American intellectuals and sociologists such as Andre Gunder Frank, Fernando Henrique Cardoso, and Enzo Faletto, dependency theory argues that economic relations between core and peripheral regions are structurally imbalanced (Frank 1967; Dos Santos 1970; Cardoso and Faletto 1979). The "core" refers to industrialised, wealthy countries, while the "periphery" consists of poorer nations that provide primary resources and serve as markets for industrial goods. This core-periphery dynamic involves the transfer of value from the periphery to the core, where peripheral regions depend on the export of primary commodities at lower prices while importing manufactured goods at higher prices, resulting in an "unequal exchange" (Frank 1967; Leiss 1977; Sylla 2014).

This imbalance limits the autonomy and development potential of peripheral regions, with policies often designed to prioritise the core's interests. Initially aimed at explaining international relations, dependency theory has been adapted to analyse the relationship between regions within a single country, where a central power acts as the core and peripheral regions, like Sabah, serve as the periphery (Brenner 2004; Swyngedouw 2004). These peripheral regions often depend on central transfers, have policies imposed by the core or lack the fiscal tools to escape underdevelopment. Dependency theory challenges the assumption of equal prosperity within a unified system, revealing systemic barriers that create long-lasting dependency justified under the guise of national unity (Dos Santos 1970; Cardoso and Faletto 1979). Despite its enduring analytical appeal, dependency theory has faced significant critiques over the decades. Scholars such as Namkoong (1999) and Özekin (2020) argue that the theory's core assumptions are overly deterministic, often presenting peripheral regions as structurally trapped in conditions of underdevelopment with little room for institutional or political agency.

Wallerstein (2004) similarly noted that while dependency theory provided an important challenge to modernisation orthodoxy, it struggled to generate testable hypotheses or adapt to new global configurations. More recent contributions by Kvangraven (2021) suggest dependency theory remains relevant but needs to integrate empirical complexity, acknowledging that peripheries can sometimes negotiate better terms. Meanwhile, scholars like Hillman et al. (2009) and Ghosh (2019) highlight alternative approaches, such as resource dependence theory, which emphasises the strategic autonomy and contingent nature of power in asymmetrical relationships.

These critiques highlight the limitations of dependency theory but also reinforce its value when applied with greater nuance. As Amsden (2003) argues, rather than discarding the theory, it must be revised with sharper analytical tools and empirical depth. In Sabah's case, dependency theory provides a useful framework to understand the imbalances in Malaysia's federal-state fiscal arrangements, particularly the centralisation of resource revenues and the constraints on Sabah's fiscal agency.

Nonetheless, this study does not assume that Sabah is permanently trapped in dependency. Instead, it recognises both structural constraints and potential avenues for reform, such as renegotiation, institutional redesign, and coalition-building. Engaging with these critiques, this study uses dependency theory as a heuristic device, highlighting asymmetries in power while remaining open to alternative frameworks.

## A Conceptual Link Between Dependency Theory and Fiscal Federalism

At first glance, dependency theory and fiscal federalism may appear unrelated. Fiscal federalism focuses on the allocation of taxing and spending responsibilities across levels of government to promote economic efficiency and public well-being (Oates 1972; Bird 2000). However, the two frameworks intersect when analysing fiscal systems in which the central government controls significant revenue sources such as petroleum rents, corporate taxes, and income taxes while states, like Sabah, rely heavily on intergovernmental transfers (Rodden et al. 2003; Bird and Vaillancourt 2006; Boadway and Shah 2009).

In principle, fiscal federalism seeks to reduce regional inequalities by ensuring an equitable distribution of resources (Hepp and von Hagen 2012). However, when the central government controls most fiscal resources, it can entrench subnational dependency and limit the autonomy of regional governments. Dependency Theory explains how this centralisation limits fiscal independence in peripheral regions like Sabah, which contributes significantly to the national economy but receives a disproportionate share of revenues. This situation mirrors the concept of unequal exchange in dependency theory, where peripheral regions supply resources yet receive only limited returns (Padlee and Yaakop 2024).

Additionally, legal and constitutional barriers prevent Sabah from renegotiating fiscal terms and attempts to address these inequities often encounter political resistance. This institutional rigidity reinforces dependency, particularly when state revenues are influenced by federal elections or changing national priorities. Moreover, oil price volatility exacerbates fiscal uncertainty, as Sabah lacks stabilising mechanisms or direct control over its revenue streams.

