

THE PROGRESSIVITY OF THE MALAYSIAN PERSONAL INCOME TAX SYSTEM

Yong Kuan Chen

School of Social Science, Universiti Sains Malaysia, 11800 USM, Penang

Email: kcyong137@gmail.com

In general, Malaysia has a progressive personal income tax system in which the tax rate increases as an individual's income increases. The system is intended to provide assistance for low-income earners so as not to increase their living expenses; in contrast, high-income earners can afford to contribute more to the government's revenue. The increase in tax rate across different income levels, however, may not help to achieve income equality due to factors such as a rising marginal tax rate across income brackets, tax deductions, inflation, fluctuations in earnings, tax evasion and legal loopholes. These factors cause a more uneven distribution of income, even though the income tax system is progressive. Therefore, this study aims to confirm that such factors reduce the progressivity of personal income taxation and further suggests policies that could be used to help restore the progressivity of the income tax system. Among them are the implementation of flat tax rates and the replacement of tax deductions with tax credits.

Keywords: progressivity, personal income tax system, Malaysia

INTRODUCTION

Tax is often used as an instrument to reduce income inequality. In Malaysia, two types of taxes are applied, direct and indirect taxes. Either tax can be designed to directly reduce post-tax incomes among tax payers or to impose taxes to raise revenues, which are then channelled to fund programs designed to narrow income differences. The personal (or individual) income tax, for example, is a tax instrument designed to do both simultaneously. Designed to tax higher incomes utilising rising marginal tax rates, it seeks to reduce income differences among tax payers. By being a tax that captures most, if not all, earned income, it also generates substantial revenues to fund anti-poverty programmes that help the poor who fall outside the income tax net. Rising marginal tax rates, however, have a negative impact on the incentive to work. Most countries continue to implement a progressive income tax in the belief that both the direct and indirect

effects of alleviating income inequalities more than offset the tax's negative impact on the incentive to work.

The personal income tax is a tax imposed on earned incomes. Depending on whether the marginal tax rate rises, remains constant or falls as income brackets increase, the income tax can be made progressive, proportional or regressive, respectively, with regard to the income base. Malaysia implements a progressive income tax rate structure in which an individual's average tax rate increases with the income base. This is achieved by ensuring that the marginal tax rate (or the rate imposed on the last ringgit earned) increases as the income bands rise, suggesting that the rate structure is also designed to address the income inequalities in the country. The major distortion caused by a progressive tax rate is that it reduces the incentive to work because each additional band of income earned is taxed at a higher rate than the previous band. Unfortunately, this disincentive effect on working (and saving) will be strongest among groups that have the greatest capacity to work and save (the higher income groups) because progressive tax rates fall more heavily on higher incomes. The challenge is, therefore, to design an income tax system that minimises the disincentive to work while maintaining some measure of progressivity to narrow income inequalities, both directly and indirectly.

The notion that a progressive income tax with a progressive marginal tax rate should be used as the main tool to improve income equality appears to be widely accepted. Almost all countries have adopted this model in designing their personal income taxation. It is built on the idea that because income measures someone's ability to pay, the rich should have a higher share in supporting the government and its expenditures favouring the poor (Asian Tax Reform, 1984). Several authors, however, have noted that personal tax systems, though designed to be progressive, often lose some of the progressivity on account of several factors (Livingston, 2000; Hall and Rabushka, 1983). However, this point has not gained sufficient attention in standard public finance texts (see for example Rosen and Gayer, 2008; Hyman, 2005). There has also been very little discussion concerning whether an alternative system might yield progressivity while avoiding or minimising the adverse consequences of the progressive income tax currently in place. There are studies, largely in the US, that hypothesise that a progressive income tax structure per se does not guarantee that the tax will succeed in narrowing income inequalities. No similar studies, however, have been reported for Malaysia.

