

CHAPTER 1

OVERVIEW OF THE STUDY

1.1 OVERVIEW OF MALAYSIAN TAXATION

Taxes in Malaysia (Malaya) which were introduced by early Malay rulers came about in 1910. The principal aims of implementing tax policies are to revitalize economic growth through the granting of fiscal incentives and to provide funds for the numerous development projects. Tax revenue will continue to be the main source for Malaysia as the country continues to experience economic growth. The government of Malaysia generally imposes two broad types of taxes namely direct and indirect taxes.

The definition of indirect tax is originally of an administrative nature and refers principally to the method of collection. (Hicks, 1946). According to Musgrave and Musgrave (1989),

“... direct taxes are those which are imposed initially on the individual or household that is meant to bear the burden. Indirect taxes are imposed at some other point in the system, but are meant to be shifted to whom ever is supposed to be the final bearer of the burden.”

The responsibility to administer direct taxes lies with the Director General of Inland Revenue Board while indirect taxes is administered by the Director General Of the Royal Customs Malaysia. Direct taxes and their tax legislations are Income Tax (Income Tax Act 1967), Petroleum Income Tax (Petroleum (Income Tax) Act 1967), Real Property Gains Tax (RPGT Act 1976) and Stamp Duty (Stamp Act 1949). While indirect taxes and their legislations are as follows:

Customs duties (Customs Act 1967)

Excise duty (Excise Act 1976)

Sales Tax (Sales Tax Act 1972)

Service Tax (Service Tax Act 1975)

1.2 TREND OF INDIRECT TAXATION IN MALAYSIA

Musgrave (1987) noted that most developing countries relied heavily on indirect taxes during the early stages of their development. In Malaysia, indirect taxes also played an important role in the early 1960s. It accounted for 78.4% of the total Federal Tax Revenue in 1960, while direct taxes contributed only 21.6% of total revenue. However the relative importance of indirect taxes has steadily declined over the years from 72.9% in 1965 to 65% in 1970 and to a low of 46% in 1985. Correspondingly the importance of direct taxes increased.

However since 1985, the trend has been changing to an increasing importance of indirect taxes. The reason might be the reduction of income tax rates of individuals in stages from a high of between 6% and 55% to the current rates of between 0% and 28%. In the 2002 Budget, the government also announced its fiscal strategy to increase the purchasing power of the public by reducing personal income tax and thus relying on a multiplier effect to help the economy avert a full blow long-term recession. The revenue foregone through lower direct taxation will be compensated by an increased forecast in indirect tax revenue collection.

The strategy of increasing the spending power and the shift towards greater indirect taxation is highlighted in the following extract from the 2002 Budget speech:

" ..the reduction and abolition of tax proposals will result in a loss of Government revenue totalling RM 1.2 billion. At the same time, the Government has increased expenditure to stimulate domestic economic activities. Thus the Government must seek other sources of revenue to strengthen its financial position by proposing that the threshold be lowered from 500 thousand ringgit to 300 thousand ringgit and above; and..the threshold of 300 thousand ringgit be reduced to 150 thousand ringgit..."

The shift towards higher indirect taxes also has been adopted by the Government in the 8th Malaysia Plan where it is stated as:

"...direct taxes will continue to be a major contributor but its growth is expected to slow down in line with Government's efforts to provide a competitive tax structure to further improve the environment for doing business in Malaysia".

1.2.1 INCREASING RELIANCE ON SERVICE TAX

The increasing reliance on service tax as a source of revenue is quantified in the forecast of revenue under the 8th Malaysia Plan (2000 to 2005) whereby it is expected to increase by 201.4% to RM14.73 billion in comparison to that earned under the 7th Malaysia Plan (1995 to 2000). (Refer Table 1.1)

TABLE 1.1

FEDERAL GOVERNMENT REVENUE, 1995-2005

Source	RM million					Percentage Total			Average Annual Growth %	
	Year	Year	Year	Cumulative						
	1995	2000	2005	7MP	8MP	1995	2000	2005	7MP	8MP
Direct taxes	22,699	29,156	37,166	142,702	171,669	44.5	47.1	41.3	5.1	5.0
Indirect taxes	18,972	18,017	36,201	96,036	144,938	37.2	29.1	40.2	-1.0	15.0
Export duties	853	1,032	908	4,419	5,003	1.7	1.7	1.0	3.9	-2.5
Sales tax	4,869	5,968	17,637	25,941	64,988	9.6	9.6	19.6	4.2	24.2
Service tax	1,016	1,701	3,807	7,313	14,731	2.0	2.7	4.2	10.9	17.5
Import duties	5,622	3,599	4,411	24,843	20,985	11	5.8	4.9	-8.5	4.2
Excise duties	5,280	3,803	6,018	23,956	25,622	10.4	6.1	6.7	-6.4	9.6
Other	1,332	1,914	3,421	9,580	13,969	2.6	3.1	3.8	7.5	12.3
indirect taxes										
Non tax revenue	8,467	14,097	15,659	59,406	75,873	16.6	22.8	17.4	10.7	2.1
Non revenue receipt	814	594	996	3,107	4,269	1.6	1.0	1.1	-6.1	10.9
Total revenue	50,953	61,864	90,023	301,267	396,748	100.0	100.0	100.0	4.0	7.8

