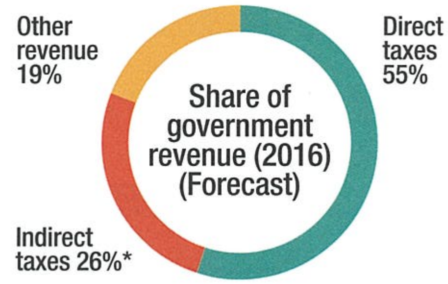
Guest writer

BY BENEDICT FRANCIS

Budget 2017: Balance between direct and indirect taxes

Will the tax rate come down or GST rate increase further, putting more strain on the lower and middle-income groups?

The government is unlikely to increase the GST rate now as it could aggravate the situation for lower and middle income groups



*GST amounts to 17% of total government revenue

Source: Ministry of Finance Economic Report 2015/2016 and International Monetary Fund Government Finance Statistics

THE late, great proponent of supply-side economics Jude Wanniski once suggested that taxes are a penalty placed on work, so the focus should be on reducing the penalties placed on work with an eye towards stimulating even more work.

Wanniski was also instrumental in popularising the "Laffer Curve" theory, which implies that increasing tax rates beyond a certain point will be counter-productive for raising further tax revenue.

So with the introduction of the goods and services tax (GST) on April 1, 2015, many expected the corporate and individual tax rates to come down. And they did come down, albeit marginally.

There were reductions in individual tax rates too (for the year of assessment [YA] 2015) and an income band expansion for chargeable income above RM100,000 – which are the right moves in line with the Laffer Curve theory.

Conversely, in Budget 2016, in what can be regarded as an about-turn of sorts, tax rates for individuals with chargeable income above RM600,000 saw an increase of 1% while chargeable income above RM1 mil increased by 3%. Some view the approach to be regressive with negative implications towards the attraction and retention of talent pool.

Corporate tax rate also saw a decrease but it was a marginal 1% reduction to 24% taking effect only from year of assessment 2016.

What is the rationale for delaying the effective date by one year? The word on the ground was that GST is new so the government needed to ensure a sustainable and steady revenue stream from the new consumption tax, hence the time lag.

Shift towards indirect taxes globally

GST or Value Added Tax (VAT), as it is known in some countries, is spreading across the world at a rapid pace, whether as a new tax or as a replacement of other narrower forms of consumption tax. Drawing from experiences abroad, the introduction of GST/VAT is generally followed by a reduction in corporate and individual tax rates. For example, a 2% and 3% reduction in tax rates in the year of GST introduction by Australia and Singapore respectively.

An economic crisis forces governments to explore just where more revenue can be easily identified, Malaysia included. There are underlying theories explaining that indirect taxes are the choice. Several Organisation for Economic Co-operation and Development (OECD) studies indicate that corporate income tax is the least growth-friendly, while VAT is the most growth-friendly and progressive. Generally, the higher the corporate tax rate, the bigger the incentive for companies to shift income to lower tax jurisdictions.

The data in the table show that government revenue was highly reliant on direct taxes before GST was implemented, representing 57% of total government revenue in 2014. In contrast, our regional peers' government revenue contribution from direct taxes is between 31% and 33%.

Post-GST implementation, nothing much has changed in terms of revenue contribution from direct taxes. The forecast data for this year in the chart show direct taxes as 55% of total government revenue. In contrast, indirect taxes is expected to contribute 26% of government revenue this year (17% of total revenue attributed to GST collections).

Indirect taxes account for the largest share of government revenue for most countries in the region. The government should move away from its reliance on direct taxes and should strongly consider lowering them as the current split between direct and indirect taxes is not sustainable.

Global tax enviroment

Also, current tax rates are not competitive compared to other countries in the region. We need to be cognisant that tax regulations in the past were largely written for a different type of global economy. However, with today's complex global tax environment, these rules may no longer be relevant to see the country through to developed nation status in barely four years.

A good observation of the significance of tax is how it has moved up the boardroom agenda, whereas in the past, tax was always an afterthought when it comes to investment decisions.

Tax incentives used to be a pull factor to lower effective tax rates but over the years, the authorities have tightened the qualifying conditions and this has caused businesses to struggle and in more serious situations be disqualified from enjoying the tax incentives. Evidently, tax incentives are no longer a differentiating factor as our neighbouring countries have also upped the ante and are offering more attractive tax incentives besides having lower direct taxes.

If we were to lower our direct taxes, the country will be better able to compete for foreign direct investments. Businesses will have more working capital to reinvest in their business, thus increasing consumption, job opportunities and overall competitiveness.

In addition, Malaysia will be better able to attract and retain talents, while individuals will have more disposal income to cushion the rising cost of living which has been a major concern ever since GST was introduced.

A healthy balance

So what is a good balance between direct and indirect taxes? While there is no simple answer to what's the right balance, a check against countries that have been in this journey longer would be a good start.

Do I think the tax rates will come down in Budget 2017? In view of the current environment, it is unlikely (although I do hope I'm wrong).

Do I think GST rates will be increased? Increasing the GST rate now could aggravate the situation further, especially when the lower and middle income groups are struggling to make ends meet. Therefore, it's unlikely in Budget 2017 but it is an avenue the government is likely to consider in the near future if it is to rely on consumption tax as a way to shift reliance from direct to indirect taxes.

Overall, it would be beneficial to have a more well-thought out tax strategy with longer lasting impact, focusing on measures targeted at the groups that need them. FocusM

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Share of government revenue (2014)

Sources of revenue	Malaysia	Singapore	Thailand	Indonesia
Direct taxes	57%	33%	32%	31%
Indirect taxes	17%	42%	50%	42%
Other revenue	26%	25%	18%	27%

Source: Ministry of Finance Economic Report 2015/2016 and International Monetary Fund Government Finance Statistics