
Malaysia's Tax System Friend or Foe to Prosperity?

Dan Mitchell



Summary

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

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.

Malaysia's tax system is neither great nor terrible. It is not nearly as good as zero-tax paradises like Monaco or Cayman Islands or low-tax jurisdictions such as Hong Kong and Singapore but the tax system in Malaysia is significantly better than other OECD and industrialised nations.

To achieve better economic performance however, the author emphasises the importance of a pro-market tax system to boost economic production from domestic sources of labour and capital, as well as to attract foreign capital. Mitchell provides case studies of successful tax reforms in the United States and Ireland which resulted in higher revenue collection and highlights the negative impact of high taxation using the Laffer Curve as a reference.

The author ends with a discussion on why OECD's anti-growth message should be rejected and provides recommendations for an optimal fiscal policy in Malaysia. Contrary to popular opinion not all taxes are bad. Income and corporate taxes are high cost forms of raising revenue whereas consumption, excise and property taxes are less costly. 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.

Introduction

Malaysia has the capacity to grow more rapidly and become a high-income nation.

Better tax policy is key to achieving better economic performance. A pro-market tax system not only helps to boost economic production from domestic sources of labour and capital, it also plays a key role in attracting capital from elsewhere, which is a very effective shortcut for growth.

The key principles of good tax policy are:



Low rates are always better than high rates

Since taxes are a penalty, it is counterproductive to impose high rates on productive activity such as work and entrepreneurship.



A tax bias against savings and investment is self-destructive

Every economic theory since Marxism agrees that capital formation is key to long-run growth, it is counterproductive to impose extra taxes on income that is saved and invested.



Special preferences are an inefficient form of industrial policy

Since economic output is maximised when resources are allocated by market forces, it is counterproductive to have special preferences which distort economic decision-making.



A big public sector means a bad tax system

Since most government outlays are financed by public revenues, it is counterproductive to have a large burden of government spending that will require a punitive tax burden.



High tax rates do not mean high tax revenues

Since taxpayers can change their behaviour to avoid and/or evade punitive taxes, it is counterproductive to impose high tax rates that often times don't even produce much revenue.



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The Malaysian Tax System

The tax system in Malaysia is neither great nor terrible. It is not nearly as good as zero-tax paradises such as the Cayman Islands or Monaco. Neither is it as good as low-tax jurisdictions such as Hong Kong and Singapore.

But the tax system in Malaysia is significantly better than the fiscal regimes found in The Organisation for Economic Co-operation and Development (OECD) nations. It compares favourably with industrialised nations that have reasonable tax systems, such as Australia and Switzerland. Malaysia's system is also far better than what is found in countries such as France and Italy. Simply stated, tax rates tend to be lower in Malaysia and the overall tax burden is more modest.

Here 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."

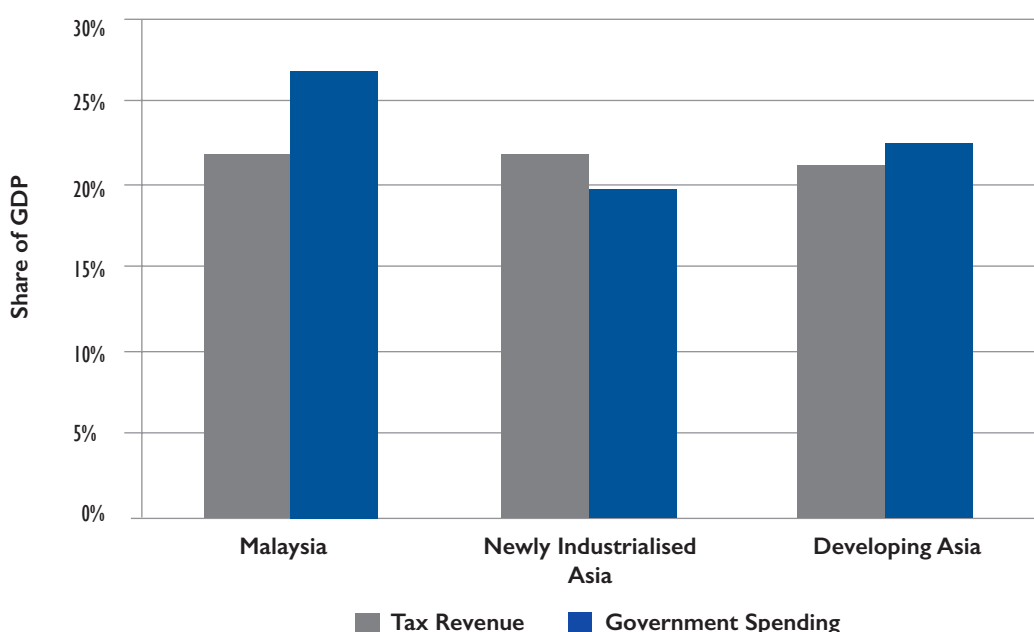
Malaysia's Competitive Position

Compared to regional competitors, Malaysia is not a low-tax nation. According to the International Monetary Fund's (IMF) World Economic Outlook (WEO) database, taxes consume about 22 percent of economic output in Malaysia while government spending consumes more than 27 percent of GDP (there are other sources with different estimates of the spending and tax burden, but IMF data is used to facilitate comparisons with a wide range of other jurisdictions).

