GST should be retained

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IN keeping with its election manifesto, the Pakatan Harapan government has announced that the Goods and Services Tax (GST) will be abolished. Pending abolition, the rate was brought down from 6% to 0% effective June 1, and at the end of a three -month review period, the government will decide whether to bring back the previous Sales and Service Tax (SST).

Although the SST revenue is not expected to be anywhere near the GST collection of RM42bil (20% of total federal government revenue), the government is confident it can still keep the fiscal position in balance from other revenue sources.

Government supporters argue that income tax and other revenue items would respond positively to the upbeat mood of consumer sentiment and the feel-good factor in the economy after GE14 .

Analysts also say that the broad-based reforms that are being introduced to restore the rule of law and reduce corruption would facilitate growth and revenue expansion.

And on top of it all, the oil price is still at its high level. Thus, with all these favourable changes, the GST is no longer important.

While these measures are all clearly important for sound management of the country's finances, the fact remains that a weak revenue base will make the country overly exposed to the oil price and the vagaries of the world economy. These were the same concerns that prompted the Finance Ministry in the mid-1980s to look at the revenue system after the country was struck by the "twin deficit" recession of 1985/86 caused by the deficit in both the balance of payments and the federal government budget which was unprecedented in the country's economic history.

The government was forced to make drastic cuts on its expenditures, causing knock-on effects on the private sector. Companies that relied on government contracts directly and indirectly for their business suffered the most.

Many Malay entrepreneurs and contractors became insolvent during the 1985/86 recession because of their high dependence on government procurement. They had to be rescued from bankruptcy actions by the commercial banks.

A special fund was created in Bank Negara for this rescue operation as the government could not be seen to fail under the New Economic Policy in developing a viable bumiputra commercial and industrial community. The fund was able to recover the loans after the Malay businesses were successfully restructured to make them profitable again. The inefficient ones which could not be saved were allowed to die off.

The trauma of the recession prompted the Treasury, Bank Negara and Economic Planning Unit (EPU) to study the findings of the IMF report on the revenue structure, which stated basically that as Malaysia's income tax base had been so badly eroded over the years through generous reliefs, exemptions and tax holidays, it had lost its dynamism and buoyancy to respond to upward business cycles.

Furthermore, as countries in the region were lowering taxes on personal and business incomes, Malaysia could not possibly raise its income tax rates as this would make it lose its competitiveness in attracting foreign investments. Federal revenue, therefore, could only be made to grow at a healthy rate through taxation on consumption.

Malaysia had been taxing consumption through the SST at 10% and 15% since the 70s. But as there were several weaknesses in the SST, the three central agencies agreed that the country needed to move to the Value Added Tax (VAT) as found in many advanced economies. Although both are taxes on consumption, VAT (or GST as we prefer to call it) is more efficient than the SST in bringing more establishments into the tax net.

Moreover, Malaysia had the necessary staff resources and infrastructure in the Customs Department to implement the GST based on its long experience with the SST.

The GST proposal gained more serious attention when the country was struck by the 1997/8 East Asian financial crisis, which led to another recession that hit the GLC sector very hard. It was decided in 2001 that the UEM-Renong Group had to be rescued by Khazanah Nasional Berhad as it was considered too big in the stock market and too important under the New Economic Policy to allow it to fail.

Fast forward, the New Economic Model in 2011 recommended strong fiscal reforms including introducing the GST and removal of fuel subsidies as part of the structural transformation to take Malaysia out of the "middle income trap".

As the deficit in the federal budget/GDP ratio was rising from year to year, threatening a possible downgrade of the country's sovereign rating, which would trigger a serious effect on market confidence, the government had no choice but to implement tough fiscal measures.

As a result of implementing both the subsidy removal in 2014, followed by the GST the following year, there were price increases which were exacerbated by the declining ringgit and its impact on costs of imports. It was a double whammy, as critics described it, but unavoidable to restore the health of the economy. The government introduced BR1M to lessen the burden on the poor.

> **Customs administration has also improved the refund system, which was the main complaint from small business operators.**

As I understand it, at the end of August, the government will decide what to do next. If it is decided to retain GST, I would propose that the rate be reduced from 6% to 4%. In fact, the original intention of the Treasury planners was to start at a low rate. It was calculated that at 4%, it would be revenue neutral as a replacement to the SST. However, with the many political pressures to exempt so many items, the Treasury officers decided that the revenue neutral rate would have to be higher at 6%.

It was quite surprising even to the Treasury officers that the actual collection exceeded expectations, thanks to the hard work of the Customs Department and also to the recovery of the economy from 3% to 4% previously to over 5% in 2016 and 2017.

Bank Negara's annual reports attributed the higher performance to the success of the various reform measures.

Customs administration has also improved the refund system, which was the main complaint from small business operators and SMEs as delays in getting refunds were costly to them, especially those mom-and-pop businesses which had spent money to computerise their accounts and employ qualified staff to do the documentation and filing of their GST returns and refund claims.

The efficiency of the GST as a tax on value added and its fairness to tax registrants lies in its refund system to avoid multi-stage taxation down the value chain. Its structure is designed such that only the final consumer pays the tax, not the manufacturers, wholesalers or retailers as it is a tax on consumption, not on production.

Under the GST, when companies submit their quarterly returns, they will declare and pay to the Customs Department the GST amount they collected from their sales to customers in their value chain.

At the same time, they also claim from Customs for refund on the GST they themselves paid when buying raw materials and other inputs for their business. If there are delays in the refunds, they will have a cash flow problem in their business operations.

In addition, there was confusion over which goods and services were exempt items and which were zero rated as the tax treatment is different between the two categories. The GST refund system has been fixed after the initial glitches and there is better understanding now on the categorisation of goods and services.

As the system is now working well, I propose that the GST be retained but reduced to 4% or 3% to provide a stable source of revenue to sustain government expenditures in the event the oil price suddenly drops to the low levels like before or the world economy goes into recession.

Like other countries, and as Singapore is doing on its GST, the rate can be increased gradually as income levels rise with the development of the economy. Singapore started with 3% and has raised it step by step to 7% today. It has also issued a notice that the rate will be increased further by 2022. Malaysia can also do the same.

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