CHAPTER 2: LITERATURE REVIEW

2.1. Automobile Industry

Many developing countries regard the automobile industry as an economically strategic sector "in the light of its contribution to national production, employment and technology, reinforced through the magnitude of upstream and downstream activities" (Fujita, 2001). This is due to the fact that an automobile is made up of over 5,000 parts and components and thus the industry can create significant linkages and clustering as many of these parts and components are manufactured by suppliers in other industries, such as plastic, steel, electronic, rubber, textile, glass and metal (Tham, 2003). Both agree that the above factors as well as the large amounts of investment and large-scale production typically required of capital-intensive industry, largely explain government's extensive intervention in the sector, prevalent in many countries.

2.2. Government's Policies in Developing the Automobile Industry

In general, Malaysia chose to develop the automobile sector through national car productions, whereas the Philippines and Thailand tapped on foreign direct investment (FDI) and joint ventures (JV). Indonesia also used the same route as Philippines and Thailand, though there was a brief attempt to develop a national car. All countries utilized the import-substitution and subsidies approach to promote the development of the automotive sector in their respective economies (Tham, 2003).

Gabiliaia (2001) indicates that in order for the government to protect the automobile industry against foreign competition, there are certain amounts of protection used by each country in the form of tariff and non-tariff barriers i.e.

high import duty for passenger cars, import bans and quotas as well as investment requirement.

The Malaysian automotive sector is the most highly protected in the ASEAN market as well as the world market while the Philippines is the most liberalized in the global market. Indonesia is the most open in the ASEAN, followed by Thailand and the Philippines.

Fujita (2001) examines how the policies adopted by Thailand and Malaysia have shaped the development patterns and structure of the industry. The Thai government encouraged foreign multinational corporations (MNCs) to establish their production bases by providing various privileges and protection, and the government simultaneously adopted policies to develop local parts suppliers. In addition, Thailand utilized import-substitution to induce the development of the automotive sector in the country through the establishment of joint ventures with the automobile multinationals from Japan, the United States (US) and Europe (Abbot, 2003).

Additionally, a more liberalized policy was pursued by Thailand by the removal of the local content requirement in 2000, in compliance with the Trade-Related Investment Measures (TRIMs) Agreement, lowering import tariffs and relaxing equity policy to attract foreign direct investment (Tham, 2003)

In the case of Malaysia – a high import duty and local content policies are used to protect the national cars, domestic assemblers and component parts makers to enable the national passenger cars to capture the domestic market. Alavi (1996) estimated that the effective rate of protection of the transport and equipment sub-sector was as high as 252% in 1987. In contrast, the first national car, Proton, was given a preferential import duty rate of 13% on CKD parts and a 50% exemption from excise duty (Tham, 2001). Likewise, the second national car, Perodua, was provided with a full exemption of import duty and a partial exemption on excise duty on certain models.

In addition to these, the Ministry of International Trade and Industry (MITI) further regulated the selling price of each model, for both national and non-national cars, as its approval was required for price-setting.

2.3. The National Automobile Industry

The history of the Malaysian automobile industry goes back to the early 1960s, when the Malaysian government developed a policy to promote an integrated automobile industry to strengthen Malaysia's industrial base. The main objectives of the government in promoting an automobile assembly industry were to reduce imports, save foreign exchange, create employment, develop strong forward and backward linkages with the rest of the economy, and obtain transfer of industrial technology. The government's efforts were fully reimbursed - industry managed to move into the manufacture of motor vehicles and component parts in the 1980s and 1990s from just being a fragmented and inefficient assembly base in the 1960s and 1970s. The industry fulfilled the abovementioned goals, which have significantly contributed to the national economy in terms of manufacturing output and employment.