The tax burden is very similar to revenue collections in both Newly Industrialised Asian Countries (Hong Kong, Singapore, Taiwan, and South Korea) and Developing Asian Countries (all other Asian nations other than Japan). So Malaysia is not a low-tax nation, but it's not a high-tax nation either.

However, as shown in the chart, the burden of government spending is significantly higher than it is in the Newly Industrialised Asian Countries and somewhat higher than the spending burden of Developing Asian Countries. This is not encouraging for Malaysia. It means a greater share of the economy is being allocated by political forces rather than more efficient market forces, and also because a higher burden of government spending inevitably means a higher burden of taxation.

Malaysia: Average Tax Burden, Excessive Spending Burden



Source: IMF

Looking at tax rates on productive behaviour is another way of gauging Malaysia's competitiveness. The bad news is that top personal tax rates and top corporate tax rates in places such as Hong Kong and Singapore are lower than comparable tax rates in Malaysia.

The good news is that Malaysia's tax system looks better when it is compared to the tax regimes of its major regional trading partners. According to KPMG, a major accounting firm, below are the top personal income tax rates and top corporate tax rates for 10 of Malaysia's major trading partners in 2016 (KPMG, 2016). These are just the rates for income tax. Actual top rates may be slightly higher in some nations because of social insurance taxes, capital taxes, and other levies.

	Top personal rate	Corporate rate
Singapore:	22	17
China:	45	25
Japan:	55.95	30.86
Thailand:	35	20
Hong Kong:	15	16.5
India:	35.54	34.61
Indonesia:	30	25
Australia:	45	30
Vietnam:	35	20
Korea:	38	24.2

Not all Taxes Are Equally Bad

Taxation is the compulsory extraction of money from citizens and businesses. Taxpayers part with their funds reluctantly and oftentimes can resist onerous policies either by reducing their economic activity or by figuring out ways to avoid or evade the demands of government. It makes sense for lawmakers to figure out the most practical way of grabbing money while causing the lowest amount of economic damage and political opposition. Here are some basic rules.

- **Personal income taxes are a high-cost way of collecting revenue** – It is very damaging to have high rates of tax and it is also very damaging to have a tax bias against savings and investment. Unfortunately, a personal income tax is the usual way that politicians impose these two indicators of bad tax policy. Jurisdictions such as Hong Kong show it is possible to have a sensible income tax based on a low rate and no double taxation, but it is far more likely that a personal income tax will be a vehicle for destructive policy.
- **Corporate income taxes are a high-cost way of collecting revenue** – It is very damaging to punish investment and production. That frequently happens with a corporate income tax. To be sure, a well-designed corporate tax system, featuring a low rate and a proper definition of income (expensing rather than depreciation, for example), will collect money in a relatively benign manner. But corporate taxes commonly feature high rates and punitive distortions.
- **Capital taxes are a high-cost way of collecting revenue** – There are a wide range of levies that penalise savings and investment. Most income taxes include discriminatory taxes on interest, dividends, and capital gains. Some nations even impose death taxes or wealth taxes. All of these taxes inhibit capital formation, thus stifling long-term prosperity.
- **Consumption taxes are a medium-cost way of collecting revenue** – While it is a mistake to adopt a broad-based levy such as the Value-Added Tax without first abolishing income taxes, at least VATs do not impose a discriminatory burden on savings and investment. However, VATs do drive a wedge between pre-tax income and post-tax consumption, so they do discourage productive economic behaviour.
- **Excise taxes are a medium-cost way of collecting revenue** – In addition to comprehensive taxes on consumption, governments commonly target certain goods and services for additional taxes. By definition, extra taxes on products such as gasoline and tobacco distort consumption patterns and can cause secondary problems such as evasion and smuggling.
- **Property taxes are a medium-cost way of collecting revenue** – Taxes on land and certain types of personal property (cars, boats, etc.) exist in many nations. They do not do as much damage as income taxes (taxes on land, for instance, will not reduce the supply of land), but they impose a fiscal burden and also can distort consumption patterns.

Case Studies

To understand the negative impact of taxation, as well as the issues that policymakers should consider when setting tax rates, let's look at three examples that cover various major sources of revenue.