The objective of this paper is to demonstrate that the Malaysian personal income tax system suffers limitations as a tool for reducing income inequalities both directly and indirectly while its effect as a disincentive to work remains. Through a series of examples, it will be shown that the progressivity apparent from the

rising marginal tax rates on income bands is considerably reduced by many other provisions of the income tax that reduces its ability to improve income inequality directly. Moreover, the system's narrow base limits its capacity to lessen income differences indirectly because it generates only a small share of total tax revenues. Against this, the rising marginal tax rate remains as a disincentive to work relative to a constant marginal tax rate. In short, the personal income tax system in Malaysia performs poorly as an income equaliser and as a tool that encourages work effort. The paper concludes by offering suggestions that can maintain or strengthen the role of the personal income tax as an income equaliser without affecting the incentive to work.

The paper is organised as follows. It begins with a working definition of progressive personal income tax, followed by a brief description of the Malaysian personal income tax structure. The main section demonstrates how the progressive marginal tax rate, ironically, undermines the progressivity of the personal income tax. The subsequent two sections note how the limited coverage of the tax and the various legal loopholes further diminish its capacity to narrow income differences. The final section summarises the main points and discusses policy options to address the weaknesses in the personal income tax structure.

DEFINITION OF PROGRESSIVITY

While a more formal definition of progressivity is available (Musgrave and Thin, 1948), for the purposes of this paper, a progressive tax is defined as one in which the proportion of income (Y) given up in taxes (T) rises with an increase in income (the tax base in the case of the personal income tax). In other words, under a progressive personal income tax, the ratio (T/Y) increases with income (Y). This progressivity is achieved by imposing a marginal tax rate (or the tax rate imposed on the last ringgit) that rises with income bands. The end result is that under a progressive income tax, the marginal tax rate (defined mathematically as (dT/dY)) will exceed the average tax rate (or T/Y).

By definition, progressivity will be zero (neutral) when the marginal tax rate is equal to average tax rate. This would be the case if the income tax were a proportionate system. At the other extreme, a regressive income tax would show the average tax rate exceeding the marginal tax rate—a situation in which lower income tax payers would be giving up a larger proportion of their income in taxes than higher income tax payers.

THE MALAYSIAN PERSONAL INCOME TAX

The Malaysian personal income tax is a progressive system. The tax is based on chargeable income (the total earned income minus all non-tax deductions and rebates) and has been made progressive through the imposition of a progressive tax rate structure (see Table 1). All resident individuals are liable to be taxed on income accrued in and derived from Malaysia or received in Malaysia from outside Malaysia¹. The individual is taxed on the taxable income, which is derived after deducting the various tax deductions from the chargeable income. The taxable income is subjected to a graduated tax rate that rises from 0% to 26% with the effect from the year of assessment, 2010, shown in Table 1.

It is clear that a progressive income tax structure has been created by the imposition of rising marginal tax rates (the rate relevant to the last ringgit) on higher income brackets. For example, on the first RM2,500 of taxable income, no tax is imposed, but on the last RM100 (000 or more), the maximum rate of 26% is applied.

Table 1: Malaysia's income tax structure

| Individual income tax rates in Malaysia | | | |
|---|--------------------|--------|----------|
| Income bracket (RM) | Calculation (RM) | Rate % | Tax (RM) |
| 0–2,500 | On the first 2,500 | 0 | 0 |
| 2,501–5,000 | Next 2,500 | 1 | 25 |
| 5,001–10,000 | First 5,000 | – | 25 |
| | Next 5,000 | 3 | 150 |
| 10,001–20,000 | First 10,000 | – | 175 |
| | Next 10,000 | 3 | 300 |
| 20,001–35,000 | First 20,000 | – | 475 |
| | Next 15,000 | 7 | 1,050 |
| 35,001–50,000 | First 35,000 | – | 1,525 |
| | Next 15,000 | 13 | 1,950 |
| 50,001–70,000 | First 50,000 | – | 3,475 |
| | Next 20,000 | 19 | 3,800 |
| 70,001–100,000 | First 70,000 | – | 7,275 |
| | Next 30,000 | 24 | 7,200 |
| 100,001+ | First 100,000 | – | 14,475 |
| | Next 500,00 | 26 | ... |

Source: Inland Revenue Board of Malaysia, n.d.a.

