Executive Summary

Malaysia's tax system friend or Foe to Prosperity?

Malaysia has the capacity to grow more rapidly and become a high-income nation. But is its tax system holding it back?

According to the International Monetary Fund (IMF) Malaysia is not a low-tax nation but it's not a high tax nation either. Its system is significantly better than fiscal regimes found in OECD nations but it is not nearly as good as zero-tax paradises such as the Cayman Islands or Monaco or even low-tax jurisdictions such as Hong Kong and Singapore.

Author Dan Mitchell's examines where Malaysia stands in the region when it comes to taxation policies implemented by the government and explores what policymakers should consider when setting tax policies. He provides case study examples of successful taxation reforms as well as the negative consequences of high taxation and makes recommendations for a more optimal fiscal policy for Malaysia.

Simply stated, tax rates tend to be lower in Malaysia and the overall tax burden is more modest. Below are some of the key features of Malaysia's tax system.

- Corporate tax rate of
  24%
  The tax rate on businesses is high compared to some regional competitors, but in line with the average for OECD nations.
- Top personal tax rate of
  28%
  The tax rate on households is high compared to some regional competitors, but is reasonable compared to top tax rates in OECD nations.
- Goods and services (VAT) rate of
  6%
  It's undesirable to have both income taxes and consumption taxes, but the GST rate is modest.
- Central provident fund payments of
  23%-24%
  Such payments are a combination of a tax (reducing incentives to earn income) and a type of deferred compensation (presumably no major impact on incentives).
- There is no death tax or gift tax, no wealth tax, and no capital gains tax except on real property.
  The relative lack of double taxation on capital is a **positive feature**.
- Ease of tax compliance
  Malaysia ranks #23 in the World Bank's Doing Business, but only ranks #61 in the category on "paying taxes."

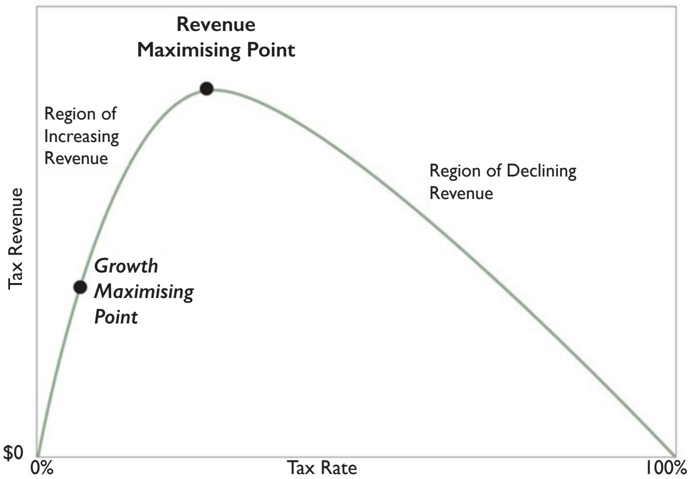
Taxation is the compulsory extraction of money from citizens and businesses. Tax payers' part with funds reluctantly and oftentimes can resist burdensome policies either by reducing their economic activity or by figuring out ways to avoid the demands of government. To avoid this here are some basic rules.

- **Personal income taxes** (high-cost revenue collection) It is very damaging to have high rates of tax and to have a tax bias against saving and investment.
- **Corporate income taxes** (high-cost revenue collection) It is very damaging to punish investment and production through corporate income tax. A low rate and a proper definition of income, e.g., expensing rather than depreciation, is a better way of collecting money. But corporate taxes commonly feature high rates and punitive distortions.
- **Capital taxes** (high-cost revenue collection) Death, wealth taxes; levies on savings and investments; discriminatory taxes on interest, dividends, and capital gains are all taxes that inhibit capital formation, thus stifling long-term prosperity.
- **Consumption taxes** (medium-cost revenue collection) Broad-based levies such as the Value-Added Tax (VAT) do not burden savings and investments. However, VATs can discourage productive economic behaviour by creating a wedge between pre-tax income and post-tax consumption.
- **Excise taxes** (medium-cost revenue collection). Governments commonly target certain goods and services for additional taxes. But this distorts consumption patterns and can cause secondary problems such as evasion and smuggling.
- **Property taxes** (medium-cost revenue collection). Taxes on land and certain types of personal property exist in many nations. They don't do as much damage as income taxes, but they impose a fiscal burden and also can distort consumption patterns.

For Malaysia to achieve better economic performance, it is important to adopt a pro-market tax system to boost economic production from domestic sources of labour and capital, as well as to attract foreign capital.

Successful tax reforms in the United States (US) and Ireland show how lowering personal income taxes and corporate incomes taxes respectively resulted in higher revenue collection from taxes. In the former's case, President Ronald Reagan's decision to reduce the top personal tax rate from 70 percent to 28 percent resulted in a dramatic increase of revenue from $19 billion in income taxes to more than $99 billion. Conversely, overly high taxation can result in serious negative consequences as can be seen in Malaysia's case of excessive taxation on cigarettes. While increases in excise was meant to reduce smoking prevalence, it has not worked as smokers merely switched from consuming legal products to illegal products which has resulted in illegal cigarettes overtaking the cigarette industry in Malaysia at 52.3 percent of the market.

The Laffer Curve



The Laffer curve in this sense demonstrates that if the government wants to maximise revenue, the tax rate should be set at some point well below 100 percent preferably at the growth maximising point. It is a mistake to set tax rates above the revenue-maximising level because that means losses for both the private economy and the government's treasury. Second, it is wise to set tax rates significantly below the revenue-maximising level because the economic damage of collecting additionally revenue becomes prohibitively high as tax rates increase.

The author ends with recommendations for an optimal fiscal policy in Malaysia. Here Malaysia can opt for a complete abolishment of personal and corporate income tax to become a fiscal paradise. Or it could opt for more modest reforms by lowering personal and corporate tax rates to 15 percent. Regardless of whether Malaysia goes with a "big bang" reform or incremental reform, pro-growth changes will not be durable and sustainable unless they are accompanied by meaningful spending restraint.

Dan Mitchell is a senior fellow at the Cato Institute who specialises in fiscal policy, particularly tax reform, international tax competition, and the economic burden of government spending. He also serves on the editorial board of the Cayman Financial Review. Prior to joining Cato, Mitchell was a senior fellow with the Heritage Foundation, and an economist for Senator Bob Packwood and the Senate Finance Committee. His work has been published in numerous outlets, including the Wall Street Journal, New York Times, Villanova Law Review, Public Choice, Emory Law Journal, Forbes, USA Today, Offshore Investment, Playboy, and Investor's Business Daily. He has appeared on all the major TV networks, and has given speeches in almost 40 states and more than 30 countries. Mitchell earned a PhD in economics from George Mason University.