How Can Domestic Resource Mobilisation (DRM) Through Taxation Help Reduce Poverty and Inequality

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1. Introduction

The government of Malaysia relies heavily on revenues from taxation to fund the various development projects and social programs in the country. Most of these revenues are derived from direct taxes (Appendix 1). Traditionally, progressive taxation is a policy which is used to reduce income inequality amongst individuals, that is those with higher income pay more taxes whereas corporations in Malaysia are taxed at a flat rate. Corporate taxes contribute approximately half of the total direct taxes collected by the Inland Revenue Board of Malaysia (IRBM). A portion of the revenues collected would then be utilised on public spending to assist the poor. Thus the income is redistributed from the rich to the poor. But is the tax system which has progressive income tax and high corporate tax the best system? Does an individual who has more income pay more tax? How high the rates can the Government impose on its people and businesses?

2. Sharing the tax burden

In Malaysia, only a fifth of the total workforce in the country (approximately 1.2 million individuals) are paying income taxes. Is the tax burden being shared fairly and equally in Malaysia? Are people paying the taxes that are due from them?

2.1 The self-employed

The gap between the highest personal and corporate tax rate is 6% (Appendix II). The self-employed can take advantage of the disparity and choose the corporate form of doing business if his marginal tax rate is more than 20%.

2.2 The rich

The rich or the high income group can afford to employ the best tax professionals to devise sophisticated tax schemes to reduce his tax or not paying any tax at all (The rich aren't like us; they pay less tax – by Peter De Vries, an American author).

2.3 The multinational corporations (MNCs)

The MNCs in Malaysia are paying little or no taxes at all because of the various tax incentives that are being granted by the Government. Though the

MNCs have created many jobs in Malaysia, the irony is Malaysia has a shortage of labor in the country and most of the workers employed by the MNCs are foreign workers from neighboring countries like Indonesia, Vietnam and Bangladesh.

2.4 The informal sectors

The informal sectors or underground economies in Malaysia are not paying taxes at all. The individuals involved in these sectors do not registered with the IRBM and they are difficult to trace. More often than not, the ones involved in illegal activities are syndicated and well organized.

2.5 The salaried group

This group of taxpayers especially the middle-income group is bearing the brunt of the tax burden as every dollar that an employee earned is taxed through the Schedular Tax Deduction Scheme where a portion of his monthly salary is deducted by his employer and remitted to the IRBM.

The issues mentioned above are further compounded by the Self Assessment System (SAS) that was introduced in 2004. SAS is an efficient tax administration system whereby a person computes his own tax liability and pays his tax by the due date. The IRBM need not examines his tax return and issues notice of assessment to him. In recent years, there are quite a number of dishonest taxpayers who have submitted their self-assessed tax returns by making maximum claims on reliefs and deductions which they are not entitled to since there is no requirement to attach any receipts or documents as proof. Their unscrupulous actions have caused the Government huge losses in tax revenues.

3. Trend of taxation in Malaysia

From observation, the trend of taxation in Malaysia is gradual reduction in personal and corporate tax rates in recent years. The highest personal tax rate and the corporate tax rate have been reduced from 30% and 28% in 2000 to 26% and 25% respectively in 2010. A small and medium corporation can further enjoy a preferential tax rate of 20% for its first RM500,000 chargeable income. The rates are reduced to maintain a competitive fiscal environment in Malaysia in view of the keen competition from her neighbors. However, competitiveness has a price. Reduced tax rates would mean decreased revenues from direct taxes, bearing in mind that direct taxes contribute more than 50% of the country's total revenues. Petroleum tax that has been contributing 30% to 40% of the total direct taxes for the past many years is losing its glory. Petroleum resources are depleting in Malaysia and the price is subject to volatile fluctuations. The Government cannot therefore rely on petroleum for its much needed revenues and has to find a

substitute to ensure the country continues to have a steady source of tax revenues.

4. Recommendations

The tax system in Malaysia needs to be reviewed in order to redistribute wealth to reduce poverty in the country and income inequality amongst individuals. Some of the recommendations are:

4.1 Reducing the highest marginal tax rate for individual

A good tax policy should ensure that the highest marginal tax rate for individual should not differ from that of the corporate tax rate. Currently an individual may be taxed at the highest rate of 26% whereas a small and medium corporation (SMC) is taxed at a flat rate of 20%. The gap of 6% between personal and corporate tax rate provides strong incentive for certain individuals to choose the corporate form of doing business. In this respect, professionals and sole-proprietors can legally avoid being taxed at the highest personal income tax rate. It is time the Government seriously thinking about closing the gap.

