THE INTRODUCTION OF GOODS AND SERVICES TAX IN MALAYSIA:
A Policy Analysis

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The idea of introducing a flat consumption based Goods and Services Tax (GST) in Malaysia has been floated since 1989. It now seems as though this may become a reality in the 2014 Budget, with implementation beginning within 18 to 24 months at an initial rate of 4 % on the supply chain. The plan to overhaul the tax system has begun to gain momentum as the government deals with an increasingly weak economic outlook, combined with global uncertainty.

While not at the emergency levels of many advanced Western European economies, Malaysia has not run a structural budget surplus since the Asian Financial Crisis hit in 1997. Federal government debt as a percentage of Gross Domestic Product (GDP) currently sits at 55.4 %. For the time being, this is manageable, but it is the government’s ability to reign this spending in, as well as lack of budgetary reform that has led ratings agency Fitch to downgrade Malaysia’s credit outlook to negative this year.

The government’s recent 20 sen cut to the fuel subsidy and increasing speculation of a GST framework to be included in the upcoming budget can be seen as evidence that they are trying to remedy both structural and cyclical economic challenges. Furthermore, for far too long there has been an overdependence on the revenue generated from oil and gas dividends, which currently account for over a third of total government revenues.

A GST offers a single unified system where the tax burden is equally shared between the services and manufacturing industries, whilst simultaneously broadening the tax base. This will help to minimise tax exemptions as well as the compounding effects of pyramiding tax, tax erosion, transfer pricing and value shifting. In the current economic climate, it will also ensure a level of

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1 Bank Negara Malaysia & Department of Statistics Malaysia (2013)
2 The World Bank (2012)
stability, as a GST is less susceptible to the fluctuations inherent in commodity markets.

As evidenced in other countries that have introduced a GST or value-added tax (VAT) at varying rates, this system offers one of the most simplistic mechanisms available for calculating receipts that in turn will lead to greater compliance of the code. Issues surrounding the regressive nature of the GST and how it could disproportionately affect low-income households need to be addressed in its design so as not to put further financial stress on the 56 % of Malaysian households whose monthly income is RM3000 or less. The current inefficient system also needs to be restructured so as to give a greater level of transparency to the public, as well as reduce tax avoidance.

The following policy paper gives a snapshot of the current tax system in Malaysia and analyses what effect a GST may have on the economy. It also shows how similar tax reforms have been realized in other countries and offers policy recommendations for the implementation process of such a reform.

II. The current tax system and major issues

Diversifying government revenue

A new source of consumption tax is needed to improve the collection of public revenue. The Malaysian direct tax base only covers 1.7 million out of a workforce of approximately 12 million. At 15 % of total government revenue, this is smaller than the share of petroleum income tax. Oil and gas revenues continue to be the largest source of income through export duties (a form of indirect tax), as well as non-tax revenues, such as royalties and other proceeds. Duties imposed on imports and exports are expected to remain stable or contract due to Malaysia’s commitments to the liberalization of tariffs under various trade agreements. Therefore, a new form of tax is needed to

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3 Yeoh, T. (2011), pg. 37
4 Lee, W. L. (2012)
both expand the tax base to increase revenue collection, and gradually replace oil-related revenue and excise duties.

The existing Sales and Services Tax (SST) contributes only 7.7 % of total revenue. Receipts from the SST depend on the strength of private consumption and business spending activities. The standard rates of SST are 10 % and 6 %, with different rates or exemptions for certain goods and services. The weaknesses of the SST include high incidence of tax avoidance, double taxation along the value-chain that pushes prices up, as well as extensive exemptions. This goes some way in explaining the low collection of revenue from the SST.

Figure 1 Federal Government Revenue, 2013 estimate

Source: Ministry of Finance, Malaysia (2013)
General Operation of GST

The GST aims to improve the process of tax collection. As a value-added tax, the GST is a multi-stage tax, whereby payments are made at every stage of production through to the final consumer. However, under the GST the tax chargeable on non-capital inputs are claimable, or eligible for refund. Therefore, this passes on the tax burden once to final customers at the point of purchase. In contrast, the current sales tax is imposed on the manufacturer, before the services tax is imposed on the consumer at the point of purchase. Double taxation in SST pushes up prices and reduces consumer welfare. The GST boasts a self-policing mechanism, whereby businesses automatically factor in the GST as part of the selling price on inputs to other manufacturers. This indirectly administers the imposition of the GST, while significantly reducing cases of tax avoidance. Businesses know that the GST is claimable and have less incentive to evade tax. By transferring the tax burden from manufacturers to consumers, the cost of doing business is further reduced and the gains should (in theory) be passed on to consumers through lower prices.