Personal income tax

Personal income taxes discourage people from earning and reporting income by driving a wedge between pre-tax income and post-tax consumption. There is considerable recognition that tax rates discourage output and undermine competitiveness. However, many government officials do not understand that economic harm grows exponentially as tax rates increase. This also means that high tax rates impose enormous damage, not only to economic performance, but also can backfire on governments by generating less revenue.

Consider what happened in the United States. In 1980, the top personal tax rate in the United States was 70 percent. According to IRS data that year, there were about 117,000 taxpayers making over \$200,000 per year (and therefore subject to the 70 percent rate). Those upper-income taxpayers declared about \$36 billion of income above \$200,000 and paid \$19 billion of personal income tax (Internal Revenue Service, 1980).

As part of the 1981 Economic Recovery Tax Act and the 1986 Tax Reform Act, Ronald Reagan reduced the top rate to 28 percent. Critics argued that this policy was unfair. They said rich people would not pay enough tax and they said the Treasury would be deprived of large amounts of tax revenue. So what actually happened? If one examines the 1988 data, there was a dramatic change in tax revenue paid by rich taxpayers. Instead of dropping, revenues actually increased dramatically, rising from \$19 billion to more than \$99 billion. (Internal Revenue Service, 1988) This happened because there was a big increase in the number of rich people and an even bigger increase in taxable income.

1980 Taxes Paid on Income Over \$200 Thousand

	1980 Returns	1980 Taxable income	1980 Income Tax Paid
\$200k - \$500K	99,971	\$22,696,007	\$11,089,114
\$500k - \$1 Mil	12,397	\$6,512,424	\$3,613,195
\$1 Mil-plus	4,389	\$7,013,225	\$4,301,111
Total	116,757	\$36,221,656	\$19,003,420

1988 Taxes Paid on Income Over \$200 Thousand

	1988 Returns	1988 Taxable income	1988 Income Tax Paid
\$200k - \$500K	547,329	\$134,655,949	\$38,446,620
\$500k - \$1 Mil	114,582	\$67,552,225	\$19,040,802
\$1 Mil-plus	61,896	\$150,744,777	\$42,254,821
Total	723,697	\$352,952,951	\$99,742,043

To be sure, there were many factors which drove this remarkable increase in tax revenue. There was inflation, population growth, as well as other economic reforms that presumably helped to boost economic performance. But what happened in the 1980s was very clear evidence that taxable income is extremely sensitive to tax rates.

Indeed, the moral of the story is that the best way to collect more tax from rich people is by keeping tax rates very modest.

Corporate income tax

Lawmakers should be cautious when imposing taxes on relatively mobile activities. High tax rates on multinational companies, for instance, are ill advised since such firms have considerable discretion over where to conduct their operations, as well as sophisticated legal strategies to engage in tax avoidance. High tax rates on smaller companies can also backfire since such businesses are more likely to shift some activities into the shadow economy in response to excessive demands by government.

Consider what happened in Ireland. Back in the 1980s, Ireland's corporate tax rate was 50 percent, a punitive burden that contributed to the general weakness that plagued the Irish economy. As part of a series of reforms, Ireland began to reduce the corporate rate, at first creating a split 30 percent/10 percent rate structure for local companies/multinational companies, and then choosing to apply a 12.5 percent tax to all corporations.

All told, the corporate rate fell by 75 percent. Did that mean a big drop in tax revenue for the Irish government? It is important to note that it was around this time that Ireland's economy began to boom. The "sick man of Europe" soon became known as the "Celtic Tiger." Multinationals not only began building factories and creating jobs, they also had incentives to declare income rather than to engage in avoidance and evasion.

This meant a big increase in taxable income which resulted in more tax revenue. *According to OECD data, corporate tax revenue in Ireland averaged less than 1.3 percent of GDP in the 1980s. Over the past 10 years, however, corporate tax revenue has averaged more than 2.6 percent of GDP. But this understates what happened to revenue since GDP is dramatically bigger now in part because of the lower corporate tax rates.*

In other words, Ireland's government slashed the corporate tax rate and is now collecting a bigger slice of tax from a much bigger economic pie.

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Excise duties on selected products

Governments often levy specific taxes on specific products based on various rationale (luxury taxes, user fees, sin taxes, externalities, etc.). Some of these reasons are more legitimate than others, but the economic impact is the same regardless of the excuse for why the tax was imposed. Simply stated, the higher the tax, the lower the quantity demanded.

Consider what happened in New York because of high tobacco taxes. The statewide tax is \$4.35 and New York City added another \$1.50 of tax. Politicians may have thought this would give them a windfall of additional tax revenue, but demand for legal cigarettes has dropped so much that receipts are more than 50 percent lower than they were 10 years ago (Mitchell, 2015).

