

## CHAPTER I

### INTRODUCTION

#### Scope of Exercise

In this exercise, an attempt will be made to study the system and structure of taxation in the States of Malaya and later Malaysia. 1958 has been chosen as a starting point. It must be borne in mind that there is nothing extremely important in commencing our exercise in this year. For want of a convenient starting point, perhaps one that signalled the independence of our country, would have a strong claim.<sup>1</sup> As such our analysis will, in fact, begin in 1958. Since correct figures are not available after 1964, it is proposed to use revised estimates of 1965 and the estimates of 1966.

A study of the tax structure during the period 1958-1966 involves many problems. The most perplexing of them is the formation of Malaysia in September 1963, when regions beyond what was formerly the Federation of Malaya, were merged into a larger federation called Malaysia. An increase in the geographical area inevitably involves an increase in the scope of our analysis. In other words, we shall have to deal with the new financial relationships which were agreed upon and became applicable also to the States of Sabah, Sarawak, and Singapore. But a further problem arises as a consequence of the separation of Singapore from Malaysia in August 1965. Malaysia, as originally conceived only existed as a political entity for less than 2 years. Therefore as the exercise proceeds and at relevant places we shall note the significance and implications of not only the formation of Malaysia but also of Singapore's separation from Malaysia.

Malaysia is a federation of states and the study of its tax structure will be a study in the context of a federal system of government. As such, a chapter on "State Revenue" would have been relevant but lack of accurate statistics and the pressure of space have been of deciding importance in its exclusion. However, in this chapter we shall examine briefly the financial provisions and the allocation of financial resources between the central and state governments.

The exercise as the title implies will lead us into the realms of tax revenue. We shall be dealing with inland revenue, customs duties, excise duties and licences. We shall discuss them individually

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<sup>1</sup>Though independence was granted in August 1957, the financial position as an independent country started in 1958.

and in reasonable detail to show the significance and importance of each one of the items in not only total tax revenue but also in total governmental revenue. A chapter, towards the end of the exercise will deal with what has been commonly termed as "non-tax revenue". The concluding chapter will include the comparison of the Malaysian tax structure with the tax structure of a developed country. Implicit in such a comparison is that there are some basic differences in the tax structure of an underdeveloped economy like Malaysia and a developed economy like that of the United Kingdom.

### The Problem of Federalism<sup>2</sup>

Since Malaysia is a federation any study of the tax structure is conducted in the context of a federal system of government. It would thus be best if we dealt with, in the introduction chapter, some of the features and special problems that arise in the operation of a tax structure in a federation. We shall deal with the principal factors that have to be encountered in any federation of states.

Federalism is essentially a product of political and economic factors. Federalism as a form of government in the modern era can be said to have evolved from the United States Constitution. Malaya (and now Malaysia) has maintained a federal form of government since independence. The most significant feature of the federal system is that powers are divided. There is a threefold division of jurisdiction and powers:

- 1) Federal,
- 2) State, and
- 3) Concurrent.

The central government is supreme within its own sphere which is carefully defined and limited and the states are co-equally supreme in their own sphere. Secondly, the central government has its impact in certain fields and so does the state government. This impact is direct i.e. the state's impact is not through the federal government and vice versa.

The problem of the federal system of taxation stems from the basic structure of the federal government. For instance, each must have independent financial resources; each must be financially co-ordinate and not financially subordinate. Such basic characteristics give rise to certain problems which do not lend themselves to ready or easy solutions. Firstly, there is the question of distribution of

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<sup>2</sup>For the old system refer to Huan Tzu Heng, "The New System of Revenue Allocation to the States and Settlements in the Federation of Malaya", The Malayan Economic Review Vol. II, No. 1, April 1957.

functions and powers between the state and central government. Secondly, and more important, is the allocation of financial resources between the federal and state governments with some measure of confidence so that future experience would bear out that resources and functions of respective parties expand or contract harmoniously. In actual fact, the state financial resources should be adjusted downwards or decreased and the centre's financial resources adjusted upwards (i.e. increased). This is essentially a field that calls for goodwill between the states and the centre. One useful lesson to be learned from the separation of Singapore from the Federation of Malaysia is that the test of a federal government is not that it should enable a federal system to operate but more fundamentally whether it allows a good government acceptable to both the centre and states to operate.

