



Public Finances in Malaya & Singapore

C.T. EDWARDS

This book presents the first organised and comprehensive study of public finances in Malaya and Singapore. It not only brings together statistical and descriptive material which at present is available only from a large number of sources but also subjects this material to much critical analysis. In addition, far-reaching but constructive recommendations are made concerning government policies in this area for the two countries.

In view of the expansion of the role of the government sector in the development of both Malaya and Singapore, a detailed analysis of public finances is opportune, and the suggestions for change should provoke discussion.

The book deserves close study by students of economics and by government officials in Malaysia and Singapore. Students and government officials in other developing countries may well benefit by comparing the structure and performance of fiscal measures in their countries with the experience of Malaya and Singapore. The book will also be valuable to those readers interested in public finance generally, and in Asian affairs.

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Dr C. T. Edwards is a graduate of the University of Melbourne and the Australian National University. In 1963-4 he spent a year in Malaya and Singapore carrying out field research in connection with this book, and returned briefly in 1967. He is at present Senior Lecturer in Economics in the School of General Studies, Australian National University.

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Preface

The object of this book is twofold; first, to outline and analyse the salient features of public finances in Malaya and Singapore and, second, to make suggestions designed to raise more revenue, to achieve a more equitable distribution of the tax burden, and to enhance the contribution of the fiscal system to economic stabilisation and growth. To give perspective to the pattern of government expenditure and revenue in Malaya and Singapore, a survey of social, political, and economic developments is provided in the introductory chapter. In this survey, emphasis is placed on those aspects which help to explain the reasons for the prevailing pattern of public finances. Attention throughout is concentrated on developments since World War II but, in those instances where earlier developments have an important bearing on the present-day structure, an attempt has been made to sketch the pre-war history. The book is primarily concerned with public finances in Malaya but, because the tax system in Singapore is similar to that in Malaya and because of the high degree of interdependence between the two countries, the coverage has been extended to include Singapore.

The Malay peninsula has experienced several political changes since 1960. The mainland States, which were grouped together in 1948 to form the Federation of Malaya, joined Singapore, Sabah, and Sarawak to form Malaysia in 1963. At this juncture, the terminology for the mainland States was changed from Federation of Malaya to States of Malaya in order to distinguish this part of Malaysia from Singapore, Sabah, and Sarawak. Subsequently Singapore left the Malaysian Federation. Following Singapore's departure, the mainland States were renamed West Malaysia, and Sabah and Sarawak were jointly referred to as representing East Malaysia. For ease of exposition, the terminology for the mainland States used in this book has been abbreviated from West Malaysia to Malaya.

I am greatly indebted to the Australian National University for giving me the opportunity to undertake a lengthy research project under excellent conditions. The number of people who provided assistance,

advice, and encouragement is far too large to detail. I shall content myself by expressing my appreciation to members of the Departments of Economics at the University of Malaya, the University of Singapore, and the Australian National University, of the Economic Research Centre at the University of Singapore, of the Treasury, the Department of Statistics and the Economic Planning Unit in both Malaysia and Singapore, and of the Bank Negara Malaysia. I owe a special debt to Mr Ramesh Chander, Chief Statistician for Malaysia, who gave me unlimited assistance whenever I asked. My gratitude to Professor Sir John Crawford, Professor H. W. Arndt, Dr W. M. Corden, and Mr R. Ma (all of the Australian National University) and to Professor Ungku Aziz of the University of Malaya and Professor You Poh Seng of the University of Singapore, also deserves specific mention.

My wife, Meredith, was forced to live every minute of this project and she happily accepted the challenge. She read the manuscript, commented on it most constructively, and typed it many times, but somehow managed to maintain her enthusiasm for each new draft. I am most grateful for her assistance.

C.T.E.

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Abbreviations

CPF	Central Provident Fund
EDB	Economic Development Board
EPF	Employees' Provident Fund
EPU	Economic Planning Unit
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
MIDFL	Malayan Industrial Development Finance Ltd
NDPC	National Development Planning Committee
NFC	National Finance Council
PAP	People's Action Party
RPC	Rubber Producers' Council
SDR	special drawing rights
VAT	value added tax

I

A Political, Social, and Economic Survey

POLITICAL DEVELOPMENT AND MACHINERY OF GOVERNMENT

European influence in the Malay peninsula effectively dates from the settlement of Singapore by the British in 1819. The Portuguese had established trade contacts as early as 1509. In the seventeenth and eighteenth centuries the Dutch traded at various west coast ports, and in 1786 the East India Company took possession of Penang Island and Province Wellesley on the mainland. But it was the rapid growth of Singapore to entrepôt supremacy which led to the active extension of European influence in the Malay peninsula. British political intervention beyond the port areas was stimulated partly by the need to protect the growing supply of Malayan export produce (particularly tin and spices) from the disruptive influence of indigenous and foreign forces, and partly by the desire to provide a climate conducive to British investment.

Responsibility for the affairs of the Straits Settlements (Penang, Malacca, and Singapore) was transferred from the East India Company to the British Colonial Office in 1867. These settlements were grouped together as a Crown Colony. The four central Malay States (Perak, Selangor, Negri-Sembilan, and Pahang) formed a loose federation in 1895. The other five Malay States (Johore, Trengganu, Kelantan, Kedah, and Perlis) continued to be separate political entities at the time of the Japanese occupation of the Malay peninsula in 1942. The interchange of administrative and technical officials between the Malay States and Straits Settlements ensured a measure of uniformity throughout the peninsula in governmental structure, policies, and laws. However, one important contrast between Malay State and Straits Settlement policies did emerge in the pre-World War II period. In the Malay States, a large influx of Chinese and Indian immigrants threatened the economic position and political privileges of the indigenous Malay community. Consequently, attempts were made by British advisers to

protect the Malay way of life; in specified areas, land was reserved solely for Malay ownership, and preference was given to Malays in civil service appointments. Singapore became the main Straits Settlement. Because its population was small at the time of colonisation, subsequent immigration did not threaten any vested indigenous interests. Moreover, a predominantly immigrant population heavily dependent on the precarious fortunes of entrepôt trade could not afford to place barriers, racial or otherwise, in the path of competition.

Post-World War II Era

Malaya. On resuming power after the war, the British realised that the period of 'divide and rule' was over. Colonial Office despatches emphasised the need to create a unitary state and, to permit this development, the State Sultans were encouraged to transfer sovereignty to the British Crown. A Union Agreement was signed on 1 April 1946. Singapore, with its predominantly Chinese population, was excluded, partly on racial grounds and partly because it was a British military base. Union citizenship was not restricted to Malays; it was open to all who could claim to belong to the country by reason of birth or a specified period of residence. Malays realised that common citizenship would eventually lead to the erosion of the political status and privileges they enjoyed before the war. Heated and protracted opposition from the Malays forced the British to reinstate the Sultans with sovereign rights and to replace the Union Agreement with a Federal Agreement. The Federation of Malaya, formed on 1 February 1948, embraced the same territories as the Malayan Union but safeguarded the pre-war political rights and privileges of the Malays.

The Federation Agreement provided for the establishment of a Federal government comprising a High Commissioner, an Executive Council to aid and advise the High Commissioner, and a Legislative Council. All members of the Legislative Council were appointed by the High Commissioner. Most appointees were nominated to represent special interests such as rubber, tin, commerce, labour, racial communities, or State rights. The Executive Council consisted mostly of civil service appointees, but it included some members of the Legislative Council as a step towards ministerial responsibility. A small scale replica of the Federal government structure was set up in each of the eleven States and Settlements. Legislative power was concentrated at the Federal level, but considerable executive power was delegated to the State governments.

An armed rebellion by a Chinese minority created a period of national emergency from 1948 to 1960 and initially slowed progress towards self-government. The rebellion is popularly referred to as 'the Emergency'. Socialist political activity was suppressed. Political communalism, fostered by the British in the pre-war period, provided a further barrier to self-government—there was no multi-racial national sentiment. State government elections in 1954 paved the way to the first national election in 1955. The Alliance Party, a combination of Malay aristocracy and wealthy Chinese and Indian merchants and financiers, gained fifty-one of the fifty-two seats open to elected members.¹ The stage was now set for self-government. A commission was set up in 1956 to make recommendations for a new constitution. Among many suggestions, the commission sought to qualify Malay privileges, but their conclusions in this respect were firmly rejected by representatives of the Malay Sultans, the ruling Alliance Party, and Britain. Self-government was granted on 31 August 1957. Under the new constitution, two parliamentary bodies were established: a fully elected lower house (Dewan Ra'ayat) and a nominated upper house (Dewan Negara). Each of the eleven States had a fully elected Legislative Assembly, and each was governed by a Chief Minister and an Executive Council representative of the majority party in the Assembly. Apart from land and a small range of other matters, legislative and executive power was vested with the federal government. The first election after the attainment of self-government was held in 1959, and the Alliance Party gained control of the Dewan Ra'ayat, the Dewan Negara, and most State governments.

Local government has been established on an extensive scale in Malaya. The largest towns (Kuala Lumpur, George Town, Malacca, and Ipoh) are served by municipal councils, small to medium sized towns by town boards (some eighty altogether) and village and rural areas by over three hundred local councils. Apart from the municipal councils and the town boards, the development of local authorities has been a recent phenomenon stimulated by resettlement programs for security purposes during the Emergency. All local authorities have elected members and most are financially autonomous. While municipal councils are responsible for the provision of all local government services, the

¹ It should, perhaps, be mentioned that the Malay community possessed electoral voting power far greater than its representation in the population. Of the 1.2 million people who qualified to vote at the 1955 election, approximately 84% were Malays, 11% Chinese, and 5% Indians and other races. Of the total population in 1955, Malays accounted for 50%, Chinese 37%, and Indians and others 13%.

responsibilities of local councils in less advanced areas are limited. Three semi-public bodies provide rail, harbour, and electricity facilities in Malaya.

Singapore. The creation of the Malayan Union in April 1946 separated Singapore from the other Straits Settlements (Penang and Malacca), and from the mainland political and administrative machinery. The island remained a Crown Colony. Its advance to self-government, while conditioned by mainland developments, followed a separate course.

A Legislative Council was reconstituted at the end of the war, a minority of its members being elected. The Council elected two of its number to a nominated Executive Council, which consisted mostly of civil service appointees and which tendered advice to the Governor.

The Emergency on the mainland and British interest in Singapore as a strategic military base slowed progress towards self-government. The stagnation in political advance fostered political and industrial unrest which culminated in a series of riots in 1955 and 1956. Constitutional changes in 1955 enlarged electoral rolls and provided for an elected majority in the Legislative Council. The Executive Council was renamed the Council of Ministers and it became an integral part of the Legislative Council. In consequence no upper house was formed in Singapore. Internal self-rule was achieved in 1959. Britain retained responsibility for defence and external affairs, and the right to maintain such military installations in Singapore as it judged necessary. Internal security was managed jointly by Britain, Malaya, and Singapore.

A fully elected city council was responsible for local government services in Singapore, but the functions of the council were hived off to a newly-created Public Utilities Board or absorbed by the State government after 1960. As in Malaya, a variety of services are provided by semi-public bodies—the Economic Development Board, the Housing and Development Board, the Public Utilities Board, the Telephone Board, and the Harbour Board.

Malaysia. There was strong opposition in Singapore after 1959 to the limitations placed on its independence. The government under the leadership of Lee Kuan Yew believed that political merger with Malaya was the best course open to Singapore. Economically both territories were closely linked; political division appeared to be artificial. Malaya, however, showed no interest in merger plans. In fact, by 1960, disturbing separationist tendencies began to appear. Both territories began to implement ambitious industrial development programs which, without a high degree of co-ordination, were bound to be competitive. Shortly

afterwards, Malaya imposed a limited number of discriminatory tariffs, and at the same time drew up plans for port development with the express intention of decreasing its dependence on Singapore. As the consequences of economic and political separation became clearer, the idea of merger gained acceptance. The possibility of controlling Singapore's internal security finally weakened Malaya's resistance. To offset the potential influence of Singapore's Chinese population on racial balances within any new federation, Malaya insisted that the three British Borneo territories (Sabah, Sarawak, and Brunei) be included in merger arrangements. Britain readily agreed to divest itself of sovereignty over these territories. Brunei, however, withdrew at the last minute, largely because agreement could not be reached over the Federal-State government division of its annual oil revenue and of its substantial external reserves. Malaysia was formed on 14 September 1963. Singapore became a State of Malaysia, but it retained greater autonomy than the other thirteen States. In exchange, Singapore received less than proportional representation in the central government legislature. Responsibility for Singapore's defence, internal security, and external affairs was transferred to the central Malaysian government. The Alliance Party was returned to power at the first post-Malaysia general election held in April 1964.