Source: 8th Malaysia Plan

This large increment in revenue forecasted, would seemingly require significant changes in some of the following areas to achieve the projected growth rate:

1. Increased enforcement, which would require further expenditure by the Customs authorities.
2. Further widening of the service tax base.
3. Continuing to lower the qualifying threshold for service tax.
4. Increasing the rates of sales tax and service tax.

The increasing importance of service tax also has to be viewed in line with the fact that revenue from certain indirect taxes like import duties (and sales tax) are set to fall. In line with its commitments as a signatory to the General Agreement for Trade and Tariffs (GATT) and under the Common Effective Preferential Treatment (CEPT) Scheme within the Asean Free Trade Area (AFTA), Malaysia has implemented tariff reduction schedules and the easing of non-tariff barriers.

Under the CEPT Scheme, the tariffs for products traded between ASEAN member countries will be reduced to between 0% and 5% by January, 2003 for products with the required 40% ASEAN content (with the exception of motor vehicles, where implementation of the tariff reduction has been delayed until 2005). In this case the government will need to recover the shortfall in revenue from import duties. The government targets to increase in revenue collection from service tax by lowering the qualifying threshold for service tax.

1.3 TAX COMPLIANCE ISSUE

Tax compliance has been a major issue faced by tax authorities in most countries around the world and till today it still becomes the interest of many researchers in any discipline. Many researchers believe that non-compliance of tax laws is a behavioural problem that seriously threatens the capacity of a government to raise public revenue. It is a problem that transcends cultural and political boundaries (Clotfelter, 1983).

Tax non-compliance and evasion are of serious concern for a variety reasons. Besides causing losses in current revenue, it fosters disenchantment over taxes, posing serious threats to voluntary compliance and thus demoralising the conscientious majority who pay their just share of their taxes. In fact, taxes are used by governments for a variety of purposes. Revenue is raised through taxes to meet public expenditure for the provision of goods and services and transfer payments. Taxes are used in fiscal policy to regulate aggregate demand in the economy, as well as bring about greater equity in the distribution of income and wealth in the country. Furthermore, taxes are imposed to control the volume of imports into the country in order to achieve balance of payment equilibrium.

According to Barry and Slemrod (1992), tax evasion is a pervasive phenomenon that threatens the fairness and efficiency of tax system. It threatens the fairness of tax system because people differ in both their willingness and opportunities to evade taxes and these differences result in the tax burden becoming capricious in its incidence. It is said to threaten the efficiency of tax system because it draws resources into activities in which evasion is facilitated, because citizens use resources to camouflage their evasion and because it requires bureaucratic resources to keep it in check.

In Malaysia, even though no one can know for certain the degree of tax evasion, the revenue collections from taxes and penalties from various civil

suits may provide an indication that there is widespread tax evasion in the country which ultimately results in a drop in revenue. Bird (1989) noted that corruption and tax evasion are widespread especially in developing countries resulting in more than half of all taxes going uncollected. The Royal Customs Malaysia reported that they expected to collect indirect taxes revenue amounted RM 32,369,160 in 2001. However the tax collected in that year was only RM 16,200,920 (Table 1.2). In this case, RM 16,168,240 (or 49.9%) was uncollected in 2001. The number of cases prosecuted and compounded for the year 2000 and 2001 are shown in Table 1.3. It shows that there is an increased in the number of both prosecuted and compounded cases for the year 2001.