The Malaysian national automobile industry symbolizes the determination of the nation to shake off its traditional status as a producer of primary commodities and to emerge as a member of the community of industrialized nations. It is not only one of the major industrial sectors but also a national pride. (Gabilaia, 2001)

The automobile (i.e., passenger car) industry is one of the sub-sectors of the motor vehicle sector. The other sub-sectors are commercial vehicles, four-wheel drive vehicles (4WD) and motorcycles. The automobile market in Malaysia can be grouped into two major categories; i.e. the national car (Proton and Perodua) and the non-national car segments. The automobile industry generally constitutes over 80% of the total motor vehicle market in the country.

The automobile sector in Malaysia is assumed to be an engine of industrial development, provider of technological capability, and generator of inter-industry linkages (plastics, steel, electronics, glass, metal, rubber, textile industry). In addition, the industry is recognised as a priority industry to act as a catalyst for the development of the engineering and other supporting industries in the country due to the requirement of a high degree of technological development, skills, precision, and extensive linkages with other industries.

Apart from the protection given by the government, the national car (Proton) has a disadvantage in the size of the Malaysian market and in the size of its installed capacity. Proton has two production plants that are capable of producing 230,000 cars per annum. The new Tanjung Malim plant is reported to have a capacity of 150,000 cars per annum and it is scheduled for completion by 2004 (The Star, 14th June, 2002). In contrast, the Korean automobile Kia, reportedly has a yearly production capacity of 1.15 million units (The Star, 24th November, 2003). The Hwasung plant alone produces 600,000 vehicles annually.

While global competitors can spread the high cost of development and expensive tooling over larger production units and world-wide sales, Proton has to amortize the same expenses over much smaller numbers and mainly for the Malaysian market alone. Hence, it inevitably faces higher production cost per unit. It is also deprived by its shorter history and limited distribution network outside Malaysia and the United Kingdom (Koo, 2001).

Further, the national car is competing against global brand names that are operating in the other ASEAN countries. Thus, the prospects of Proton capturing a significant size of AFTA market is quite dim. A strategic alliance with one of the leading auto companies will enable it to improve its cost and branding problems.

Under the highly protected environment and rapid growth in domestic demand, the automobile industry in Malaysia grew at an average growth rate of 10% during the period 1991-2000.

2.4. Towards Liberalisation

The global move towards liberalization is gradually freeing up the flow of capital and products even in this heavily protected sector; and emerging markets are slowly being integrated into the global network of automotive industry. At the same time, however, many developing countries are still concerned about protection of domestic industries, which are not ready to compete with global players, and they are exerting a countervailing force against liberalization (Fujita, 2001).

In January 1992, heads of the Association of South East Nations (ASEAN) governments agreed to establish an ASEAN Free Trade Area (AFTA). One of the objectives of AFTA can be achieved through a reduction or elimination of tariffs on intra-ASEAN trade in the goods sectors. The target is to achieve tariff between 0%-5% in 2003.

With AFTA, all trade barriers will be removed and this in turn can have negative implications for the Malaysian automotive industry in several areas. Firstly, foreign competition can pose a serious threat to the future development of the local automotive industry. Secondly, the national car producers will face outside pressure on the local market from other manufacturers, in both the component and finished products. Finally, there is a possibility of collapse of the inefficient and weak firms at the expense of stronger and more efficient ones. (Gabilaia, 2001)

Thailand had the advantage of liberalizing earlier than Malaysia in its AFTA and TRIMs commitments, and it therefore had a first mover advantage in capturing the AFTA market, excluding Malaysia.

2.5. Taxation in Malaysia

Government authorities generally impose two broad types of taxes, namely direct and indirect taxes. In Malaysia, the responsibility to administer direct taxation lies with the Director General of Inland Revenue while indirect taxation is administered by the Director General of the Royal Customs Department. Tax revenue is the main source of income for the government of Malaysia as the country continues to experience economic development.

