

MALAYSIAN TAX SEMINAR 2004

CHALLENGES IN MALAYSIAN TAX SYSTEM AND ADMINISTRATION

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It is indeed an honour to have been invited to this national seminar on taxation to present my thought to such distinguished and prominent audience. I wish to record my sincere gratitude to the organizing committee for choosing me to present the theme paper of this seminar on Challenges in the Tax System. The challenge to me rather is how to lift up to the expectation of the organiser and the fellow audience.

I have kept the subject matters in my mind for months to hibernate hoping that it will generate some fresh ideas so I could share them with all of you. But the ideas had never hatch. Finally I decided that I will just explore the subject with an open mind by broadening the scope as far as possible to invite all of you the distinguished audience here to join me in my journey into the *Future World of Taxation* – from my wildest dream.

Hence, though the seminar brochure emphasised the ‘Era of Self Assessment’, I have taken the liberty to journey further to the long future perhaps surpassing the 2020 target year for Malaysia to be a developed nation. Instead of presenting challenges in the form of ‘*mechanical problems*’ I have taken the liberty to discuss the pertinent issues and explore the various alternative route to journey, to overcome the challenges and to build a model of tax system that fit the anticipated environment.

I have also gone beyond the normal scope by exploring the area of Public Finance to relate to some pertinent points in the discussion. Please pardon me if this does not meet your expectation. An academia always treasure an opportunity to share his dream with others and I am not about to let this golden opportunities passed by.

INTRODUCTION

I will start with a brief history of Taxation. Taxation as a ‘system’ is a 20th. Century phenomenon ¹. Before this, Taxation was just an ad hoc means of collecting state’s revenue for specific purposes especially to fund the ‘war’. Hence the focus were on the easiest form of

taxes namely the 'trading taxes' (Import and Export) and the Land Tax ². It was in the 20th. Century that Taxation had become political instruments to pursue a specific economic interest and ideology. It is in this so called "*Modern Taxation*" era that policies such as '*efficiency*' and '*productivity*' had bloomed. To make the system more sophisticated, taxation had also been used to direct the economy towards the '*preferred*' sectors through Investment Tax Incentives and the likes. Further development saw that attempt was made to use Taxation as one of the State's economic and financial policies. The success of this tax instrument in directing and controlling the economy has always been debated by the academia.

The Malaysian Tax System has evolved in more or less following the same trail. We were fortunate that The British Government had inherited us with the '*most up to date*' System of Taxation when they left us in 1957. The system that Hearsman³ has introduced in Malaya in 1947 was considered most advanced at that time. That very system had lasted over half a century and still not be seen as too outdated. Some of the elements of the system still formed the Fundamental of Taxation System in our country that clearly distinguished us from the American system for example⁴ . The taxation system survived the colonization process in a way.

The Taxation System in Malaysia had progressed very far from that of a War Tax in 1910 , to '*Class Tax*'⁵ in the Income Tax system to '*Mass Tax*'⁶ and finally to semi-voluntary tax system in the form of '*Self Assessment Tax*'. Though the tax still emphasised on the corporate sectors as the main target, it had wide spread in terms of coverage making Inland Revenue Board as the most 'networked institution' in the country⁷ . The later development showed a

¹ See discussion by Sven Steinmo (2003) on the the evolution of taxation.

² In Malaya Taxation was introduced in 1910. In 1917 a temporat tax was initiated as a war measure and repealed in 1922, then introduced back in 1945 during the 2nd. World War solely for Imperial Defence.

³ R.B.Hearsman was commissioned to recommend a tax system for Malaya by the then British Government.

⁴ Though the later had been succeeded in colonising the thinking, technology, system and life style with the 'American Way' at every facet of our life today.

⁵ Where taxes were the affairs of the very riches in society – basically in the form of Income Tax.

⁶ Where taxes were paid by the public masses – in the form of Income Tax and Consumption Tax

⁷ Inland Revenue Department has the records and network addresses with almost all of the works force in the economy and those participated in the country economy.

move in emphasis from the Direct Taxation System towards 'Expenditure type of tax'⁸ – indirectly collected through the business premises.

Globalisation as a crucial environmental change affecting taxation system

Globalisation is a fact and a process. It is both technological and human. Globalisation emphasise the process of international convergence. It focuses on the increasing interdependency between countries of the world. Globalisation leads to increasing interdependence of the earth's people in term of opportunities it offers and imperatives it commands. Globalisation impacts trade in goods and services, the movement of labour, the spread of information and the capital flows⁹. Indeed, Globalisation is the most significant phenomenon affecting every one of us directly or indirectly without us realising. Unfortunately we have only seen the 'tip of the ice berg' and we are not able to anticipate what is coming next and how fast. The '*global village*' phenomenon is expected to penetrate into every facet of our life - slowly but surely. For a start, the opening up of the nations' boundaries will cause rapid mobility of population worldwide at the speed unimaginable before. The world has suddenly become so small – just like a small village relatively because of the demise in the concept of 'distance' and 'space' caused by the rapid development in information technology. Mobility will also extend to a lot of the economic activities causing kiosk in some economies that were not prepared for it. With World Trade Organisation promoting the opening up of domestic economies, all form of tariffs will be abolished resulting in a free movement of trades between nations without any form of protection and duties. This might cause heavy movement in investments and trades from one nation to another affecting the wellbeing of the population in some nations seriously.