### Federal Jurisdiction<sup>3</sup>

The desire and necessity of a uniform policy has required the fields of currency, coinage, and banking to be entirely central government spheres. Furthermore most customs and excise revenue accrue to the centre.<sup>4</sup> Likewise licences connected with mechanically propelled vehicles, electrical installations and registration of businesses are federal sources. The main reason for this arrangement is the need for uniformity in the whole federation. Revenue from these sources are, furthermore, easy to collect and form a dependable source of revenue. In Malaysia, as in other underdeveloped countries they form a sizeable portion of total governmental revenue. In Malaysia, unlike for example in Nigeria before, income tax<sup>5</sup> is a federal source of revenue. In the case of company tax, the reason for this centralisation is to make foreign investors feel more secure in that it would prevent regional governments from exploiting the situation and would obviate the difficulties arising from assessment when a company has its operations beyond the boundaries of one state. It also prevents industry from following a wrong locational pattern. As such income tax by being a federal matter enables a nationally integrated policy towards private investment both domestic and foreign. The rationale of personal income tax being federal revenue is that it enhances the chances of maintaining economic stability. Further, income tax should contribute to the country as a whole and should not be left in the hands of the state. Centralising the revenue would also enable a federation to iron out inter-regional inequalities in economic development and fiscal capacity. The other

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<sup>3</sup> Malaysia - The Federal Constitution Government Printer, 1964, Ninth Schedule, List I, p. 133.

<sup>4</sup> Exceptions become apparent when we deal with "State Revenue".

<sup>5</sup> Both company and personal income tax.

sources of federal revenue are the non-tax sources<sup>6</sup> of:

- 1) Receipts for and in aid of specific federal government services.
- 2) Receipts on account of undertakings of a commercial character.
- 3) Revenue from federal government property.
- 4) Miscellaneous receipts and sales.

#### State Jurisdiction<sup>7</sup>

The following sources of revenue are assigned to the states:

- 1) Revenue from toddy shops.
- 2) Revenue from land, mines and forests.
- 3) Revenue from licences other than those connected with mechanically propelled vehicles, electrical installations and registration of businesses.
- 4) Entertainments duty.
- 5) Fees in courts other than federal courts.
- 6) Fees and receipts in respect of specific services rendered by departments of state governments.
- 7) Revenue of town boards, town councils, rural boards, local councils and similar local authorities unless these have power under written law to retain their revenues and control their own spending. Also excluded are municipalities established under any Municipal Ordinance.
- 8) Receipts in respect of water supplies, including water rates.

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<sup>6</sup> Estimates of Malaysia Federal Revenue and Expenditure, Government Printer. Any issue for details of above category.

In this exercise "tax revenue" included customs, inland revenue, excise and licences.

<sup>7</sup> Malaysia - The Federal Constitution, op. cit., Article 110, Page 62 and Part III, Tenth Schedule, p. 142. The data also obtainable in H.E. Groves, The Constitution of Malaysia, Malaysia Publications Ltd. 1964, p. 143.

- 9) Rents on state property.
- 10) Interest on state balances.
- 11) Receipts from land sales and sale of state property.
- 12) Fines and forfeitures in courts other than federal courts.
- 13) The various types of Muslim revenue, and
- 14) Treasure trove are federal sources.

The most prominent feature of the above sources is that all matters and revenue in respect of land is left in the hands of the individual states. It is also worthwhile to note that Parliament may from time to time by law substitute for any source of revenue specified in (1), (3), (4), (5), (6), (7), (8), (12), or (14), above or for any source so substituted another source of revenue of substantially equal value.<sup>8</sup> In addition each state shall receive on such terms and conditions as may be provided by or under federal law, ten percent, or such greater amount as may be so provided of the export duty<sup>on tin</sup> produced in the state.<sup>9</sup> Parliament may by law assign to the states the whole or any portion of the proceeds of any tax raised or levied by the Federation.

#### Additional Sources of Revenue Assigned to the Borneo States<sup>10</sup>

In view of the circumstances under which Sabah and Sarawak joined with the States of Malaya certain additional sources of revenue were assigned to these two states. In addition to the provisions we have outlined the following additional sources of revenue were assigned to the Borneo States of Sabah and Sarawak:

- 1) Import duty and export duty on petroleum products.
- 2) Export duty on timber and other forest produce.
- 3) So long as the royalty levied by a Borneo State on any mineral chargeable with export duty, other than tin, (but including mineral oils) does not amount to ten percent ad valorem calculated as for export duty, export duty on that

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<sup>8</sup>Malaysia - The Federal Constitution, op.cit., Article 101(2), p. 62

<sup>9</sup>Ibid., Article 101(3), p. 62.

<sup>10</sup>Ibid., Part V, Tenth Schedule, p. 144. Also see H.E. Groves, op. cit., p. 144.

mineral, or such part of the export duty as makes the total of royalty and duty on exported mineral up to ten percent ad valorem so calculated, goes to the state.