As previously noted, the taxable income is obtained by subtracting all of the deductions (or reliefs) allowed legally from the income. These are numerous and are shown in Table 2. Of course, not every taxpayer is eligible for each of the deductions shown. For example, the deductions given to disabled individuals cannot be utilised by others, while the allowance permitted for a wife and children cannot be taken advantage of by an unmarried taxpayer.

Table 2: The individual income tax reliefs allowed by law

| No. | Individual relief types | Amount (RM) |
|-----|--|------------------|
| 1 | Self and dependent | 9,000 |
| 2 | Medical expenses for parents | 5,000 (Limited) |
| 3 | Basic supporting equipment | 5,000 (Limited) |
| 4 | Disabled individual | 6,000 |
| 5 | Education fees (individual) | 5,000 (Limited) |
| 6 | Medical expenses for serious diseases | 5,000 (Limited) |
| 7 | Complete medical examination | 500 (Limited) |
| 8 | Purchase of books, journals, magazines and publications | 1,000 (Limited) |
| 9 | Purchase of personal computer | 3,000 (Limited) |
| 10 | Net saving in national education saving scheme (SSPN) | 3,000 (Limited) |
| 11 | Purchase of sport equipment for sport activities | 300 (Limited) |
| 12 | Subscription fees for broadband registered in the name of the individual | 500 (Limited) |
| 13 | Interest expended to finance purchase of residential property. Relief of up to RM10,000 a year for three consecutive years from the first year the interest is paid. | 10,000 (Limited) |

Subject to the following conditions:

- (i) the taxpayer is a Malaysian citizen and a resident;
- (ii) limited to one residential unit;
- (iii) the sale and purchase agreement is signed between 10 March 2009 and 31 December 2010
- (iv) the residential property is not rented out.

Where:

- (a) two or more individuals are eligible to claim relief for the same property; and
- (b) total interest expended by those individuals exceeds the allowable amount for that year. Each individual is allowed an amount of relief for each year based on the following formula:

$A \times B$; A = total interest allowable in the relevant year; B = total interest expended by the relevant individual in the relevant year;

C; C = total interest expended by all the individuals.

Continued on next page

Table 2: (continued)

| No. | Individual relief types | Amount (RM) |
|-----|--|-----------------|
| 14 | Husband/wife/alimony payments | 3,000 (Limited) |
| 15 | Disabled wife/husband | 3,500 |
| 16 | Ordinary child relief | 1,000 |
| 17 | Child age 18 years old and above, not married and receiving full-time tertiary education | 1,000 |
| 18 | Child age 18 years old and above, not married and pursuing diplomas or above qualification in Malaysia or bachelor degree or above outside Malaysia in program and in Higher Education Institute that is accredited by related Government authorities | 4,000 |
| 19 | Disabled child (additional exemption of RM4,000 disable child age 18 years old and above, not married and pursuing diplomas or above qualification in Malaysia or bachelor degree or above outside Malaysia in program and in Higher Education Institute that is accredited by related Government authorities) | 5,000 |
| 20 | Life insurance and Employee Provident Fund (EPF) | 6,000 (Limited) |
| 21 | Premium on new annuity scheme or additional premium paid on existing annuity scheme commencing payment from 1 January 2010 (amount exceeding RM1,000 can be claimed together with life insurance premium) | 1,000 (Limited) |
| 22 | Insurance premium for education or medical benefit | 3,000 (Limited) |

Source: Inland Revenue Board of Malaysia, n.d.b.

