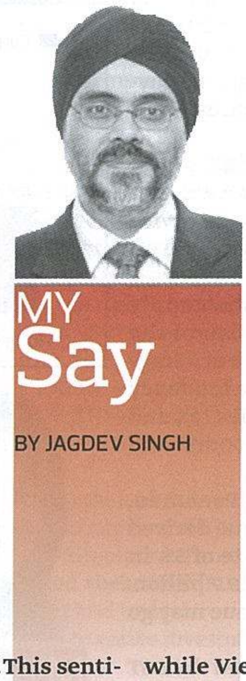
Can we afford to reduce tax rates?



With all the buzz about the Goods and Services Tax (GST) in the run-up to Budget 2014, many of the other conventional issues one would see discussed have taken a back seat. This includes the usual speculation about a reduction in tax rates.

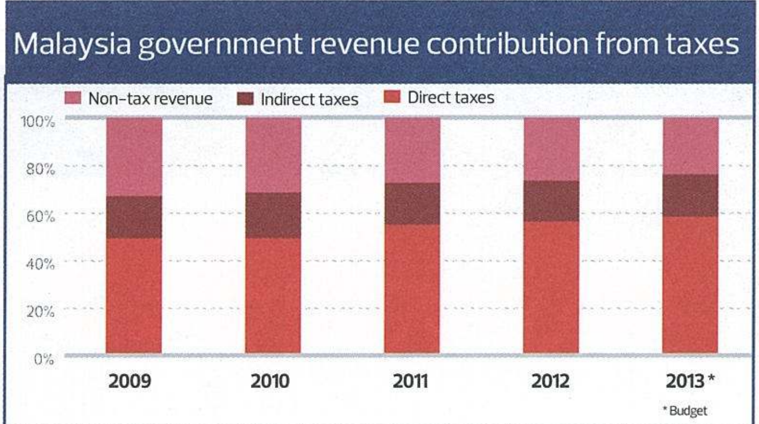
In his announcement of a fuel subsidy reduction last month, Prime Minister Datuk Seri Najib Razak lamented that the external environment is becoming increasingly challenging and, closer to home, issues such as the continued fiscal deficit pose medium-term risks to the economy.

The government requires more tools at its disposal to slash the fiscal deficit to 3% by 2015 (from the 4.5% recorded last year), and the introduction of a broad-based tax system such as GST is seen to be the right solution. This sentiment is echoed by many economists and analysts. Whilst GST is a bitter pill that the rakyat will have to swallow, it will set Malaysia on a better base to improve its fiscal deficit position in a sustainable manner.

Drawing from experiences abroad, the introduction of a broad-based tax system is generally followed by reduction in corporate and individual tax rates. Some recent examples of such trends include Singapore (3% reduction in tax rate in year of introduction) and Australia (2% reduction in tax rate in year of introduction). The general presumption is that Malaysia will do the same. Nevertheless, the elephant in the room remains — can the government afford a reduction in taxes?

CHART 1

SOURCE: MALAYSIA ECONOMIC REPORT 2012/13



	2009	2010	2011	2012	2013*
Fiscal deficit (RM million)	47,424	43,275	42,509	42,297	39,993
Percentage of GDP	6.7%	5.4%	4.8%	4.5%	4.0%

CHART 2

SOURCE: VARIOUS GOVERNMENT BUDGETS AND ECONOMIC REPORTS

The data in Chart 1 shows that the government revenue side of the equation is highly reliant on direct taxes. We should applaud the efforts of the Inland Revenue Board (IRB) which has overseen a steady increase in direct tax collection from RM90.65 billion in 2008 to RM124.69 billion last year and is on track to achieve its target of RM130 billion this year.

Of this, a significant portion comes from corporate tax, which has almost doubled in the last few years. This is against the backdrop of a reduction in tax rates in 2009, 2010 and 2013 as well as a growth rate of less than 7% in the underlying economy. This additional revenue has gone a long way towards helping fund the increase in government expenditure in the last few years whilst keeping the fiscal deficit in check.

However, the competitive pressure is mounting with another round of aggressive tax rate reductions in neighbouring countries. Leaving Singapore with its low corporate tax rate of 17% aside, Thailand has reduced rates rapidly to 20% for 2013/14 (23% previously) while Vietnam has acted similarly by announcing a reduction from the current 25% to 20% for 2016.

Would GST then help in balancing the numbers as far as the government's coffers are concerned? Minister in the Prime Minister's Department Datuk Seri Idris Jala had previously commented that GST will generate an additional revenue of RM20 billion to RM27 billion at maturity, but will this be sufficient to buffer the fall in tax revenue in the event of a reduction in tax rates?

A quick glance at our neighbours that have implemented a broad-based tax system shows that they have managed to achieve a good balance between indirect and direct taxes. (See Chart 2) This lays a strong foundation to cushion any downturn in economic activity, and is something our government can aim to achieve if and when it introduces GST.

In considering any reductions, it is equally important to look at how wide the impact would be. Out of a population of 29 million people, it is indeed an eye-opener that only four million are registered with the IRB, of which one million pay taxes. Similarly, only 75,000 out of 450,000 companies registered with the IRB contribute to the government's coffers.

This implies that 58.4% of the government's revenue comes from this tiny pool of taxpayers. This again points to a need for a robust framework that is able to address this inequality. All fingers point to a broad-based tax system in the form of GST.

With the likely announcement of GST in Budget 2014, Najib may throw in a committed tax reduction plan for the next few years as part of the overall tax reform. And if he does, the amount of tax that can be reduced will have to be delicately balanced against how much the government can gain from GST.

If this balance can be struck, it will go a long way towards helping the nation's transition from an economy heavily reliant on direct taxes to one that has a diversified and broad-based tax system. It will also make it easier to swallow the bitter pill. E

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