4) In the case of Sabah, as long as medicine and health are in the concurrent list and expenses in respect of these items are born by the state, then 30 percent of all customs revenue other than (1), (2) and (3) above accrue to the state.

5) For any year before 1974, and if at the beginning of 1974, the legislative of the state has power to make laws with respect to the carriage of passengers and goods by land, or with respect to mechanically propelled road vehicles, then during the continuance of that power, the state is entitled to the fees from such licences.

6) Similarly for the same period if the state has power to make laws with respect to mechanically propelled road vehicles, it is entitled to the fees from the registration of such vehicles.

7) State sales tax and

8) Fees and dues from ports and harbours other than federal ports and harbours accrues to the state.

There is also an additional field of revenue as far as the state governments are concerned. It takes the form of grants and can form sizeable proportion of the revenue of the state governments. In Malaysia, it may be as large as 50 percent and above. But such grants can only be an independent source of revenue if they are obligatory. In such a case then there can be two methods for the allocation of the grants:

1) Based on population.

2) Or a fixed proportion of revenue from certain federal sources.

In the case of special grants, they arise because of a need for bringing about uniform development. They depend largely on the bargaining powers of the states. In the case of escalating grants, less populated states get higher average than populous states.

Grants are employed to enable the poorer states to fulfil their functions. And furthermore, since the centre has control of customs and excise it is just fair to provide aids in the form of unconditional grants. Three main principles may be said to be taken into account in

deciding the criteria for allocation:

- 1) Principle of compensation.
- 2) Principle of derivation, and
- 3) The principle of need.

The principle of compensation arises for the following reasons: firstly in a federation the states make a sacrifice of their sources of revenue. Secondly, federal policy has different impact on different states. As a result certain states experience greater difficulties than others. But the difficulties encountered are enormous and normally the principle is not adopted.

The application of the principle of derivation is governed partly by the nature of the federation. If it is a loose federation, it seems an attractive proposition. This is borne out in financial arrangements to the new states when Malaysia was formed in 1963. In the case of Singapore, the principle was embodied in the 60% - 40% arrangement.<sup>11</sup> The state government received 60 percent and the central government of the Joint Fund. In the case of the Borneo States, timber revenue was left to the Borneo States. However, when the federation is close-knit and when you want to provide a uniform opportunity and facilities strict application of the derivation principle would, far from achieving the objectives, aggravate the inequalities.

Since in most federations, different states start off at different economic levels and with different capacities to raise money, the principle of need can be used as the real rational principle in determining the allocation of grants. In translating this, a useful measuring rod, would be population. Such grants can be supplemented by special grants.

In the context of Malaysia, we shall be dealing with the Capitation Grant, the Road Grant, and the Special Grant to the Borneo States.

#### Capitation Grant<sup>12</sup>

All states of the Federation of Malaysia are entitled to an annual federal capitation grant calculated at the rate of \$15 per person for the first 50,000 of the state's population, \$10 per person for the next 200,000 and \$4 per person for the remainder. It is based

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<sup>11</sup> Malaysia - Agreement concluded between the Federation of Malaya, United Kingdom of Great Britain and Northern Ireland, North Borneo, Sarawak, and Singapore, Government Printer, 1963, Annex J.

<sup>12</sup> Malaysia - The Federal Constitution, op. cit., Part (I), Tenth Schedule, p. 142 and Article 109(1)(a), p. 61.

on the population of the state as determined at the last census taken before the beginning of the preceding financial year. Quite evidently the capitation grant is based on the principle of need and employs population as the criteria for allocation.

### State Road Grant<sup>13</sup>

The States of Malaya receive a grant for the maintenance of roads based on the mileage of state roads in that state. It is calculated by multiplying the average cost to a state of maintaining a mile of state road at the minimum standard determined for state roads in these states by the Federal Government after consultations with the National Finance Council, by so much of the mileage of state roads in that state as qualifies for grant. The state road grant has been most helpful in maintaining the high standard of our roads.

### Special Grants to Borneo States<sup>14</sup>

Sabah: For Sabah a rather complex formula for additional Federal grants to that state was devised. The year 1963 has been taken as the base year; and the hypothetical net amount of revenue which the federation would have derived from Sabah for that year had the Malaysia Act been in effect for the whole of the year must be calculated.<sup>15</sup> Two-fifths of this hypothetical sum is the amount of the additional yearly grant to Sabah. As far as the State Road grant from the Federal government under the formula applicable to the states of Malaysia, if it falls below \$5,179,500<sup>16</sup> in any year before 1968, a federal supplement will be made to its grant to bring it up to that figure.