Although dependency theory has faced critiques for its determinism, it remains valuable in explaining how institutional structures, particularly in federal systems can either reinforce or alleviate dependency. In Sabah's case, the intersection of legal constraints and fiscal discretion underscores that reform depends not only on theoretical feasibility but on institutional design. For example, the creation of independent fiscal commissions or transparent revenue-sharing frameworks could help address these fiscal imbalances and empower Sabah to take more control over its fiscal affairs.

To further enrich this analysis, fiscal bargaining theories provide insights into how Sabah's political mobilisation can influence fiscal negotiations with the federal government. Fiscal bargaining theories examine how subnational governments negotiate with central authorities to secure more favourable fiscal terms (Herianti et al. 2024; Koranyi 2025). In Sabah's case, this could involve political leaders leveraging public support and building coalitions to negotiate a higher share of oil revenues or more control over resources. The calls for higher oil royalties in past political campaigns highlight how political leverage can shift fiscal negotiations, even in the face of asymmetric power dynamics (Jomo and Chong 2002).

Institutionalist perspectives also deepen the analysis by examining how legal frameworks and institutional practices shape fiscal relations. In Sabah's case, the PDA and MA63 centralise control over oil revenues, preventing Sabah from renegotiating fiscal terms. Institutional theory suggests that reform such as establishing independent fiscal bodies or improving transparency in revenue-sharing could help Sabah regain fiscal autonomy and participate more actively in negotiations with the federal government.

By integrating dependency theory with fiscal federalism, this analysis positions Sabah's fiscal subordination within a broader institutional context. It demonstrates how federal fiscal design through both legal structures and discretionary practices, perpetuates uneven development and undermines subnational financial autonomy. Moreover, incorporating fiscal bargaining theories and institutionalist perspectives enriches the understanding of Sabah's fiscal situation by emphasising the roles of negotiation, institutional reform, and political agency in overcoming fiscal imbalances. Together, these frameworks offer a multi-dimensional view of how Sabah's fiscal dependency could be addressed through political leverage and institutional change.

## Fiscal Federalism Impact on Sabah's Autonomy

In theory, a well-designed fiscal federal system should empower subnational governments to manage their affairs effectively. This includes the ability to generate revenue, set spending priorities, and customise development policies to meet local needs. When properly implemented, fiscal federalism offers benefits such as higher efficiency, improved public services, and responsive governance (Oates 1999; Shah 2007; Boadway and Shah 2009).

However, in Malaysia, the concentration of fiscal power at the federal level has prevented these benefits from being fully realised. A key issue for Sabah is its lack of significant own-source revenue, with taxation powers under the state's control remaining minimal (Rosly 2006). Instead, Sabah heavily relies on federal transfers, including capital grants, road grants, and specific-purpose transfers (IDEAS 2022; Yeoh 2024). Although these transfers alleviate some fiscal pressures, they are unstable, politically contingent, and subject to disruption.

A centralised fiscal system has tangible consequences for Sabah's ability to address local developmental challenges. For instance, in 2022, only 78% of rural households in Sabah had reliable access to electricity, compared to 99% in Peninsular Malaysia (Department of Statistics Malaysia 2022; *Forever Sabah* n.d). Similarly, Sabah's poverty rate was 19.4% in 2022, the highest in Malaysia, compared to the national average of 6.2% (Department of Statistics Malaysia 2022).

Additionally, multidimensional poverty indicators reveal that nearly one in four Sabahan households experience deprivations beyond income, including poor access to health, education, and infrastructure (Economic Planning Unit 2024). These disparities highlight the urgent need for targeted, autonomous fiscal policies that are aligned with local development priorities (Wangkiat 2022). Nevertheless, federal allocations continue to prioritise politically strategic constituencies and national mega projects in Peninsular Malaysia (Fong 2024), leading to a misalignment with Sabah's actual development needs.

This misalignment is exacerbated by bureaucratic inefficiencies. The Auditor-General's Report (National Audit Department of Malaysia 2024) noted that over MYR1.2 billion of federal development funds allocated to Sabah went unspent in 2023 due to procedural bottlenecks, overlapping jurisdictions and delayed approvals. Such inefficiencies not only damage the credibility of the federal government but also hinder infrastructure development and undermine public trust (Santos 2023).