THE IMPACT OF THE PROGRESSIVE MARGINAL TAX RATE ON EQUITY

Tax Savings from Deductions Favour the Higher Income Tax Payers

In general, although the deductions lower the taxes payable by all taxpayers, they favour higher income tax payers by providing them with greater tax savings. In other words, the amount of income that escapes taxation as a result of these deductions is larger for higher income tax payers than for their lower income counterparts. By favouring higher income taxpayers, these allowances and deductions contradict the principle of progressivity. This can be illustrated by the following example.

Consider two people: individual A has a yearly income of RM30,000 (or RM2,500 a month) and B has a yearly income of RM60,000 (or RM5,000 per month). Other circumstances are assumed identical for both. Each individual has a spouse and two children. Two of the children are under 18. The computation of taxable income is as follows:

Taxable income = Chargeable income – Deductions received

Both individuals receive similar exemptions, which equals RM14,000². A's chargeable income is RM30,000. Thus, his taxable income is RM16,000. According to Table 1, he will be paying RM355 (i.e., RM175 + 0.03 × RM6,000) as income tax. In the case of B, the chargeable income is RM60,000. Thus, the taxable income is RM46,000. According to Table 1, his payable taxes are RM2,955 (i.e., RM1,525 + 0.13 × RM11,000). It should be noted that both A and B received similar exemptions, although B's income was double that of A's. Nonetheless, B's payable tax is higher than that of A, which is consistent with the principle of progressivity. The main concern here, however, is the amount the higher and lower income taxpayers actually save from the tax deductions.

Individual A with a taxable income of RM30,000 will pay a tax of RM1,175 (i.e., RM475 + RM10,000 × 0.07) in the absence of any deduction. With the granting of deductions, the payable tax is reduced to RM355, giving a "tax saving" of RM820 (i.e., RM1,175 – RM355). In the case of individual B, his taxable income in the absence of deductions is RM60,000 and the payable tax amounts to RM5,375 (i.e., RM3,475 + RM10,000 × 0.19). After accounting for deductions, the payable tax is lowered to RM2,955. The total "tax savings" is RM2,420 (or RM5,375 – RM2,955). In absolute terms, individual B, who has double the income of individual A, saves more from the deductions granted by way of a reduction in the taxes paid. The exemptions therefore give greater tax savings to the higher income individual than to the lower income taxpayer.

Deductions granted in the form of deductions from the chargeable income, therefore, may reduce the progressivity of the tax system as the higher income tax payers gain a greater tax saving from an identical deduction relative to lower income tax payers. This discrepancy arises because the size of the tax saving from a deduction awarded in this manner depends on the marginal tax rate of the taxpayer. The higher the marginal tax rate faced by the tax payer, the higher the tax saving from the deductions granted. Because higher income taxpayers face a higher marginal tax rate under a progressive tax structure, they will enjoy greater tax savings.

Stable Income Earners Benefit as Opposed to Those Earning Fluctuating Incomes

Another weakness of a progressive tax rate structure is that two individuals with identical incomes over a period of time can end up paying two very different amounts of tax, even if we disregard the effect of deductions discussed earlier.

Consider two individuals, A and B. Both have similar total incomes over, say, a three year period, but A's income comes in a constant stream of RM100,000 per year (Table 3) while B's income stream fluctuates as shown in Table 4 below.

Table 3: Stable income case (Individual A)

| Year | Taxable income (RM) | Marginal tax rate | Tax (RM) |
|-------|---------------------|-------------------|----------|
| 1 | 100,000 | 24% | 14,475 |
| 2 | 100,000 | 24% | 14,475 |
| 3 | 100,000 | 24% | 14,475 |
| Total | 300,000 | – | 43,425 |

Individual A has an identical taxable income of RM100,000 each year, which falls into the RM70,001–RM100,000 income band for the purposes of taxation. (It is assumed that no deductions are allowed for simplicity. Taking deductions into account will not alter the argument being made.) The payable tax is RM14,475 (or RM7,275 + RM30,000 × 0.24) per year, resulting in a total of RM43,425 paid in taxes for the three year period (Table 3).