Sarawak: Sarawak is to receive a grant of \$5,800,000 in each year. She is also to receive a grant of which the amount in 1964 and each of the following years was to be respectively \$3½ m., \$7 m., \$11½ m., \$16 m. and \$21 m. In the case of the state road grant there was no specification as to the amount but the constitution merely states that it was to be "of such amount as may be agreed between the Federal and State governments".<sup>17</sup>

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<sup>13</sup> Ibid., Article 109(1)(b), p. 61.

<sup>14</sup> Ibid., Part IV, Tenth Schedule, p. 144.

<sup>15</sup> For this calculation any alteration of any tax or fee made after Malaysia Day is included.

<sup>16</sup> At the rate of \$4,500 a mile in respect of a mileage of 1,150 miles.

<sup>17</sup> Malaysia - The Federal Constitution, op. cit., Part II, Section 6(1), Tenth Schedule.



There is provision in the Constitution as regards the review of these additional grants to the Borneo States.<sup>18</sup> On the first review, i.e. after 5 years, the matter of the grant itself may not be brought into question, only the amounts for the succeeding five years. Review as to the abolition of the grants cannot, therefore, take place until 1974. In fact, it is quite obvious that abolition or continuation of the special grants will depend on the level and rate of development of these two states. If the Federal and State governments are unable to reach agreement on any matter, it is to be referred to an independent assessor but no machinery is provided for the appointment of the assessor. Groves H.E. feels that it is "wise in view of the long period of time before any possibility of his need can arise".<sup>19</sup>

#### Additional Provisions to Singapore

The revenue provisions to Singapore were far less specific than those applying to the Borneo States. In fact most matter with Singapore were to be settled from time to time and by agreement between the Federal government and the Singapore government. However we may briefly state the important provisions as laid down in the Malaysia Agreement (Annex J).<sup>20</sup> The authority in respect of the collection in Singapore of customs duties and excise and income tax was delegated to the Singapore government. However, the Federal government "may evoke this authority if the Singapore government fails to comply with any direction properly given to it by the Federal government".<sup>21</sup> All revenue collected in Singapore, with certain exceptions were paid into a separate fund in a branch of the Central Bank established in Singapore and the fund was divided between the governments each year in the proportion of 60 percent to the Singapore government and 40 percent to the Federal government.<sup>22</sup> Furthermore, 60 percent of income tax

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<sup>18</sup> Ibid., Article 112D, p. 64.

<sup>19</sup> H.E. Groves, op. cit., p. 146

<sup>20</sup> Malaysia Agreement, op. cit., Annex J, p. 226.

<sup>21</sup> Ibid., Annex J, p. 228.

<sup>22</sup> Exceptions were:

- 1) The revenue specified in Part III of The Tenth Schedule of the Federal Constitution.
- 2) Customs duties and other charges collected in Singapore on goods exported from or imported into Malaysia outside Singapore. This was paid into the Federal Consolidated Fund.
- 3) Income tax collected in Singapore and attributable to income derived from the States of Malaya to be paid into the Federal Consolidated Fund.

collected in the States of Malaya but attributable to income derived from Singapore was to be paid to the Singapore government. Income tax attributable to income derived from Singapore and collected by an agent outside Malaysia was paid into the Joint Fund established. Singapore was to pay the Federal government the cost of capital development of federal project, in Singapore other than projects for defence and internal security. It was also intended to form a Common Market to facilitate the maximum practicable degree of economic integration of the territories of Malaysia. There has been established a Tariff Advisory Board and attempts are being made to continue with the Common Market arrangements even though Singapore is now an independent country. However, generally the provisions as laid down in Annex J of the Malaysia Agreement are not operative since the separation of Singapore from Malaysia.

### Concurrent Jurisdiction<sup>23</sup>

In this category the bulk of the provisions are more legal and functional than financial. However, for our purpose we may here include two provisions which though are not laid down as Concurrent in the Constitution, are yet very much like concurrent sources of revenue. Firstly, each state receives 10 percent or such greater amount as may be so provided of the export duty on tin produced in that State.<sup>24</sup> Further, Article 110(3A) of the Federal Constitution provides that each state shall receive, on such terms and conditions as may be prescribed by or under federal law, such proportion as may be so prescribed of the export duty on minerals (other than tin in that state). This provision in fact may give rise to a Concurrent list of financial provisions in the future.