The Singapore based People's Action Party (PAP), led by Lee Kuan Yew, joined forces with a number of small opposition parties in Malaysia, and Alliance Party programs were subjected to increasingly thorough scrutiny. Shortcomings in the rural development, industrialisation, health, and social security programs were quickly revealed. By highlighting the degree of discrimination against the Chinese in Malaya, the political appeal of the PAP outside of Singapore increased. Fear that pressure from the PAP would force a steady erosion of established Malay privileges strengthened the position of the staunchly pro-Malay element within the Alliance Party, and thereby threatened the unity of the Alliance Party and the continuance of racial harmony. Bitter haggling over the allocation of revenue and industries between Singapore and the other Malaysian territories magnified tension within the newly formed Federation, and all factors combined to lead to Singapore's departure from Malaysia on 9 August 1965. Singapore is now an independent sovereign republic. Singapore's withdrawal removed the initial reason for incorporating the Borneo territories into the Federation. However, despite apprehension in Kuala Lumpur over the financial cost of keeping the Borneo territories within the Federation and a degree of dissatisfaction in the Borneo territories regarding the suitability of

policies decided in distant Kuala Lumpur, the loose Federation has managed to hold itself together.

Three main points emerge from this brief survey of political developments which help to clarify the reasons for the prevailing fiscal structure. They are, first, the British heritage, second, the federal form of government in Malaysia, and third, the political privileges extended to the Malay section of the community.

THE PEOPLE

Malaya is a complex plural society. The two main racial groups, the Malays and Chinese, respectively accounted for 50% and 37% of the total population in 1966 (Table 1). Indians are the main minority race.

Table 1 Malaya and Singapore: population by race, December 1966
(‘000 persons)

Race	Malaya		Singapore	
	Total	%	Total	%
Malays	4,221	50.2	281	14.5
Chinese	3,076	36.5	1,444	74.4
Indians	932	11.1	158	8.2
Others	186	2.2	57	2.9
Total	8,415	100.0	1,940	100.0

Source: Malaysia 1968a: Table 1:1, p. 3; Singapore 1968: Table 2:3.

Singapore's population is predominantly Chinese, but Malays and Indians form a substantial minority.

Both Malaya and Singapore are experiencing a period of rapid population growth. Although population projections are subject to a margin of error, it is probable that Malaya's population will double the 1957 Census level of 6.4 million by 1982. A parallel situation holds true in Singapore despite a significant decline in the birth rate in recent years.

A high population growth rate has not been uncommon to Malaya and Singapore. What is different is the cause of this phenomenon. Migration, the principal force in the pre-war years, has been negligible since 1945. The primary determinant has been a fall in the death rate which, in conjunction with a high birth rate, has led to a natural growth rate of 3% per annum, one of the highest in the world.

The characteristics of an internally-generated population differ in two important respects from those of the more transient population typical of the two decades after 1920. First, the function of migration

as a pressure valve facilitating adjustment of the labour force to changing levels of economic activity is absent. Second, the age composition of the population is markedly different. Both factors necessitate a different emphasis in government economic and social policies, the implications of which deserve consideration.

The future labour force has already been born and is resident in Malaya and Singapore; a sudden fall in the rate of population growth cannot alter this fact. This labour force has a growth potential which, for the decade 1966-75, will be almost 50% greater than that experienced during the decade 1956-65. The significant departure from the pre-World War II situation is that this expansion will take place regardless of future economic circumstances. The implications for government policy are twofold. First, in any serious short-term recession, effective countercyclical employment policies will be required in place of the automatic adjustment previously supplied by emigration. Second, the government will be forced to review at regular intervals the relationship between the potential labour force and available employment opportunities. A government survey of unemployment in Malaya in 1967 indicated that 7% of the labour force was unemployed. Still more significant was the finding that the rate of unemployment had risen above 10% in the fast expanding young age group (15-25 years). Given that 45% of Malaya's population is under 15 years of age, the problem of preventing a further rise in unemployment will be made progressively more difficult as the potential labour force swells during the decade 1966-75. The position is equally acute in Singapore. A government can ill afford to run the risk of increasing unemployment, and an integral element in future fiscal policy may have to be the disbursement of funds in directions which broadly achieve desired ends but, at the same time, add most to employment opportunities.

The age structure of the present population also has far reaching implications for government expenditure policy. The ratio of dependants and, in particular, child dependants to the labour force is much higher in the present 'permanent' population than in the pre-war 'transitory' population. Consequently, the government will be forced at least to maintain the existing high level of expenditure on primary education if a deterioration in the standard of these services per head of school-age population is to be avoided, and to expand significantly expenditure on secondary, tertiary, and particularly vocational (technical) education. Similarly, it would seem that expenditure on medical and health facilities, which lagged well behind population growth in the decade after 1950, will now have to be expanded proportionately more.

Malaya's population is predominantly rural, Singapore's predominantly urban. Sixty per cent of Malaya's workforce is employed in agriculture, forestry, fishing, mining, and quarrying, 30% in commerce, transportation, and a multitude of service activities, and 10% in manufacturing, building, and construction activities. In sharp contrast, commerce employs 70% of Singapore's workforce, manufacturing 20%, and agriculture only 10%. The Malays inhabit the rural areas and are concentrated in the smallholder sector. The Chinese in Malaya as well as in Singapore are dominant in urban areas. Although the increase in the rural population since 1947 has been small, there has been a rise in the proportion of Malays in rural areas; migration from rural to urban areas has been dominated by non-Malays. More than four-fifths of Malaya's population live in the west coast States. The east coast States, dominantly Malay, are much less developed, and vast areas are covered by virgin jungle.

THE ECONOMY

The outstanding characteristic of Malaya and Singapore is their wealth when judged by Asian standards. Only Japan and the island city states of Taiwan and Hong Kong have a higher per capita income. Still more revealing is the fact that per capita income in Malaya and Singapore is more than twice as high as that ruling in Burma, Thailand, Indonesia, and the Philippines—all neighbouring countries. A high per capita income suggests that the taxable capacity of the economy is high. But aggregate statistics obscure real world complexities. It is illuminating, therefore, to ask why income per head is so high, to assess the prospect for future growth, and to inquire into the pattern of income distribution, for answers to these queries should shed light on the salient characteristics of taxable capacity in Malaya and Singapore.

Malaya

What accounts for Malaya's high level of per capita income? The answer lies principally in one agricultural product: rubber. During the five years 1961-5, rubber occupied 60% of the cultivated land, employed 30% of the workforce, produced 17% of gross domestic product (15% in 1965), and generated some 55% of Malaya's export receipts. Despite intensified diversification programs, particularly since 1960, rubber continues to dominate the Malayan economy, and post-war prosperity has been achieved mainly because the world demand for natural rubber has remained high. Rubber's hold on the economy results partly from its profitability compared with alternative agricultural products, partly

from its ability to flourish in the heavily leached soils that cover much of the Malay peninsula, and partly from its ease of cultivation. To a very large extent, the scale and form of future development depend on the fortunes of this one product.

The rubber industry is divided into two sectors: estates and smallholdings. Estates occupy almost half the rubber acreage, account for 60% of production and, for the most part, utilise advanced, large-scale, production methods. European companies control 60% of estate acreage. A large number of small estates worked by Chinese and Malays occupy the remaining estate acreage. Most European companies delegate responsibility for plantation management to a small number of resident agency houses. These agency houses form a powerful and articulate pressure group. Time and again they have combined to influence government tax and expenditure policies in the interests of the rubber estates. Although a high proportion of the net profit of estates is remitted abroad, this sector provides a significant contribution—both direct (through the employment of labour and tax payments) and indirect (through subsidiary needs such as rubber processing, transport, and commercial requirements)—to the maintenance of Malaya's high level of per capita income.

Rubber smallholdings are worked predominantly by Chinese and Malays. Until quite recently, smallholders have been unable or unprepared to take advantage of technical innovations since the war on the same scale as the estates. Consequently their trees are older, their production techniques are less advanced, and the level of output per tree is lower and its quality more variable. Malay political power indirectly provides the smallholder with a measure of influence over government tax and expenditure policies but, because smallholders lack cohesion, programs of assistance are not always closely adapted to their requirements. Nevertheless, despite the limited application of modern production techniques, the strong demand for rubber in the post-war years has brought prosperity to this sector of the economy.

Less than 20% of Malaya's total area (57,000 square miles) is cultivated; the balance is covered by tropical rain forest or is marshland. Rice, the major food crop, is by far the most important agricultural commodity apart from rubber. Rice farming is predominantly a Malay activity. While important in the agriculture of most States, acreage is heavily concentrated in the northern States of Perlis, Kedah, Province Wellesley, Kelantan, and Trengganu. Cultivation is of the subsistence type, and is carried out on smallholdings. Little use is made of mechanical equipment, fertilisers, or other modern production techniques. Per

acre yields are, however, reasonably high by Asian standards. The extension of irrigation facilities has permitted double cropping in some areas but, although future expectations are high, the contribution of the second crop to total production has been small so far. Exploitation of tenant farmers by landowners and middlemen is typical, and the expansion of the Malay rural labour force, combined with restrictive land alienation policies, has led to increasing pressure on available rice land and thus to the fragmentation of holdings. Rice occupies 16% of the cultivated area and employs 20% of the workforce but, compared with rubber, the value of output per head is low: rice contributed only 6% of gross domestic product in 1965.

Despite an increase in production in recent years, Malaya continues to depend on imports for 35% of total rice requirements. Population growth and a strong preference for imported rice varieties explain why the demand for imported rice remains high. The government has been implementing an extensive development program designed to increase domestic rice production. The measures taken include programs to expand acreage under rice, and to raise the per acre yield by providing irrigation and drainage facilities, fertilisers, improved seeds, farm husbandry extension services, and a guaranteed minimum price. Encouragement is also given to the processing and marketing of rice on co-operative lines to ensure that the growers derive maximum returns. Each program is subsidised by the government; fertilisers, for example, are sold below cost and, in most cases, the beneficiaries of drainage and irrigation projects are not asked to share associated expenses. In addition, the tax burden borne by the rice sector of the economy is negligible. Smallholders are outside the income tax net, and the tax on rice land amounts to no more than a token payment. Moreover, unlike rubber, rice is not subject to a marketing tax. In fact, the government price support scheme subsidises domestic production. However, because the support price does not vary with quality, the scheme has not stimulated the production of better quality rice, or of rice more suited to local requirements. Before 1965, the attainment of self-sufficiency in rice was not regarded as an urgent policy objective. Consequently, many of the programs of assistance languished for want of incentive, and the people tended to regard rural development as something expected of the government rather than as a means of helping them to increase the productivity of their own efforts. With financial assistance from the International Bank for Reconstruction and Development (IBRD), a more determined effort has been made since 1965 to expand the rice sector of the economy and to improve its efficiency.

The growing of coconuts, which occupies 7% of the cultivated area, is next in importance to rubber and rice, and is predominantly a smallholder crop. A steady decline in world price and a deterioration in the competitive position of the Malayan industry have led to stagnation during the last decade. In general, smallholdings are poorly managed, trees are aged and are of inferior quality, yields are declining, and there has been no significant replanting or new planting activity. In addition, smallholder processing and marketing activities are not well organised. Estates are better managed than smallholdings but, because of a shift from coconut to oil palm cultivation (a far more rewarding activity), estate production had declined steadily in recent years. The government has initiated a research program aimed at developing improved clonal varieties and better cultivation practices, and is contemplating the introduction of a replanting program, but the prospect of achieving significant results is limited.

Oil palm cultivation is largely confined to estates because of the heavy capital outlay required for the purchase of processing equipment and the need for a high degree of co-ordination in harvesting, transportation, and processing activities. The Federal Land Development Authority has, however, succeeded in developing some smallholder oil palm 'estates' in recent years, each smallholder being allocated ten acres within an 'estate'. Production has risen sharply since 1960, and Malaya has emerged as the world's leading exporter of oil palm. Nevertheless, compared with rubber, oil palm is still a small industry in Malaya; it occupies only 6% of the cultivated area. Because of an expected substantial increase in Malayan production and because of increased competition from other oil seeds (particularly soybeans), future prices are uncertain. The fall in the price of rubber since 1960 has, however, enhanced the attractiveness of oil palm but, apart from a switch by estates out of rubber, expansion possibilities are limited; there are political obstacles to the alienation of further large blocks of land for estate production and, as a smallholder crop, operational efficiency is not easily achieved.