2.6. Indirect Taxation

Indirect taxes include export, import, excise, sales, levy and service taxes. Duties and taxes are fixed by the Minister of Finance and gazetted under the relevant Order on recommendations made by the Special Advisory Committee on Tariffs (SACT) and the Treasury. The concept of Customs control envisages the complete control of all goods entering and leaving a country by sea, land or air. Procedures for the import and export of goods are laid down in the Customs Department Instructions. Import Duty, Surtax and Sales tax are the duties payable on imported goods. Import duty is either *ad valorem* or at specific rates specified in the Custom Duties Order. Surtax is additional to import duty and was at the fixed rate of 5 percent. Surtax was imposed only on selected goods listed in the Schedule to the Customs Order. However, surtax has been abolished with effect from 29 March 1990. It is now incorporated as part of the import duty rate. Both import and surtax (prior to abolishment) are regarded as Customs duty and is levied under the Customs Act. Sales Tax is imposed under the Sales Tax Act and is applicable to both imported and locally manufactured goods.

Developing countries rely heavily on indirect taxes for convenient tax revenue generation in the early stages of their tax system (Musgrave, 1987). This trend applied too in the case of Malaysia.

Table 2-1: Indirect Taxes as a Percentage of Federal Tax Revenue

Year	Export Duties	Import Duties & Surtax	Excise Tax	Sales Tax	Other Indirect Tax	Total Indirect Tax
	%	%	%	%	%	%
1960	29.2	40.0	0.9	-	6.4	78.4
1965	19.9	40.1	0.8	-	12.1	72.9
1970	14.0	27.9	12.5	-	10.6	65.0
1975	13.7	17.5	9.3	5.9	9.4	55.8
1980	20.2	15.9	7.6	5.4	6.6	55.7
1985	10.0	14.9	8.3	7.4	7.8	48.4
1988	10.1	17.4	11.3	7.9	4.2	50.9
1991	8.3	16.2	11.1	9.8	3.3	48.7
1993	4.6	14.3	11.6	10.9	5.1	46.5
1995	2.0	13.5	12.7	11.7	5.6	45.5
1996	2.2	14.9	13.9	13.1	7.1	51.2
1997	2.2	15.0	14.6	14.5	7.6	53.7

Source: Department of Customs & Excise, Malaysia, Annual Reports, Various Issues.

The fast expansion in indirect taxes was primarily due to the significant role played by traditional taxes such as Import Surtax and Rubber Export Surcharge introduced in 1960's. The relative importance of indirect taxes has steadily declined over the years (from 72.9 percent in 1965 to 65 percent in 1970 and to a low of 48.4 percent in 1985). In 1992, the proportion of indirect taxes to Federal

Tax Revenue stood at 49.4 percent. Correspondingly, the importance of direct taxes increased. In 1960, direct taxes contributed only 21.6 percent of total tax revenue. Its share reached 50 percent in 1985, and since then has remained almost constant up to 1992. In 1995, the share of indirect taxes stood at 45.5 percent of total tax. In 1996 and 1997, there was a reduction in the share of direct taxes compared to indirect taxes.

2.7. Import Duty

Import duty is imposed on goods (animals, birds, fish, plants and all kinds of moveable property) imported into Malaysia. Certain classes of persons and types of goods are exempt from customs duties under specific exemption orders. However, the Customs (Prohibition of Imports) Order 1988 prohibits the import of specified goods into Malaysia. Such prohibition could be an absolute prohibition; or the goods could only be imported if a licence to do so is obtained; or the goods could be imported in a specific manner, e.g. fresh and chilled fruits can be imported subject to inspection by the Ministry of Agriculture.

Import duties on heavy machinery such as crane trucks, bulldozers, graders, scrapers, road rollers and pile drivers were abolished with effect from 28 October 1994. The abolition of the duty was made to assist in the implementation of development projects, which require substantial use of heavy machinery and equipment. In an attempt to promote the activity of reconditioning used heavy machinery and equipment, import duties were re-imposed (from 25 October 1996) on selected heavy machinery.

