CHAPTER 2

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter consists of various studies associated with the impact of taxation on the Malaysian economy. Since, this paper focuses on the impact of taxation on Malaysian economy, the literature related to the topic will be reviewed before proceeding to further chapters and will be presented in chronological order.

2.2 PRIOR RESEARCH AND FINDINGS

A study by Carla Rapoport (1999) titled "Great Tax Holiday" the government gave a sizeable tax breaks to companies in selected industries that locate their operational headquarters in the country. Revenue officials also grant tax cuts to companies that increase their export sales or their expenditures on research and development. Beyond that, government officials declared a tax holiday for companies in 1999 and, like Indonesia, announced a self-assessment corporate tax system.

According to her, the strategy appeared to be working. Reinvestment plans filed by corporations went up by 130 percent in the previous year.

According to Dr Ismail Mohd Salleh (2001), in his paper titled "Malaysian Budget Strategy", he pointed out that the post-tax income inequality was greater than pre-tax inequality, while the tax structure became more regressive over the 1970s. Unfortunately, this regressive impact has worsened since the mid-1980s, after the then Finance Minister began reducing the income tax and estate duty rates on companies and the rich. Both these taxes are progressive. Hence, direct taxes now are less progressive than before. Thus, the overall tax structure is even more regressive today compared to the 1970s, when it was already regressive. Now, almost half of government revenue comes from direct taxes, whereas indirect taxes account for only 27%. The current government's intention to balance the contribution of both types of taxes by 2010 will make the overall tax impact even more regressive.

In an article titled "Barriers to Automative Trade" by Allen Consulting-Deloitte Touche Tohmatsu (2002), it is revealed that the use of investment incentives is widespread in developed countries, although World Trade Organisation (WTO) rules (particularly under the Subsidies and TRIMs Agreements) and the European Union's policy on State Aids have set some limits on the types of incentives that can be offered. Typically, such incentives take the form of cash, tradeable credits which can be offset against income tax or import duty liabilities, land improvement spending or

concessions on a range of direct and indirect tax measures (such as payroll tax).

In developing countries, tax concessions tend to be the dominant form of assistance offered to attract automotive investment. In Thailand, for example, corporate tax exemptions for between 8 and 20 years may be granted dependent on location. Similarly, in Malaysia, tax may be levied on only 15 to 30 per cent of corporate income for five years, with significant tax offsets and accelerated depreciation allowances also available.

In a paper titled "Taxation and its Impact on the Economic Development of Malaysia" presented by Dr. A. Thillaisundaram at the National Workshop on Taxation and Social Development on 12 to 13 June 2002, it was highlighted that, the there was a substantial shortfall in the government's revenue compared to the expenditure. The government has been proposing deficit budgets in order to overcome the effects of 1997 financial crisis. However, the study did not highlight on the success of the governments effort to help the economy get out of the doldrums in which it is mired.

The 2002 Budget Proposal was analysed by Choong Kwai Fatt (2002) and he feels the budget proposal did not address the following issues:

a. **Service Tax**

Service tax is a form of indirect tax imposed on engaging the services of professionals or the consumption of food and beverages in hotels and restaurants. The responsibility of collecting the service tax is on the business operator and penalties would be imposed on non-collection / late collection.

The Service Tax Act 1975 requires the business operator who has reached the threshold limit for a period of 12 preceding months to apply for the service tax license to collect service tax. Previously, the threshold setting was RM300, 000 or RM500, 000 depending on the type of business carried on. However, with effect from 1 January 2002, the threshold of the business were reduced by half to RM150, 000 or RM300, 000 accordingly affecting more such business operators.

b. **The Abolishment Of The Bonus Restriction**

Previously, the excess of two months bonus payable to an employee was not tax deductible in the accounts of business enterprises, being sole proprietors, partnership or companies. In order to accelerate local spending and to increase productivity, the employer is now able to award its employees excess bonus without the concern of the non-tax deduction of excessive bonus. The legislation took effect from the year of assessment 2002, which is not timely. The period for the year of assessment 2002

refers to the calendar year 1 January 2002 to 31 December 2002 or the financial year ending 2002 for business enterprises, which have opted for non 31 December year-end. This would mean that employers who close their accounts before or on 31 December 2001 would continue to be effected from this bonus restriction if the bonus is paid in the year 2001.

c. **New Appeal Procedure For Stamp Duties**

Previously, an appeal on stamp duties has to be made to the High Court, as the Collector of Stamp Duties has no jurisdiction to hear any appeal.

In the 2002 budget, a new Section 38A was introduced to the Stamp Act 1949 to allow the Collector of Stamp Duties at the first instance to review the assessment of stamp duties. The taxpayer is however, required to first pay the stamp duties despite a pending appeal. This is to prevent any taxpayer using the appeal procedure to defer the payment of stamp duties. The notice of appeal together with the ground of appeal must be filed within 30 days from the date of notice of assessment.