The remaining agricultural activities, which include timber, spices, tea, vegetable and fruit growing, livestock, and fishing, account for a sizeable portion of total economic activity and provide employment for 8% of the workforce. Most of these activities are carried out on a small-scale basis by Malays and Chinese. Available indicators of output trends are incomplete, but it appears that there has been moderate expansion in most of these activities in recent years. Other agricultural activities

apart from rubber and rice accounted for 8% of gross domestic product in 1965.

The uncertain long-run outlook for natural rubber is the most critical economic problem facing Malaya. Continued dependence on this product would leave the economy highly vulnerable to the impact of major technological improvements that may be made in the production of synthetic rubber in future decades.

At present, the synthetic threat lies primarily in its expansion into areas still dependent on natural rubber.² To compete, the price of natural rubber has been forced down from just over 100 Malaysian cents per pound in 1960 to 54 cents in 1967, and still lower in 1968. As a result of replanting, natural rubber production costs in Malaya are expected to fall on average to 30–35 cents per pound, and the industry should continue to prosper at prices around 45–50 cents per pound. But in the longer term it is possible that stereo-regular synthetics (which have similar qualities to natural rubber but which are presently more expensive to produce than most other synthetic rubbers) can be produced at lower cost than at present, and an even more serious risk lies in the development of new synthetics that can outperform natural in all uses and can be produced at a low cost. Both of these possibilities reflect technology as yet unknown, but such risks cannot be ignored in an economy so heavily dependent on a single commodity. Should either (or both) of these developments occur, the impact would be borne by producers of the existing range of synthetic rubbers as well as by the producers of natural rubber. The problem is that the expansion of the market for natural rubber may become negligible at a time when Malayan production is rising rapidly. While conditioned by developments in other natural rubber-producing countries (Indonesia, for example), a position of over-supply would lead to a further fall in the price of natural rubber. It is probable that continued research in Malaya will produce still higher-yielding rubber seedlings that may permit the natural rubber industry to meet any future challenge from synthetics. But, in contrast to the synthetic industry, the incorporation of significant new findings into the final product of the natural rubber industry is subject to a long time lag. The economic life of a rubber tree is in excess of thirty years, and most estates together with an increasing number of smallholdings have recently replanted. Moreover, even if some segments

² In 1954, natural rubber accounted for 70% of total world consumption of all rubbers (natural and synthetic). Although there has been an absolute increase in the world consumption of natural rubber, its share of the total market had fallen to 45% in 1964.

of the industry were prepared to uproot producing trees or to extend acreage, there remains a six-year gestation period before new seedlings begin commercial production. The Malayan government and the Malayan rubber producers have invested heavily in the rubber industry and have succeeded in maintaining its viability despite a substantial price fall. In itself, this is a significant achievement. Unfortunately, however, the investment has not guaranteed the future prosperity of the industry. In these circumstances, there is a need to search for alternatives, and the need is urgent, for it will take a long time to effect a major reduction in Malaya's relative dependence on natural rubber.

The alternatives to rubber in agriculture are limited. Rice offers the best prospect; there is considerable scope for an expansion of both single and double crop acreage at low cost. Oil palm is the most profitable alternative to rubber but, as indicated, there are obstacles to its expansion, and it is by no means clear that, in respect of price, it will fare any better than rubber in the longer term. Sugar cane, corn, tapioca, peanuts, and soybeans are crops which might eventually become important in Malaya, but the development of large-scale alternatives to rubber will depend on more intensive research, soil survey work, experimentation, and agricultural extension services. What then can be said of the potential of other sectors of the economy?

The production of tin is Malaya's most important primary industry outside of the agricultural sector. Because deposits are predominantly alluvial, Malaya is a low-cost producer by world standards. Iron ore and to a lesser extent bauxite, ilmenite, columbite, and gold are the only other known metallic minerals of commercial significance. In total, mining and quarrying contributed only 9% to gross domestic product in 1965. Yet tin and rubber together accounted for 80% of Malaya's export earnings.

There are two distinct methods of tin mining—dredging, a large-scale operation undertaken by European companies, and gravel-pump mining, a small-scale production method operated mainly by Chinese. European companies produced 60% of total output in 1965. Control of European interests is concentrated in the hands of a small number of resident agency houses. Like rubber, the tin industry lends itself to taxation. All output is exported through a small number of ports, so that the collection of export levies presents no difficulty. In addition, the large companies are subject to income taxation and, because numbers are small, tax evasion is difficult.

After a period of surplus production and world output restraint during 1958–60, industrial conflict and economic stagnation in several

production centres led to world shortages and large price rises. The Malayan tin industry is currently operating at close to maximum capacity, yet production has not increased significantly. Limited on-shore prospecting and the steady depletion of known reserves have combined to restrain output expansion. Several observers have predicted a long-term decline in tin production, but the recent discovery of substantial off-shore tin deposits offers a clear prospect for a contradiction of these predictions. The continued expansion of this sector would not, however, reduce the vulnerability of the Malayan economy; the increased use of electrolytic plating has reduced the ratio of tin to steel used in the production of tinplate, and increased competition from aluminium threatens to narrow the market of tin.

Apart from the expansion of the rice sector, Malaya will be forced to rely increasingly on manufacturing as a source of income and employment. At present, the manufacturing sector of the economy is small, employing 7% of the workforce and accounting for only 10% of gross domestic product in 1965 (15% if construction activity is included within the manufacturing sector). However, there has been steady, if not spectacular, growth in manufacturing investment since 1957.

The industrial pattern reflects an early stage of industrialisation; activity is concentrated on the processing of primary products (rubber remilling, oil palm, coconut oil, timber, and rice milling), the production of consumer goods (food, beverages, tobacco, textiles, handicrafts, furniture, and other wood products), and repair services. Manufacturing is the exclusive preserve of private enterprise. Most establishments are small, the majority being owned by Chinese and operated on a family basis; almost 75% of all establishments employ fewer than ten employees. Corporate firms account for only 10% of industrial establishments, but these firms produce almost two-thirds of total value added within the manufacturing sector. From a taxation viewpoint, this fact is significant but, in view of the difficulty experienced in taxing non-corporate business organisations, it is equally important to note that 90% of total establishments are either individual proprietorships or partnerships, and that the contribution of these firms to total value added by the manufacturing sector is not insignificant.

The promotion of industrial development as a means of providing more employment opportunities and of diversifying the economy is now a major objective of government economic policy. Extensive industrialisation is not contemplated; the government's objective is simply to develop various consumer-goods and other light industries (particularly import-saving industries). Assistance is granted by means of tax relief

for new industrial firms, for investment activity, and for exporting, the imposition of protective tariffs in appropriate cases, the provision of industrial loan finance, the establishment of industrial estates, and the expansion of technical training facilities.

Commerce, transportation, and other service trades contributed 48% to gross domestic product in 1965 and employed 30% of the workforce. Under statutory regulations, Malays have been granted preferential employment treatment in the public service and sections of the transport industry. But, in general, service trades are dominated by Chinese. Most service trades are carried out on a family basis, but it is significant from a tax viewpoint to note that, as in the manufacturing sector, a relatively small number of large firms (mostly European controlled) account for a high proportion of total value added. As other sectors expand and private demand grows, the demand for service trades can be expected to rise, but these trades do not provide the kernel for an effective diversification program; they are supporting rather than initiating activities.

In summary, while every endeavour should be made to enhance the productivity of the natural rubber industry, increasing emphasis in government policy will have to be given to the development of the rice and manufacturing sectors of the economy. This implies a significant switch in government policy from export promoting to import replacing activities. With the assistance of the World Bank, the government has recently embarked on a determined effort to convert Malaya into a net rice exporter. Manufacturing offers a significant prospect for diversifying the economy and increasing per capita income but, in the short term, the relatively narrow base of entrepreneurial and technical skills sets definite limits.

Malaya has experienced considerable economic growth since World War II. In real terms, gross domestic product more than doubled between 1950 and 1965. Despite a high rate of population growth and an adverse movement in the terms of trade after 1960, real per capita income has increased at an average rate of almost 2% per annum since 1950, a remarkable achievement by less developed country standards.

In the decade after 1950, the level of economic activity fluctuated with the fortunes of the export sector. In sharp contrast, gross domestic product has increased substantially since 1960 despite comparative stagnation in the level of export earnings (Table 2). This has been due to a rise in the level of investment spending which increased its share of gross domestic product from 12% in 1960 to almost 17% in 1965, largely as a result of an expansion of government spending. In consequence, the contribution of exports to domestic product fell from 50%

Table 2 Malaya: expenditure and savings, 1955-67
(\$ million)

Item	1955	1956	1957	1958	1959	1960	1961	1962
Consumption expenditure								
Private	3,611	3,861	3,989	3,946	4,159	4,449	4,713	4,974
Public	2,964	3,156	3,251	3,178	3,385	3,652	3,842	4,047
Investment expenditure								
Private	647	705	738	768	774	797	871	927
Public	460	557	630	580	580	755	906	1,130
Increase in stocks	301	361	395	376	406	567	582	630
Exports	159	196	235	204	174	188	324	500
Less imports	13	21	26	34	-60	120	80	78
Trade balance	2,488	2,422	2,351	2,040	2,638	3,094	2,794	2,790
GDP at market prices	1,580	1,801	1,870	1,704	1,790	2,284	2,391	2,605
Less net factor payments abroad	908	621	481	336	848	810	403	185
GNP at market prices	4,992	5,060	5,126	4,896	5,527	6,134	6,102	6,367
Less consumption expenditure	236	218	178	138	211	248	187	140
Gross domestic savings	4,756	4,842	4,948	4,758	5,316	5,886	5,915	6,227
Consumption/GDP (%)	3,611	3,861	3,989	3,946	4,159	4,449	4,713	4,974
Fixed investment/GDP (%)	1,145	981	959	812	1,157	1,437	1,202	1,253
Savings/GDP (%)	72.3	76.3	77.8	80.6	75.2	72.5	77.2	78.1
Exports/GDP (%)	9.2	11.0	12.3	11.9	10.5	12.3	14.8	17.7
Imports/GDP (%)	22.9	19.4	18.7	16.6	20.9	23.4	19.7	19.7
	49.8	47.9	45.9	41.7	47.8	50.4	45.9	43.9
	31.7	35.6	36.5	34.9	32.4	37.2	39.2	40.9

Item	1963	1964	1965	1966 ^a	1967 ^a	Annual average growth rate (%)		
						1958-67	1958-62	1963-7
Consumption expenditure	5,352	5,732	6,099	6,494	6,751	5.5	4.7	4.8
Private	4,289	4,509	4,742	4,956	5,151	5.0	5.0	3.7
Public	1,063	1,223	1,357	1,538	1,600	7.6	3.8	8.5
Investment expenditure	1,194	1,226	1,311	1,423 ^b	1,473 ^b	9.8	14.3	4.3
Private	710	759	785	934	909	9.2	10.9	5.2
Public	484	467	526	489	564	10.7	19.7	3.2
Increase in stocks	64	68	72	—	—			
Exports	2,880	2,986	3,328	3,331	3,074	4.2	6.5	1.3
Less imports	2,708	2,791	2,889	2,948	2,862	5.3	8.9	1.1
Trade balance	172	195	439	383	212	-4.7	-12.7	4.3
GDP at market prices	6,782	7,221	7,921	8,300	8,436	5.6	5.4	4.5
Less net factor payments abroad	159	214	264	272	218			
GNP at market prices	6,623	7,007	7,657	8,028	8,218	5.6	5.5	4.4
Less consumption expenditure	5,352	5,732	6,099	6,494	6,751			
Gross domestic savings	1,271	1,275	1,558	1,534	1,467	6.1	9.1	2.9
Consumption/GDP (%)	78.9	79.4	77.0	78.2	80.0			
Fixed investment/GDP (%)	17.6	17.0	16.6	17.1	17.5			
Savings/GDP (%)	18.7	17.7	19.7	18.5	17.4			
Exports/GDP (%)	42.5	41.4	42.0	40.1	36.4			
Imports/GDP (%)	39.9	38.7	36.5	35.5	33.9			

^a Preliminary estimates. ^b Includes change in stocks.

Source: Malaysia 1965b: Table 1; Malaysia 1967: Table 1; Malaysia 1968b: Table 1.4.

in 1960 to 42% in 1965, a structural change of considerable importance from the viewpoint of government finances in Malaya. A high savings ratio (equal to almost 20% of gross domestic product during the period 1960-5), considerable underemployment of resources, and an increase in productive capacity as a result of past investment in resource and infrastructure development, permitted expansion to take place without creating inflationary pressures.