Deferment and Readiness Issues

The GST has been introduced in various countries, across all stages of economic development. At the suggested initial rate of 4 %, Malaysia would be charging the lowest GST in the region (Thailand: 7 %, Singapore 7 %, Vietnam 10 %, Indonesia 10% and Philippines 12 %).\(^5\) In Europe, the rate of GST or VAT is between 16 % and 25 %, and accounts for nearly 8 % of total GDP. Based on simulation studies by the Ministry of Finance (MoF), a 4 % GST would be a revenue-neutral rate, through which an additional RM1bn is estimated to be raised. Furthermore, the Performance Management & Delivery Unit (PEMANDU) study of a GST rate set at 5 % and 7 %, found that the tax could potentially raise an additional RM8bn and RM27bn respectively.\(^6\)

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\(^5\) Royal Malaysian Customs Department's official website.
\(^6\) Jayaraman, P. (2013)
All things equal, a 7 % GST could potentially wipe out the budget deficit of RM41bn in a single year.\(^7\)

The implementation of the GST has received a strong response from tax experts, academics, the business community and the general public. The starting date of the GST is still unknown. However, having had the debate for so long and the potential merits and shortcomings of this proposal widely discussed, this has made it difficult for consumers and firms to properly prepare. Former Prime Minister Tun Abdullah Ahmad Badawi, announced that an eight-member Tax Review Panel would be set up to formulate the details of the GST during his speech at the release of Budget 2005. It was scheduled to be introduced in January 2007. However, in February 2006, the government announced that the GST would be postponed to a later date. Apart from the political considerations, the deferment of the GST was due to several readiness issues within the business community. A survey by the Federation of Malaysian Manufacturers (FMM) showed that over 60 % of businesses were not ready for the GST.\(^8\) Many businesses, especially in the small and medium-sized enterprise (SME) community, were concerned that the GST would have a profound impact on financial reporting and strategic decision-making issues, such as pricing.\(^9\) Readiness on the part of Royal Malaysian Customs Department, the chief agency for collecting GST revenue, is also a source of concern, and new investments in hardware and human capital training must be considered.\(^10\)

### III. Assessment of the Economic Effects

#### Current Global Outlook

The global economic outlook remains tepid as the advanced economies continue to recover from the global financial crisis and China shifts its focus to bolstering domestic demand. This will cause a lower but more sustainable...

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\(^7\) SST is estimated to generate RM16bn revenue in 2013. Adding the extra gain of RM27bn revenue at 7 % GST could, on paper, produce a budget surplus.

\(^8\) Jayaraman, P. (2013)

\(^9\) Mansor & Ilias, (2013)

expansion rate. Weak global growth poses downside risks to Malaysia’s exports that contribute approximately half of the country’s GDP. Demand for export commodities has slowed, contracting by 0.8 % this year to date in comparison to the same period last year.\textsuperscript{11} Malaysia’s current account surplus narrowed to RM2.6bn in the second quarter of this year, the closest the country has come to recording a deficit since 1999\textsuperscript{12}. This further strengthens the case for an immediate plan to reduce the budget deficit in order to avoid the twin deficits as witnessed in other emerging markets (India and Indonesia). A current account deficit would cause the ringgit to plunge and further push up inflation on imported items. It would also cause interest rate hikes and discourage investment activities, which would in turn restrain growth and increase the debt-to-GDP ratio. The challenge is to effectively introduce a GST that increases the share of non-oil related revenues and institutionalises spending reforms to slow the growth of the budget deficit and public debt.

\textbf{Figure 2. Value of Current Account and Trade by Quarter, 2005 - Q2, 2013}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure2}
\caption{Value of Current Account and Trade by Quarter, 2005 - Q2, 2013}
\end{figure}

Source: Department of Statistics, Malaysia (2013).

\textsuperscript{11} Malaysia External Trade Statistics, August 2013.
\textsuperscript{12} Liau, Y. S. (2013)
Impact on Growth

A shift from taxes on income to taxes on consumption will, over time, improve the fiscal outlook for Malaysia. As mentioned, the primary weakness with the existing tax system is that it only has a base of 1.7 million taxpayers. The efficiency of tax revenue collection from an already narrow tax base is further complicated by the generous exemptions offered by the government. Overdependence on revenue from petroleum and other natural resources limits the government’s capacity to smooth out global market volatility due to the large pro-cyclical sensitivities of commodity prices. Slight movements in the global political economy generate disproportionately large swings in oil revenue. In turn, this destabilises public financing and revenue projection. The oil revenue generated today comes at the expense of future growth, which in effect, passes on the fiscal burden to future generations. Personal and corporate income taxes are also pro-cyclical. Where revenue collapses during an economic downturn, the government resorts to huge borrowing to fund expenditure that ends up increasing the debt-to-GDP ratio.