To make the environmental changes more drastic, electronics and technology development will also cause a lot of commotion in an economy. The creation of '*Cyber World*' as a keen competitor to the 'conventional physical world' will disorientate all of us making this world a 'foreign avenue' to most of us. 'Virtual living' will become the prime theme in all facet of our life in a very near future. Information technology and Telecommunication will penetrate into

⁸ Either in the form of Consumptions Taxes or Expenditure Tax – the forms that was introduced by Professor Richard Kaldor in India in the 60s.

⁹ See for example George C. Loge, (1995) Managing Globalisation in the age of interdependence.

every aspect of life and economic activities creating virtual living environment that is so strange at first.

As a result of the creation of an alternative 'Cyber world', a lot of activities in this 'conventional world' will be replaced by virtual activities. We can expect that Internet will take over as the prime focus in our life. 'Web page' and 'e-mail' will become the only identity that existed in this virtual world. Physical existent become least important as long as a person can get access to his web page, others and his e-mail. E-mail will take over as the '*permanent address*' allowing a person to have multiple addresses only in the Cyber world. Business entity will only exist in the virtual form. Business office premises, shopping complexes, universities campuses or even governments facilities and departments will only exist in virtual forms – i.e. on the web. Even retail outlets will now exist only in the internet – imagine a virtual restaurants with 'home delivery' and 'personal services' delivered direct to the requested venue. All form of physical asset and wealth such as properties, luxury cars, yacht or even antiques will only exist in 'virtual' form i.e. 'chip cards'. Holding physical wealth has become so cumbersome that most people would prefer to hold a chip cards just like the 'time sharing membership' that will entitle one to enjoy the wealth without having to take care of it physically.

Challenges from globalization and the emergence of Cyber world

All the above development will have some serious implication on the tax system and its effectiveness. At least the following very pertinent phenomenon must be observed and taken into account in the ongoing reform in the tax system in Malaysia as challenges ahead :

a. The thinning and eroding in the citizenships loyalty

As the world become so small like a small village, mobility has become so convenient and easy ¹⁰ that it is difficult to tell what nationality a person is. As a result, the concept of citizenship becomes less and less relevant nor significant to a person. A person may be keeping multiple citizenships for convenient sake. The consequence of this is that the '*World basis of taxation*' applied on the basis of citizenship may become out of date and impractical .

¹⁰ That a person could practically have three or four residents worldwide – having breakfast in Tokyo, morning break in Kuala Lumpur, Lunch in Dubai and Dinner at San Francisco.

b. The multiple residents in different nations phenomenon

Relating to the above scenario, families might be so mobile that it becomes so impractical to determine their resident status ¹¹. Families will become 'modern nomad' who will move from one city to another capitalizing on the weather, events and specific schedules happening worldwide. As a consequence of this, the use of 'Resident Basis of taxation' and 'taxation based on remittance basis' will also become out of date.

c. The virtual business and factories as the 'master mind' of the economy

Retail outlets will only exist in the cyber world through web page and the 'Virtual supermarket, departmental store and shopping complexes'. It allows consumers to serve on the net and virtually walk through the departmental stores to 'window shop' and 'to pick up goods on the shelf'. Purchasing will only be a matter of clicking on the icons buttons ¹². Virtual factories will exist in the form of virtual Multinational Corporation that will integrate their suppliers to produce a specific product based on the vendors program – outsourcing all the raw materials, packing it and preparing it for delivery ¹³. The virtual factories owner only owns the design and the customer's networks. The consequent of this is that it is difficult to establish the 'permanent establishment' of a business. It will make it difficult for the Inland Revenue Board to apply 'derivation' as a source of taxable income. Now, if the 'worldwide basis of taxation' become impossible to apply, the 'remittance basis' of taxation – cumbersome and the *derivation basis of taxation* becomes impractical, what other choice do we have in continuing to stress on Income Taxation in a particular nation ? The question is what alternative do we have ?

d. The demise of all form of trade taxes – Import and Export and Excise taxes

Import taxes will be the first one to go in order to conform to the World Trade Organisation's (W.T.O.) call and the A.F.T.A.. Agreements. As a result, all nations will loss significant sources of income from the import activities that all along has been

¹¹ Imagine the case of time sharing membership that allow a family to move from one city to another just by producing membership cards at the chosen living accommodation.

¹² This is indeed not an imagination anymore. A hypermarket in Hongkong is giving away sophisticated 'goggle' to their valued customers to encourage them to do their shopping through the Virtual Hypermarket that they created.

¹³ With a D.I.Y. concept at the end – expecting the final consumers to assembled themselves.

regarded as the most convenient and strategic. Export taxes will also have to go as it will be impossible to implement and it does not make sense as it makes the local products less competitive in the world market. The same applies to the Excise taxes which resulted in the more costly goods that came out of the factories. Perhaps Excise taxes on sales of goods could still be applied on local purchasers. But this could also become impractical as consumers could now move to the neighbouring nations to make their purchase of similar goods. Furthermore, Excise tax could be combined with Retails taxes that will be imposed on the local consumption. Consumption tax will be the only viable tax over long run in this global village scenario. 'Value Added tax' or 'Goods and Services Tax' could conveniently be imposed on anyone make consumption in Malaysia without discriminating their resident or citizenship status.

e. The Cyber world business and consumers transactions

The *Cyber world* will slowly bloom a take over a lot of business transactions and consumptions made by the worldwide consumers. The challenge is to detect these transactions and to record them. Having done that, we need to establish the tax authority and jurisdiction . The only means of connection with all the above transaction is through the '*Internet Service Providers*' (ISP) that exist in the economy. The challenge is to establish a devise and scheme to detect purchases and transactions conducted by local population with the rest of the world - to capture the transactions and the value. To devise the mechanism of taxing the transactions is another challenge that might require extensive creative approach in *e-taxation*.

f. The international pressure towards Harmonization of Taxation

As nations' boundaries become less apparent, each country is under pressure to conform and harmonise with others in order to make living in the country as attractive as in other part of the world. The '*pull factor*' becomes so important to population that could conveniently move to other state or nation either permanently or just for their daily consumption . This pressure will cause us to slowly lose control of our economy. Effort to expand the tax base is most important in relation to raising tax rate. It means attracting more population to reside and spend their money in our country. This will be the biggest challenge in managing the economy. The mobility of capital and other resources will also be a function of this harmonization effort.