However, the punitive tax burden actually boosted the sale of black-market cigarettes and sales in untaxed Indian reservations. A 2014 study by the Makinac Center estimated that 57 percent of cigarettes consumed in New York were from untaxed and illicit sources (Mitchell, 2014).

Excise taxes are an even bigger issue in Malaysia. Taxes on imported automobiles are prohibitive, involving a 30 percent tariff (for cars from non-ASEAN nations), a 10 percent sales tax, and an excise tax that can climb to more than 100 percent for vehicles with large engine capacity (Malaysian Automotive Association, 2008). This punitive system makes ownership very difficult for ordinary citizens.

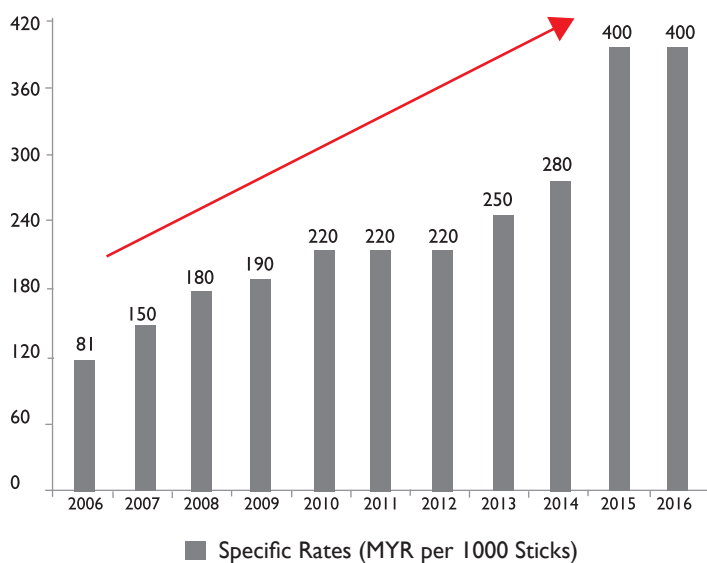
At times, these onerous taxes have been justified on protectionist grounds. But trade barriers not only impose costs on consumers, but they lead to a misallocation of labour and capital in a nation, further reducing overall prosperity. As with all taxes, governments also get addicted to the revenue generated, even if it collected at the cost of overall consumer welfare. Sometimes high automobile taxes are pushed for environmental reasons, even though it is far more efficient and fair to use congestion pricing and fuel taxes to achieve those goals.

Malaysia also imposes excessive taxes on cigarettes. Just as high excise tax rates lead to smuggling in the United States and other nations, there has also been a significant increase in sales of illegal products in Malaysia as high excise-led price increases over the years widened the price gap between legal and illegal products.

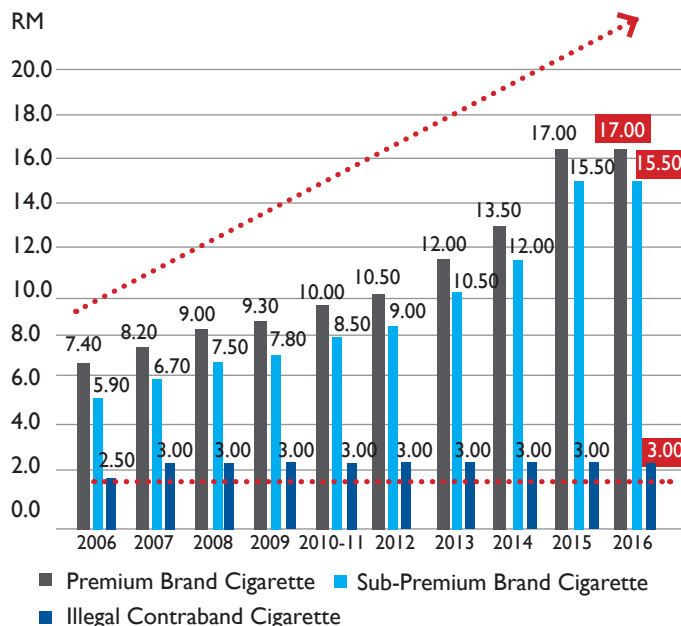
Coupled with low enforcement, porous borders and long coast lines, Malaysia has been a natural target for smugglers and this has contributed to the extremely high levels of illegal tobacco trade – **among the highest in the world**. The following charts below show a fairly robust relationship between tobacco taxes and black market sales. That is ever-higher tobacco taxes produce ever-higher levels of black-market sales.