The GST boasts greater predictability because of the consumption smoothing process. A household will maintain a stable standard of living by saving more during good times and drawing down on savings during periods of lower income - at least temporarily. By anchoring public revenue to a more stable source of income (consumption), the government can credibly commit to its budget deficit reduction plans. This means that investors are more confident in the government’s ability to raise enough revenue to restore the public financial health, and are better placed to cope with an unexpected downturn in the global economy. The net result is an increase in private investment and job creation, which will help to sustain economic growth.

The immediate impact of the GST will be lower short-term growth, before picking up as households gradually adjust their consumption behaviour. At an

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13 Habib, S. (2013)
15 This conclusion is supported by an empirical study which suggests that a reduction in income taxes while increasing consumption tax is associated with faster growth, except for low-income countries. See Santiago Acosta-Ormaechea and Yoo, J. (2012)
initial rate of 4 - 5 %, the impact on the consumption level is expected to be modest. However, at a rate of 7 %, it runs the risk of jolting the economy into a self-induced contraction. At 7 % GST, high inflation would kick in and consumers would experience a sudden drop in purchasing power, therefore increasing the incidence of precautionary saving. Prolonged inflation may trigger higher interest rates; dampen private investment, as well as overall economic growth. If this vicious cycle were to persist, households would have to set aside even larger amounts savings due to greater uncertainties in future income. While conventional wisdom says that persistent inflation is “always and everywhere” a result of uncontrollable growth in monetary supply, and that a one-off spike in the price of goods will eventually return to normal, it remains a concern if the duration of market adjustment is too long and factors like rising household debt complicate the situation further. Since the market has largely expected an initial GST rate of a 4 - 5 %, the quarters preceding its full implementation may actually show accelerated growth in consumption as households bring forward future purchases to avoid paying GST. The government should consider introducing the initial rate of GST at 5 % to begin a meaningful collection of tax revenue and allow for adequate time to adjust consumption behaviour.

The GST has the potential to do more harm to growth if it is introduced without complementary reform to public sector spending. Private consumption and investment growth depend on the growth rate of public expenditure. This is because raising tax revenue without commensurate spending cuts is tantamount to filling up a bucket of water with a hole in the bottom. A simulation of the fiscal consolidation plans executed by 16 OECD countries over a 30-year period, show that cutting spending will result in smaller and shorter (if any) output losses than raising taxes.\textsuperscript{16} Empirical studies have also suggested that deficit reductions that did not spark recessions were found in countries that had well-targeted combined spending cuts with supply-side reforms, such as deregulation, liberalization, as well as tax reforms that incentivized work\textsuperscript{17}. GST revenues alone may not necessarily result in budget deficits.

\textsuperscript{16} Alesina, Favero & Giavazzi. (2012)
\textsuperscript{17} Alesina & Ardagna. (2009)
When the government cuts spending or reduces the growth of expenditure, it signals to investors and consumers that tax rates will not have to rise drastically in the future. This creates a favourable outlook on the return on investment and minimizes the risk of expropriation of wealth through monetary inflation or currency devaluation in order to fund budget shortfalls. Conversely, private consumption is likely to rise as consumers who expect a lower future tax rate, feel wealthier today and this will have the effect of increasing their propensity to consume.

However, a direct comparison with OECD countries is imperfect given that tax rates were introduced at comparatively high levels and an increase in an additional unit of tax may diminish the amount of revenue collection as more people choose leisure over work. The key takeaways for Malaysia are nonetheless justified on the grounds that higher government expenditure crowds out private activities. These contribute about 36 % of GDP\(^{18}\). Liberalization is warranted on industries that are presently dominated by government-linked corporations (GLCs), as they will encourage private investment and competition. The interlocking relationships between GLCs and bureaucracies have erected high barriers to entry due to preferential treatment in awarding contracts as well as implicitly guaranteeing a bailout to industries that are deemed important to national interest. The introduction of a GST should be studied from a broader perspective, which is to complement spending reforms in the run up to achieving long-run fiscal sustainability.

**Inflation**

According to the price impact study conducted by the MoF, with a 4 % GST, the Consumer Price Index (CPI) is expected to decrease by 0.1 % with prices falling the most in clothing and footwear, as well as communications.\(^{19}\) Since a GST shifts the tax burden to consumers, the cost of doing business drops as tax on non-capital inputs is claimable and firms can save up to RM4.13bn

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\(^{18}\) Public consumption and investment stand at 7.1 % and 6.0 % of GDP respectively. See *Economic Report 2012/2013, Ministry of Finance, Malaysia.*

\(^{19}\) Ministry of Finance Malaysia's Tax Review Panel.
from the abolishment of SST. But, how much of these savings would translate into cheaper products and services?