The case of individual B is shown in Table 4, for whom income varies yearly. In the first year, his taxable income is RM40,000, which falls into the RM35,001–RM50,000 income band. The payable tax is RM2,175 (RM1,525 + RM5,000 × 0.13). In the second year, his taxable income is RM100,000, which falls into the RM70,001 – RM100,000 income band. The tax owed is RM14,475 (or RM7,275 + RM30,000 × 0.24). In the third year, his taxable income is RM160,000, which falls into the >RM100,001 income band. The tax payable on this amount is RM27,475 (or RM27,975 + RM10,000 × 0.26).

Table 4: Fluctuating income case (Individual B)

| Year | Taxable income (RM) | Marginal tax rate | Tax (RM) |
|-------|---------------------|-------------------|----------|
| 1 | 40,000 | 13% | 2,175 |
| 2 | 100,000 | 24% | 14,475 |
| 3 | 160,000 | 26% | 27,475 |
| Total | 300,000 | – | 44,125 |

Despite receiving same amount of total income over the three year period, because individual B's income fluctuates, he ends up paying more taxes compared to individual A (Table 4). Because his income fluctuates, he falls into an income bracket that experiences higher marginal tax rates, thus he pays more in taxes. With the increasing marginal tax rate, if tax payers have highly fluctuating

incomes, they will pay more in taxes compared to those who receive income in a constant stream, even though the total is the same for both types of tax payers over a given number of years.

Inflation and "Bracket Creep" Disadvantages Lower Income Tax Payers

Under a progressive tax structure, inflation pushes tax payers into a higher income tax bracket (a phenomenon known as "bracket creep") based on increases in their *nominal* income, although their *real* income (nominal income adjusted for inflation) may have actually fallen. This bracket creep can widen income differences between tax payers.

To illustrate, assume there are two individuals, A and B, who differ only in the amount of their annual incomes. Both are assumed to receive the same deduction for self (RM9,000). Table 5 shows their position prior to inflation.

Table 5: Taxation computation before inflation

| | A | B |
|------------------------|--------|---------|
| Chargeable income (RM) | 39,000 | 109,000 |
| Deduction (RM) | 9,000 | 9,000 |
| Taxable income (RM) | 30,000 | 100,000 |
| Marginal tax rate (%) | 7 | 24 |
| Payable tax (RM) | 1,175 | 14,475 |
| Average tax rate (%) | 3.01 | 13.28 |

A's taxable income is RM30,000 and falls into the RM20,001 – RM35,000 income band, resulting in a tax liability of RM1,175 (or $RM475 + 0.07 \times RM10,000$). His average tax rate is 3.01% (or $1,175 / 39,000 \times 100\%$). In the case of B, his taxable income is RM100,000, which falls into the RM70,001 – RM100,000 income band and results in a tax liability of RM14,475 (or $RM7,275 + 0.24 \times RM30,000$). His average tax rate is 13.28% (or $14,475 / 109,000 \times 100\%$).

With an inflation rate of 100%, the nominal taxable income is doubled. The deduction, however, is not doubled because deductions are not adjusted for inflation. A's income is now increased to RM69,000, which falls into the RM50,001 – RM70,000 income band. The payable tax amounts to RM7,085 (or $RM3,475 + 0.19 \times RM19,000$) and the average tax rate rises to 8.84% (or $6,895 / 78,000 \times 100\%$). This is shown in Table 6.

Table 6: Taxation computation after 100% rate of inflation

| | A | B |
|------------------------|--------|---------|
| Chargeable income (RM) | 78,000 | 218,000 |
| Deduction (RM) | 9,000 | 9,000 |
| Taxable income (RM) | 69,000 | 209,000 |
| Marginal tax rate (%) | 19 | 26 |
| Payable tax (RM) | 6,895 | 42,555 |
| Average tax rate (%) | 8.84 | 19.52 |

Similarly, in the case of B, his income increases to RM216,000, which falls into the >RM100,001 income band. The payable tax increases to RM42,555 (or RM14,475 + 0.26 × RM108,000) and raises the average tax rate to 19.25% (or 42,555 / 216,000 × 100%).