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Excise increase on cigarettes in Malaysia over the years

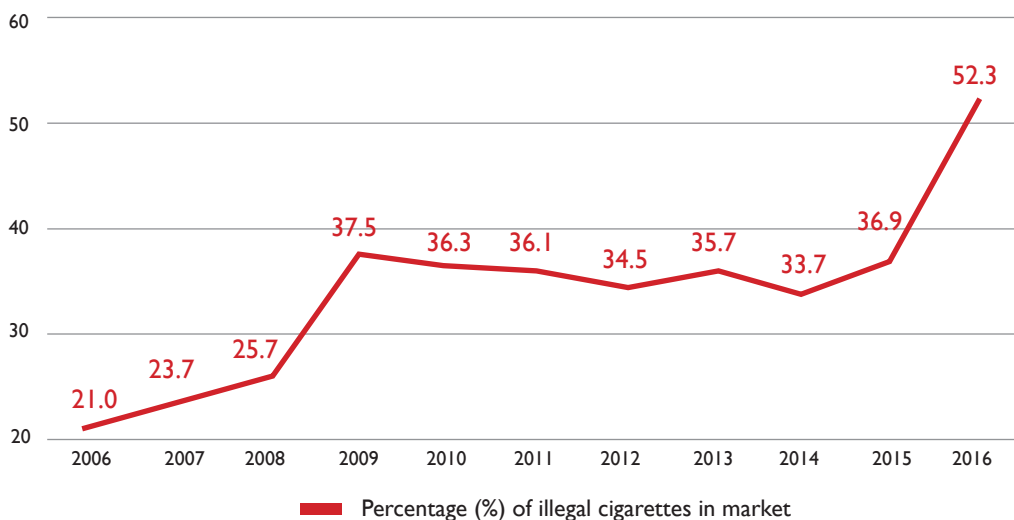


Price Comparison in MYR (20 Sticks)



Excise increases over the years widened the price gap between legal and illegal products. As a result, this has led to an alarming surge in illegal cigarette trade.

Percentage increases of illegal cigarettes available in the market.



Source: Nielsen's Illicit Cigarette Survey 2006 - 2016 (Annualised)

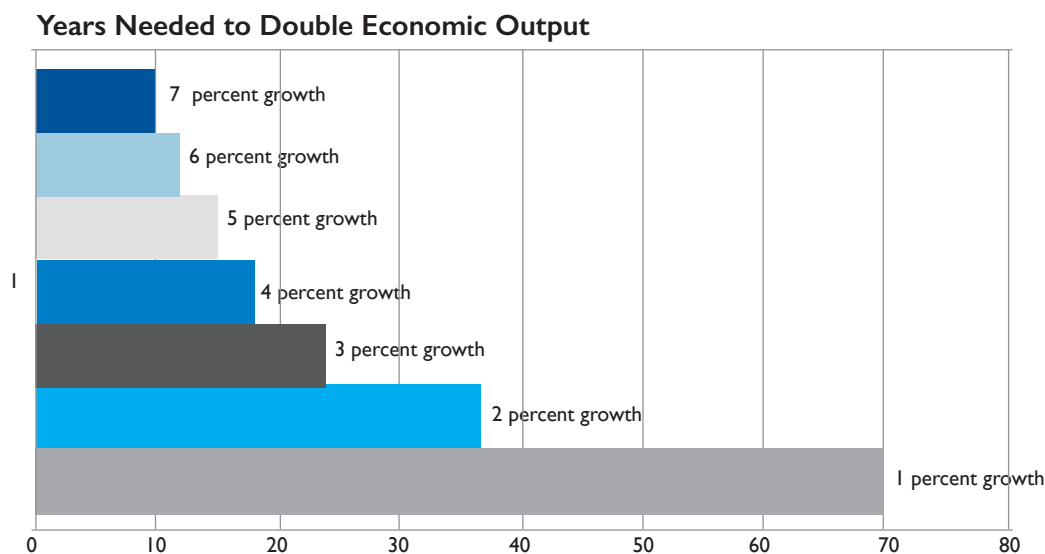
Negative consequences of high taxation

Considering all the practical evidence previously discussed, there are two very important economic principles that should guide government officials as they design tax policy.

I. Punitive taxation reduces growth and competitiveness

In a globalised economy, investors, entrepreneurs, and business owners have a wide range of choices when deciding where to create jobs and conduct economic activity. Such decisions are guided by many policies, including rule of law and the regulatory system. But oftentimes taxes are a dominant and deciding factor.

A sensible fiscal structure featuring low tax rates can yield big economic dividends. Even small differences in annual growth, if sustained over many years, can have enormous impact on a nation's living standards. As can be seen from the chart below, an economy that grows about 5 percent annually will double economic output about every 15 years. This is a very reasonable and achievable goal for Malaysia.