Prices are known to be “sticky downwards” especially in developing countries like Malaysia, where a relatively high growth rate results in competition for scarce resources and consistently pushes up menu prices. Businesses that are eligible for GST claims may be reluctant to price down. The onus will then fall on consumers to compare prices and allow the market forces to keep businesses price-competitive. Profiteering activities can be so widespread that an aggregate upward revision of prices shrinks purchasing power and worsens the standard of living. The Anti-Profiteering Act assumes a high level of efficiency on the part of enforcement agencies to carry out their duties. Given that some 78% of total business establishments are out of the GST system, it remains doubtful that the regulatory authorities possess sufficient resources to investigate the large frequency of price-fixing complaints and carry out punishments. Poor and rural households are more susceptible to price manipulation. Price competition is less intense in rural areas due to the small number of business establishments and low awareness of their consumer rights.

**Figure 3 Changes in CPI by Components at 4 % GST**

<table>
<thead>
<tr>
<th>Component</th>
<th>CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food away from home</td>
<td>0.88%</td>
</tr>
<tr>
<td>Food &amp; non alcoholic beverages</td>
<td>0.67%</td>
</tr>
<tr>
<td>Alcoholic beverages &amp;</td>
<td></td>
</tr>
<tr>
<td>Clothing and footwear</td>
<td></td>
</tr>
<tr>
<td>Housing, water..</td>
<td></td>
</tr>
<tr>
<td>Furnishing, household..</td>
<td></td>
</tr>
<tr>
<td>Health</td>
<td>2.07%</td>
</tr>
<tr>
<td>Transport</td>
<td></td>
</tr>
<tr>
<td>Communication</td>
<td></td>
</tr>
<tr>
<td>Recreation and culture</td>
<td>2.21%</td>
</tr>
<tr>
<td>Education</td>
<td></td>
</tr>
<tr>
<td>Restaurants and hotels</td>
<td></td>
</tr>
<tr>
<td>Misc.</td>
<td>0.75%</td>
</tr>
<tr>
<td>Misc.</td>
<td>-0.08%</td>
</tr>
<tr>
<td>Misc.</td>
<td>-1.20%</td>
</tr>
<tr>
<td>Misc.</td>
<td>-1.86%</td>
</tr>
<tr>
<td>Misc.</td>
<td>-2.12%</td>
</tr>
<tr>
<td>Misc.</td>
<td>-2.71%</td>
</tr>
<tr>
<td>Misc.</td>
<td>-3.23%</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Malaysia (2013).
Adjusting consumption behaviour may prove difficult in at least 60 % of Malaysian households when it comes to substituting basic necessities and essential services (like health). In the short run, where income remains constant, GST-induced price hikes compel households to search for cheaper goods and services. Certain items are less perfectly substituted. For instance, receiving treatment at a private hospital is very different from a public hospital. Choices made in health services go beyond a simple price comparison; they entail a much more in-depth consideration in terms of quality, personal satisfaction and other psychological needs that have significant repercussions on happiness and well-being.

The other 40 % of households who earn a monthly income in excess of the national average (RM5000) could be relatively better at managing inflation. This is considering they consume more ‘luxurious’ goods and have plenty of room to substitute for cheaper alternatives. Also, a larger share of goods and services consumed by these households are already subject to SST. The 4 % GST is in fact a tax cut for many high-income consumers. According to the MoF, the tax burden under a 4 % GST is lower across all income groups compared with SST, although a larger share of tax is paid by the high income group. Over longer periods, rising average household income will lessen the pain of consumption behaviour adjustment.

While combating profiteering activities in the short term, the government needs to be consistent in pressing for supply-side reforms that will accelerate income growth across all segments of the population. A timeline to GST revision is recommended to promote price stability and provide sufficient time for households to plan for consumption needs.
Figure 4 Comparison of Tax Burden under SST and GST

<table>
<thead>
<tr>
<th>Income Group</th>
<th>Average monthly expenditure (RM)</th>
<th>SST Tax burden (%)</th>
<th>SST Tax paid (RM)</th>
<th>GST Tax burden (%)</th>
<th>GST Tax paid (RM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poor</td>
<td>570</td>
<td>2.38</td>
<td>13.57</td>
<td>2.17</td>
<td>12.37</td>
</tr>
<tr>
<td>Lower</td>
<td>1,856</td>
<td>2.75</td>
<td>51.04</td>
<td>2.43</td>
<td>45.10</td>
</tr>
<tr>
<td>Middle</td>
<td>3,767</td>
<td>2.94</td>
<td>110.75</td>
<td>2.57</td>
<td>96.81</td>
</tr>
<tr>
<td>High</td>
<td>7,211</td>
<td>3.13</td>
<td>225.70</td>
<td>2.74</td>
<td>197.58</td>
</tr>
<tr>
<td>Average</td>
<td>2,041</td>
<td>2.88</td>
<td>58.78</td>
<td>2.53</td>
<td>51.64</td>
</tr>
</tbody>
</table>

Source: Royal Malaysian Customs Department

Notes:
Poor: Income less than RM800 per month
Lower: Income from RM800 to RM1,999 per month
Middle: Income from RM2,000 to RM3,999 per month
High: Income RM4,000 and above per month