Table 3 indicates the changing state of the balance of payments. Tables 2 and 3 are not strictly comparable, for one refers to West Malaysia, the other to total Malaysia (West and East). However, by comparing exports and imports, it can be seen that the addition of the East Malaysian territories does not make a significant difference. Moreover, it is the change in the West Malaysian balance of payments that accounts for the main changes in the state of the Malaysian balance of payments. The table is self-explanatory, though two points deserve attention. First, apart from a temporary reversal in 1965, there has been a steady deterioration in the overall state of the balance of payments since 1960. Second, the deficits have largely been financed by a reduction in the net foreign assets of the commercial banks; the monetary authorities have sold domestic securities to the commercial banks in exchange for their foreign balances, and it is largely these balances which the monetary authorities have used to meet the balance of payments deficits.

Malaya is fortunate in that there are few natural hazards which can affect the domestic production of its two major exports, rubber and tin. But, as has been indicated, both products have been subject to an inordinate degree of price instability, and intensive specialisation has inevitably led to domestic economic vulnerability. Monetary arrangements in Malaya tend to accentuate the impact of fluctuations in the terms of trade on the domestic economy. Despite significant changes in the range and policies of financial institutions following the establishment of a Central Bank in 1959, Malaya has not broken away from the old colonial Currency Board system which requires a foreign exchange cover (normally a full 100% cover) to be held as a backing against the currency component of the money supply. Under this system, the main causes of an increase in the money supply are a surplus on the balance of payments (more specifically, a surplus on autonomous external trade transactions) and/or an increase in the willingness of the banks operating in Malaya to expand local assets. The willingness of the banks to expand local assets depends on their ability to do so, which is conditioned by the ratio of their liquid assets to demand liabilities.

Table 3 Malaysia: balance of payments, 1960-7
(\$ million)

Item	1960	1961	1962	1963	1964	1965	1966 ^a	1967 ^a
Exports (f.o.b.)	3,622	3,208	3,232	3,296	3,346	3,752	3,808	3,679
Imports (f.o.b.)	2,613	2,669	2,892	3,010	3,071	3,226	3,254	3,149
Merchandise surplus	1,009	539	340	286	275	526	554	530
Non-monetary gold (net)	<i>n.a.</i>	-28	-3	-3	-3	-5	-6	-2
Freight and insurance (net)	<i>n.a.</i>	-133	-145	-156	-154	-162	-165	-170
Other transportation (net)	<i>n.a.</i>	4	3	3	3	2	2	5
Travel (net)	<i>n.a.</i>	-67	-70	-69	-74	-80	-78	-69
Investment income (net)	<i>n.a.</i>	-231	-177	-195	-252	-303	-313	-257
Government transactions n.i.e. (net)	<i>n.a.</i>	145	131	151	184	227	185	135
Other services (net)	<i>n.a.</i>	-54	-49	-55	-64	-74	-78	-80
Services deficit	-379	-364	-310	-324	-360	-395	-453	-438
Balance on goods and services	630	175	30	-38	-85	131	101	92
Private transfers (net)	-214	-205	-207	-206	-201	-195	-196	-185
Government transfers (net)	17	12	13	25	127	124	82	30
Transfer payments	-197	-193	-194	-181	-74	-71	-114	-155
Balance on goods, services, and transfers	433	-18	-164	-219	-159	60	-13	-63
Private long-term capital (net)	150	180	235	270	205	190	160	135
Official long-term capital (net)	50	15	47	87	19	94	7	126
Official short-term capital (net)	—	—	12	-5	71	116	-11	-183
Errors and omissions, including other short-term capital	-203	-99	-109	-210	-275	-326	-314	-262
Overall surplus/deficit	430	78	21	-77	-139	134	-171	-247
Monetary movements:								
Official reserves ^b	427	155	44	-18	-139	32	-138	-56
Net foreign assets of commercial banks	2	-77	-23	-59	—	102	-33	-191

^a Preliminary estimates.

^b Changes arising from devaluation of the pound sterling in November 1967 are ignored since the revaluation of reserves in terms of Malaysian dollars reflects the assignment of a different rate of exchange and not balance of payments transactions proper.

Source: Bank Negara Malaysia 1968: Table 25.

In the decade after 1950, banking activity was dominated by a small number of overseas (mostly British) banks. The banks concentrated their activity on financing trade transactions; they played only a limited role in making credit available to domestic borrowers and were generally conservative in their lending habits. Each of the banks maintained large liquid asset balances in London which were lent out for use by their head offices. During this period, the money supply varied with the state of the balance of payments. An improvement in the balance of payments due, for example, to an increase in export earnings, had two monetary effects. First, it increased the net deposit liabilities of the banks in Malaya and thus automatically increased the domestic money supply. Second, it increased the sterling balances of the Malayan banks by an equivalent amount and thus increased their liquid assets ratio. This latter effect, however, was of little consequence so far as the domestic money supply was concerned for, in most instances, the liquid assets ratio maintained by the various banks was already high. As increased export earnings stimulated the demand for imports, the banks increased advances to satisfy the rise in demand for trade credit, and thus a secondary increase in the money supply occurred. But the important point was that this secondary increase depended on the willingness rather than on the ability of the banks to extend credit. Because their liquid assets ratio was high, the banks had the ability to expand advances even when there was an adverse movement in the balance of payments, but they generally failed to do so for they were unable to find domestic investment projects outside of the international trade sector which satisfied their credit requirements.

As a result of Central Bank assistance and spurred on by increased competition, the banks have substantially increased their local assets since 1960, and most are now operating with a low ratio of liquid reserves to demand deposits. In addition, the Central Bank has wrought a significant change in the content of the liquid assets held by the commercial banks. By imposing a local liquid assets ratio requirement, domestic liquid assets have been sold by the Central Bank to the commercial banks in exchange for foreign assets. These developments have largely eliminated the discretionary power the commercial banks exercised over the domestic money supply. In view of this change, the question which needs to be asked is whether the developments have increased the discretionary power of the governing authorities.

By requiring the commercial banks to observe a local liquid assets ratio requirement and by imposing a domestic portfolio investment requirement on other financial institutions, the external cover held by

the monetary authorities against the currency issue has increased substantially; at the end of 1967, the cover amounted to 150% of domestic currency in circulation. Under the Currency Board system, it is normal to hold a 100% cover, but authority to make a fiduciary issue which would reduce the requisite cover towards 80% was granted in 1960. However, following the separation of Singapore from Malaysia, separate currencies were established in these countries. To enhance the confidence of the public in its newly-issued currency, the Singapore government has explicitly indicated that a full 100% foreign exchange backing will be held against the currency component of the money supply in Singapore. In consequence, the Malayan monetary authorities have been forced to the same conclusion. It is probable that the battle to maintain confidence in the respective currencies will preclude a fiduciary issue in respect of currency circulating within Malaya at least until some workable means of monetary co-operation is established between the two countries.

By reducing the external cover held against the domestic currency issue and by encouraging the private sector to continue to substitute domestic for foreign securities, the Central Bank can continue to exercise a significant influence over the domestic money supply. Further, by selling part of its foreign balances and by switching its cash balances between the Central Bank and the commercial banks, the Malayan government can, in conjunction with the Central Bank, also exercise some influence. Prolonged use of these forms of assistance during a protracted trade deficit would, however, gradually reduce the ability of the governing authorities to continue to exercise an important influence over the domestic money supply so that, by default, the balance of payments would once more emerge as the key determinant of the level of domestic activity. A similar result would, of course, occur in countries where no external cover is required as backing for the domestic currency. But, because these countries are holding external reserves for one purpose (to mitigate the effect on the level of domestic activity of temporary balance of payments difficulties) instead of two (temporary balance of payments difficulties and a cover against the issue of domestic currency), it is probable that the reins would not be tightened as quickly, with the result that the prospect of revival would be given a more reasonable chance to prove itself.

In general, countercyclical monetary policies have been pursued in Malaya since 1960, and there remains reasonable scope for the continuance of these policies. What, then, should be the nature of countercyclical fiscal policies?

The nature of countercyclical fiscal policies needed in Malaya can be appreciated by tracing the impact on the domestic economy of a decline in export earnings due to a fall in export prices, the most common cause of a recession in Malaya. The effects (which would largely occur simultaneously so that a numbering of the points does not imply any chronological order) would be as follows. First, the balance of payments would be adversely affected. However, because a major part of production for export is undertaken by foreigners, it is likely that the level of foreign exchange remittances would decline, an effect which would partially mitigate the adverse movement in the balance of payments. On the other hand, if the export price decline were expected to be permanent, foreign investors might attempt to repatriate their capital and so maintain or increase remittance payments, a tendency which would add to short-term balance of payments difficulties. Second, export and income tax revenue and, to a lesser extent, import duty revenue would fall. If government expenditure commitments could not be reduced, fiscal policy would automatically be countercyclical. Third, money income per head would decrease. Since domestically-produced goods (apart from basic foodstuffs) satisfy only a small proportion of total domestic demand, the brunt of the fall in money demand would be borne by imports. But because Malaya accounts for only a small fraction of total world demand, import supply price (and, consequently, the internal price level) would not be significantly affected. Real income per head would therefore fall. Fourth, production for export would decline. But the decline would be due almost wholly to a switch by smallholders from rubber tapping to the more intensive cultivation of subsidiary crops (rice and tapioca, for example); in the post-war period, estate output has been unresponsive to short-term price changes. Thus, while underemployment may increase on smallholdings, unemployment would not be a serious problem in rural areas. The decline in domestic demand would, however, cause some contraction in commercial and other urban activities. Credit restraint may intensify this contraction. Consequently, although the main effect of a fall in export price would be a decline in per capita income, the major problem confronting the government would be a rise in urban unemployment.

There appears to be scope for a substantial fall in per capita income before nationwide unrest would ferment—consider, for example, the position in neighbouring Indonesia. But, in sharp contrast, urban unemployment can quickly be translated into widespread discontent. Countercyclical expenditure policies would therefore need to be concentrated in urban areas.

A rise in export prices entails a different emphasis in countercyclical policy requirements. Part of the rise will be sent abroad in the form of higher remittance payments. But the major effect will be an increase in per capita money income. Since the scope for increasing the domestic production of foodstuffs and other domestic requirements is limited in the short term, and since time must elapse before a rise in import orders can be fulfilled, the major immediate problem is demand inflation. To reduce the magnitude of this problem, tax policies need to be sensitive to fluctuations in export price.

While cyclical problems are important, increasing population pressure and the uncertain future for rubber imply that, in expenditure and tax policy, the government should give precedence to the implementation of long-term growth and diversification policies.

Insights into the pattern of income distribution may be gleaned from the foregoing analysis of the structure of the economy. Although no accurate statistics are available, it would appear that approximately 10% of gross domestic product is earned by non-Asians (mostly British). Non-Asians are concentrated in the prosperous and most heavily taxed sectors of the economy—rubber, tin, manufacturing, and commerce. Compared with the Asian community, the per capita income of non-Asians is extremely high.

Outside of the non-Asian segment of the economy, official statistics on income distribution by race do not exist, but a brave attempt has been made by T. H. Silcock to achieve a rough approximation. Silcock's results, presented in Table 4, indicate that the Chinese earned 55% of

Table 4 Malaya: income per head by race, 1957

	Malay	Chinese	Indian	Total
Individual income (\$m.)	1,150	1,950	475	3,575
Per cent of total	32	55	13	100
Population (million)	3.13	2.33	0.71	6.28
Income per head (\$)	367	837	669	585

Source: Silcock 1963: Table A5.

total Asian individual (that is non-corporate) income in 1957, Malays 32%, and Indians 13%, and that the per capita income of Chinese was more than double that of Malays. It would be expected, therefore, that the Chinese would bear a heavier tax burden than the Malays. A household budget survey undertaken by the Department of Statistics in Malaya in 1957-8 (Federation of Malaya 1959) sheds further light on the

distribution of income. The survey found that people of all races living in urban areas received a higher per capita income than their kinsmen in rural areas. In addition, the survey pointed out that Chinese earn more than Malays in both urban and rural areas. If the analysis could be carried further, it would probably show that Malays living in west coast States earn more than their kinsmen in east coast States where production techniques are more backward and communications poorer. Despite statistical inadequacies, it is clear that income is extremely unevenly distributed in Malaya between town and countryside, and among races, sectors of the economy, and regions of the country. Nevertheless, although income is unevenly distributed, inequality is not blatantly obvious, partly because most non-Asians are non-residents and partly because the Chinese are not particularly ostentatious in their spending habits.