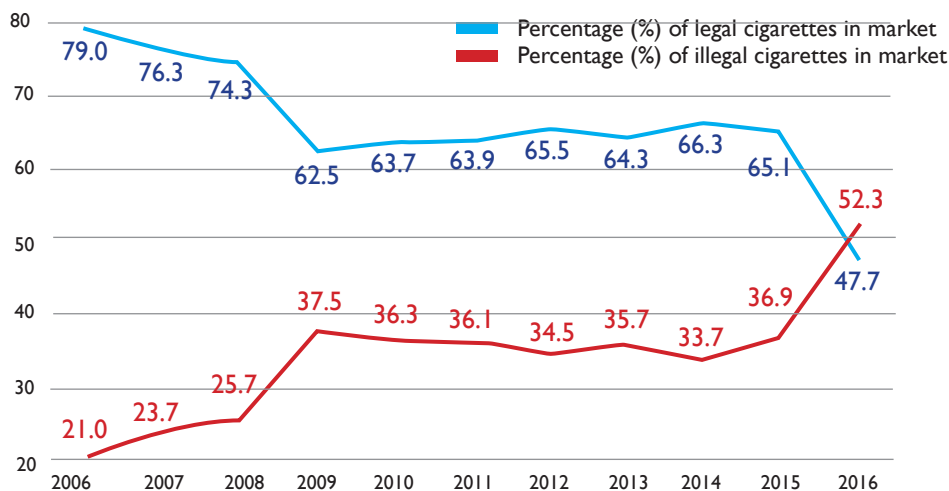


By contrast, an economy with a burdensome tax regime is much less likely to enjoy strong economic performance. If a nation grows only 2 percent annually, it will take about 35 years for economic output to double. The economic stagnation in many European countries is grim evidence that excessive taxation imposes a very heavy cost.

Another example is Malaysia's excessive taxation on cigarettes. While increases in excise is meant to reduce smoking prevalence, it has not worked as smokers merely switched from consuming legal products to illegal products. It has caused a huge impact to the legitimate industry as illegal cigarettes grew at the expense of the legal products. This has ultimately led to significant losses in excise revenues and no significant changes in tobacco consumption.

Illegal Cigarettes have overtaken the cigarette industry in Malaysia

- 1 out of 2 packs sold in the Malaysian market in 2016

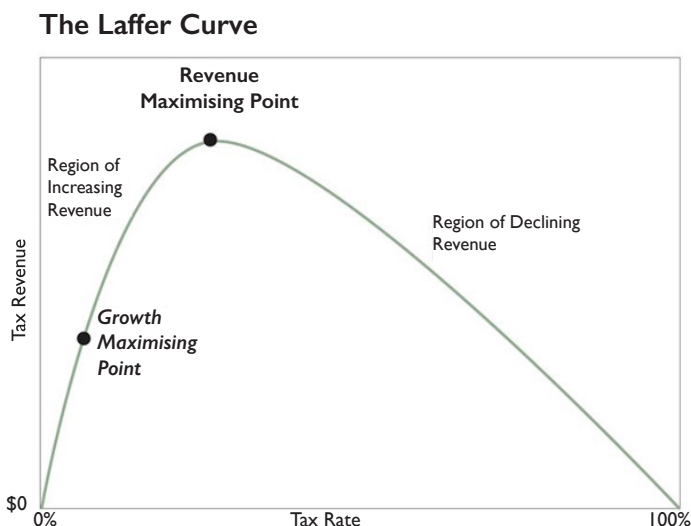


Source: Nielsen's Illicit Cigarette Survey 2006 - 2016 (Annualised).

2. A sluggish economy generates less tax revenue

A weak economy means less economic output over time. Less economic output translates into lower levels of income. Barring an unusual tax system, lower levels of income mean reductions in tax revenue. This is the essential insight of the “Laffer Curve.” If tax rates are too high and the economy is stagnant, the government will not collect a bounty of tax receipts.

Below is a visual depiction of the Laffer Curve. It shows that the government will not collect any revenue when a tax rate is zero. Yet there also will not be any tax revenue (or barely any tax revenue) when tax rates are at 100 percent. Every economist agrees that if the government wants to maximise revenue, the tax rate should be set at some point well below 100 percent.