**Equity and Socio-economic Development**

The implementation of a GST could raise barriers to upward social mobility for lower income households. Spending behaviours by lower income households are more sensitive to fluctuations in income, commodity-related revenue, and informal sector earnings are unstable and make the poor more vulnerable to price shocks in the economy. In addition, low-income households have very little savings because the lion’s share of income is spent on essential items, such as food and utilities. Households with earning less than RM1,000 per month will, on average, spend 30% of income on food compared to 5% for those earning above RM10,000 per month. On the other hand, an average household earning over RM10,000 per month saves up to a quarter of their income, at least three times greater than the lowest income segment. A tax on food consumption among other things, will further limit the capability to save for many of the lower income households. Without sufficient savings, the poor could face tremendous difficulties in accumulating assets or having better access to information technology and education - therefore widening the divide between the have and the have nots even further.

The experience from other countries shows a variety of measures taken to keep in check the regressive nature of a GST. Many countries apply a reduced rate of consumption tax to certain necessities in order to minimize the tax burden on the poor. The standard VAT rate in the United Kingdom is
20 %, which is chargeable to most goods and services. A reduced rate of 5 % applies to items such as electricity bills for residential use and mobility aids for the elderly.\textsuperscript{20} This measure is better than providing exemptions, because additional revenue could still be raised in addition to lower the tax burden on the poor. However, there could be a major problem with definition, for example - is packaged fruit considered as a basic foodstuff? If the government attempts to protect the poor by expanding the list of exempted goods and services, this then jeopardizes the larger objective of budget deficit reduction. Moreover, the rich will benefit from these exemptions more than the poor due to their larger consumptive power.

\textbf{Figure 5 Spending and Saving Patterns across Income Groups}

[Graph showing spending and saving patterns across income groups]

\textit{Source: Outlook and Policy in 2013, Bank Negara Malaysia (2013)}

\textsuperscript{20} HM Revenue & Customs
The government faces another problem if it tries to protect the poor through income-related transfers. One of the immediate ways of helping the poor is to offer direct cash-handouts that put additional money straight into pockets. The 1Malaysia People’s Aid (BR1M), worth RM500, is given to households earning RM3,000 or less. This assistance could be extended to include households earnings between RM4,000 and RM5,000 per month. Apart from the general argument of leakages, the extension of cash assistance could distort decisions to work, especially from those falling within the borderline. It is also important to acknowledge that cash handouts do offer temporary relief to the poor, and that assistance should be better directed to those in needs. Furthermore, the government should phase out all forms of short-term cash assistance to introduce the right incentives on workers to stay productive.

In the long run, the government should transfer revenue gains to improving the social safety net in order to protect the most vulnerable groups in society. Conscious choice must be made to trade high-end construction projects in for welfare spending, since the poor will also be increasing their share of tax revenue.

IV. Singapore Goods and Service Tax Case Study

Singapore introduced a GST in April 1994, paired with a reduction of direct and other indirect taxes. This restructuring of the tax system began with a GST rate of 3%. It is important to note that Singapore did not have fiscal consolidation on the agenda when they applied the GST, as they were running a budget surplus. Rather, their 3-main objectives were to:

1. Reduce the inefficient income tax system.
2. Broaden the indirect tax base.
3. Make the tax base more resilient for the long-term in view of population aging.

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21 Jaspal, Singh. (2013)
Singapore’s Experience

The implementation of taxation restructuring actually lowered the government’s surplus because of the combined introduction of GST with the reduction of direct income tax. The method was aimed at reducing the disincentive feedback, while also maintaining the international competitiveness of Singapore’s tax rates. This acted as a cushion for citizens to smoothen their consumption before a future increase in the rate of GST. Additionally, the government promised not to raise the tax further for another 5 years, which was an important step in encouraging consumer’s behaviour and received a generally positive reception. The next rise in GST came 9 years later in 2003, when the rate was increased to 4 % followed by another increase the following year to 5 %. Today, Singapore’s GST rate is 7 % - its last revision was in 2007.

Figure 6 Historical GST Rates

<table>
<thead>
<tr>
<th>Year</th>
<th>GST Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Apr 1994 to 31 Dec 2002</td>
<td>3 %</td>
</tr>
<tr>
<td>1 Jan 2003 to 31 Dec 2003</td>
<td>4 %</td>
</tr>
<tr>
<td>1 Jan 2004 to 30 Jun 2007</td>
<td>5 %</td>
</tr>
<tr>
<td>1 Jul 2007 onwards</td>
<td>7 %</td>
</tr>
</tbody>
</table>

Source: Inland Revenue Authority of Singapore, 2013

The introduction of a GST in 1993 corresponded with a decrease in the top bracket of personal income and company tax rate from 33 % and 30 % to 30 % and 27 %, respectively. A rebate system was also employed to soften the blow of the GST, which benefited lower income groups on an annual income of less than SGD $30,000. Singapore selected a low rate of GST to start off with, so that it was not sufficiently high so as to motivate companies to take the risk of cheating and evading taxes. The GST is a multi-stage tax and the probability of detecting tax evaders is reasonably high. Therefore, it was fairly

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22 Inland Revenue Authority of Singapore
easy to deter companies from under declaring income and revenue. Their collection system is also facilitated by advanced information technology to help in the accounting of taxes.