TABLE 1.2

TAX REVENUE DETECTED VS TAX COLLECTED (YEAR 1998 TO 2001)

	1998	1999	2000	2001
Potential tax detected (RM)	31,365,686	28,339,265	21,243,237	32,369,160
Tax collected (RM)	15,723,526	15,108,552	14,534,971	16,200,920
Collected vs Detected (%)	50.1%	53.31%	68.42%	50.1%

Source: Royal Customs Annual Report 2001

TABLE 1.3

NUMBER OF CASES PROSECUTED AND COMPOUNDED (YEAR 2000 – 2001)

	Year 2000	Year 2001
Number of cases prosecuted	499	629
Number of cases compounded	4756	5995
Compound fees	RM 7,735,834.04	RM 12,784,098.92
Penalties imposed by Courts	RM 4,564,500.00	RM 4,488,862.30

Source: Royal Customs Annual Report 2000 and 2001

1.4 PROBLEM STATEMENT

In Budget 2002, the Prime Minister YAB Dato' Seri Dr. Mahathir Mohamad who is also the Finance Minister has outlined three main strategies:

1. Strengthening the nation's economic growth.
2. Diversifying sources of growth and;
3. Ensuring equitable distribution of income between the urban and rural areas, between high and low income earners as well as between the more developed and less developed states.

To achieve such strategies, the Finance Minister has proposed the reduction and abolishment of import duties on several selected goods and granting tax exemptions to certain sectors such as car rental operators and private institution of higher learning.

As such proposals obviously result in the loss of Government revenues, the Government must seek other sources of revenues to strengthen its financial position. The Finance Minister has proposed among others the following:

1. Increasing the import duty and excise duty on cigarettes and other tobacco products.
2. Lowering the threshold for the imposition of service tax.

The threshold for restaurants, bars, snack bars and coffee houses, private clubs and advertising companies is reduced from annual sales turnover of RM 500,000 to RM 300,000 and above. The threshold for professional services is reduced from RM300,000 annual sales turnover to RM150,000.

Under such circumstances, the Government is aware that these measures may increase smuggling activities and tax evasion among service providers. Thus, a more aggressive and effective approach must be taken to ensure that such non-compliance activities are curbed by the Customs authority and other enforcement authorities. From this statement, it can be deduced that the effect

of such proposals in the 2002 Budget is to give challenges to the Royal Customs Malaysia to increase the administrative efficiency to enforce the compliance in indirect taxes.

The Director General of Customs reported that the loss of revenue in 2001 due to tax evasion amounted to RM 3 billion and 60% of the businesses visited by the authorities during "OPS KESAN" failed to comply with the requirements under the Sales Tax Act 1972 and Service Tax Act 1975. The Royal Customs Malaysia also estimated in 2002 that there are more than 3600 businesses operating without service tax and sales tax licences. In the 2003 budget, the Prime Minister has directed IRB and the Royal Customs Malaysia to step up enforcement in order to overcome tax evasion.

Given all the facts above, this study attempts to clarify such issues in indirect taxes which focus on Custom duties and Service tax. Therefore this study seeks to answer the following questions:

1. What are the strategies taken by the Royal Customs Malaysia to curb smuggling activities and non-compliance in service tax?
2. What are the procedures used to detect any non-compliance in service tax? (For e.g. not complying with required threshold, doing business without licences and collecting tax without licence).
3. What are the best strategies should be implemented to enforce the compliance among the service providers?

1.5 OBJECTIVES OF THE STUDY

The objectives of this study are as follows:

1. To identify the strategies taken by Customs authority to curb smuggling activities and non-compliance under the Service Tax Act 1975.
2. To gauge the perception of service providers regarding the service tax.
3. To determine what are the main factors that contribute to non-compliance in service tax.

It is hoped the findings of this study will provide insight to interested parties and will lead to other studies determine the effectiveness of enforcement strategies adopted by Customs authorities. This study may provide such information as needed by the public in order to create a "Customs Literate Society".

1.6 RESEARCH METHODOLOGY

Both primary and secondary data are used in this study. The primary data was obtained by conducting a survey and interviewing the Customs officers. The survey was conducted in order to gauge the perceptions of service providers regarding the compliance in service tax. The secondary data was obtained from journals, magazines, internet, seminars papers and sources from the library of Royal Customs Malaysia.

1.7 SCOPE OF THE STUDY

As this study attempts to clarify the issues in the Budget 2002 i.e. the effects on compliance of increasing import duties on tobacco products and lowering the threshold of service tax, the scope of this study is limited only to the customs duties and service tax. Besides, this study is not an attempt to measure the degree of indirect tax evasion in Malaysia.

1.8 ORGANISATION OF THE STUDY

This study is organised into five chapters as follows:

Chapter 1: An overview of the study

Chapter 2: Literature Review

Chapter 3: Research Methodology

Chapter 4: Service Tax

Chapter 5: Customs Duties

Chapter 6: Conclusion

1.9 CONCLUSION

This chapter provides an overview of the study that explains the purpose of the study and a brief overview of taxation in Malaysia. The next chapter will review the prior literature in tax compliance by overseas and local researchers.