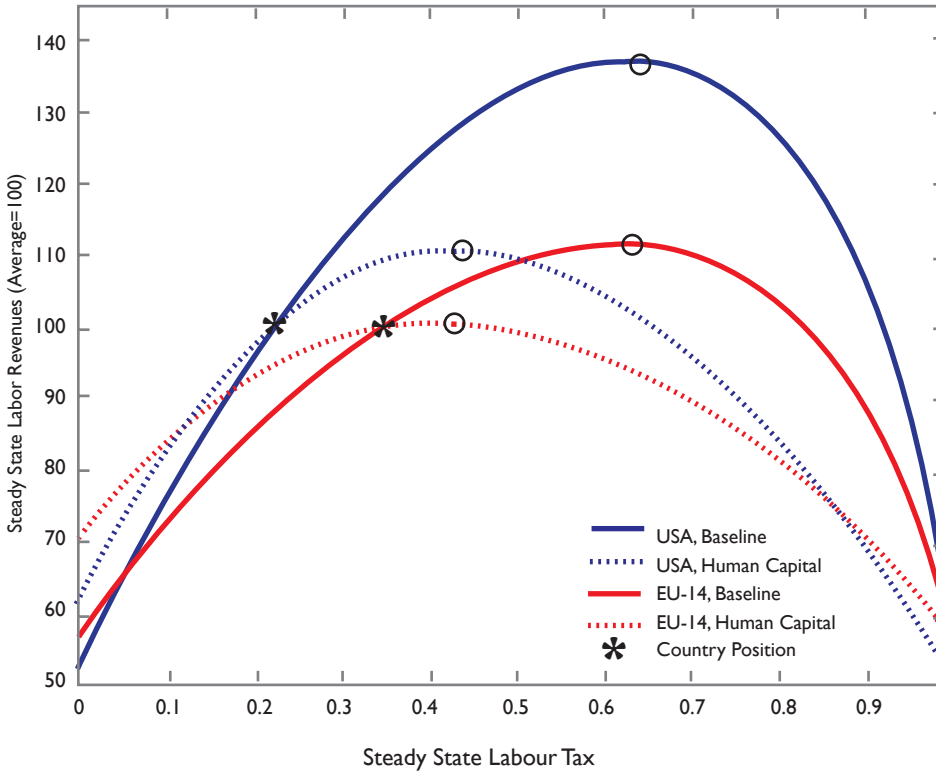
The debate about the “revenue-maximising” point on the Laffer Curve is very contentious, but it is actually irrelevant. This is because policymakers should be striving to set tax rates at the “growth-maximising” level. That is the point when government has collected the modest amount of money necessary to fund the legitimate (and limited) functions of government.

However, if policy makers do not follow this advice and decide to impose high tax rates thinking they can get more revenue, they need to be aware that it is very counterproductive to do so. What actually happens is that the economic damage is so severe that the government actually collects less revenue. It is not a good idea to set tax rates at the revenue-maximising level. Or even close to it.

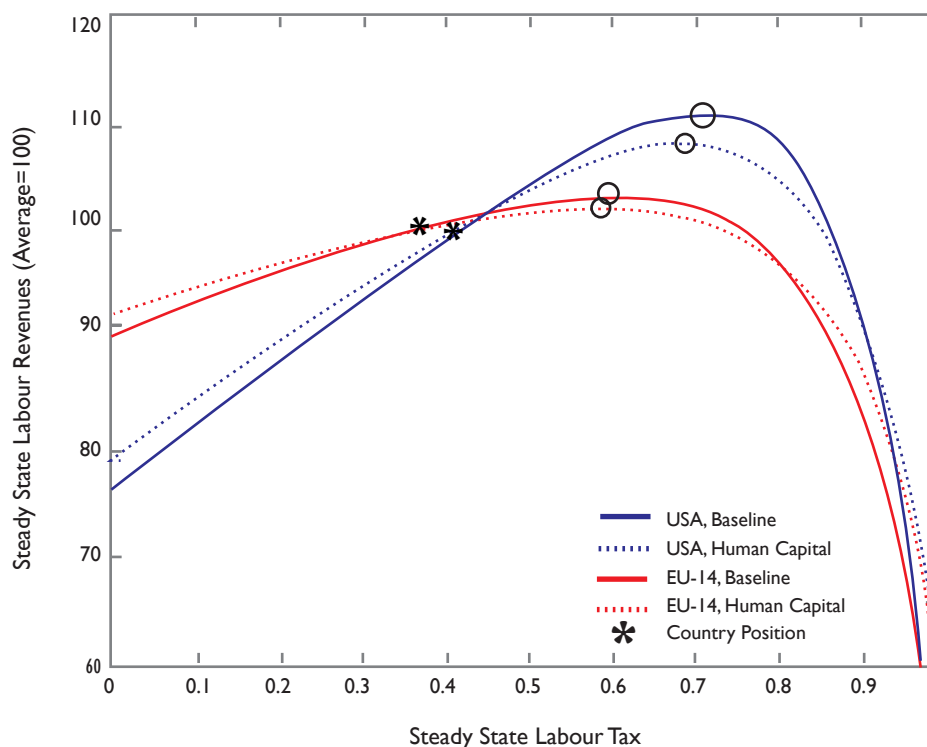
Consider these two charts from a study published by the European Central Bank (Trabandt and Uhlig, 2010). The top chart shows the Laffer Curve for labour taxation, and the bottom chart shows the Laffer Curve for capital taxation. And both charts show different curves for the United States and an average of 14 European nations. They demonstrate how the Laffer Curves change if you add some real-world assumptions about the role of human capital.