### Borrowing

This is another sphere in which the Federal and State governments resort to. Borrowing is a field which calls for co-ordination. In Malaysia there is a National Finance Council (N.F.C.). More will be said of the N.F.C. later but at this stage it is enough to note that co-ordination is required to enable some control over state expenditure. According to Article 111 of the Malaysian Constitution<sup>25</sup> the Federation shall not borrow except under the authority of the Federal law. In the case of states, a state shall not borrow except under the authority of State Law. In fact the State Law does not authorise a State to borrow except from the Federation or, for a period not exceeding one year, from a bank approved for that purpose by the Federal government.

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<sup>23</sup> For a complete list of Concurrent jurisdiction, look up List III, IIIA and IIIB, Ninth Schedule, Federal Constitution.

<sup>24</sup> Malaysia - The Federal Constitution, op. cit., Article 110(3) p. 62.

<sup>25</sup> Ibid., Article III, p. 63, "Restriction on Borrowing".

## The National Finance Council

In a federal system, there is a need for a machinery for consultation between the centre and the states. In Malaysia the N.F.C. performs this function. It consists of the Prime Minister who presides at meetings, of one other Minister designated by the Prime Minister and one representative from each of the states, appointed by the Ruler or Governor. In practice, however, the Deputy Prime Minister, presides over the meetings and the other Minister represented in the Council is the Finance Minister.<sup>26</sup> In terms of membership it has overwhelming state representation. The N.F.C. meets at least once a year but it may be summoned by the Prime Minister as often as he considers necessary, as well as whenever the representatives of 3 or more states demand a meeting.

The objective of the N.F.C. is spelled out in Article 108 of the Constitution. It is the duty of the federal government to consult the N.F.C. in respect of (a) the making of grants by the federal government to the states; (b) the assignment to the states of the whole or any portion of the proceeds of any federal tax or fee; (c) the annual loan requirement of the Federation and the states and the exercise of the Federation and the states of their borrowing powers; (d) the making of loans to any of the states and (e) the making of national development plans. The other functions of the N.F.C. include the consultation of the N.F.C. on the financial and accounting procedure and the purchase, custody and disposal of public property, other than land, of the Federation and of the states. The government also consults the N.F.C. as regards audit and accounts of the Federation, states and other public authorities. It also has to consult this body if the government intends to introduce a Bill varying the rates of the capitation grant or to affect the receipt by a state of export duty on tin or other minerals produced in that state. The federal government is also to refer to the N.F.C. on any other matter in respect of which either the Constitution or Federal law make provision for consultation. Further, it consults the N.F.C. as to the sum it shall pay each financial year into the State Reserve Fund. Finally, the federal government may consult the N.F.C. in respect of any other matter, whether or not it involves questions of finance, and the government of a state may consult the Council in respect of any matter which affects the financial position of that state.

Basically the N.F.C. is a consultative body; it has no executive functions. It enables co-operation not only in finance but also in economic planning between state and federal governments. But the fact that it must meet once a year, makes possible regular adjustment in financial and economic planning. Furthermore since it deals with the question of making loans, it dispenses with the need for a separate machinery for raising loans.

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<sup>26</sup> This information was obtained from members of the Federal Treasury.

What comes out is that the central government should have necessary fiscal powers to promote economic development and maintain economic stability. The central government is in a better position than individual states to plan development and maintain stability. Therefore, the principal sources of revenue are apportioned to the centre. In trying to appraise any financial arrangement it should be borne in mind that no financial arrangement can be said to be satisfactory unless it has worked out well in practice. Generally, the Malaysian system ensures financial responsibility on the part of the states and the central government. It does preserve the essentials of federalism; and probably it may achieve a balance between the two opposing forces of centralisation and decentralisation which is the essence of any federal system of government.

### General Considerations

The Malaysian tax structure is overwhelmingly based on indirect taxes of customs and excise. Income tax plays a relatively insignificant part as a proportion of total tax revenue. Further, it will become evident that there is a heavy concentration on a few commodities. In Malaysia, indirect taxes assume a particular significance because direct taxes have inadequate coverage and because of administrative complexities.

According to Prest<sup>27</sup> the general characteristics of taxation in underdeveloped countries is:

- 1) "The secular growth in government expenditure" and
- 2) "The instability of government finance".

The main reasons for these characteristics, which are also applicable to Malaysia, are an increase in public services and an urge to increase and maintain the standard of living. There has been a sudden awakening of the possibilities of economic development. There has been a growth in the belief that it is the duty of the government to purchase many goods and services; to redistribute income and the public provision of infra-structure. Such factors have increased the importance of taxation in countries like Malaysia which subsequently reflects constant change.

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<sup>27</sup>Prest, A.R., Public Finance in Underdeveloped Countries, London, Weidenfeld and Nicholson, 1962, p. 13.