The Collector of Stamp Duties is required to review the appeal and notify the taxpayer of his decision. However, there is no time limit imposed on the Collector to carry out such a review of an appeal and this would be a disadvantage to the taxpayer as he had already paid the stamp duties. A delay in the decision may affect the taxpayer's cash flow given the fact that

the rate of stamp duties is as high as 3% in the case of acquisition of real property.

The taxpayer can further appeal to the High Court within 21 days after the notification from the Collector in the event he is dissatisfied with the Collector's decision.

The new appeal procedure allowing the Collector of Stamp Duties to carry out the review and adjust the stamp duties accordingly would no doubt streamline the appeal and expedite stamp duty cases. However, the fact that there is no time limit imposed on the Collector to carry out the review may be seen as a shortcoming.

The WTO Secretariat report for the third trade policy review of Malaysia by the Trade Policy Review Body of the WTO on 3 and 5 December 2001 stated that the electronic sector in Malaysian appears to offer a striking example of the benefits of an open regime in fostering development. The sector has drawn significant flows of foreign direct investment (FDI), has had fairly little tariff and non-tariff protection, and has grown to account for approximately 2.5% of global electronics production: it has been among the main engines of Malaysia's growth, and its strong external competitiveness was an important element in Malaysia's recovery from Asian financial

crisis, with the sector accounting for more than half of Malaysia's total exports.

In a paper titled "Taxation and Social Development" presented by M. Nadarajah at Taxation and Social Development workshop in Kuala Lumpur, organized by the Malaysian Trades Union Congress (MTUC), he stated that the Malaysian tax system hardly helps workers and their families. The tax system virtually institutionalises an indirect tax regime. A projection of tax revenues from 2000 to 2005 indicates that personal income tax will drop by about 0.5 percent while sales tax will increase by about 10 percent. Instead of being premised on progressive redistribution, the Malaysian tax structure is fast becoming regressive, pro-business and pro-rich. Indirect taxation in a highly unequal society results in regressive distribution where the tax burden shifts to and hurts the poor.

A study by Elayne Yee (2003) in her paper titled "Reviving the Property Sector" states that since 1998, efforts by the Government and private sector to revive the property industry, particularly by lowering interest rates, relaxation of rules for property ownership by foreigners, home ownership campaigns and the resumption of several infrastructure projects helped turn the sector around.

PERPUSTAKAAN UNIVERSITI MALAYA

From the late 1980s to the mid-90s, the construction sector played an important role in the development of the Malaysian economy. Through the creation of fixed assets, it complements other sectors by providing a basis for generating output income and employment, all necessary ingredients for promoting economic growth.

However, the property sector has always been highly sensitive to economic ups and downs everywhere, with prices soaring during boom times and melting during slumps.

It is also capable of contributing to the boom and bust cycles through over-construction when the economy is soaring.

Falling property prices can cause problems for financial institutions which use properties as collateral. Experience elsewhere has shown that a collapse of the property market can even lead to severe outcomes, including bank failures. But the property market is cyclical and it is not bad all the time.

The growth trend of the construction sector almost moved in consonance with gross domestic product (GDP), although the former demonstrates more volatility. Prior to the 1998 Asian economic crisis the construction sector grew considerably, particularly since 1990.

There was an unprecedented and sustained economic boom that commenced in 1987 and ended in 1997, during which the property market characteristically was in overdrive.

The sector grew at 13.4 per cent per annum during 1990-1997 (pre- crisis period) arising from the active property market and accelerated development of infrastructure projects. It then plummeted drastically in 1998 (-23 per cent growth) due to the Asian crisis which sent the economy into a severe recession.

It began to recover, albeit slowly, after 1999. The effect of these initiatives was observed in the third quarter of 1999 when growth in this sector was at 4.6 percent.

A study by Frances Po (2003) titled "Malaysia - The Role of Tax-related Measures in the years of Economic Downturn" says that in the 2003 Budget, the Government directed policy measures to strengthen domestic sources of growth, particularly the private sector. The Government has implemented expansionary fiscal policies for five consecutive years since 1998, resulting in an increase in public investment but a decrease in private investment.

Tax-related measures constitute one aspect of Government's policy measures to address the decline in private investment and spending is tax related measures. These tax measures have been mainly in the form of tax incentives to stimulate the private sector.

Some sectors of the Malaysian business community were disappointed that the current corporate tax rate of 28% was not reduced during the recent Budget. However, what many non-tax practitioners do not realise is that Malaysia does not impose further withholding taxes on repatriation of dividends unlike Taiwan, Japan and Thailand. If this were taken into account, the tax burden in these countries would be significantly higher.

The public perception that a low corporate tax regime will attract more foreign direct investment is also not necessarily true. In the past, Malaysia has been successful in attracting foreign direct investment, even when the corporate tax rates were higher.