With effect from 28 October 1994, the import duty on a whole range of raw materials and components, which are used for the manufacture of goods, has been abolished. This was done so as to increase the productivity and competitiveness of the manufacturers for the domestic market. In addition, import duty on goods such as food items, petroleum products, textiles, electrical machinery and equipment, household appliances and pianos were also lowered or abolished. The reduction or abolition of duties is designed to assist in the effort to control inflation and promote competition with the view to overcome market imperfections and stabilize prices.

With effect from 27 October 1995, import duties on some 800 items of raw materials/components and equipment were abolished. As a measure to control inflation caused by rising prices of food, exemption from import duties on specific equipment and inputs that are directly used in the production of food has been granted. Duties on around 710 items were also reduced in line with the objective to reduce tariff protection to enhance efficiency of local manufacturers.

Duties on specific items were reduced in line with Malaysia's commitment to the World Trade Organization (WTO) and AFTA to progressively reduce tariffs. In addition, duties on all basic medical equipment were abolished so as to promote better health care. It was also announced that exemption of duties on broadcasting equipment and production/post production equipment for the film and music industry will be given so as to promote the local broadcasting industry.

From 26 October 1996, import duties on a few items were also reduced or abolished. These items included dental alloys, deodorants, cosmetics and soap products, instant print film, duplicating paper, carpets, razors and blades, modems, uninterruptible power systems and transmissions apparatus. In addition, import duty exemption on equipment for converting petrol/diesel vehicles into natural gas vehicles has been extended to any local vehicle assembler/manufacturer.

From 17 October 1997, with the view to develop the local engineering, mechanical and construction industries as well as to curb the over dependence on the importation of capital, heavy machinery and intermediate goods, import duties were imposed or revised on a variety of heavy machinery, construction material and equipment. In an effort to curb the import of luxury vehicles (including cars, 4 wheel drives (4WD), multi-purpose van (MPV), vans and motorcycles), an increase in import duties took effect from 17 October 1997.

As we can see, every year, changes are made to import duties for several purposes as follows:

i) To increase the competitiveness of domestic producers (who have been enjoying tariff protection for a long time)

ii) To reduce the cost of doing business (as in the case of exemptions of spare parts and consumables)

iii) To increase tax revenue

iv) To encourage the development of certain sectors (e.g. to create an efficient and modern distribution system to support the manufacturing and trading sectors, prime movers and trailers used by hauliers were exempted from import duty and sales tax from 28 October 2000)

v) To encourage various activities such as energy conservation (as such equipment used for this is exempt from import duty and sales tax), waste recycling and generation of energy using biomass, etc.

As mentioned above, goods from ASEAN origin are entitled to preferential rate of import duty under the Customs Duties (Exemption) (Goods of ASEAN origin) Order. The relevant Certificate of Origin duly authorized by the Government Agency or Ministry concerned from the originating country must be produced at the time of importation to be granted the exemption. The exemption granted is either partial or full and applicable to import duty only. Other taxes, such as surtax (prior to abolishment) and sales tax are not exempted.

2.7.1. Import Duties on Motor Vehicles

As mentioned earlier, the Malaysian government policies in protecting national car industries include imposing high import duty on imported cars. High import tariffs have contributed significantly to developing Malaysia's national car production. By relying less on imported automobiles, Malaysia has, to some extent, reduced its balance of payment deficit. The impact of high tariff on imported vehicles has resulted in the following:

i) Protection of the domestic automobile industry: local producers of national cars earn higher profits due to their higher prices and increase in production.

ii) Reduced foreign exchange outlays: tariffs reduce demand for imported cars because the price differential makes imported automobiles unaffordable for many people.

iii) Higher government revenue: unlike quotas, the government of importing country collects revenues from tariffs.

For the past few years, the import duty for passenger cars is between 140-300 percent, based on engine displacement. [New Diesel cars (CBUs) are charged a rate of 120 percent, while used diesel cars are charged the same rates as gasoline engine vehicles (chart below)].