Singapore

Before the formation of Malaysia and the beginning of Indonesian confrontation, entrepôt trade contributed almost 30% to gross domestic product in Singapore, industry 20%, expenditure by the United Kingdom on defence forces stationed in Singapore 15%, government expenditure 12%, tourism 3%, and other services including agriculture 20%. Singapore has shared liberally in the expansion of activity experienced in Southeast Asia over the past century, and its high per capita income has been due primarily to its role as the trading centre of the region—it processes and exports raw materials produced in the region, and imports foodstuffs and manufactures for re-export to neighbouring countries. Singapore's dominance of entrepôt trade is attributable to its strategic location, to an excellent natural port, to a hardworking population directed by one of the world's leading communities of traders, and to sound fiscal and monetary conditions. In the decade after 1950, traditional entrepôt activities were increasingly supplemented by entrepôt trade in oil, by ship repair services, and by a modest amount of industrial exports.

Entrepôt earnings are derived from two main activities: the processing of primary products (approximately half of total earnings), and service activities such as sorting, grading, storage, shipping, and wharfage. Rubber dominates entrepôt trade; it accounted for 33% of total earnings in 1963. A wide range of manufactured goods added a further 25%, and agricultural products other than rubber contributed 20%. Most of Singapore's entrepôt trade in 1963 was conducted with Malaysia and Indonesia. Large firms, mostly European-controlled, dominate process-

ing activities, and the exchange of raw materials and manufactures with industrialised countries. However, with the exception of oil transactions, trade with the major entrepôt countries in the region is carried out by Chinese.

The imposition of a trade ban by Indonesia following the formation of Malaysia highlighted the precarious nature of entrepôt activities. Since it is mainly Indonesian rubber which needs to be remilled, a fall in rubber imports from Indonesia had a greater impact on employment and national income in Singapore than an equivalent fall in rubber imports from Malaya. But even in the absence of Indonesia's trade ban, there was little prospect for a significant expansion of entrepôt trade. Estate rubber production in Indonesia has declined since 1953; small-holder production (which accounts for 66% of total output) has fluctuated with rubber price movements around a static trend. The failure to replant, combined with the possibility of a future price decline, suggest that the downward trend in Indonesian production will continue. Moreover, an acute shortage of foreign exchange sets a definite limit to the scope for an expansion of re-exports to Indonesia. Malaya's trade (particularly in rubber) will expand, and Singapore should be able to maintain its share. But in the case of rubber the expected decline in price will shrink Singapore's trading margin, and a reduction in the magnitude of price fluctuations will cut speculative profits. In addition, important voices in both government and business in many neighbouring countries, including Malaya, are pressing for a greater degree of direct trading. The potential for growth in entrepôt activities is therefore limited; Indonesia's trade ban simply accentuated Singapore's structural difficulties. Unless new sources of income can be found and quickly developed, a continued rise in unemployment (presently in excess of 10% of the labour force) and a fall in per capita income are likely; the need for diversification is more urgent in Singapore—a predominantly urban community—than in Malaya. What are the prospects?

Forest, scrub, and swamp vegetation cover 20% of Singapore's total area of 210 square miles, agriculture 30%, and the remainder is divided into urban and military land. More than half of the agricultural land is devoted to rubber and coconuts. The government is endeavouring to bring more land under vegetable and fruit cultivation by reducing the acreage under low-yielding rubber and coconut trees, and by reclaiming land. But although there is scope for improving the use of land, its absolute scarcity obviously imposes rigid limitations on the possibility of enlarging the cultivated area and increasing agricultural employment above 6% of the workforce.

Commerce, transport, storage, and other service activities employed 70% of the workforce in 1965. Despite an increase in tourism and scope for an expansion of manufacturing activity, the stagnation in entrepôt trade will restrain the growth of employment in this sector of the economy.

Industrialisation is held to be Singapore's main hope for achieving a satisfactory rate of expansion in the future. Apart from processing entrepôt products, Singapore has a wide variety of industrial undertakings ranging from the manufacture of transport machinery and electrical equipment, building requirements (cement, bricks, tiles, and glass), food and beverages, to tailoring, dressmaking, footwear, and various repair service establishments. Yet, despite expansion since 1961, manufacturing is still only a small segment of the economy; it employed approximately 18% of the workforce in 1965 and contributed 15% to gross domestic product. While large firms (mostly subsidiaries of European firms) account for a high proportion of total employment and value added, most establishments are small, and are operated by Chinese. In many instances, equipment in small establishments is obsolete, production methods deficient, and productivity low. Singapore exports almost half of its total production, Malaya being its main market.

By tax incentives, an expanded industrial estate program, the provision of long-term loan capital,³ the protection of selected industries, and efforts to improve industrial relations, the government is attempting to stimulate industrial expansion. But a massive industrialisation program is fraught with difficulties. Although Singapore has a skilled labour supply, a central location in Southeast Asia, a highly developed financial and trading infrastructure, and a reasonably satisfactory power supply, it has no natural resources—industry is dependent on imported materials. In addition, the home market is limited—industrial expansion will depend on Singapore's ability to compete in world markets. Yet, compared with competitive neighbouring countries—Japan, Hong Kong, and Taiwan—labour costs are high in Singapore; because of continued prosperity, high wages have been paid by the rubber and tin industries and wage levels in these industries have influenced wage levels in other sectors of the economy in both Malaya and Singapore. In consequence, Singapore has been forced to concentrate increasingly on capital inten-

³ An Economic Development Board has been established to undertake intensive industrial promotion, and to provide loan and equity financing. The Board has participated with foreign firms in establishing an oil refinery, a cement plant, a steel rolling mill, a ship building yard, and several light manufacturing industries.

sive industries. Moreover, the instability of Indonesian demand and the implementation of a partly competitive industrialisation program in Malaya threaten to narrow Singapore's traditional outlets, and management uncertainties are magnified by the prospect of political instability and industrial unrest on Singapore island. Nevertheless, the foresight of the government and the determination, dedication, and enterprise of Singaporeans should guarantee a large measure of success.

During the decade 1949-58, the building industry was the most dynamic sector of Singapore's economy. Post-war housing shortages, accentuated by fast population growth together with favourable developments in income and savings in the early fifties, resulted in a rapid increase in construction activity. Employment in this sector doubled during the decade, and amounted to 5% of the workforce in 1957. A sharp recession in 1959-60 due to a reduction in public capital outlays was quickly alleviated, and the continued growth in demand for housing, hospital, educational, manufacturing, and other building constructions indicates that this sector of the economy will remain buoyant in the next decade.

The stimulus given by the United Kingdom military base to economic activity in Singapore has recently been given the prominence it deserves following the United Kingdom decision to close the base by the end of 1971; the base employs 7% of Singapore's workforce (a high proportion in industrial workshops), generates 15% of gross domestic product, and payments by the United Kingdom provide some 33% of Singapore's foreign exchange earnings. Disbandment of the base is now taking place, and the Singapore government is attempting to alleviate the associated distress by encouraging industries to establish themselves in the affected areas to make use of a sizeable pool of skilled labour.

Table 5, derived from Silcock's findings, indicates income per head by race in 1957. Per capita income is higher in Singapore than in Malaya for all races, but the Chinese have the highest standard of living. The

Table 5 Singapore: income per head by race, 1957

	Malay	Chinese	Indian	Total
Individual income (\$m.)	100	1,420	80	1,600
Per cent of total	6	89	5	100
Population (million)	0.20	1.09	0.12	1.41
Income per head (\$)	500	1,303	667	1,135

Source: Silcock 1963: Table A6.

racial allocation of income is not, however, the main feature of income distribution in Singapore, for the population is predominantly Chinese. Within the Chinese community there is an extremely wide disparity in income levels. Thus, as in Malaya, income is very unevenly distributed.

Economic instability is more marked in Singapore than in Malaya. The island has to contend not only with the uncertainties of the rubber trade, but with the prospect of elimination of large sections of the entrepôt trade overnight and the disbandment of the United Kingdom military base. Moreover, Singapore is an urban metropolis; a fall in export earnings leads directly to a rise in urban unemployment which quickly breeds discontent. The need to diversify is more urgent and the need to pursue effective countercyclical policies is more important in Singapore than in Malaya.

The Government Sector

A discussion of government sector transactions must be prefaced by a definition of the term 'government sector'. Government bodies may be classified into three categories: agencies, enterprises, and corporations. A government agency is defined as a unit, the expenditure of which is determined by parliamentary decision and is financed by specific appropriation from government funds.¹ Agencies in Malaya and Singapore include most ministries and departments, the Rubber Industry Replanting Board, the Federal Land Development Authority, the Federal Industrial Development Authority, and the Employees' Provident Fund (the Central Provident Fund in Singapore).

The *modus operandi* of government enterprises is similar to that of commercial firms: they sell their output to the public at stated prices, their output is determined by market demand, and their costs are financed from sales. They differ, however, in that their operating profit or loss accrues to the government, their price policy is subject to political decision, and their capital expenditure is financed primarily from government revenue. Postal, telecommunications, broadcasting, and water departments are examples.

Public corporations differ from public agencies and public enterprises in that, although they are subject to parliamentary review, they have a large measure of autonomy; their managements follow the policy laid down by the government but, in implementing it, they are free to make whatever decisions they think best. The accounts of public corporations are kept on a commercial basis and are separate from those of the government. The National Electricity Board, the Malayan Railways, and the Singapore Housing and Development Board are examples.

¹ Agencies sometimes charge for their services (for example hospital and education fees), but such charges are incidental to the main activities of the agency.

In Malaya, government agencies accounted for approximately 82% of total government sector expenditure in 1965, government enterprises for 7%, and public corporations for 11%. The pattern is similar in Singapore, except that the contribution of public corporations to total government sector expenditure is relatively greater.

In most countries, the government sector is defined to include all departments, agencies, and public bodies over which the elected representatives of the people exercise direct control. This definition would include government agencies and enterprises, but would exclude public corporations for, although such bodies are instruments of public policy, they are independent of the day-to-day financial control and administrative direction of the legislature and affiliated departmental bodies. Such a narrow interpretation of the term 'government sector' is unrealistic for Malaya and Singapore: the Malayan Railways, for example, are effectively operated as a government department. Similarly, the pricing and investment policies of the National Electricity Board, the Housing and Development Board, and other public corporations are subject to a high degree of central government direction. Public corporations are therefore included within the definition of the public sector used in this study. The objective of this chapter is to analyse the structure of government transactions in Malaya, and then in Singapore. Attention is directed first to the pattern of government expenditure, then to sources of revenue, and finally to sources of deficit finance.

MALAYA

Expenditure

The government sector in Malaya was responsible for 24% of gross national expenditure in 1965. This figure is more than double the share of total expenditure undertaken by the government sector in 1950, and national expenditure has itself doubled since then. The post-war period has therefore witnessed a significant increase in the influence of the government sector over the level and composition of domestic activity.

Although exceeded by some less developed countries, the Malayan government's share of total expenditure is high by Asian standards, and even compares favourably with some of the more advanced nations. There has been considerable expansion and diversification in the demand for government services in Malaya since the war, and the governing authorities became more aware of this growing demand following the institution of elected parliaments in 1954. The transition to an independent nation coincided with a temporary period of financial stringency, and this slowed

the growth of government expenditure. Nevertheless, the governing authorities appreciated the key role the people of Malaya assigned to the government sector in the development of the economy, and they responded by developing an organisational infrastructure (including a planning body, the tentacles of which extend down to the rural and village council level in search of development projects) which permitted a substantial increase in government spending after 1960. On a per capita basis, government expenditure in Malaya is very high compared with other Asian countries but is, of course, quite low when compared with the more advanced nations—\$US100 per head compared with over \$US400 per head.

Expenditure on current account amounted to 70% of total government expenditure in Malaya in 1965. Most of this was spent on wage and salary payments to government employees; the purchase of other goods and services accounted for little more than one-quarter of total current expenditure. While current expenditures leave no tangible assets, they can contribute to general productivity, and thus to the growth of the economy; education and health outlays, for example, are important forms of long-term investment, and expenditure on the maintenance of assets is probably as important as capital expenditure itself. Of total current account government expenditure undertaken in Malaya in 1965, general administration (including the maintenance of law and order) and education both accounted for 25%, defence services for 20%, economic services (basically on road maintenance and extension services to the agricultural sector) for 18%, and health services for 12%. Many governments of small nations in Asia have been able to spend as much of their national product on current outlays as the Malayan government, but they have felt compelled to devote a substantial proportion of their budget to defence—Indonesia, Burma, Thailand, Cambodia, Laos, South Vietnam, and South Korea, for example. Although defence expenditure rose rapidly in Malaya after 1963 following the commencement of Indonesian confrontation, the government has been able to keep expenditure on this head within reasonable control and, as a result, has been able to devote by far the greater part of its current expenditure to activities which enhance the productivity of the nation. While education expenditure per head of school-age population is low in Malaya when compared with advanced countries, it is nevertheless most respectable by Asian standards. Similarly, although the Malayan government spends relatively little on health services, expenditure per capita is reasonably high by Asian standards.