⋮

Taxation might have to be a secondary source of revenue for the government in the intermediate future. Nations of the world will need to find other permanent source of income to compliment taxation. Taxation will most likely be limited to the Consumption taxes , the rate, procedures and mechanism of which must conform to the accepted system applied worldwide. As a major part of the consumptions will be done through the Cyber world, each nation must design a sophisticated system of taxation to capture that transaction in order to legitimately tax them. Income tax could still be applied on the corporate sectors particularly the multinational corporations who serve the local populations. The 'earmarked tax' is the most natural tax that will exist in an economy. Consumers pay tax only to the extent that they enjoy the benefit from the services provided by the privatize entity. If only all privatization projects are retained by the government's entity, it could form as a major source of Malaysian government revenue in the intermediate future.

The other basic challenges from the conventional taxation paradigm

Taxation system has been designed to meet the government objective of raising revenue to fund the administrative and development expenditures. Taxation system had to be designed to make sure that it conforms to the 'normal rules' in taxation. Other than the basic "*Maxim of Taxation*"¹⁴ , which basically emphasis on the *ability to pay, certainty, convenience* and the *minimum burden*, the modern taxation system had emphasised three basic objectives as follows:

a. Equality objective

Equality has been a much debated issues in economics and had at least produced two distinguished Nobel Prize winners. Professor Rawls (1971) ¹⁵won it for his '*Just Society*' Philosophy which asserted the *Equality Principle* -i.e.. '*Equal rights to each person*' and *Difference Principle* – i.e. *inequalities is justifiable only to the extent that they contribute to the improvement of the least fortunate*'. It was this 'Difference Principle' that has resulted

¹⁴ refer to Adam Smith (1776)

in the creation of 'Vertical Equity' in Taxation. Professor Norzick (1974)¹⁶ on the other hand won with his counter proposal – '*Entitlement Theory of Justice*'. The emphasis were on the '*right and entitlement to their possessions – no matter how unequal the distribution of goods in society as a whole – provided that the goods have been acquired legitimately without making anyone else worse off*'.

From the two arguments came the two level of equity pursued in taxation.

i. The Horizontal Equity

Horizontal equity does not translate directly into '*Flat Tax*'¹⁷ rate. It went beyond by saying that '*identical tax treatment must apply to taxpayers of identical income and position*'. This is a challenging objective especially 'administrative' wise. Of course, there are no two identical taxpayers. But to classify taxpayers with identical income and position is almost an impossible task. Imagine how difficult it is to determine the surrounding that they lives, the position that they are in – their families, their employment, the neighbourhood and all the circumstances which will make them different in their '*real ability to pay*'. Are we taxing their true income, real income or well being ?

ii. The Vertical Equity

Vertical Equity has been defined as '*different tax treatment of different taxpayers with an objective of correcting income distribution or innate differences*'. The idea is to ensure that the well to do contribute to improve the least fortunate – just to borrow Rawls's words. Surprisingly this virtue has been accepted by the masses taxpayers despite the substantial argument by Norzick. This is also a challenging task as far as the Tax Policies makers and Tax Administrators are concerned. A tax system could have been designed to make sure that Vertical Equity principle is being achieved. But in the final analysis, the outcome will depend on 'how *pragmatic*' the system is. This can be measured by the actual *distribution of tax burden*. The question is how do we measure the actual tax burden suffered by each taxpayer ?. Even for Income Tax which is imposed directly on each

¹⁵ based on Rawls J. (1971) A Theory of Justice,

¹⁶ See Spencer, 1978.

¹⁷ Or Proportional tax rate or single tax rate

taxpayer, the effort will have to be tremendous. In the case of Consumption tax for example, the task is near impossible. Most tax policies maker will take 'Income and Wealth Distribution' as the proxy to tax burden distribution which is quite far from the truth as it is affected by a rays of factors other than just taxation.

b. Efficiency objective

Economic efficiency has always been the ideal dream of economist and the tax policies maker. Efficiency here relates to the objectives of '*Pareto Optima*' in economic. In order to achieve efficiency in taxation, we need to uphold the spirit of '*neutrality*'¹⁸. The concern of economist in designing a tax system is to blend tax instruments and create structure¹⁹ that will minimise or eliminate the '*dead weight loss*' associated with the raising of a given amount of government revenue. Translated into a practical principle, we need to introduce a tax system that will not create a '*dramatic impact*' in terms of *behaviours and preference*. The taxpayers must not be able to *shift the tax burden* or *avoid from paying taxes by shifting their preference*. Taxation must be imposed on goods, services and income that is *inelastic* in nature²⁰ such as '*basic necessities*'²¹. The '*Optimal Taxation*' according to Sadmo (1976) attempt to achieve three basic objectives of minimising '*Excess Burden*' or *dead weight loss* for any given tax revenue, minimising *resources* involved in collecting and maximising *justice and fairness* in every aspect.

c. Productivity or administrative efficiency objective

Productivity here can be measured both in terms of '*output*' i.e. tax collection²² and in terms of '*input*' i.e. cost of collection²³. It is basically an *administrative effectiveness*

¹⁸ Neutrality is based on the slogan of '*leave them as you find them*'.