Although federal development allocations to Sabah rose incrementally from MYR5.16 billion in 2022 to MYR6.70 billion in 2025 (in Sabah and Malaysia Budget Speeches, Sabah State Government 2022, 2023, 2024, 2025; *The Star* 2024), they remain modest compared to Sabah's contributions to national revenues. Moreover, these amounts are insufficient to resolve deep-seated inequalities. In comparison, Sabah's own state budgets grew from MYR4.596 billion in 2022 to MYR6.421 billion in 2025 (in Sabah Budget Speeches, Sabah State Government 2022, 2023, 2024, 2025), signalling efforts to assert fiscal autonomy despite structural constraints. However, as summarised in Table 1, federal allocations have consistently remained higher than state-controlled spending, underscoring Sabah's continued fiscal dependency.

Table 1: Sabah state budget and federal development allocations, 2022–2025

| Year | Sabah state budget (state-controlled) | Federal allocation in Sabah (federal-controlled) |
|---|---|---|
| 2022 | MYR4.596 billion | MYR5.16 billion |
| 2023 | MYR5.138 billion | MYR6.50 billion |
| 2024 | MYR5.701 billion | MYR6.60 billion |
| 2025 | MYR6.421 billion | MYR6.70 billion |

*Sources:* Sabah State Government (2022, 2023, 2024, 2025).

The failure to implement the 40% revenue entitlement promised under MA63 further illustrates this fiscal imbalance. According to Article 112C and Part IV of the Tenth Schedule of the Federal Constitution, Sabah is entitled to at least 40% of net federal revenue collected from the state (Constitution of Malaysia 1957; Sabah State Attorney General's Chambers 2012). Despite this guarantee, federal reviews of this entitlement, which are mandated every five years, have not been conducted since 1974, a situation the Sabah Law Society (SLS) refers to as the "lost years" (*Nabalu News* 2024; Yatim 2024).

In 2022, SLS initiated legal proceedings against the federal government, contesting the gazetted grant of MYR125.6 million as unconstitutional and seeking a judicial review to restore Sabah's fiscal rights under MA63 (Yatim 2024). Although the federal government committed to finalising the 40% formula by July 2024 (Lee 2023), scepticism remains due to the long history of delays.

These fiscal dynamics exemplify the core–periphery relationship described in dependency theory, with the federal government (the core) retaining control over resources and dictating development trajectories, while Sabah (the periphery) remains economically and politically subordinate. To address this imbalance, higher allocations alone are insufficient; systemic reforms to Malaysia's fiscal governance are required. The implementation of constitutional guarantees, such as those outlined in MA63, is crucial to restoring Sabah's fiscal autonomy and ensuring that the state can address its development challenges effectively.

## A STUDY IN CONTRAST OF OTHER FEDERATIONS

The comparative experiences of Canada, Australia, and Nigeria illustrate different institutional responses to fiscal dependency, offering useful contrasts to Malaysia's case. Canada and Australia are two federations that have contended with resource-rich provinces and states but have had more transparent and consistent revenue-sharing agreements and robust equalisation programmes. Alberta in Canada and Western Australia in Australia have both had strong negotiation hands and steady flows of revenue from natural resources, which have afforded them greater fiscal autonomy and opportunities to invest in long-term planning (Searle 2007).

Nigeria, a federation that, like Malaysia, has significant petroleum wealth provides a closer analogy to Sabah, as its petroleum-producing states are dependent on federal allocations of petroleum revenue which have led to political conflict and charges of unfairness. However, even in Nigeria, the constitution lays out a formula for petroleum revenue sharing and petroleum-producing states have negotiated increases in their shares over time. None of these examples are perfect, but they suggest that negotiation and constitutional change can disrupt dependency (Elebiju 2024).

The cases indicate that although resource-rich states such as Sabah often navigate a maze of subnational-state negotiations, transparency, constitutional stability, and fair dispute resolution mechanisms can diminish dependency and facilitate more equitable outcomes. In Malaysia, achieving similar goals would likely necessitate political leadership, competent bureaucracy, and a fresh examination of the country's foundational accords and how they have been interpreted.

Canada's equalisation model is constitutionally enshrined under Section 36(2) of the Constitution Act, 1982, ensuring all provinces can deliver comparable public services at similar taxation levels (Government of Canada 2024). The programme, recalculated every five years, uses objective indicators of fiscal capacity and is overseen by the Department of Finance (Library of Parliament 2025). Boadway and Watts (2004) emphasise that this predictability removes political discretion from intergovernmental transfers.