Current transfer payments to the private sector do not represent part of the public sector's claim on goods and services and are not therefore taken into account in determining the government's share of gross national expenditure. Nevertheless, such transfers account for 30% or more of aggregate government current expenditure in advanced nations, and are important in many Asian countries, although the form of such assistance differs. In the advanced nations, primary attention is given to pension, medical, and other forms of social security for specific groups in need of assistance; in the Asian countries, nation-wide food subsidy schemes, particularly for rice, tend to absorb the greater part of such payments. However, current transfer payments amount to only a small proportion of aggregate current expenditure undertaken by the government sector in Malaya. Non-contributory social welfare assistance has not been developed on an extensive scale, and there are no government food subsidy schemes apart from a price-support program for rice. Since this program is indirectly financed by a levy on rice imports, the cost to the government sector has been negligible.²

While expenditure on current account dwarfed expenditure on capital account, the government sector in Malaya was nevertheless responsible for 40% of aggregate capital expenditure in 1965 (Table 6). Moreover, the government provides a significant stimulus to investment in the private sector by means of rubber replanting grants and other capital transfer payments. The ratio of government investment to total investment in Malaya is matched by several other countries in Asia, but government investment per head and, perhaps more important, per acre of cultivated land, is considerably higher in Malaya. It is probable, therefore, that government investment has a more significant impact on the individual in Malaya than in most other countries of Asia apart from the centrally planned economies and Japan.

Expenditure control is highly centralised in Malaya, the Federal government being responsible for almost 80% of total government expenditure. An extension of the responsibilities of the Federal government has been a prominent feature of constitutional developments in the post-war period. The 1948 Constitution gave the Federal government legislative power with respect to almost all functions of government. Executive power, however, was more widely dispersed, the State governments being responsible for the implementation of education and

² If the price-support program were to cease, it is almost certain that the levy on rice imports would be abolished. It is therefore difficult to construe the levy on rice imports as a general (non-tied) source of government revenue. The scheme is considered in more detail in an appendix to Chapter 6 below.

health programs among other functions. This division of legislative and executive power inevitably made control over the level and direction of expenditure difficult. The situation was partially corrected in 1958 by the transfer from the State governments to the Federal government of executive authority for the implementation of education and health programs.

Table 6 Malaya: estimates of gross domestic product, gross fixed capital formation, and government fixed capital formation, 1949-67^a

Year	Gross domestic product at market prices	Gross fixed capital formation		Government fixed capital formation	
		\$m.	Per cent of gross domestic product	\$m.	Per cent of gross capital formation
1949	2,556	271	10.6	71	26.1
1950	3,848	174	4.5	59	34.1
1951	5,414	330	6.1	111	33.5
1952	4,572	544	11.9	167	30.7
1953	4,162	432	10.4	156	36.1
1954	4,750	460	9.7	173	37.6
1955	4,992	460	9.2	159	34.6
1956	5,060	557	11.0	196	35.2
1957	5,126	630	12.3	235	37.3
1958	4,896	580	11.9	204	35.2
1959	5,527	580	10.5	174	30.0
1960	6,134	755	12.3	188	24.9
1961	6,102	906	14.8	324	35.8
1962	6,367	1,130	17.7	500	44.2
1963	6,782	1,194	17.6	484	40.5
1964	7,221	1,226	17.0	467	38.1
1965	7,921	1,311	16.6	526	40.1
1966	8,300	1,423	17.1	489	34.4
1967	8,436	1,473	17.5	564	38.3

^a No official figures of gross domestic product and gross fixed capital formation are available for the period 1949-54. Figures for the period 1949-53 have been calculated from figures for Malaya and Singapore given in IBRD 1955. The 1954 figures are my own estimates.

Source: IBRD 1955; Malaysia 1965b: Table 1; Malaysia 1967: Table 1; Malaysia 1968b: Table 1.4.

As indicated above, public corporations undertook only 11% of total expenditure by the government sector in Malaya in 1965; in general,

direct participation by the government in agricultural, industrial, or commercial ventures is eschewed. Largely because of increased competition from road transport, the Malayan Railways have recorded increasing deficits since 1960, but the other major corporation, the National Electricity Board, has set prices at levels which permit it to cover operating expenses (including depreciation and interest charges on outstanding loan finance) with a margin to spare. This margin has been a valuable asset, for it has made the task of loan raising considerably easier, and thus has permitted continuous expansion of National Electricity Board operations.

Government expenditure rose rapidly between 1947 and 1953, but the extent of increase tapered off thereafter. A determined effort to implement the third Malayan development plan (1961-5) led to the first significant rise in government expenditure for almost a decade. This plan also heralded a significant change in the attitude of the government to its role in the development of the economy, a change which can best be appreciated by considering the objectives and achievements of development planning in Malaya.

First Development Plan, 1950-5. Four development plans have been implemented since 1950. The first was formulated in response to the provisions of the United Kingdom Colonial Development and Welfare Act, and spanned the period 1950-5. This plan had been drawn up in a period of budgetary uncertainty, for post-war rehabilitation programs and the outbreak of the Emergency in 1948 had forced government expenditure above revenue. However, by the time the plan was published, the Korean War had started and in consequence the prices of rubber and tin had risen substantially. The rise in the prices of these products increased tax revenue and reversed the financial situation so much so that, in a prefatory note, the High Commissioner conceded that the plan no longer appeared as ambitious as it once seemed (Federation of Malaya 1950a). Target expenditures were revised upwards in 1951 and again in 1952, the revisions increasing planned expenditure fourfold.

The expenditure pattern broadly reflected the prevailing attitude of the government to its role in the development of the economy. The goal in the immediate post-war years was to reconstruct and extend the infrastructure established in the pre-war period so as to permit the continued development of Malaya's main export industries by private initiative; primary attention was given to the development of roads, railways, ports, communications, water, and electricity supplies.

During this first plan period, the principal goals of the government were to finance current expenditure, to satisfy the requirements of the Emergency, and to increase external reserves as a precautionary cover against future need; development expenditure tended to be regarded as the residual component in total Federal government operations. Actual expenditure on development amounted to only 76% of target expenditure, and much of this expenditure was associated with the Emergency rather than with economic development (expenditure on housing and village resettlement, for example). Plans for the development of rail, harbour, and electricity facilities were not fulfilled, but a relatively more serious shortfall occurred in the provision of education and health facilities.

The first plan amounted to little more than an aggregation of separate departmental expansion programs. No attempt had been made to assess available resources or community needs. Consequently, little attention was given to the central problem of economic planning—the question of how aggregate resources available to the government sector could best be combined to meet community needs. The lack of a co-ordinated program of advance became more apparent in the implementation stage. The various departments acted in isolation of each other, and inevitably the stronger and more centralised departments (roads, communications, railways, and electricity) gained at the expense of the weaker and less centralised departments (education and health).³

Second Development Plan, 1956–60. A Mission from the IBRD visited Malaya at the government's request in 1954 to prepare a long-term development plan. In a detailed report (IBRD 1955) the Mission emphasised that transport, communication, electric power, and other overhead facilities were extremely well developed in so far as the main export industries were concerned, and particularly in respect of the large-scale, European-dominated segment of the export sector. While agreeing with departmental heads on the need to improve existing facilities, the Mission stressed that the most pressing problems in Malaya were: (a) the need to rehabilitate the rubber industry to enable it to survive the future challenge of competition from synthetic rubber, (b) the need to diversify the economy, and particularly to extend overhead facilities to the non-export, predominantly Malay, rural sector of the economy, and (c) the need to expand education and health facilities.

³ Executive authority for the implementation of education and health programs rested with the State governments. Co-ordination among the various State governments was not easily achieved. Consequently, expenditure on these heads languished.

Government current expenditure on education and health had risen steadily since the war, but the paucity of capital expenditure in these fields indicated the government's reluctance to commit itself to an extended program of social assistance. The Mission's report revealed that available facilities and teachers could provide education for only one-half of the children of primary school age, that significant inequalities in educational opportunities existed among States, and that the school-age population was growing at an unprecedented rate. Deficiencies in the provision of health facilities, particularly in the rural areas, were no less serious. Moreover, public demand for the provision of comprehensive social services was increasing, and the prospect of self-government had stimulated a political awareness of social problems. The Mission cautioned that the gap between awakening aspirations and available facilities could not be eliminated within a short period of time without threatening the fiscal capacity of the country and compelling the neglect of other essential public functions. The Mission was not prepared to accept this cost, and thus gave priority in its proposed development plan to the rehabilitation of the rubber industry and to attempts to diversify the economy.

The Mission's plan was drawn up at the height of the Emergency and during a period of financial restraint following a decline in budget revenue from the peak attained in the Korean War boom. The financial situation had mellowed by 1956 and, in consequence, the Mission's plan did not appear as ambitious as the Mission itself claimed it to be. Bids by government departments almost doubled the level of expenditure recommended by the Mission, and the government did not seriously attempt to pare these claims. However, in percentage terms, the pattern of expenditure outlay finally agreed upon was broadly similar to that recommended by the Mission. The plan is summarised in Table 7 and compared with actual development expenditure for the period 1956-60.

Despite a substantial underestimation of the growth of recurrent expenditure and a financial crisis in 1957-8 which, although mild, was considerably exaggerated at the governmental level and ushered in a period of expenditure restraint which lasted until 1961, actual development expenditure amounted to 92% of planned expenditure. The fulfilment of the expenditure target did not overstretch the resources of the government, for the potential for raising long-term domestic loan finance was not fully appreciated when the plan was drawn up.

While the expenditure shortfall was small, there were significant differences in sectoral performances. The government's massive rubber replanting program achieved considerable success, particularly in respect

of estate replanting; replanting on smallholdings lagged behind schedule. For most other agricultural activities, expenditure shortfalls were recorded. The most serious occurred in the provision of irrigation and drainage facilities to rice growers; actual achievements here were 50% below physical targets. Moreover, attempts to improve smallholder marketing arrangements and to foster a co-operative movement met with little success. The targets for public utility, transport, and communication expenditure were broadly achieved, but development was concentrated on improving existing links rather than on extending facilities to the less developed rural areas. In a review of departmental plans, the IBRD Mission had warned against a continuation of this form of development. Existing links, it had insisted, were quite adequate—further embellishments could be postponed without serious detriment. But departmental heads were unable to effect the requisite reorientation in their development programs. The most glaring discrepancy occurred in the provision of roads and bridges. The State governments, who were almost completely responsible for the development of village and rural feeder roads (the Federal government being responsible for interstate road links), undertook only 25% of total expenditure on roads during the plan period, and most of this was spent on improving well established urban roads.

The level of expenditure on education and health facilities and on the development of local authority services fell well short of target. Moreover, a high proportion of expenditure on these heads was devoted to improving existing urban facilities rather than to extending these services to the rural areas. The shortfall in capital expenditure was due to continued confusion as to Federal-State government responsibilities in these fields, and to the period of financial stringency from 1957–60, the burden of which was borne almost completely by a contraction of expenditure on social services.