¹⁹ Pareto Efficient tax instruments – as pioneered by Ramsay (1927) and Pigou (1947).

²⁰ See for example Mirrlees (1938) - who pioneered the principle of *Optimal Taxation* – defined '*optimal tax structure as one that maximises social welfare, in which choice between equity and efficiency best reflects society's attitude towards these competing goals.*

²¹ Of course a tax on cigarettes do fall under this categories of Inelastic goods tax

²² Normally relates with the National Income - a ratio of effective tax rate. This ratio is not popular as in taxation minimum tax burden could also be an objective. Using the classical quote of Colbert, the Minister of Finance during Louis XIV (1619-1683) – I quote " The art of taxation consists in so plucking the goose as to obtain the most feathers for the smallest amount of hissing"

²³ Collection cost per RM of tax revenue could be used as a basis of evaluating administrative performance – a good measure of productivity.

measure. In the case of Inland Revenue Board today, the *input measures* is more meaningful. We are interested to know the cost of collecting tax per RM. Of course there should also be a longer term measures that take into account the effectiveness of the 'Tax Literacy' program and the 'level of tax compliance'. Productivity could also be relates to other 'effort base' such as the number of *manpower, investment* and the 'Cost to the Economy'²⁴. The challenge in practice is on how we separate the medium and long term expenditure in promoting taxation from the total tax administration expenditures – i.e. investment from the actual operating cost. The cost of collection per RM of tax revenue should only take into account the *actual operating costs*.

To achieve the three basic objectives in Taxation above is already a big challenge for any taxation system. In most cases, tax policies makers choose to ignore those objectives in lieu of the pressing need to raise sufficient revenue for the government. In other cases, the tax system had to be tailored made to achieve some particular development objectives by loading it with *incentives and preference packages* that made the system loop sided.

Investment Incentives Program and the erosion of the tax objective in a Tax system

It is difficult if not impossible to find a tax system anywhere in the world today that does not have any form of Investment Incentives program built in it. Regardless of how developed a nation is, investment tax Incentive is seen as a *necessities*. This is despite the fact that policies makers realised of the damaging effect it has in eroding the tax base and in destroying the equity objective in taxation. At the same time, no proven evidence and research that had concluded that Investment Tax Incentive Programs had been responsible in attracting investors to invest in a particular activities or sectors in an economy. At most, investors interviewed commented that *Investment Tax Incentive Program* acted as a *signal to welcome* foreign investors.

The first challenge here is to prove that Investment Incentives Programs is useful and pertinent in attracting and directing investment in an economy. Having done that, we then need to re-design Investment Incentive Program outside the taxation system. Of course the reason of having Investment Tax Incentive in the tax system is to hide the 'Expenditure Tax'²⁵

²⁴ Using some sort of Cost-Benefit-Analysis model.

²⁵ i.e. public expenditure incurred through the tax system on the basis of 'profit earned' basis. – Tax expenditure will only be incurred when investor came, operate and make money. Hence the opportunity cost is rather small.

from the annual budget²⁶. This is however *an act of deception* which is like '*the off balance sheet financing*' strategies. In terms of accountability, *Tax Expenditure* in the form of Investment Tax Incentive cost the same as the *direct subsidy or grant* to the government. Designing an investment incentives program outside the taxation system may not pose a big challenge to Malaysian government. There have been numerous direct grant and incentives offered to investors and entrepreneurs and the like existed in the economy. The potential benefit impact will be tremendous as it close most of the loopholes in the tax system and immediately broaden the tax base overall. It will also enhance the achievement of equity objective in the tax system.

The conflicting Equity vs Efficiency objectives in the tax system

Equity objectives relates to *preference* and *discrimination* in the tax system. Basically, to achieve '*vertical equity*' we need to discriminate taxpayers according to their '*ability to pay*' and *impose tax at different rate to these different groups*. This immediately destroys the '*neutrality principle*' in taxation. Taxation may not be neutral *between two taxpayers, between two types of income or between two levels of income*. But this is an old issue that has not really posed major problem in the past – Not a problem because efficiency objective has never been taken seriously. This is because 'efficiency' objective is so abstract – just how do us measure '*welfare losses, dead weight losses or excess burden*'. This can only be shown on a *demand and supply equilibrium graph* in the classroom.

In terms of practicality however, efficiency objectives could be observed from the '*tax shifting behaviour*' and the '*consumption and preference shift*' that occur as a result of taxation. Income and Import Taxes on small businesses for example could immediately be shifted to the consumers who frequent the shops for supplies if demand is rather inelastic. Consumers could over the time shift their behaviour on consumption and choose the least taxed goods in lieu of their '*actual preference*' as a result of taxation – Just observe the consumer behaviour in the automobile industry in Malaysia – the strong preference for Proton and Perodua's cars were initially due to the high tariff on the imported cars. The question is whether consumers

²⁶ The alternative is to provide cash or cash equivalent benefit to the new investor which might blow the government budget out of proportion.

had actually achieve the maximum '*satisfaction*' from their '*forced consumption*'?. Of course these are still as abstract and may not be measurable in real world.