The foresight of the Singaporean government to consider future demographic changes helped them to recognise that over-dependence on the income tax system made the economy vulnerable to population aging, as their labour force numbers peaked and their demographic window opened in 1980. This indicates that their workforce numbers would be at their highest for several years. The government saw the importance in shifting from direct to indirect taxes as the income tax base shrunk gradually, because the number of citizens moving into retirement exceeded those who entered the labour force post-demographic window. Singapore’s approach was to integrate the GST into the tax system at a low rate, thus enhancing public acceptance and minimising the rate of inflation. To keep track of inflation, there was assistance to government-linked companies (GLC) to absorb the GST on key goods during the initial period to keep the Consumer Price Index (CPI) low.

During the initial stages, tax regulators carried out training to provide information on GST compliance to companies. They maintained effective internal training to ensure methods and procedures worked over time as workers adjusted to the GST. Administration and implementation costs went down over time with marginal gains in productivity. The Inland Revenue Authority of Singapore (IRAS) conducts regular seminars and interactive meetings to facilitate dialogue with the citizens and gathers feedback from taxpayers as well as educating them on the GST system. This transparency minimises the uncertainty that plays a big role in the psychology and satisfaction of the people in regards to the taxation system.

After implementation, Singapore faced several negative impacts. Singaporeans earning a fixed income faced the biggest problem because their income was not protected against inflation. This was especially true for

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pensioners and annuity subscribers. There were also concerns over the possible growth of the underground economy if taxpayers and companies retaliated by under declaring income due to perceived dissatisfaction.

**Malaysia’s Expectations**

Compared to Singapore’s foresighted approach, Malaysia has distinctively different motives in implementing the GST. Malaysia’s main aim is to increase revenue collection to cut the debt that Malaysia has accumulated through lavish government spending, which, in turn, resulted in the downgrading of its international credit rating by *Fitch*. Malaysia also intends to finally shift to a more efficient tax system that is fairer and will result in improved international competitiveness.

There are many inefficiencies in the current tax system, and Malaysia’s short-sighted approach has levied an enormous income tax burden on only 4% of the workforce. The United Nations estimates that Malaysia’s demographic window opened in 2010\(^{24}\), which means that its workforce is at its peak right now and will start shrinking over the next decade along with the income tax base. Since the GST will take almost 2 years to fully implement, it is crucial to include it in upcoming budget.

It is important to analyse the impact on the general public after the restructuring of this taxation system to evaluate the efficiency of the GST and whether it is comparable across countries. Singapore and Malaysia share a common advantage through applying a GST system. Both have a large amount of foreign workers. Foreign workers benefit from the growing economy but are exempt from income tax. However, the GST will cover all residents through their consumptive habits. In regards to retirees and senior citizens, Singapore and Malaysia have top tier social security savings plans through their respective Central Provident Fund (CPF) and Employees Provident Fund (EPF) systems. Malaysia must be aware of the fixed income worker’s problem and ensure that these groups of people, such as pensioners

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receive an increase in their income that will help alleviate some of the extra cost of the GST.

Malaysia’s shadow economy is estimated at 30 %, which represents a vast potential for tax revenue. The informal economy workers, such as roadside vendors and part-time workers can contribute by this widening of the tax base. The GST net also captures tax from unethical evasion and avoidance activities endorsed by creative accountants. Illegal activities such as embezzlement and smuggling will, at some level, be indirectly subjected to GST. If the GST is successfully implemented, it will be a blanket that covers the majority of the economy. This represents an even larger responsibility upon the government to adhere to moral values and spend prudently.

V. Australia GST: A Case Study

The GST took effect in Australia on July 1, 2000 through the passing of the A New Tax System (Goods and Services Tax) Act, 1999. The idea was first floated in 1975, and at times supported and promoted by different leaders and treasurers. However, it was not until the election of John Howard’s Liberal National Coalition (1996-2007) that any party had enough political capital to enact the reform. After stating in 1996 that there would “never ever” be a GST, Howard went to the 1998 election with it as one of his signature policy platforms. His party ultimately faced a voter backlash and lost the popular vote but was able to hold enough seats to form government.