Passenger Cars	CBU	CKD
Engine Capacity (cc)		
Less than 1,800	140%	42%
1,800 - 1,999	170%	42%
2,000 - 2,499	200%	60%
2,500 - 2,999	250%	70%
3,000 and above	300%	80%

Vans/MPVs		
Less than 1,500	60%	5%
1,500 – 1799	60%	10%
1,800 - 1,999	80%	20%
2,000 - 2,499	150%	30%
2,500 - 2,999	180%	40%
3,000 and above	200%	40%
4WD		
Less than 1,800	60%	10%
1,800 - 1,999	80%	20%
2,000 - 2,499	150%	30%
2,500 - 2,999	180%	40%
3,000 and above	200%	40%

Sources: Customs Duties Order 2002

The import duty for auto parts and components ranges from 5-30 percent, and is tied to local content regulations. However, the import duty for national car (CKDs) is given a special exemption in which only 13 percent is imposed on all products.

2.8. Excise Duty

Excise duty is a form of indirect tax. It is also known as consumption tax because it is levied on production and sales of products, which are produced or manufactured locally. In Malaysia, excise duty, prior to 1 January 2004, was levied on domestically produced goods whose elasticity of demand and supply are low.

Rejab (1968) indicates that in underdeveloped countries, revenue from excise duty is very small. This is because only small portions of goods consumed in those countries are produced domestically. Thus, the collection of excise duty is limited to a few numbers of goods only. In those countries, there is a heavy reliance on export and import tax revenue as their principle source of finance, which in turn depends on the fortune of a few primary export commodities.

However, in developed countries, which is characterised by intense industrial and manufacturing activities, such as United Kingdom and Unites States of America, the bulk of the revenue comes from income on internal transactions.

However, in Malaysia, excise duty is merely a form of revenue duty. It is formed primarily to collect duty, unless in a developed fiscal system, the excise duty plays a similar role as other indirect taxes, i.e. to fulfil income correction role. In other words, excise duty is levied on a commodity with high-income elasticity of demand. Therefore, in times of slump, consumption falls greater proportionate to income. Excise duty also plays a role as a checker on consumption of luxuries and other commodities that are not essential for health and efficiency such as alcoholic drinks and cigarettes.

The British introduced excise duty in Malaysia in order to control the brewing and distilling of all forms of intoxicating liquor including samsu and toddy, which was consumed by the immigrant population. Excise duty was also implemented to collect duty on the manufacture and sale of intoxicating liquors and the rates were specific and the collection process was therefore simple.

In the last few decades, the importance of excise duty has increased due to an increase in the switch from import to domestically manufactured goods. In addition, the extension in coverage of excise duty over a wider range of locally manufactured goods has also contributed to the higher dependence towards excise duty. The major increase of excise duty revenue is due to the presence of oil refining industry in Malaysia. The excise duty on petrol is very high and the low elasticity of demand for petrol results in a very substantial income to the government.

The Excise Enactment came into force in 1932 and a few more items were added to the excisable list of goods. These included matches, kerosene and playing cards. No changes were made until the 1960s when the government announced its incentive scheme for industrial development in Malaysia. Manufacturers of consumables and durable goods taking advantage of generous exemptions made available under the scheme established their factories here. Simultaneously, the provision of tariff protections for local industries assisted manufacturers to secure a substantial portion of the local market for their products.

The need to obtain revenue from locally produced goods prompted the government to place newly established factories under excise control. In 1968, 63 items were subject to excise duty. This figure increased to 100 in 1978 as more and more consumer goods were produced locally, but dropped to 58 and 50 in 1981 and 1988 respectively due to the implementation of sales tax.

Excise duty is no longer at specific rates as it was when excise was first introduced in this country. Of the 50 dutiable items in 1988, 16 are subject to *ad valorem* excise duty rates ranging from 5 to 65 percent, the highest rates being imposed on motor vehicles.