Does that mean that we could put aside the *efficiency objective* and focus more on the *equity objective* for a moment until we find ways to measure *the attainment of efficiency objectives*? . Or do we at least take into account the '*inelastic*' nature of goods and services in the design of a tax system?. Bear in mind also that the attempt to achieve '*efficiency objective*' could work adversely towards the attainment of the '*equity objective*'. Just consider the Consumption tax on basic necessities such as rice, sugar, edible oil and proteins base. It will mean that the low income group will be subjected to tax on almost all their hard earned income while the rich only pay a small proportion of tax on their income. Will this be fair? And will that not worsen the tax burden distribution in the economy?. The challenge is then on how do we neutralise the equity impact from the Consumption tax on basic necessities. Should it be done through the tax system by granting *exemptions* and *exclusion* which would *erode the tax base* and create a *major loophole* in the system, or should we do it using the direct approach of *subsidy and grant* ²⁷ to the needy group in the economy?.

The attainment of equity objective in taxation

Even though equity objectives has been dated back from the 17th. Century. Until today, its attainment by most taxation system is still questionable. Equity objective can only be measured by the *tax burden distribution* resulted from the system rather than the tax instruments and tax structure designed for the system. In most instances, equity objectives are seen as just another '*lips service*' and will not be taken seriously in practice. The Malaysian tax system had been found to be *least progressive* after all. Does this means that we failed in achieving our most fundamental tax objective? This is despite the fact that the policies maker still designed a tax system that is seen to be equitable with all the '*progressivity theme*' being built in and implanted all over it.

The challenge is could we just disband the *equity objective* from the system and clearly attempt *efficiency objective* at least in the design of a tax system. There have been several attempts towards that pursued by the other developed nations. The introduction of a '*flat income tax rate*' or '*two tier income tax rates*' and the focus to '*Consumption based tax*' were

²⁷ Such as the 'Food Stamp' system applied in the developed nations

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• some of the examples observed. Again, the challenge is 'are we willing to defend an 'efficient tax system' over 'equitable tax system' for Malaysia in the near future?.

The approach in achieving redistribution objective in the economy

The basic premise in imposing *equity objective* in taxation was that Taxation System as a 'toll on income and wealth' is the most convenient mechanism of achieving 're-distribution objective' in the economy. The idea is to plug it at source immediately after income has been earned or to carve it from the wealth preserved by the owner. The weakness of the assumption is however that tax instruments has always been evaluated on its own without any serious attempt to evaluate the progressivity of the overall system – taking into accounts exemption, exclusion, incentives and preferences. Another serious weakness is the failure in assessing the practicality of a system. What is seen to be a 'perfect' system might be administratively impractical. As a result, the 'seen administrative inefficiency' had caused the failure in overall achievement of the *re-distribution objective* in the system.

The basic flaw in the system is in the design. May be we could learn something from the other system. Consider the 'Zakat System' in Islam. It has the same objective of achieving *equity and re-distribution objective*. However the emphasis is on the 'Output' factor rather than the 'input' factor. The zakat rate is a 'flat' single tax rate of 2.5% on the base. However, the 'output' is being controlled i.e. the beneficiaries were stipulated before hand permanently. As a result, the achievement of the Zakat system is measured in terms of 'final distribution' of the zakat collection rather than the 'zakat burden'. The same thing applies to Tiths and other religious contribution. Is not these model of perfect systems from God that we must follow to succeed ?.

The challenge is then - could we design a tax system that is both responsible in collecting and in distributing at least a substantial part of the collection to the specific target groups to achieve the re-distribution objective ?. Just like zakat, some portion such as the 'a'mil's and the 'Fi Shabillillah' portions could still be surrendered to the government to pay for the administrative and development expenditure. Another aspect of the model that can be learned is the proportion or percentage of administrative expense allowed in the collection effort. It must not exceed 12.5% (or one-eight) as stipulated in the al-Qur'an.

The design of an efficient Income tax system

In the west, the tax experts had concluded that the perfect tax – efficiency wise is the 'Poll Tax'. Poll tax or also known as 'Head Tax' is a tax on every citizen based on head count. The tax is a *flat amount* tax to every taxpayer. In Islam we have the '*Zakat Fitrah*' which is paid by every Muslim regardless of their age, once a year at a fixed rate. This is definitely the perfect version of a Poll Tax though in terms of amount collected, it is quite insignificant because the tax rate is very minimal. '*Jizyah*' is another form of Poll Tax imposed on the non-Muslim during the Caliphs period. A three tiers tax rates were apply according to the 'ability to pay' principle.

The challenge posed to us is then - can we design a 'Poll Tax' system to replace Income tax system that could achieve the efficiency objective and at the same time generate substantial tax revenue for the government ?.

In Iran, the economic management had been tailored made to give emphasis on the 'Micro management' with the 'mosque' as the central focus. Each mosque is responsible for its own 'qari'ah'²⁸. Each mosque will have a committee comprises of the member of the qari'ah and representative of the local administrators. Each mosque dictates on the '*compulsory contribution*' in the form of '*Humus*'²⁹ to the mosque. The contribution will be utilised to take care of the whole 'qari'ah' member's wellbeing. The mosque must make sure that there are no poverty among the qari'ah members and they will be sufficient emergency fund to take care of death, accident, unforeseen circumstances including wedding and celebration for among the qari'ah members. As the number of qari'ah are relatively small in each mosque and everyone know each other as neighbour, the maintenance of wellbeing of all qari'ah members are quite practical. Of course there might be some necessities to transfer some of the excess fund from some mosque to the less fortunate neighbourhood as a contribution to the society at large. Such a system could be tested on a pilot basis in order to supplement and compliment the tax system in the effort to achieve the re-distribution objective.