In the case of A, the average tax rate rose by 201.33% (or [9.07 – 3.01] / 3.01 × 100%), while for B the rate of increase is 48.45% (or [19.70 – 13.28] / 13.28 × 100%).

Note that the average tax rate more than doubled for the low income tax payer, A, while it increased less than proportionately for the higher income tax payer, B. Inflation shifted the former by two income brackets to attract an even higher marginal tax rate. On the other hand, B was only shifted up by one bracket. By increasing the marginal tax rate of lower income tax payer at a more rapid pace than that of the higher income tax payer, the bracket creep induced by inflation actually reduces the progressivity of the progressive income tax. Again, the source of the problem is the progressive marginal tax rates.

Rising Marginal Tax Rates Encourage Evasion

Little is known about the extent of tax evasion in Malaysia, but there is much literature that suggests that increasing marginal tax rates encourage evasion (for example, Yitzhaki, 1974; Clotfelter, 1983). Clotfelter (1983), for example, shows that tax evasion is highly sensitive to the value of the marginal tax rate. He found that the elasticity of underreported income with respect to the marginal tax rate is positive, which implies that increases in the marginal tax rate will increase tax evasion. Different people, however, have various opportunities to evade and different risk preferences, which contribute to differences in the value of these elasticities that tend to range from 0.5 to 3.0. The progressivity of the personal income tax will be undermined to the extent that the richer taxpayers, faced with higher marginal tax rates, are more likely to evade taxes than lower income tax payers.

LIMITED COVERAGE

If the progressive marginal tax rates actually erode the progressivity of the income tax system and limit its ability to equalise incomes among tax payers directly, their limited coverage compromises their capacity to narrow the income gap indirectly by raising revenues to fund pro-poor programs.

In Malaysia, the personal income tax receipts accounted for no more than 12% of total federal revenue in the period from 2000 to 2010 (Table 7). This is in spite of the fact that incomes have been rising and that the economy has become more monetised over the years. In comparison, in 2002, the weighted average of the proportion of total revenue contributed by personal income taxes in 30 countries, including the US, UK, Japan, Australia and Canada, was 26.1%, far exceeding that of Malaysia³.

At least two reasons explain this poor level of contribution to receipts. First, the income threshold (when a tax payer becomes liable for taxes) and deductions have increased periodically as pro-poor measures. In the 2009 budget proposals, for example, the tax rebate was raised from RM350 to RM400 for individuals with taxable incomes not exceeding RM35,000 per annum. And in the 2010 budget proposals, the individual deduction for insurance and employee provident fund (EPF) contributions was raised from RM6,000 to RM7,000 and individual tax deduction was raised from RM8,000 to RM9,000. These were touted as measures to lighten the burden. The latter measure to increase tax deduction alone removed an estimated 100,000 taxpayers from the taxable income group (Narayanan, 2011).

Second, of Malaysia's 10.5 million workers, only one million (9.5%) pay any income tax; the increase in absolute revenue from individual income tax is therefore explained by higher taxpayer compliance, estimated at approximately 75%, and improved efficiency rather than by a growing tax base (Narayanan, 2011).

With such limited coverage, tax deductions offered through the income tax system neither reach the poor (because they do not pay taxes) nor generate substantial revenue to fund direct poverty alleviation projects.