Béland et al. (2017) note that while the equalisation programme has been a cornerstone of Canadian fiscal federalism, it has also faced political contestation particularly from provinces like Alberta, which perceive themselves as net contributors. Nevertheless, its institutionalisation, transparency, and legal foundation have helped maintain its overall legitimacy and functionality across partisan and regional divides. Even Alberta, a resource-rich province, continues to operate within the framework, highlighting how constitutionalised equalisation can preserve long-term intergovernmental consensus (Dougherty and Nebrada 2023). The presence of formula-based distribution, embedded in constitutional guarantees, stands in stark contrast to Malaysia's ad hoc fiscal transfers to Sabah.

Australia's system is administered by the Commonwealth Grants Commission (CGC), an independent statutory body responsible for allocating Goods and Services Tax (GST) revenue based on states' fiscal capacity (CGC 2024). The CGC publishes detailed methodology reviews and data annually, upholding its technocratic and apolitical mandate (CGC 2025). Fenwick and Stewart (2025) analyses Australia's shift from full to partial equalisation, driven by Western Australia's challenge and observe that the CGC's institutional design allows for adjustments like the 2018 GST "floor" while maintaining equalisation principles.

The CGC's research paper further confirms that Australia's model is among the most structured and transparent fiscal equalisation systems globally (CGC 2022). Mechanisms such as constitutionally independent, data-driven, and publicly accountable commissions enable the federation to sustain horizontal equity without sacrificing state autonomy. Malaysia, by contrast, lacks comparable institutional architecture to mediate state allocations impartially, leaving Sabah's fiscal position reliant on federal discretion.

Nigeria's 13% derivation principle is constitutionally guaranteed under Section 162(2) of its 1999 Constitution, ensuring petroleum-producing states receive a defined share of resource revenues (Revenue Mobilisation, Allocation and Fiscal Commission [RMAFC] 2024). Administered by the RMAFC, this arrangement was intended to reduce regional grievances and bolster fiscal equity. Suberu (2001) identifies the derivation principle as an important instrument that empowered marginalised states like Bayelsa to gain financial leverage within Nigeria's centralised federation. More recently, Dauda et al. (2023) demonstrate that while oil revenues have had a positive short-term effect on Nigeria's economic growth, their over-dependence has undermined long-term sustainability, reinforcing vulnerabilities among subnational units.

This finding supports dependency theory's claim that unbalanced resource control leads to chronic structural reliance unless embedded in robust, transparent institutions. Unlike Nigeria, Malaysia has yet to institutionalise comparable derivation-based fiscal mechanisms for Sabah, leaving it without fixed entitlements or transparent distribution rules. The comparative features of these federations are summarised in Table 2, which highlights Malaysia's structural deficiencies in embedding equalisation and fiscal autonomy.

Table 2: Comparative features of fiscal federalism in Canada, Australia, Nigeria, and Malaysia

| Feature/ Mechanism | Canada | Australia | Nigeria | Malaysia |
|---|---|---|---|---|
| Legal basis | Section 36(2) of Constitution Act, 1982 | Statute-based CGC system | Section 162(2), 1999 Constitution | MA63; Limited statutory implementation and ambiguous enforceability |
| Equalisation mechanism | Constitutionally mandated; Objective formula | GST-based horizontal equalisation via CGC | 13% derivation for oil-producing states | None; Ad hoc, discretionary transfers |
| Administrative body | Federal Department of Finance | CGC | RMAFC | Ministry of Finance; Prime Minister's Department |
| Transparency and predictability | High; 5-year recalculations; Cross-party support | High; Annual methodology review, public reporting | Improving; Digital tracking, statutory formula | Low; Politicised, lacks formula or independent oversight |

(*continued on next page*)

Table 2: (*continued*)

| Feature/ Mechanism | Canada | Australia | Nigeria | Malaysia |
|---|---|---|---|---|
| Resource-rich state outcomes | Alberta supports equalisation while retaining autonomy | WA benefits from post-2018 GST floor | Rivers and Bayelsa negotiated increased shares | Sabah receives 5% royalty; 40% entitlement unfulfilled |
| Dispute resolution | Legal and institutionalised mechanisms | Administrative and technocratic resolution via CGC | Legal and federal commissions involved | Politically negotiated, often unresolved or delayed; No impartial adjudicatory mechanism |

*Sources:* Suberu (2001); Searle (2007); Béland et al. (2017); Dauda et al. (2023); Organisation for Economic Co-operation and Development (2023); CGC (2024); RMAFC (2024); Library of Parliament (2025).