The issue of tax base is also crucial in the case of income tax. All along '*income in RM*' has been used as the appropriate tax base. The issue that arises is whether the *RM income*

²⁸ Member of the mosque – which encompassed all the population that live within a particular radius of the mosque. Normally each mosque will have about 200 – 300 qari'ah members.

²⁹ Humus came from the root word 'hamsa' means 'one-fifth'. Hence the normal contribution rate is at 20% of each family's head income.

reflects the 'real income' in terms of *purchasing power*. Does 'RM income' reflect the 'true ability to pay'. Perhaps we need to explore other possible tax base. Perhaps 'taxpayers well being' is a better measure of *true ability to pay*. But how do we measure the 'well being' of each taxpayer. Perhaps taxpayers *life style, facilities, living accommodation qualities, environment and surrounding* could be taken into account in determining the 'well being index'. This could then be taken into account in assessing each taxpayer if equity objective is still considered crucial in our tax system.

If income is not a practical tax base, we could explore the alternative source which is as attractive namely *saving and consumption*. From the economics equation of :

Income = Consumption + Saving , we could convert it into

Income = Consumption + Investment hence

Saving = Investment

The mechanism of taxing consumption is rather conventional and could be implemented conveniently. In the case of *saving or investment* however, it is more delicate and might cause some behavioural changes in the economy . This could result in an some adverse impact to the economy. A mechanism could however be devised to conveniently tax saving or investment in the form of withholding tax through the third parties that handle the saving or investment. We must make sure however that income is not taxed more than once.

The taxation of corporate bodies

Malaysia has one of the most unique features in the corporate tax system. The '*full imputation system*' has allow the Inland Revenue to collect '*advanced tax*' from the corporate body though in principle final taxation only applies to the individual taxpayers namely the shareholders of the corporation. However, '*imputation system*' only allows tax collected in advance to be returned to the shareholders at the point of dividend received by them. At that point, dividend will be grossed and tax will be imposed on each shareholder based on their individual tax rate with tax credit being made available to the extent of the tax associated with the dividend received. To add to the uniqueness, in Malaysia, the average rate of dividend payment by corporation is only at 10% of the profit earned. Hence the other 90% are

automatically re-invested as retained earning. With the normal economic cycle at work – normally the retained earning will be partly exhausted and demised by the effect of recession which happened every ten years. Hence, what was meant to be an advanced tax collected at source – at the corporate body level, has often naturally becomes a final tax. This is indeed an *ingenious mechanism in taxation*.

With such a marvelous tax system, all we need to do is to implement it in the most efficient manner. It is the collection system that must be improved. If collection could be done on monthly basis like in the case of Employment income then the corporate tax system will become much more productive and efficient.

What can be learned from the corporate tax model above is, we need a system of *'Withholding Tax'* at source that could form as an *advance* with the final tax burden on individual taxpayer to be declared at the end of the year. It must provide option for the taxpayers not to declare provided that tax collected at source is always overstated.

There is another far fetch system that we could explore in regards to the corporate sectors in Malaysia. With the advancement of *'Malaysia Incorporated' program*. The corporate sectors have been seen as partners to the government in economic development. The government provides investment and business opportunities in the economy and efficient services to help the corporate sectors develop and expand. In return, the corporate sectors contribute to the government in the form of taxation. Perhaps in the long term, government through its holdings institution such as *'Khazanah Malaysia'* could acquire 25% equity in every corporate body in Malaysia on installment basis using the tax that is supposed to be collected from each of them. The government will then dictate the dividend policy of all corporations in Malaysia to fit into its cash flow requirements. As such, we do not have to have a tax system at all. The annual dividend distribution will form as substitute to taxation ³⁰.

Long term advanced or loans as a form of taxation

I believe that in the intermediate future a mechanism will be created in the taxation system to collect *'advances'* from the taxpayers under the pretax of taxation. It is very attractive psychologically as it does not *'pinch away'* one hard earned income for the management of the state'. Rather, it is a mechanism to *'borrow'* from the taxpayers in the form of *'force savings'* –

³⁰ Of course the proposal warrant a deeper thought and study as it move drastically from the current tax paradigm.

...
a concept more like the 'Employee Provident Fund Contribution' mechanism. If this could be designed in such a way like the 'Pension Fund' or 'insurance' scheme which will lapse as the saver's demises, it could become a great potential instruments and mechanism to fund the government expenditure. Even if the 'loan' from the public will need to be re-paid in full later, the rapid development rate in the economy will be able to generate sufficient resources for the government provided that the government is actively involve in business and investment activities in the economy. Using the normal 'Government bonds' can also be another practical alternative. To use an Islamic model, we could also implement the 'Qardul Hassan' model of financial institution. 'Qardul Hassan', literally means 'Benevolent loans' has been mentioned eight times in seven different surahs in the Al-Qur'an in the form of challenges to the ummah to lend to Allah. We could create an Islamic financial institution owned by the ummah but managed by the state to take up loans from individuals from their income and saving. When depositing fund into the institution, each one of us must make an intent that we want to lent to Allah through the institution. The fund will be kept just like the *normal saving account management* in the conventional bank. About 30% will be kept as *liquid fund* to allow for short term withdrawal by the depositors. Another 40% will be used for *long term development expenditure* or loaned to the *needy groups* in the economy such as the college students - to pay for their tuitions and to the homeless - to acquire low cost houses. The other 30% will be invested in the intermediate investment program by the government as the manager of the fund. This could be invested through institutions such as **PNB** and **Khazanah** which could yield attractive return to pay for the institutional and government expenditures.