4.2 Rationalizing personal reliefs and deductions

Current tax laws provide a myriad of reliefs and deductions which an individual may claim (Appendix III). The numerous reliefs and deductions not only made tax administration works difficult but are subject to abuses by taxpayers as well. In my opinion, most of these reliefs and deductions can be done away with and be rationalized to a few basic reliefs (self, spouse and children) and allow full deduction for statutory contribution to Employee Provident Fund and payment for premiums on life and medical insurance. With the rationalization, the tax system for personal income tax would be easier to administer with not much chance of fraudulent claims and everyone pays his fair share of tax.

4.3 Goods and Services Tax (GST)

Since independence in 1957, Malaysia has had not more than six years of fiscal surpluses. There is a dire need for broadening the country's tax base while reducing the corporate and personal tax rates so as to stay competitive with Singapore and other ASEAN countries. The proposed introduction of GST could be a new source of revenue for the Malaysian government. The GST was first announced in the 2005 Budget but its implementation was deferred due to unforeseen circumstances. The GST is being proposed again in the recent 2010 Budget. GST is a broad-based consumption tax based on

value-added concept and is also known as Value Added Tax (VAT) in some countries. It is viewed to be a more equitable and efficient tax than the present sales tax and service tax which have many inherent weaknesses. Many countries have successfully adopted GST/VAT as part of their fiscal strategy. In fact most countries now rely on the consumption tax for their revenues instead of direct taxes like income tax. Most of Malaysia's neighbors have introduced GST/VAT since the 1980s and 1990s (Appendix IV). However, the idea of GST is not received well by everybody in Malaysia. A senior leader of an opposition party has expressed his concern that GST will create more hardship for the lower-income earners and erode the competitiveness of small and medium-sized enterprises. Those individuals who are paying income taxes would certainly welcome GST because higher prices of goods and services would be compensated by reduction in personal income tax. Moreover, one would only pay GST if one consumes. However, the lower-income group who are out of the tax net may feel the pinch more because their disposal income would be less by the GST that they have to pay. GST is perceived to be more regressive than income tax. However, the Government has announced in December 2009 that basic necessities and businesses with turnover not more than RM500,000 will be exempted from GST. The proposed rate is 4% with implementation date in September 2011. Despite the assurances, would the elected Members of Parliament vote in favor of GST?. The Bill on GST has to be passed in the Parliament and Malaysia has a very strong coalition opposition party since the last general election on 8 March 2008. The Government definitely has to take many factors into consideration, especially the political sentiments prevailing in the country then before implementing the tax.

5. Conclusion

With so much economic uncertainties in the world today, Malaysia as a developing country must constantly review its fiscal policy to continuously enhance its competitiveness in the global markets. It is always the aim of the Government to raise enough revenues for the country without much pain being felt by its people and to mobilize the domestic resources to improve the standard of living for the poor in the country. It is also the desire of the Government to eradicate poverty in the country and to achieve a more equitable society.

The views expressed in this paper are the views of the writer and do not represent the views of the Inland Revenue Board of Malaysia.