As shown in Table 2, Malaysia's system, by comparison, lacks all the critical elements present in the other models. Sabah's 5% oil royalty and its 40% net-revenue entitlement under MA63 remain subject to federal discretion and litigation rather than protected by statute or independent oversight. Unlike Canada's constitution, Australia's grants commission or Nigeria's derivation clause, Malaysia offers no formulaic, enforceable equalisation programme or fiscal commission to protect state autonomy. This comparative deficiency is not merely administrative, but structural and its absence transforms fiscal federalism into an arena of political negotiation, subject to elite bargaining rather than institutional norms, an ideal terrain for dependency to persist, as predicted by dependency theory.

Collectively, these three federations show that the reversal of fiscal dependency does not occur through rhetoric or one-off negotiations, but through the entrenchment of rights-based, legally codified, and transparently administered fiscal governance structures. To achieve fiscal autonomy, Sabah needs more than mere federal promises; it needs rule-bound mechanisms enforced by independent institutions.

## PROPOSED REFORMS AND POSSIBLE WAYS FORWARD TO IMPROVE SABAH'S FISCAL AUTONOMY

To address the cycle of dependency and shift towards a more balanced fiscal federal system in Malaysia, structural and institutional reforms are necessary. The centralisation of fiscal power restricts Sabah's fiscal autonomy, particularly in terms of petroleum revenues and its ability to generate local revenue. Reforms must address these issues while considering the political, institutional, and legal obstacles that maintain the status quo. Recognising the political dynamics and entrenched interests is crucial for any reform efforts to gain traction.

First, revisiting MA63 is essential. Although Sabah's oil and gas sector contributes significantly to the national economy, the current revenue-sharing formula fails to reflect this contribution adequately. Political negotiation and bargaining will be key to making any substantial change to this system (Chok 2021). Sabah's political actors can leverage their growing influence, especially with the Borneo bloc becoming a more prominent force in national politics through strategic alliances and public support. Given the resistance from federal stakeholders, particularly those who benefit from the status quo, reform will need to proceed gradually. Starting with small, manageable adjustments to revenue-sharing agreements would reduce potential political friction and allow for a gradual transition towards greater fiscal autonomy for Sabah.

Furthermore, an independent commission should be established to oversee the renegotiation process. This commission would provide an objective, transparent platform to assess Sabah's rightful share of national resources. The creation of this neutral body is aligned with the institutionalist framework, which emphasises the importance of independent institutions in facilitating fair and transparent fiscal decisions (Rodden et al. 2003). This would also serve to counterbalance entrenched interests in federal agencies like Petronas and ensure that fiscal arrangements reflect Sabah's contributions.

Second, empowering Sabah to generate its own revenue is critical to reducing dependency on federal transfers. Allowing Sabah to introduce local taxes on industries such as tourism, land-based activities, and local businesses would provide the state with a new source of income. The introduction of targeted taxes, such as a tourism levy or natural resource use taxes, would give Sabah the fiscal tools to manage its development and reduce reliance on federal allocations. While federal approval is likely needed for such measures, this could be implemented gradually by starting with small-scale tax initiatives that generate revenue for local development projects. This approach could demonstrate the fiscal feasibility of local revenue generation, in alignment with fiscal federalism principles, which advocate for more decentralised fiscal control (Rodden et al. 2003).

Institutionalist perspectives highlight the importance of building governance capacity at the state level to effectively manage these new resources (Lockwood et al. 2009; Ramesh et al. 2016). Sabah will need investments in civil service training, public financial management, and institutional development to ensure that its administrative structures are equipped to handle additional revenues. This is not just about revenue generation but about strengthening state institutions to manage this revenue effectively, which is a crucial step for ensuring that fiscal autonomy leads to sustainable local development.

Third, the equalisation transfer system must be overhauled to ensure predictable, transparent allocations. Currently, the system's political nature allows for ad-hoc decisions that benefit certain states based on political bargaining rather than equitable resource distribution. Implementing a rule-based formula, akin to the fiscal equalisation programmes in Canada and Australia, would ensure that Sabah receives the resources it needs to meet local development goals.