Third Development Plan, 1961–5. The third development plan (known as the Second Five-Year Development Plan, 1961–1965) was also formulated with the assistance of IBRD consultants. This plan was far more ambitious than its predecessor. While designed to consolidate and expand programs commenced during the preceding plan period, the third plan embodied a significant rearrangement of priorities. In response to an election setback received by the governing Alliance Party in predominantly Malay rural States in 1959, primary attention was given to the problem of raising the level of rural economic and social wellbeing. The government was aware of the problems of the small cultivators in northern

Table 7 Malaya: planned and actual development expenditure, 1950-70

Functional category	Development Plan I, 1950-5			Development Plan II, 1956-60			
	Planned development expenditure \$m.	Actual expenditure		IBRD proposals \$m.	Planned development expenditure \$m.	Actual expenditure	
		\$m.	Per cent of target			\$m.	Per cent of target
Agriculture	58	60	103.4	219	256	228	89.1
Rubber replanting				125	160	153	
Drainage and irrigation				55	40	38	
Land development				3	15	17	
Other				36	41	20	
Transport	164	150	91.5	152	195	206	105.6
Railways				24	60	71	
Roads and bridges				94	75	95	
Civil aviation				2	10	3	
Ports				32	43	37	
Other				—	7	—	
Communications	46	61	132.6	23	60	52	86.7
Telecommunications				18	55	47	
Postal services				5	5	3	
Other				—	—	2	

Utilities	272	170	66.3	126	165	239	144.8
Electric power				87	80	142	
Water supply				} 39	70	81	
Other (sewerage)					15	16	
Social services	302	166	55.0	117	182	139	76.4
Education				59	95	61	
Public health				37	50	13	
Housing				17	33	65	
Labour and social welfare				4	4	—	
Industrial development				6	6	11	183.3
Government	14	42	300.0	60	136	97	71.3
Government buildings				35	87	49	
Municipal, local government				17	36	14	
PWD plant and equipment				5	3	24	
Other				4	10	9	
Unallocated				74	46	—	
Development expenditure	856	649	75.8	777	1,046	972	92.9

Table 7 (continued)

Functional category	Development Plan III, 1961-5						Development Plan IV, 1966-70	
	Original targets			1962 revised targets			Planned development expenditure	
			Per cent			Per cent of revised target	\$m.	Per cent
	\$m.	Per cent		\$m.	Per cent			
Agriculture	545	26.1		550	21.1		900	28.9
Rubber replanting	165	7.9		141	5.4		140	4.5
Drainage and irrigation	100	4.8		124	4.8		319	10.2
Land development	191	9.1		157	6.0		335	10.8
Other	89	4.3		128	4.9		106	3.4
Transport	363	17.3		510	19.6		365	11.7
Railways	65	3.1		50	1.9		20	0.6
Roads and bridges	190	9.1		336	12.9		256	8.2
Civil aviation	52	2.5		60	2.3		9	0.3
Ports	55	2.6		64	2.5		81	2.6
Communications	73	3.5		129	5.0		157	5.0
Telecommunications	50	2.4		84	3.2		105	3.4
Broadcasting and TV	5	0.2		32	1.2		42	1.3
Posts	18	0.9		13	0.5		9	0.3

Utilities	402	19.2	546	20.9	535	98.0	717	23.0
Electricity	254	12.1	342	13.1	353	103.2	545	17.5
Water supply	140	6.7	196	7.5	175	89.3	154	4.8
Sewerage	8	0.4	8	0.3	8	100.0	22	0.7
Social services	491	23.5	442	17.0	414	93.7	775	24.9
Education	260	12.4	231	9.0	237	102.6	368	11.8
Public health	145	6.9	139	5.3	102	73.4	150	4.8
Housing (incl. social welfare)	86	4.1	72	2.8	75	104.2	257	8.3
Industrial development	27	1.3	60	2.3	59	98.3	110	3.5
Government	190	9.1	370	14.1	231	62.4	90	3.0
Government buildings	39	1.9	101	3.9	42	41.6	n.a.	n.a.
Municipal buildings	17	0.8	48	1.5	35	72.9	n.a.	n.a.
PWD plant and equipment	69	3.3	64	2.5	78	121.9	n.a.	n.a.
Other	65	3.1	157	6.0	76	48.4	n.a.	n.a.
Development expenditure	2,090	100.0	2,607	100.0	2,344	89.9	3,114	100.0

and eastern Malaya before the election. To a large extent, this sector of the economy had failed to share in the prosperity which had occurred in the decade after 1950, and the government realised that this sector would fare little better in the next decade without basic infrastructure developments. The election served to hasten the implementation of the government's long-term policy objective of raising per capita income and widening opportunities in the backward sectors of the economy. A second major objective of the plan was to provide adequate employment opportunities for the country's labour force, which was estimated to increase by 3% per annum during the plan period.

Planned expenditure for the third plan period is summarised in Table 7 and compared with actual achievements. Rubber and electricity dominated the second plan. While the level of expenditure on these heads was expected to rise during the third plan period,⁴ the significant feature was the substantial rise in the level of expenditure on drainage, irrigation, land development, roads (particularly village and rural feeder roads), water supply, and social services. The important innovation introduced in this plan was the attempt to relate government expenditure to the requirements of the economy as a whole rather than to those of the export sector alone.

Although short of target in 1961, government expenditure rose sharply in 1962 and during the remainder of the plan period. Following an extensive review of the plan late in 1962, plan expenditures were raised by 25%. The review disclosed that for some expenditure heads (roads, communications, public utilities, and government buildings) original targets would be reached well before 1965, and that upward revision was necessary.

While there was a substantial increase in expenditure on rural development, it was increasingly appreciated that a program extended over several decades would be needed to raise depressed rural incomes. Nevertheless, two important points were realised. First, that the administrative machinery would have to be adapted more closely to rural needs and, second, that extension services would have to be considerably expanded if investment was to make a significant contribution towards raising rural income.

While major steps were taken to raise rice production and rural output in general, the plan's contribution to diversification through industrialisation was small. It was apparent that much more vigorous programs of

⁴ In the case of rubber, greater emphasis was to be given to smallholder relative to estate replanting activity.

financial assistance, protection, and other forms of industrial promotion would be needed if industrialisation were to strengthen the balance of payments through import substitution, and thus contribute to the avowed aim of economic diversification.

Considering Malaya's rapid population growth, programs for the expansion of social services were not particularly liberal and, as in previous plans, spending on social services again fell short of target. The shortfall was due partly to overspending on other development heads, partly to administrative and technical bottlenecks, and partly to the growing pressure for the diversion of resources to defence following the military intensification of Indonesian confrontation.

Per capita output rose during the plan period, but the effect on per capita income was largely negated by a serious deterioration in the terms of trade due to a fall in the price of rubber; production and productivity rose at a rate just sufficient to offset the adverse effect of falling rubber prices on per capita income. While statistics of unemployment in Malaya are not comprehensive, it does appear that there was no significant rise in unemployment in Malaya during the plan period so that the second objective of the plan was broadly achieved.

The execution of the plan, however, placed several problems of development planning into sharp perspective. First, the administrative machinery responsible for implementing the plan failed to co-ordinate progress in the various sectors in step with plan requirements. The Economic Planning Unit (EPU)—the secretariat to the main co-ordinating body, the National Development Planning Committee (NDPC)—was understaffed, and was unable to extricate itself from day-to-day departmental queries. Consequently, neither the EPU nor the NDPC was able to devote attention to the question of priorities (one for a lack of administrative and technical personnel, the other for a lack of information), and expansion largely took place on an *ad hoc* basis.

Second, instead of co-operating, ministries and departments actively competed with each other to maintain their relative share in total expenditure. The several departments concerned with rural development, for example, did not seriously seek to co-ordinate their activities. Inevitably there was a degree of duplication and inconsistency in departmental programs. Moreover, departments undertook projects without regard to targets, and submitted further development plans often on the basis of inadequate research. Their objective was to ensure that they had sufficient funds to continue their own activities; the departments did not fully understand the notion of national priority planning. A similar problem was evident at the State level. There was a lack of co-ordination

among States, and a failure to realise that administrative boundaries were arbitrary and artificial.

Third, in relation to requirements, capital is scarce in Malaya and its flow is uncertain. This means that the costs and benefits of various projects should be assessed and those projects which add most to the nation's wellbeing should be selected. There has been little cost-benefit analysis of investment projects in Malaya. Major schemes have often been started without sufficient prior study. While much of the investment undertaken would probably be justified in economic terms, it is clear that many expensive projects would not. The development of a second airport, expenditure on Federal and State administrative buildings and on some road projects, deserved more careful evaluation.⁵ There was an observable preference for extravagant, spectacular, prestige projects. In consequence, the potential return on investment in technical education, health, and low-cost housing was underestimated.

Finally, the plan suffered because of an inadequacy of qualified administrative and technical personnel (the rural health program, for example, was hindered because of a serious shortage of medical practitioners), and because of various physical and administrative bottlenecks. For example, it was appreciated that the plan would strain the construction and technical capacity of the economy. What was not appreciated was that the departments would attempt to implement their 5-year program in the first years of the plan period. With no co-ordination, contracts were bunched and given in such a volume that costs and profit mark-ups were inevitably inflated.

First Malaysia Development Plan, 1966-70. In contrast to other periods of expansion in recent Malayan history, rapid growth has occurred since 1961 despite stagnation in the level of export earnings. The rise in domestic demand led to a substantial rise in imports which, in the face of stagnant export earnings, led to an adverse movement in the balance of trade. The trade deficit was financed partly by capital inflow but largely

⁵ In response to departmental pressure, the original road construction target of 305 miles per annum was raised to 700 miles per annum in 1962. This was considered to be an achievement; rural areas were being opened. It was later realised, however, that no attempt was being made to ensure that the road building program opened up the maximum area with the minimum mileage at an economic cost, or that projects which were likely to yield the greatest economic benefit were undertaken first. There can be little doubt that sections of the massive road program absorbed real resources which could have been better utilised elsewhere. The spending of money is not in itself an indication of efficient usage.

by a reduction in the external reserves of the commercial banks. Despite continued public investment in the production of agricultural exports and an expected 6% per annum rise in the volume of rubber exports, falling world prices for rubber, iron ore, oil palm, and coconut products, combined with stagnation in the production of tin ore, are expected to prevent any significant expansion of export receipts at least until 1970. Consequently, the plan places most emphasis on import substitution activities. Within the agricultural sector, primary attention is given to the problem of raising smallholder productivity by means of expanded extension services, irrigation, replanting, and the opening of uncultivated land. A central objective is to expand double crop rice land in order to raise production sufficiently to permit a reduction in the level of rice imports without any reduction in per capita consumption. Within the industrial sector, a more determined effort is to be made to develop industries which would replace imports. In general, the plan adopted a more enlightened approach to the need to reduce the heavy dependence of the economy on rubber.

Compared with the preceding Malayan development plans, relatively less attention is to be given to the development of transport, power, water, and communication facilities. The government is satisfied that, as a result of measures taken during the preceding plans, the economic infrastructure in Malaya is now adequate.

A substantial increase in the level of education expenditure has been planned for this 5-year period, and the government has developed a clearer appreciation of the skilled manpower needs of the country. However, expenditure on other community services (such as health and low-cost housing) has been held in check. As in previous plans, it has been pointed out that priority must be given to economic development if sufficient resources are to be created to permit the steady long-term expansion of community services.

Planned expenditure for the 5-year period 1966-70 is summarised in Table 7. The plan envisages a 33% rise in total development expenditure. While ambitious, there are indications that the plan's objectives may not be fulfilled. First, the sharp rise in recurrent expenditure since 1960 (12.5% per annum), combined with a substantial increase in defence and internal security expenditure, threatens to erode finance available for development expenditure. Second, some departments are geared to development more than others. As in the third Malayan plan, the government may find it difficult to restrain the expenditure of some departments (for example, on roads) and to expand the expenditure of others (for example, on industrial development). Third, because of the

paucity of extension services, the fruits of rural development may not be realised for several decades. Finally, heavy dependence has been placed on foreign borrowing and grants, but attempts to gear development projects to foreign assistance requirements are still meagre. It would not seem to be sufficient to argue that 'since Malaysia is making substantial efforts to raise funds internally, it has a good case for receiving . . . [large] . . . amounts of foreign assistance' (Malaysia 1965a: 13). Self-help is as essential in the external as in the internal financial sphere; to be successful, there is an urgent need to draw up detailed blueprints of development projects in a manner which will satisfy the requirements of foreign lenders.

Revenue

In the financial sphere, the Federal government is paramount—it raised 90% of total tax revenue during the period 1960–5 and, by virtue of constitutional provisions, it alone has responsibility for raising domestic and external loan finance. The constitution expressly indicates the sources of revenue assigned to State governments. Apart from land taxes, mining royalties, entertainment duties, and licence fees, the sources of State revenue are of a non-tax form: revenue from government enterprises (for example, water), fees for specific services, rent, interest, and receipts from land sales. The Federal government has sole responsibility for raising revenue by means of income, customs, and general sales taxation. In contrast to the Federal sources of revenue, the State sources possess slow growth potential and limited manipulative power. Moreover, their collection involves considerable outlay. The continued growth of State government responsibilities has meant that their expenditure has exceeded revenue, with the result that a significant and increasing part of State (and local) government expenditure has been financed by Federal grants. Nevertheless, the extent of imbalance has been greater than it need have been. In several of the assigned revenue sources (for example, land taxes and licence fees) the State governments have not sought to utilise untapped potential. In general, the States have found it easier to obtain Federal grants than to raise more State revenue.