Earmarks tax as a natural tax that has been well accepted in Malaysia

The privatisation program of the government had progressed very rapidly from the Penang Bridge era 30 years ago. Today, almost every aspect of our daily life involved some form of privatised services. From electricity, water, telephone, public transport, highway, postal service to sewerage, we have conveniently accepted the model of 'earmarked tax' as a way of life. The beauty about earmarked tax is that only those who 'choose' to use the services will be subjected to the tax. This is a very democratic way of running the economy – provided of course there is alternative ways and mode such as in the case of 'state road' in lieu of the 'federal highway'. The only issues that bother most taxpayers are the efficiency of the 'privatised entity' in managing the 'public facilities' or the 'basic necessities services'. If the

management is more inefficient than the government who were in-charged of them previously, then the overall economy will suffer as a result of privatisation.

The challenge here is to create a system of monitoring the management performances of the privatised public facilities with a provision of replacing the 'management entity' in the public interest. This could be an established permanent mechanism that will ensure the efficient management of the privatised public services. If this could be implemented, the next move would be to identify more privatisation program of the existing public facilities. This will indirectly relief the burden of government to raise revenue from taxation and hence reduces the overall tax burden on the taxpayer's part.

The move towards Masses Tax system

The original Income tax system introduced in Malaysia was meant to spread the tax burden to the masses through the '*Masses Income Tax system*'. However, as time goes by, a lot of other consideration came into the picture - not only to shrink the *Income tax base* but also *the targeted taxpayers*. A lot of the lower income groups had been purposely thrown out of the tax threshold to achieve a more equitable system and for administrative convenient. It has slowly turn Income Tax back into the *Class Tax* except for the '*Middle Income Group*' that has been trapped in the middle for convenient sake. Unfortunately, *the middle income group* is the most convenient group as most of them are employees of government organisations and corporations. Eliminating Income tax from the taxation system will relief them tremendously as currently they are the '*worst suffered*' group in terms of tax burden distribution.

Consumption type of taxes is the next best alternative if the '*masses target*' objective is to be pursued further. It still relief the middle income group but will shift the most burden to the 'lower income group'. However with some other mechanism built in outside the taxation system, the negative impact could easily be corrected. The problem is still with the higher income group. They will be drastically relieved by the abolishment of Income tax and focus on Consumption Tax. The system will not able to take into account the '*ability to pay*' principle any longer.

Another far fetch option that could be taken is to abolish all form of taxation and use '*Inflation mechanism*' as a conscious approach to tax the population. This will be the *last resort* and might be quite convenient where taxation system cannot be implemented and administered effectively any more due to the unforeseen circumstances such as the globalization and the

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Cyber world effect discussed earlier ³¹. As long as the *rate of growth* in the economy is higher than the *rate of inflation*, the nation will still benefit. The country will still grow and the well being of the population will keep improving over the years.

The administrative challenges in the current conventional system

The tax administrative system in Malaysia has progressed from that of a government department in the Ministry of Finance, into a corporatised entity under a board with separate management and responsibility. It is a matter of time that the Inland Revenue Board will become a privatized entity just like Pos Malaysia Berhad or PUSPAKOM. But before that dateline approach, Inland Revenue need to make sure that its 'operating costs' and 'productivity level' meet the expectation of the government. The benchmark measure is of course the *'collection cost per RM tax revenue'*. To use the Zakat's rule as the benchmark, the cost of collection must not exceed 12.5% to the government. That mean, the privatized body of IRB must be able to collect at less that 10 cent per RM tax revenue collected to make the privatization attractive.

In the meanwhile the administrative capacity will be fast eroded by the advanced of globalization. The tax base become so fluid that a small increase in the tax rate will cause taxpayers to migrate personally or 'to land' income in other attractive tax jurisdiction. But hopefully we do not expect this to happen so soon. We still have between 5 – 10 years to plan and get our self prepared.

In the meanwhile, the Inland Revenue Board will need to re-examine ways and means to improve or to at least maintain the current productivity level. The only real hope is in the *Self assessment system* on both the corporate taxpayers and individuals. Self assessment system is seen as a way to reduce the overall tax collection costs. Basically, the Revenue Board wants to eliminate the cost of assessment that is seen as the major bulk of the current tax administration workloads. The pertinent question is whether 'assessment costs could actually be eliminated from the introduction of a Self Assessment System. To the government, they want to know whether the taxation system will become more efficient and the assessment costs will not be shifted directly or indirectly to the taxpayers. Of course the burden of making

³¹ The system basically works by the Bank Negara controlling the circulation of fund in the economy at the rate that will result in a targeted rate of inflation.

assessment will be transferred to the taxpayers. We assumed that the 'time cost' of taxpayers are less costly than the 'time cost' incurred by the Revenue Officers ³². Is this a fair assumption?. There is of course no easy answers to all those questions.

The Inland Revenue Board's perspective of the introduction of the Self Assessment System

Let's look at the Inland Revenue perspective. It is right that, they will not be incurring any substantial cost in sending the assessment forms. They will be receiving back all these forms – already filled up together with their cheques payment. The question is what do they do next?. Do they then go through the assessments forms filled by the taxpayers and double checked the calculation and the evidences?. If they do that, then the time costs of re-assessment will in most cases exceeded the original time cost of conventional assessment³³. So where is the cost saving?. Taking into accounts the cost of introducing the new system, the Revenue Board is bound to lose money overall.