Table 7: Sources of federal revenue, Malaysia, 2000–2010 (RM billion)*

| Component | '00 | '01 | '02 | '03 | '04 | '05 | '06 | '07 | '08 | '09 | '10 |
|------------------------------------|------|------|------|------|------|-------|-------|-------|-------|-------|-------|
| Direct tax | 29.2 | 42.1 | 44.4 | 43.0 | 48.7 | 53.4 | 61.6 | 69.4 | 82.1 | 78.7 | 75.9 |
| (Personal income tax) ⁴ | 7.0 | 9.4 | 9.9 | 8.0 | 9.0 | 8.7 | 10.2 | 11.7 | 15.0 | 15.4 | 15.8 |
| Indirect tax | 18.0 | 19.4 | 22.5 | 21.9 | 23.4 | 27.1 | 25.0 | 25.8 | 30.7 | 27.8 | 27.6 |
| Tax revenue | 47.2 | 61.5 | 66.9 | 64.9 | 72.1 | 80.5 | 86.6 | 95.2 | 112.8 | 106.5 | 103.5 |
| Non-tax revenue | 14.7 | 18.1 | 16.7 | 27.7 | 27.4 | 25.7 | 36.9 | 44.7 | 46.9 | 55.6 | 44.9 |
| Total | 61.9 | 79.6 | 83.6 | 92.6 | 99.5 | 106.2 | 123.5 | 139.9 | 159.7 | 162.1 | 148.4 |

Source: Ministry of Finance Malaysia, 2010/2011.

*The figures for 2009 are revised estimates; those for 2010 are preliminary estimates

LEGAL LOOPHOLES

Several types of allowances that are taxed when given to private sector employees are freed from tax when given to public sector employees. The following is a partial list of allowances that are tax free when received by workers in the public sector Civil Income Tax Exemption (CITE)⁵.

1. Entertainment allowance
2. Housing allowance
3. Maid allowances
4. Home maintenance assistance payments

Granting these allowances a "tax-free" status further undermines the progressivity objective on two counts. The first reason is as discussed earlier; if included in the taxable income, the allowances favour wealthier tax payers rather than lower income taxpayers because the rich will be saving more as they are taxed at a higher marginal tax rate although they are receiving similar deductions. The second reason is that making these allowances tax free for only public sector employees lowers their chargeable income (relative to a private sector employees with similar incomes and allowances), and therefore their tax liabilities as well.

POLICY OPTIONS

How can the progressivity be maintained without a progressive marginal tax rate structure? Hall and Rabushka (1983) suggest doing away with the progressive tax structure altogether because it is possible to have a progressive income tax system

without it. By giving exemption to the lowest income groups and imposing a single flat rate on all incomes above this defined income threshold, a progressive tax system can be achieved. This can be demonstrated by the following example.

Assume there are three types of individuals: low income, middle income and high income earners. For simplicity, assume further that each of them receives the deduction for self and nothing more. A tax rate of 10% is applied to the income earners who earned more than a pre-determined income threshold of approximately RM20,000. The summary of payable taxes is given in Table 8.

The advantages of this innovation are many. First, a single tax rate imposed on all incomes exceeding a given threshold will remove the need for creating income brackets. This will simplify considerably the computation of tax liability and broaden the tax base. Second, with a single rate, the marginal tax rate will equal the average tax rate, eliminating the rising incentive to evade taxes. As Duncan and Peter (2008) note, if the flat tax is also capable of lowering people's participation in the underground economy, the economy benefits with more revenue and a better distribution of income. Third, all deductions will give identical tax savings to tax payers regardless of their incomes because all taxpayers face the same marginal tax rate. This will be a fair system when compared to the existing one. Fourth, people with fluctuating incomes will pay the same amount of taxes over a given number of years as their counterparts receiving similar incomes, but through a more stable stream of yearly receipts. Fifth, disincentive to work due to rising marginal tax rates will disappear. Finally, the government would give the same tax treatment to allowances regardless of whether income is earned in the public or private sectors.