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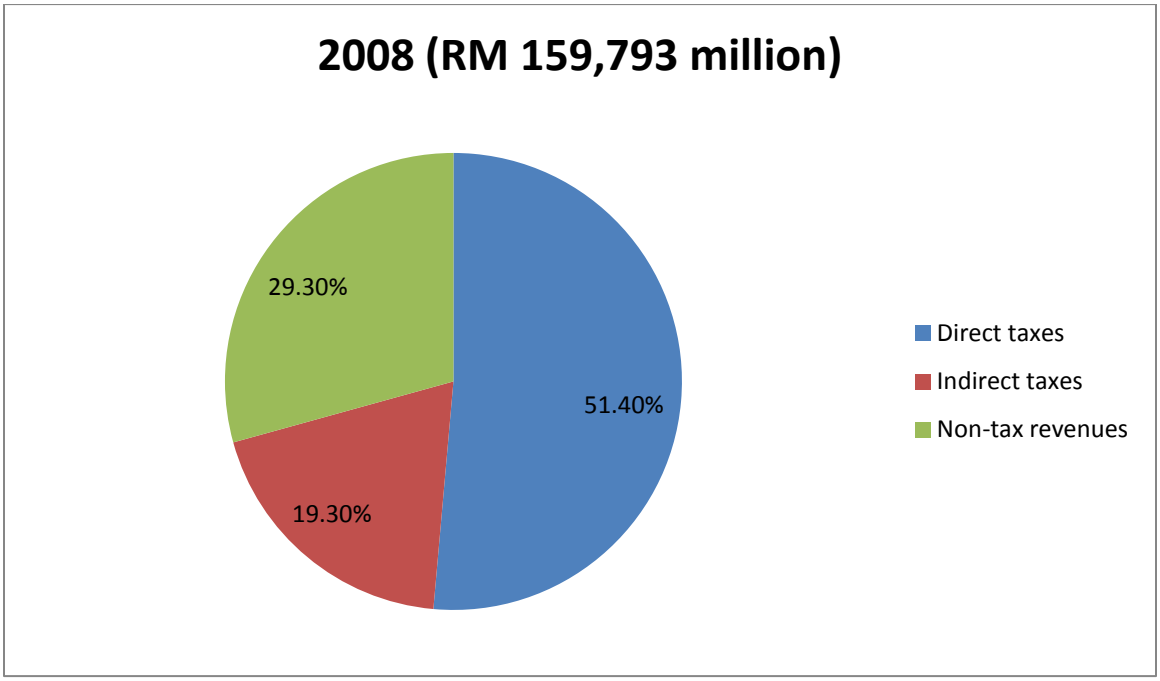
Appendix I

Federal Government Revenues



Direct taxes (RM 82,138 million = 51.40% of Federal Government Revenues)

- Corporate tax: 47%
- Personal income tax: 18%
- Petroleum tax: 30%
- Stamp duty & others: 5%

Indirect taxes (RM 30,760 million = 19.30% of Federal Government Revenues)

- Excise: 35%
- Sales tax: 27%
- Service tax: 11%
- Export duty: 9%
- Import duty: 9%
- Others: 9%

Non-tax revenues (RM 46,895 million = 29.30% of Federal Government Revenues)

- Interest & returns on investments, licenses, road tax, fines & forfeitures, contributions from foreign governments & international agencies, petroleum royalties/gas cash payments

Appendix II

Tax rates in Malaysia

Years of assessment	Individual	SMCs (paid-up capital of not more than RM2.5 million)		Big corporations (paid-up capital of more than RM2.5 million)
		First RM500,000 of chargeable income	Chargeable income exceeding RM500,000	
2010	0% to 26%	20%	25%	25%

1 euro approximates RM 5

Appendix III

Types of personal reliefs and deductions

Reliefs / deductions	Amount (RM)
Self	9,000
Further self relief - disabled	6,000
Spouse	3,000
Further spouse relief - disabled	3,500
Unmarried children below 18 years old	1,000
Unmarried children above 18 years old & pursuing tertiary education	4,000
Further relief for disabled children	5,000
Life insurance premiums, contributions to approved funds & annuities	7,000
Medical & education insurance premiums	3,000
Annuity premiums purchased thru' Employee Provident Fund	1,000
Medical expenses for self, spouse & children on serious diseases	5,000
Medical expenses for parents	5,000
Expenses on supporting equipment for disabled individual, spouse, children & parents	5,000
Course fees for acquiring skills or academic qualification	5,000
Purchase of books, journals & magazines	1,000
Purchase of computer once every three years	3,000
Purchase of sports equipment	300
Deposits made to National Education Savings Scheme	3,000
Broadband subscription fees	500

Appendix IV

ASEAN – GST/VAT rate and poverty rate			
Country	**Year introduced**	**Current GST rate (%)**	**Poverty rate (%)**
Indonesia	1985	10	18.2
Thailand	1992	7	9.8
Singapore	1994	7	0
Philippines	1998	12	30.4
Vietnam	1999	10	28.9
Cambodia	1999	10	35.9
Laos	2009	10	30.7
Malaysia	September 2011 (?)	4 (?)	7.5

Other ASEAN countries with no GST/VAT: Brunei (poverty rate: 4%); and

Myanmar (poverty rate: 32.7%)