The Australian example imposes a 10 % flat rate on goods and services and replaced a range of existing taxes – including, the wholesale sales tax (WST), debits tax, financial institutions duty, as well as stamp duty on shares, leases, mortgages and cheques. Replacing the WST evened the playing field where a tax that was implemented in the 1930s when the economy was dominated by goods, was now giving an unfair advantage to other parts of the economy that were dominated by the service industries.
Various items are exempt from the GST in Australia - most basic foods, some education and health services, as well as childcare and religious and charitable activities.\textsuperscript{25} Furthermore, there is the provision to claim on input tax credits, or tax credits for purchases related to business use.\textsuperscript{26} All businesses with an annual turnover of AUD75,000 or more and non-profit organisations with an annual turnover of AUD150,000 or more must register and include the GST in the price of sale.

The GST is collected by the Federal Government through the Australian Tax Office (ATO), and then redistributed to the six states and two territories on the amount recommended by the Commonwealth Grants Commission (CGC). In the 2011-2012 financial year, GST revenue was revised down AUD3.1 billion to AUD50.630 billion. The 2012-2013 figure stands at AUD54.230 billion.\textsuperscript{27}

The CGC uses the principle of Horizontal Fiscal Equalisation (HFE) in calculating their recommendations. This states that the pool of GST revenue should be redistributed in such a way that allows for each state and territory to have the fiscal capacity to provide infrastructure and services at the same standard, while also taking into account material factors that affect revenue and expenditure.\textsuperscript{28} However, this fiscal aim to achieve equality in the provision of services and infrastructure often causes friction between the states when the GST pie is divided. Western Australia is perhaps the strongest critic of the system. In the 2012-2013 CGC relatives, it was recommended that their share be written down from 71 cents in the dollar to 55 cents because of the resource rich state’s share of mining wealth.\textsuperscript{29}

Analysing Australia’s experience in implementing a consumption based tax model can offer helpful insights as Malaysia prepares to go down a similar path. The situation leading to the introduction of the new tax is in some ways analogous. Firstly, when Australia’s GST was introduced, it was done so not

\textsuperscript{25} Australian Taxation Office
\textsuperscript{26} Australian Government
\textsuperscript{27} Australian Government, Budget 2012-13
\textsuperscript{28} Australian Government, Commonwealth Grants Commission
\textsuperscript{29} Ludlow & Kerr (2012)
because of membership to any regional bloc, nor to fulfil the financial requirements imposed by any international organization. Despite the shape not yet being clear, Malaysia, like Australia, will implement a GST through a process of political will. In Australia, it was argued that the inefficient WST was unfairly punishing the manufacturing side of the economy while the dominant services industry was getting a free ride. Also, the pre-policy white paper (ANTS), argued that the proposed tax reform would promote economic growth by lowering effective income tax rate, compliance costs, input costs, as well as getting rid of indirect taxes.\(^\text{30}\) Conversely, in Malaysia there is a desire to neutralize the cascading effects inherent on the sales tax side of the current system.

While Australia has enjoyed 22-years of continuous growth, Malaysia is facing a worsening debt problem – a point highlighted by the recent downgrading by Fitch. Malaysia’s goal is to lower the budget deficit to 3 % of GDP by 2015 and achieve the goal of developed nation status by 2020 - aided by averaged 6 % per annum growth. This is being guided by the framework set out in the ETP run by PEMANDU.\(^\text{31}\) Like Australia, the engine of growth here will be the service-orientated economy. Some of this is dependent on international factors outside domestic control, such as China’s trend toward a domestic growth model and the effect this will have on commodity demand from Malaysia. However, moving toward the introduction of a GST will cement much needed government revenue in the years to come that has so far been stifled by a very small tax base.

Finally, there is the issue of regressivity. As a GST imposes an additional flat rate on most goods and services, there will be a higher impact on low-income household’s marginal propensity to consume. While it is not yet know what exemptions will be put in place in Malaysia and what compensation will be offered, Australia introduced a range of measures to soften the extra financial burden of the GST’s introduction. Put in place was a package of AUD12.5 billion in person tax cuts. This and other measures introduced were estimated to give the average taxpayer at the AUD10,000 annual level a 3 % gain in

\(^{30}\) ANTS White Paper (1998)  
\(^{31}\) PEMANDU (2013)
personal income and a 5% gain for the upper-middle level at AUD55,000, albeit few material benefits for lower-middle income earners. Furthermore, the exemptions to various goods and services and increased transfer payments to pensioners were amendments advocated for by the Australian Council of Social Services (ACOSS) and secured by the Australian Democrats minor party in return for their support and passage of the bill through the Senate. Upon implementation there was a significant, albeit transitionary effect on the economy as can be viewed by 4 quarters of almost double inflation, as measured through the Consumer Price Index (CPI), before falling back to trend levels in the fourth quarter of 2001.

