



# At a Crossroads: Malaysian Federalism and Special Fiscal Rights of Sabah and Sarawak

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## **At a Crossroads: Malaysian Federalism and Special Fiscal Rights of Sabah and Sarawak**

*By Shad Saleem Faruqi*

### **SYNOPSIS**

*A unique feature of the Malaysian federation is that the East Malaysian states of Sabah and Sarawak enjoy greater, "asymmetrical" powers than their 11 sister states in Peninsular Malaysia. Balancing the growing concerns of equity and efficiency in federal-state relations would be paramount for national cohesion and progress.*

### **COMMENTARY**

Malaysia is a federation comprising 13 states and three federal territories. The federal or quasi-federal system in Malaysia is unique in some respects. One is that the constitutional distribution of legislative, executive, judicial and fiscal power is apportioned heavily in favour of the federal government, especially in the fiscal field. This has led to discontent in some states, namely, Sabah, Sarawak, Kelantan, Terengganu and Johor.

Another unique feature is that the East Malaysian states of Sabah and Sarawak enjoy greater, "asymmetrical" powers than their 11 sister states in Peninsular Malaysia.

It was the promise of autonomy and special rights in the Cobbold Commission Report 1962, the Inter-Governmental Committee Report 1962, the Malaysia Agreement 1963, and the Malaysia Act 1963 that encouraged Sabah and Sarawak to federate with Malaya. Failure to resolve the brewing federal-state disagreements over oil royalties and other fiscal issues could undermine citizens' commitment in the two states to the federation and its national interests.

## Sabah and Sarawak's Special Fiscal Rights

Under Articles 109, 110 and the Tenth Schedule, the federal government is required by the Constitution to allocate the following mandatory grants and sources of revenue to all the states:

- Capitation Grants
- State Road Grants
- State Reserve Fund
- Assignment of some taxes and fees, and
- Export duty on tin produced in the state.

In addition to the above, Sabah and Sarawak are allocated special revenues to meet their needs beyond what the other states receive. These are:

- 1) Special Grants. Special grants and assignments of revenues under various provisions of the Constitution.<sup>[1]</sup>
- 2) Escalating Grant. In the case of Sarawak, there is an escalating grant under Article 112D.
- 3) Sabah's 40 per cent. Sabah is entitled to a special grant equal to 40 per cent of the *increase* in net revenue the federal government collects from the state, calculated against the 1963 baseline year, with reviews required every five years. In calculating the 40 per cent entitlement, the amounts received by the state in respect of assigned items in Part V of the Tenth Schedule are allowed to be deducted.

Periodic reviews must be conducted every five years. If there is no negotiated settlement, an independent assessor must be appointed whose findings are binding on both parties.

It appears that, from 1974 to 2021, the federal government failed to conduct the 1974 review and did not carry out subsequent proper reviews. It continued to pay the same, un-escalated annual grant established in the early 1970s, which did not reflect the constitutional formula, leading to 48 years of alleged underpayment, termed the "Lost Years".

- 4) Ten Sources of Special Revenue. Under Article 112C, Sabah and Sarawak are entitled to earnings on ten special sources of revenue, among them import and excise duty on petroleum products, export duty on timber and other forest produce, royalty on minerals, etc.
- 5) Sales Tax. State sales tax is within Sabah and Sarawak's jurisdiction. There was a serious dispute between Petronas and Sarawak about Sarawak's constitutional right to impose State Sales Tax on the sale of petroleum products under Article 95B(3) of the Federal Constitution and the (Sarawak) State Sales Tax Ordinance 1998. The dispute was resolved through a Commercial Settlement Agreement in favour of Sarawak in 2020.

6) Oil and Oilfields. Of particular concern is the billions the federal government earns from oil revenue and the [meagre five per cent oil royalty](#) Sabah and Sarawak receive in return. Federal lawyers argue that although “land” is mentioned in Item 2(a) of the State List, “oil and oilfields”, as well as “petroleum products”, “regulation of labour and safety in mines and oilfields” are assigned by the supreme Constitution to the federal government.

However, Sarawak disagrees. [It challenges the constitutional validity and ongoing applicability of three federal laws in this matter](#) – the Petroleum Development Act 1974, the Continental Shelf Act 1966, and the Petroleum Mining Act 1966.

7) Gas. The term “gas” and gas works for power and energy are mentioned in the Federal List as Item 11(c) of the 9th Schedule. Item 8(l) also mentions “dangerous and inflammable substances”. Like oil and oil fields, gas is also subject to federal jurisdiction. However, in 1963, the federal government, acting through the King, delegated this power to the Borneo States via the Borneo States (Legislative Power) Order 1963. In 1983, this power was revoked. In 2023, this power was re-conferred.

8) Territorial Waters. Before the formation of Malaysia, the territorial waters of Sabah and Sarawak extended to 12 nautical miles under their own laws. These laws were suspended by an Emergency Ordinance under the 1964 emergency. With the lifting of the emergency in 2011, the laws of Sabah and Sarawak on territorial waters came back to life. Further, Article 1(3) provides that, “The territories of each of the states ... are the territories comprised therein immediately before Malaysia Day”.

The Territorial Sea Act 2012 of the federation, reducing the territorial waters to three nautical miles from the coastal baseline, is, therefore, vulnerable to constitutional challenge under Articles 1(3) and 2(b). Note, however, that the delineation of territorial waters and the ownership of resources within these waters are different considerations. Not everything in the State’s territorial waters may belong to the States. For example, mines and mineral ores belong to the Federation,<sup>[2]</sup> but it is the States that have the power over “permits and licenses for prospecting for mines, mining leases and certificates”.<sup>[3]</sup>

## **Going Forward**

There is growing discontent in Sabah and Sarawak that they are not receiving the financial benefits they deserve despite their contributions to the national treasury from petroleum, gas, hydroelectricity, and tourism.

A thorough study of constitutional, legal, and financial provisions is needed to address the problems. The [MA63 Committees \(2018 and 2020\)](#) made some progress, and their work must continue.

The Cobbold Commission, the Inter-Governmental Committee Report, and the Malaysia Agreement conferred some fiscal rights on Sabah and Sarawak that went unenforced because in Malaysia’s “dualistic” legal system, international law is not enforceable in domestic courts unless given the kiss of life by Parliament.

However, due to the “constitutionalisation” of MA63 and the Inter-Governmental Committee Report by the Constitutional Amendment Act of 2022, Malaysian courts should now recognise the legal relevance of these international documents and use them as aids to interpret local laws. Note, however, that the Cobbold Commission Report and MA63 have interpretative force only and cannot invalidate explicit provisions of the supreme Constitution.

Balancing the concerns of equity and efficiency in intergovernmental financial relations is paramount. Petrol royalty and other fiscal issues have triggered separatist movements in many federations. An amicable, equitable settlement is necessary. On the issue of oil and oilfields, the Constitution does not dictate the federal-state split of oil royalties. Under a new contract, the oil royalty could be increased from the current five per cent to a mutually agreed percentage. That would extinguish some of the embers of discontent.

*[1] Articles 112C, 112D and Part IV and V of the Tenth Schedule.*

*[2] Schedule 9 List I, Item 8(j).*

*[3] Schedule 9, List II, Item 2(c).*

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