“Policymakers should be striving to set tax rates at the “growth-maximising” level. That is the point when government has collected the modest amount of money necessary to fund the legitimate (and limited) functions of government.”

Labour Tax Laffer Curves for USA and EU-14



Capital Tax Laffer Curves for USA and EU-14



Some people will look at these charts and conclude that there should be higher tax rates. After all, neither the U.S. or E.U. nations are at the revenue-maximising point (though the paper explains that some European nations actually are on the downward-sloping portion of the curve for capital taxes).

Think about what higher tax rates imply, for example, in the United States. According to the first chart, labour taxes could be approximately doubled before getting to the downward-sloping portion of the curve. However, tax revenues only increase by about 10 percent.

This implies that taxable income would be significantly smaller, presumably because of lower output, but also perhaps due to some combination of tax avoidance and tax evasion. Indeed, this study implies that the government would reduce private-sector taxable income by about \$20 for every \$1 of new tax revenue.

In other words, there are two big lessons from the Laffer Curve.

First, it is a mistake to set tax rates above the revenue-maximising level because that would mean losses for both the private economy and the government's treasury. Secondly, it is wise to set tax rates significantly below the revenue-maximising level because the economic damage of collecting additional revenue becomes prohibitively high as tax rates increase.

Questioning the Anti-Growth Message of the OECD

The Paris-based Organisation for Economic Cooperation and Development recently published "Revenue Statistics in Asian Countries", which covers Indonesia, Singapore, Malaysia, South Korea, Japan, and the Philippines for the 1990-2014 period (OECD, 2016). Much of the data is helpful for researchers, but some of the analysis is grossly inaccurate, starting with the completely unsubstantiated assertion that there is a need for more tax revenue in the region.

“...the need to mobilise government revenue in developing countries to fund public goods and services is increasing. ...In the Philippines and Indonesia, the governments are endeavouring to strengthen their tax revenues and have established tax-to-GDP targets. The Philippines aims to increase their tax-to-GDP ratio to 17% (excluding Social Security contributions) by 2016...and Indonesia aims to reach the same level by 2019.”

Unsurprisingly, there is no evidence presented in the report to suggest that higher taxes would lead to more economic development or more public goods. The OECD simply makes the claim and offers no corresponding evidence.

Here is the most bizarre assertion. The OECD report argues that a nation is not developed unless taxes consume at least 25 percent of GDP.

“These targets will contribute to increasing financial capacity toward the minimum tax-to-GDP ratio of 25% deemed essential to become a developed country.”

This is a deeply flawed assertion in part because most of the world's rich nations became prosperous back in the 1800s and early 1900s when government spending consumed only about 10 percent of economic output (Mitchell, 2013). Not only were taxes a concomitantly minor burden during that period, but many nations didn't even have any income taxes at all.

Moreover, the OECD report ignores the fact that Singapore (which is covered in the report) and Hong Kong (which is not) have tax burdens today that are considerably below 25 percent of GDP, yet they are among the richest countries in the world.

An Optimal Fiscal Policy for Malaysia

The ideal scenario would see the personal and corporate income tax abolished. Turning Malaysia into a fiscal paradise would have enormous economic benefits. Investors and entrepreneurs would immediately shift their economic activity to the country. There would be an enormous surge of direct and indirect investment from other nations. Malaysia would become the dominant regional economy with this type of “big bang” reform.

Changes of this magnitude presumably would require increases in other sources of revenue, such as an increase in the GST. If there are concerns about collecting enough revenue from upper-income taxpayers, it also would be possible to have selective luxury taxes on real estate and personal property such as high-value automobiles.

If policy makers prefer more modest reforms, lowering personal and corporate tax rates to 15 percent would be a very astute strategy to boost regional competitiveness. Malaysia would be better positioned to attract jobs and investment in a region where there is vigorous competition from low-tax jurisdictions such as Hong Kong and Singapore, as well as competition from lower-wage economies such as Indonesia and India.

A big advantage of modest tax rates is that compliance is stronger when the tax system does not impose heavy burdens on entrepreneurs, investors, and business owners. Research published by the International Monetary Fund is quite clear on the risks of excessive taxation (Schneider and Enste, 2002).

“Macroeconomic and microeconomic modelling studies based on data for several countries suggest that the major driving forces behind the size and growth of the shadow economy are an increasing burden of tax and social security payments. . . . The bigger the difference between the total cost of labour in the official economy and the after-tax earnings from work, the greater the incentive for employers and employees to avoid this difference and participate in the shadow economy.”

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 restraint in spending.

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