**Figure 7 Changes in Australia’s Consumer Price Index (CPI), by Quarter 1994-2005**

![Graph showing changes in Australia’s Consumer Price Index (CPI) from 1994 to 2005](image)


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32 Morse. (2011)
VI. Policy Recommendation

The implementation of a GST should be incorporated into the larger objective of achieving fiscal sustainability. There remains room for improvement for the effective implementation of GST. Both short and long term policy recommendations with regards to economic growth, inflation and equity development are provided.

Recommendation 1. Introduce initial GST rate at 5%.

The differences in the cost of consumption behaviour adjustment for a 4% and 5% GST are expected to be small given that the introductory rate is still lower than the existing SST. Assuming that the actual date of GST falls within 2015, a 5% GST is more optimal if the budget deficit is to be realistically reduced to 3% of GDP.

Recommendation 2. Enforce display of GST charges on price tag.

All items that are chargeable by GST should display the actual amount of tax payable on the price tag. Items that are zero-rated or exempted from GST should also carry price tags that describe the corresponding tax category.

Recommendation 3. Raise awareness on exemption list and stop expanding the list.

Awareness on exempted items should be raised through effective communication. Consumers should also be educated on what to do should they fall victim to price manipulation. On the other hand, the government should remain steadfast with the list of goods and services that are exempted from GST. Arbitrary expansion of the list will only limit the revenue generated from the GST, thus increasing the frequency of having to revise the GST rate upwards.
Recommendation 4. A one-off cash assistance worth RM500 should be given to households earning less than RM3,000 (40% of total households) and it should be in the form of voucher rather than direct cash handouts.

Given that average monthly spending by the poorest income group is RM570, a one-off cash assistance payment worth RM500 is sufficient to help the most vulnerable households smooth out sudden changes due to the introduction of the GST. This assistance should only be given out to households earning less than RM3,000, because they are not eligible to pay personal income tax. It is fair to limit financial aid to households falling below the threshold. Cash assistance is recommended to be carried out via vouchers that are redeemable through participating hypermarkets that have been identified to act as price setters by the government. Price-fixing is also less of an issue since these hypermarkets will be monitored by relevant agencies.

Recommendation 5. Strengthen cooperation with local consumer society to fight profiteering activities.

Individual consumers who are the victim of profiteering activities are less likely to take action against irresponsible traders. The government should promote the establishment of a local consumer association to increase the effectiveness in gathering reports of price abuse and strengthening the capacity of enforcement agencies to carry out their duties. Local households are also better informed of price changes than agencies at the national level.
Recommendation 6. Commit to a 5-year timeline and review GST with the possibility of raising the rate by 2020.

The government should commit to a 5-year timeline when introducing the GST at 5%. The government should restrict itself from arbitrarily increasing the GST rate within the 5-year period. This allows for price stability and better consumption planning. Committing to a time schedule with a review of the GST at the end of the 5-year period increases the credibility of the government to enforce its deficit-reduction plan. This timeline also serve to avoid inconsistencies due to myopic political gains or possible changes in the political structure that may jeopardize public financial health over the long run.

Recommendation 7. Enhance communication on the importance of reducing the budget deficit to raise public acceptance of the issue. Invest revenue gains in public health services and education to improve productivity.

Consistencies in communication are important to gain public acceptance on the implementation of the GST. Issues like leakages and a lack of transparency in public expenditure should be resolved more enthusiastically in order to build credibility in the government’s fiscal adjustment plans. In the long run, income growth is key to generate tax revenue and the government should reinvest revenue gains from the GST in improving the quality of public health services, promoting equal access to education and bridging the divide of access to information technology.
VII. Conclusion

Recognition must be made of the need for the government to explore methods that increase future revenue sources. On the condition that the government does announce the GST, preparations for the implementation are crucial. The primary concern will be the impact upon low-income households in acknowledgment of the regressivity inherent in a GST. The GST will put upward pressure on cost of living through inflation during the initial stages. Therefore, the government must address and strengthen the welfare state to protect those most vulnerable in society. One, all-encompassing way to provide assistance is through transfer payments in the form of vouchers and exemption targeting for goods which are deemed basic necessities.

Through analysing the implementation models in the advanced countries of Singapore and Australia, we can see from their experiences and factor in constants in preparation for the GST implementation in Malaysia. As one of the few countries in the region that still do not have in place a broad consumption based tax system, Malaysia can refer to many countries around the world who do in preparing for a successful and smooth implementation. A common trait associated with an efficient GST system is improved international competitiveness. This is in line and a goal which Malaysia aims toward in becoming a high-income nation by 2020.

Lastly and of utmost importance, if the government intends to expand the tax base and increase the efficiency of tax collection through the use of a GST, it will bring the majority of the population within the tax base. Therefore, all citizens become stakeholders in the budget and the government must begin to display strong political will to cut wastages, leakages and corruption. Prudent spending and transparent accounting will go a long way in winning over public acceptance of the GST.
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