Later, Excise Duties Order 1991 was deleted and merged the majority of excisable items into the Sales Tax Order with the purpose of easier tax administration, even though this may not be practical for all items. Items like liquor, cigarettes and petroleum will have to be tested, weighed or measured in order to determine the correct amount of excise duty that is to be collected. Moreover, collection of excise duty is direct and immediate, that is excise duty becomes payable as soon as the goods are removed from the factory, although delayed payment of duty is permitted on items like petroleum and motor vehicles.

Excise duty on motor vehicles does not become payable until the vehicle is registered by the Road Transport Department for use on the road. Excise duty payable, in this instance, is at the rate in force on the day the vehicle was released from the assembly plant, not the day on which it was registered for use. The maximum period permitted for payment of duty on motor vehicles is five years from the time of removal of the vehicle from the assembling plant.

2.8.1. Excise Duties on Motor Vehicles

Prior to 1 January 2004, all CBUs are not required to pay excise duty because excise duty is only imposed on CKD vehicles. Passenger cars are assessed on a progressive schedule as follows:

First RM 7,000 x 25%

Next RM 3,000 x 30%

Next RM 3,000 x 35%

Next RM 7,000 x 50%

Next RM 5,000 x 60%

Balance x 65%

In addition, there is a 30 percent and 45 percent excise tax imposed on MPV/Vans and 4WD vehicles respectively. However, national cars again receive a 50 percent exemption in the excise tax.

Excise Duties Order 2004 (the Order) comes into operation on 1 January 2004 and simultaneously revokes the Excise Duties Order 1991. Excise duties, as stated in the Order, shall be levied on and paid by the manufacturer or importer in respect of goods manufactured in Malaysia or imported into Malaysia. Those goods are described under the Order as follows:

i) Chapter 22 - Beverages, spirits and vinegars

ii) Chapter 24 – Tobacco and manufactured tobacco substitutes

iii) Chapter 87 - Vehicles, other than railway or tramway rolling stock, and parts and accessories thereof,

iv) Chapter 95 – Toys, games and sports requisites: parts and accessories thereof in respect of playing cards and mahjong tiles.

From the interview with the Senior Assistant Director of Customs, Internal Tax Division, Mr Bani Roslan, it was gathered that the objective of the introduction of Excise Duties Order 2004 are as follows:

i) Towards liberalisation as mandated in AFTA and WTO;

ii) To protect local industries especially the automobile; and

iii) To cover the loss of revenue from reduction in import duties.

2.8.2. *Impact of Excise Duty*

Similar to other indirect taxes, the impact of excise duty on the taxpayer is indirect. However, it depends on the elasticity of demand for and the supply of the product. In other words, it depends on the degree of competitiveness of the product in the market.

For a highly elastic product, the producers bear the bulk of the burden of the duty imposed. The reason being, any attempt to increase the price to absorb the duty will only result in consumers shifting to other close substitutes.

On the other hand, if the product is inelastic, the producers can pass at least part of the tax to the consumers. The tax is passed directly to the consumers in the form of higher prices.

Certain goods may enjoy full or partial exemption on excise duty. This is provided in Part III, Provision 10, paragraph 1, 2 and 3 of Excise Act, 1961. Most semi-government or public undertakings can get the above exemptions.

2.8.3. *Excise Duty and Import Duty*

It is important to appraise revenue from both excise duty and import duty together due to the continuing substitution of imports and growth of local manufacturing, which affect the level of imports and thus the import duty.

The growth in output for domestic use has increased due to the increase in domestic demand as well as government policy to encourage industrial development as part of the country's development programme. Since the country can produce goods and services locally, then the growth in import is low. Undeniably, the progress in industrialisation, especially in the field of import-substitution, resulted in a stagnant or decline of revenue from import duty on many products. For example, petrol, heavy fuels and liquors are currently locally produced, and thus reducing the need for imports.

To some extent, even though not fully, the decrease in import duty is offset by the increase in excise duty. This is because the import duty is normally higher than the excise duty, except for petroleum products.