However, introducing such a transparent system may face political resistance, particularly from states with larger populations or those that benefit from the current system. Incremental adjustments to the equalisation system, including pilot projects that demonstrate the fairness and efficiency of such a system, could pave the way for a more permanent reform. An independent fiscal commission, as suggested earlier, would be crucial in implementing and overseeing this change. The commission would be tasked with developing transparent formulas for resource allocation and ensuring fair distribution based on objective criteria, rather than political influence. This institutional reform would depoliticise the decision-making process and establish a clear and equitable system for fiscal transfers.

Finally, constitutional amendments clarifying the division of fiscal powers are necessary to ensure Sabah's fiscal entitlements are upheld and protected. These amendments would codify the guarantees provided to Sabah under MA63, offering legal certainty and preventing future federal overreach. Given federal reluctance, incremental reforms should begin with codifying existing agreements, ensuring that Sabah's entitlements are respected in the constitution before pushing for broader changes. This incremental approach is both pragmatic and realistic, as it allows Sabah to build support for more significant amendments over time.

## OVERCOMING OBSTACLES TO REFORM: KEY STRATEGIES

The challenge of reforming Malaysia's federal fiscal system is primarily political. The federal government and centralised stakeholders benefit from the current system and may resist changes that threaten their fiscal control. Moreover, Malaysia's regional, ethnic, and political dynamics add complexity to negotiations, especially given the rise of the Borneo bloc. This bloc, which includes both Sabah and Sarawak, has become a more influential force in national politics.

Following the 2020 Sabah state election, the Sabah state government secured a stronger political mandate, positioning itself as a more powerful voice in negotiations with the federal government (Wong 2020). This shift represents an opportunity for Sabah's leaders to use their increasing political influence to press for fiscal reforms that benefit Sabah (Govindasamy 2020). To overcome resistance, advocates for reform must build cross-party coalitions and frame the reforms in terms of national unity, economic stability, and long-term growth. Demonstrating that fiscal autonomy for Sabah will reduce regional disparities and enhance national development could help gain broader support from both state and federal political parties.

Gradualism is a critical strategy. Instead of pushing for immediate, sweeping reforms, small, manageable steps such as increasing Sabah's share of oil revenues or implementing pilot projects for state-level taxation can lay the groundwork for more comprehensive reform. This incremental approach will help build trust and political goodwill, creating momentum for further reform over time. Additionally, international development partners, think tanks, and academic institutions can provide technical support and facilitate dialogue between federal and state officials. Knowledge exchanges with other federations, such as those managed by the Forum of Federations (2024), can provide insightful lessons on how to implement successful fiscal decentralisation in Malaysia.

## CONCLUSION

The fiscal federalism framework in Malaysia, particularly in the context of Sabah, exemplifies the core-periphery dynamic identified in dependency theory. Despite Sabah's significant contribution to national resources, particularly through its oil production, its financial autonomy remains severely limited due to the centralisation of fiscal powers at the federal level. This structural dependency impedes Sabah's ability to effectively manage its resources and address its development challenges. Reforming Sabah's fiscal relationship with the federal government requires a comprehensive approach. Key reforms include the renegotiation of revenue-sharing formulas to ensure Sabah receives a fairer share of its oil revenues, the enhancement of state-level taxation authority, and the creation of independent fiscal commissions to oversee transparent and equitable resource distribution. These measures would address the structural barriers that perpetuate Sabah's fiscal dependence, fostering a more balanced and equitable federal system. Ultimately, overcoming Sabah's fiscal dependency requires institutional reforms that uphold the guarantees in the MA63 and enable Sabah to exercise greater control over its financial resources. Only through these structural changes can Sabah hope to achieve the fiscal autonomy necessary for sustainable development, ensuring that its contributions to the national economy are adequately reflected in its financial returns.

## ACKNOWLEDGEMENTS

The authors gratefully acknowledge the insightful feedback provided by the editor and two anonymous reviewers, which greatly strengthened the quality of this article. This study did not receive any external research funding. The authors gratefully acknowledge Universiti Malaysia Sabah for providing financial support for the publication fee.

## CONFLICT OF INTEREST

The authors declare that the study was carried out without any financial or commercial ties that might be interpreted as a potential conflict of interest.

## NOTES


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