Under the full fledge Self Assessment System in countries like Japan and USA, the Revenue Board is not supposed to re-check and re-assess the returned forms. They are supposed to have a mechanism to ensure the 'full compliance' by all taxpayers without having to do the re-checking works. This must be done through both the 'human approach' and the 'mechanical approach'. A nationwide campaign must be carried out to educate the taxpayers on the need to be 'ethical' and 'professional' in their tax affairs. This is on top of the effort to impart skill and knowledge as part of the Tax Literacy program. In the mechanical effort, the Revenue need to have a sufficiently sophisticated computerized system that would pick up data from the assessment forms of each taxpayers to be kept in the taxpayers soft files. The data must be assessable by another program that will match data from third parties with the income and expenses declared by the taxpayers in the return. A nationwide code such as the *Identity card number* must always be referred in all formal transactions and documents by all level of taxpayers to allow the deductibility of expenses. This will create a trace code that could be matching works by the system. The computer system could do the re-calculation of tax based

³² Presumably if we think of the taxpayers filling the form and making the assessment during their free time, the 'time cost' is almost negligible – provided the taxpayers take it as a hobby and as a way to keep himself 'tax literate'.

³³ Under the conventional system.

on the assessment made by the taxpayers ³⁴. At the same time, the system must be able to create a data base on each taxpayer recording all details of income and expenses, tax calculated and their family's background as a time series data. This will be used to check and compare the current assessment data to detect inconsistencies. In the intermediate terms, all taxpayers must be required to declare their wealth to the Inland Revenue Board to form a data base.

In the end, the objective of all the exercise above is to shift the assessment burden to the computerized system in the Inland Revenue Board that is assumed to be more efficient and cost saving than human being. The success of this objective will be heavily relying on the system itself. The investment in the most advanced computerized system is then seen to be the crucial steps towards a successful implementation of the Self Assessment System.

Another very important perspective is the collection effort. Though in theory, the taxpayers were supposed to make payment together with their assessment forms, in reality it might not be as pragmatic. Hence the success of the Self Assessment System relies heavily on the complimenting system i.e. the Installment Tax Payment System. For employment income this has been implemented very successfully with tax collected on a monthly basis without causing any major issue or problem. It has actually works better than the conventional 'Pay-as-You-Earn' system applied in other developed countries. In the case of the corporate taxpayers however, the mechanism is still in the infancy stage and tax is only collected on a quarterly basis based on the projected taxable profit for the year. We need to slowly move to monthly installment system to create a truly efficient system.

The basic rule of thumb is to collect tax installment slightly higher than the expected tax liabilities of both individual and corporate taxpayers. This will create incentive to every taxpayer to fill in the assessment forms and to return it fast for possible tax refund. We could create a mechanism to pay 'profit' ³⁵ to the taxpayers in the case of over payment.

³⁴ But this will only detect arithmetic errors in the assessment.

³⁵ In lieu of interest income

Self Assessment System from the taxpayer's perspectives

Taxpayers will always see the system from the perspective of 'burden'. To them, the system will 'double penalise' them – once for the agony of filling the forms and making the assessment themselves and secondly for the burden to pay tax as a 'pinch' from their pocket. The situation will get worst where taxpayers were either tax illiterate or are not confident in filling the forms themselves. Hence, they will have to resort to 'Tax Consultants' to help them fill the forms and make assessment of their tax liabilities. In this case, there will be 'real costs'³⁶ incurred by the taxpayers which would definitely be higher than the 'time costs' that would have been incurred by the Revenue Officer had the task be handled by them simply because of the profit margin taken by the Tax Consultants as a private business entity. Hence the effect to the economy as a whole might be negative³⁷. The assumption here is that the Tax Consultants created in the system to help taxpayers does not generate sufficient multiplier effect to the economy that could justify the profit margin taken.

The challenge here then is to create a 'buffer services brigade' from among the school leavers and universities students who could be trained to act as the '*Voluntary Tax Agents*' to help taxpayers in making them 'tax literate' and helping them to gain enough confident to fill in their forms and make income tax assessment by themselves. This could be a relatively heavy investment on the part of the Revenue Board. But it could be subsidized or sponsored by the Ministry of Education on the pretext of '*Tax Education*' Program to the students and potential taxpayers. It is actually a very viable investment for the nation as a whole.

Conclusion

I have braved myself in exploring and indulging into some of the sensitive areas in Taxation and Public Finance in Malaysia in my discussion. It was never meant to be a criticism of the system or of the government. It was merely an effort to highlight the challenges that persist in the current and future taxation system. I have also been daring in throwing out some possible solutions and course of actions that can be considered to meet the challenges.

What is left for me to do is to appeal and project the challenge to the Tax Policies Makers and the Inland Revenue Board to be *pro-active* and to *anticipate* the change in the environment

³⁶ in lieu of imputed costs presumed incurred by the Revenue Board

that warrant us to *make changes* and to *continue reforming* the Taxation System in Malaysia in an effort to make it the most up date to meet the challenge of the future. Wallahu A'lam.

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³⁷ When Cost Benefit Analysis of the introduction of the Self Assessment System were conducted. Of course the Value Added created to the economy as a result of the Tax Consultants works will produce positive multiplier effect to the economy.