Table 8: Progressivity through a single rate

| | Low | Middle | High |
|-----------------------------------|--------|--------|---------|
| Chargeable income (RM) | 25,000 | 50,000 | 100,000 |
| Deduction (RM) | 9,000 | 9,000 | 9,000 |
| Taxable income (RM) | 16,000 | 41,000 | 91,000 |
| Marginal tax rate (%) | 0 | 10 | 10 |
| Payable tax after exemption (RM) | 0 | 4,100 | 9,100 |
| Average tax rate (%) | 0 | 8.2 | 9.1 |
| Payable tax before exemption (RM) | 0 | 5,000 | 10,000 |
| Tax saved (RM) | 0 | 900 | 900 |

Payable tax before exemption = Chargeable income × Marginal tax rate

Payable tax after exemption = Taxable income × Marginal tax rate

Average tax rate = Payable tax after exemption / Chargeable income

Tax saved = Payable tax before exemption – Payable tax after exemption

A second alternative can address some, but not all, of the problems. If the government finds promoting a flat rate tax to be difficult, the tax deductions should be given as tax credits rather than as deductions so that all taxpayers, regardless of their income bracket, enjoy the same tax savings. Currently, *zakat* payments made by Muslim taxpayers are allowed as tax credits rather than as deductions. In other words, the *zakat* payment is subtracted from the total tax due (rather than the total taxable income). Hyman (2005) comments that tax credit is also advantageous for lower income tax payers because they usually do not itemise their credit in participating in certain activities (such as allowance for illness, etc.). Unfortunately, the second alternative cannot resolve the problem of uneven taxation arising from fluctuating incomes or the incentive to evade. The disincentive to work, no matter how small in practice, will also remain.

Both alternatives as suggested above cannot solve the problem arising from inflation. We suggest that earned income and the relevant deductions should be adjusted to take into account rising inflation (or deflation) to promote fairness. With these adjustments, the lower income tax payers will enjoy more benefits as they will be saved from entering a higher income bracket with higher marginal tax rates due to rising nominal incomes caused by inflation. In addition, the threshold of income liable for income taxation should not be increased. Rather, it should be lowered with rising national income and increased monetisation of the economy to capture more people capable of paying taxes.

CONCLUSION

It has been argued that several factors undermine the ability of the personal income tax system to narrow the income gap among tax payers. Malaysia's income tax system attempts to promote fairness and maintain its progressive structure by relying on progressive marginal tax rates. Unfortunately, this progression in marginal tax rates is the main source of the problems that have eroded the progressivity of the individual income tax, for example, granting greater tax savings for the rich as well as encouraging tax evasion. In addition, the limited coverage has resulted in poor revenue generation. Without enough revenue, the individual income tax cannot indirectly participate in narrowing income inequalities because it cannot provide substantial funds for poverty lifting projects. Hence, here we have suggested a few policies that will help to solve the problem sourcing from the progressive marginal tax rate while, at the same time, will promote fairness. The first suggestion was to use *zakat* as a way of paying tax, using tax credits instead of tax deduction. The second suggestion is to broaden the coverage of tax collection in favour of revenue generation; otherwise, government can choose to lower the introduced marginal tax rate so the tax savings favouring the rich may reduce bit by bit. We hope that Malaysia's

personal income tax system will evolve into a better revenue generator for the benefit of the nation's welfare and will promote equality among tax payers.

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NOTES

1. Since 2004, foreign income received in Malaysia is no longer taxed in Malaysia.
2. The exemptions received are for the individual himself (RM9,000), his spouse (RM3,000) and having 2 children under 18 (RM2,000), for a total of RM14,000.
3. NationMaster.com. 2011. Contribution of Personal Income Taxation. http://www.nationmaster.com/graph/tax_com_of_tax_per_inc_tax-taxation-components-personal-income-tax (August 2010).
4. This is the personal income tax contribution towards the government revenue, which is a part of the direct tax.
5. This information is from an interview of an official familiar with the allowances. The purpose of the interview is to clarify a few points regarding the exemptions provided for public sector employees.

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