The sources of Federal government finance in the post-war period are summarised in Table 8. In the decade after 1950, the Federal government normally achieved a surplus of revenue over current expenditure. This surplus financed the major part of Federal government development expenditure. As a result, budget deficits were small. Substantial deficits were, however, recorded in the periods of depressed trade (1953–4, 1957–8, and since 1962). Fearing that such deficits would

impair the government's ability to maintain the provision of essential services, expenditure was restrained during the 1953-4 recession and again during the 1957-8 recession. In sharp contrast, the government has deliberately pursued countercyclical fiscal policies during the trade recession which commenced in 1962; expenditure has risen, budget deficits have grown larger, and the government has been prepared to accept continuing budget deficits as a normal state of affairs. This significant change in the attitude of the government to its role in the economy during periods of depressed export trade has been made possible by a clearer appreciation of the substantial scope for raising domestic loan finance in Malaya, and by a more judicious use of the nation's external reserves.

Before we explore the sources of deficit finance, let us consider the structure of Federal government revenue. Details are provided in Table 9. Tax revenue, which amounted to 85% of total revenue during the period 1960-5, has increased more than threefold since 1950, but the yield has been subject to substantial annual variation. The tax structure is dominated by levies on export and import trade; income taxation, introduced in 1947, accounted for less than 30% of total tax revenue in 1965 (Table 10). Export tax revenue is principally derived from duties on rubber and tin. Levies on a small range of products (tobacco, liquor, petroleum, motor vehicles, textiles, and sugar) dominate the yield of import duties. No sales tax is levied in Malaya, but a surtax, levied at a nominal rate, is imposed on most imports. Excise taxes are restricted to a limited number of domestically-produced goods. Payroll tax and licence fees are the only other sources of Federal tax revenue, but revenue derived under these heads is comparatively small.

Table 11 attempts to compare some aspects of the revenue effort of several governments. The ratio of tax revenue to gross domestic product is invariably higher in developed than in less developed countries. Moreover, whereas developed countries derive most of their revenue from taxes on income and on internal transactions, less developed countries generally rely heavily on trade taxes. These differences are largely accounted for by a difference in income per head. In less developed countries, it is easier and more remunerative to tax trade than it is to tax income and internal transactions.

Wide discrepancies also exist within the less developed countries with respect to tax effort. Since trade taxes generally dominate the revenue structure, differences in the revenue performance of such countries as Ceylon and Malaya on the one hand, and Pakistan and India on the other, can partly be explained by a difference in the ratio of

Table 8 Malaya: sources of Federal government finance, 1948-68^a
(\$ million)

Item	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958
Revenue ^b	211	273	396	707	690	548	536	703	765	739	681
Current expenditure ^c	-263	-306	-306	-483	-594	-697	-647	-640	-660	-710	-772
Deficit/surplus on current account	-52	-33	90	224	96	-149	-111	63	105	29	-91
Capital (development) expenditure ^d	-22	-67	-31	-49	-72	-93	-100	-87	-154	-171	-140
Deficit/surplus on current and capital account	-74	-100	59	175	24	-242	-211	-24	-49	-142	-231
Sources of deficit finance											
External grants	1	48	28	2	7	45	111	67	11	30	35
External borrowing	—	68	—	—	—	16	110	45	35	-5	-8
Domestic borrowing	11	2	24	2	100	106	101	6	120	80	113
External reserves ^e	53	-9	-73	-184	-91	75	-105	-85	-110	35	92
Domestic balances ^e	9	-9	-38	5	-40	—	-6	-9	-7	2	-1
Total	74	100	-59	175	-24	242	-211	24	49	142	231

Item	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968
Revenue ^b	821	996	1,014	1,048	1,093	1,264	1,405	1,543	1,748	1,775
Current expenditure ^c	-755	-744	-851	-914	-1,017	-1,266	-1,438	-1,577	-1,748	-1,788
Deficit/surplus on current account	66	222	163	134	76	-2	-33	-14	—	-3
Capital (development) expenditure ^d	-142	-141	-264	-415	-455	-509	-582	-651	-680	-680
Deficit/surplus on current and capital account	-76	81	-101	-281	-379	-511	-615	-665	-680	-683
Sources of deficit finance										
External grants	38	40	31	14	8	66	58	91	46	65
External borrowing	26	25	14	22	48	-5	72	-10	27	200
Domestic borrowing	199	163	134	147	208	192	404	327	486	400
External reserves ^e	-197	-250	-140	80	90	231	70	257	121	18
Domestic balances ^e	10	22	62	18	25	27	11			
Total	76	-81	101	281	379	511	615	665	680	683

^a Figures for 1964 on refer to Malaysia; 1967 figures are revised estimates; 1968 figures are estimates.

^b Total revenue excludes foreign grants, and includes only the net operating profit of Federal government business undertakings (Posts and Telecommunications).

^c Total ordinary expenditure includes Federal allocations to States but excludes allocations to Statutory and Sinking Funds, current expenses of Posts and Telecommunications Department, and, prior to 1957, non-recurrent expenditure of the Public Works Department.

^d Development expenditure prior to 1957 has been defined as Loan Works and Public Works expenditure.

^e Minus sign means increase.

Source: Malaysia 1949-67, together with information supplied by the Treasury, Kuala Lumpur.

Table 9 Malaya: Federal government revenue, 1947-68
(\$ million)

Source	1947	1948	1949	1950	1951	1952	1953	1954	1955	1956	1957
Tax revenue	169	193	248	368	677	655	514	497	650	696	665
Income tax	—	2	38	46	127	223	158	132	112	143	129
Export taxes	48	66	71	147	298	187	112	112	235	210	180
Rubber	32	33	28	89	214	111	55	53	174	144	120
Tin	14	30	39	52	76	70	51	54	56	60	54
Other	2	3	4	6	8	6	6	5	5	6	6
Import duties	89	112	125	159	229	224	219	232	278	318	332
Excise taxes	6	4	5	6	10	8	7	6	7	7	9
Other indirect taxes	26	9	9	10	13	13	18	15	18	18	15
Non-tax revenue	84	18	25	28	30	35	34	39	53	69	74
Total revenue	253	211	273	396	707	690	548	536	703	765	739
Tax revenue/GDP	—	—	9.7	9.6	12.5	14.3	12.3	10.5	13.0	13.8	13.0

Source	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968
Tax revenue	590	721	883	874	878	906	935	1,091	1,205	1,332	1,377
Income tax	119	125	186	232	237	239	231	266	317	376	397
Export taxes	127	227	260	192	177	182	191	229	214	191	182
Rubber	91	184	196	118	93	83	69	78	68	45	47
Tin	30	36	55	65	67	71	96	118	117	114	101
Other	6	7	9	9	17	28	26	33	29	32	34
Import duties	321	344	408	419	431	419	388	433	442	532	563
Excise taxes	9	9	8	8	9	37	89	101	133	151	162
Other indirect taxes	14	16	21	23	24	29	36	62	99	82	73
Non-tax revenue	91	100	113	140	170	187	212	182	212	245	202
Total revenue	681	821	996	1,014	1,048	1,093	1,147	1,273	1,417	1,577	1,579
Tax revenue/GDP	12.1	13.0	14.4	14.3	13.8	13.3	12.9	13.8	14.5	15.8	15.8

Source: Malaysia 1949-67 together with information provided by the Treasury, Kuala Lumpur.

Table 10 Malaya: Federal government tax revenue, 1947-68

Year	Total tax revenue (\$m.)	Percentage distribution			
		Income tax	Export taxes	Import taxes	Other taxes
1947	169	—	28.4	52.7	18.9
1948	193	1.0	34.2	58.1	6.7
1949	248	15.3	28.6	50.4	5.7
1950	368	12.5	39.9	43.2	4.4
1951	677	18.8	44.0	33.8	3.4
1952	655	34.1	28.5	34.2	3.2
1953	514	30.7	21.8	42.6	4.9
1954	497	26.6	22.5	46.7	4.2
1955	650	17.2	36.2	42.8	3.8
1956	696	20.5	30.2	45.7	3.6
1957	665	19.4	27.1	49.9	3.6
1958	590	20.2	21.5	54.4	3.9
1959	721	17.3	31.5	47.7	3.5
1960	883	21.1	29.4	46.2	3.3
1961	874	26.5	22.0	47.9	3.6
1962	878	27.0	20.1	49.1	3.8
1963	906	26.4	20.1	46.2	7.3
1964	935	24.7	20.4	41.5	13.4
1965	1,091	24.4	21.0	39.7	14.9
1966	1,205	26.3	17.7	36.7	19.3
1967	1,332	28.2	14.4	39.9	17.5
1968	1,377	28.8	13.2	40.9	17.1

Source: Derived from Table 9.

Table 11 Aspects of tax effort, selected countries, 1961-5

Country	Tax revenue as % of GDP	Per cent of total tax revenue			Exports as % of GDP	Imports as % of GDP
		Income taxes	Trade taxes	Taxes on internal transactions		
India	6.2	29.3	24.1	46.5	4.3	7.0
Pakistan	5.7	21.0	32.3	46.7	6.3	10.9
Philippines	8.9	24.6	28.7	46.7	18.8	18.7
Thailand	11.0	11.5	49.9	38.6	17.5	19.0
Ceylon	18.3	23.2	50.9	26.0	27.2	28.5
Malaysia	13.6	25.7	65.4	8.9	43.1	39.0
Japan	10.1	56.2	—	43.8	10.1	10.3
Australia	20.1	48.8	21.3	29.9	16.3	16.6
Canada	15.3	58.9	9.0	32.1	20.5	20.4
Argentina	6.1	27.6	36.7	35.7	9.8	9.9
Guatemala	7.2	12.4	41.2	46.4	14.1	16.4

Source: United Nations 1967, 1968.

trade to national product. The higher this ratio, the greater is the scope for trade taxation and, in consequence, the easier it is to raise tax revenue. Moreover, the higher this ratio (and particularly the more specialised is the pattern of export production), the more likely it is that there will be a high degree of foreign intervention in the production and distribution of goods and services, that a significant proportion of total output will be produced by large production units, and that a large part of the economy will be monetised. Each of these factors enhances the ability of the government to collect income, land, and other internal taxes. Differences in income per head and in the quality of tax administration also contribute to differences in tax collecting performances but, in general, if two countries have similar taxable capacities but one is more open to trade than the other, it is likely that the trade-oriented country will be able to tap the potential taxable capacity of its people more fully than the other country.

A comparison of Malaya and Ceylon reveals that, although the ratio of trade to national product and the level of income per head are higher in Malaya, Ceylon raises more tax revenue per head. There would appear to be three main reasons for this difference. First, the Ceylonese government has broken away from the *laissez-faire* philosophy to a larger extent than the Malayan government; it has, for example, been prepared to levy much heavier taxes on individuals and on the corporate sector of the economy than has the Malayan government. Second, the Ceylonese tax structure has been conditioned by the Indian tax structure, the Malayan by the Singapore tax structure. Whereas every endeavour has been made to raise more tax revenue in India, a heavy dependence on entrepôt trade has restrained the range and level of taxation in Singapore and thus in Malaya. Third, until quite recently, the pressure for increased tax revenue has been less urgent in Malaya than in Ceylon.

The level of tax revenue raised in Malaya is directly related to the fortunes of the rubber and tin industries. The export tax on rubber is graduated with price, while the specific duty on tin is adjusted so that the effective tax amounts to a flat rate *ad valorem* charge. Consequently, the yield of export taxes is responsive to fluctuations in both the quantity and price of rubber and tin, and particularly to price fluctuations. Moreover, the yield of import and income taxes is also significantly affected by the fortunes of the export sector. As indicated in Table 6, gross national product has almost doubled since 1950 but, despite a significant increase in rubber production since 1960, a sharp and seemingly permanent fall in price has reduced the contribution of the export sector to national product from 50% in 1960 to 42% in 1965 (see Table 2). The heavy

dependence of the tax structure on the trade sector and, more specifically, on the export sector, has been the reason for the stagnation in the ratio of tax revenue to domestic product in Malaya (Table 9). The present orientation of the tax system towards the external trade sector of the economy has proved to be beneficial in partially offsetting the impact of short-term trade fluctuations on the internal economy, but has not produced a situation where tax revenue can be depended on to increase progressively with increases in domestic product over the longer term.

As in most countries, the Malayan tax structure has been built up in a haphazard manner. The British tax structure, particularly in the pre- and immediate post-World War II period was a dominant influence, export taxation being the only major indigenous tax excursion. The Malayan form of income taxation, for example, is a replica of British practice in the immediate post-war period and, given the high ratio of imports to national product and the limited extent of domestic production of manufactured goods, the narrow structure of import and excise duties represented a sensible adaptation of the British purchase tax to Malayan requirements. Multiple exchange rate manipulation, an important means of taxing and subsidising various categories of exports and imports in some Asian countries (Indonesia, Taiwan and, in the immediate post-war period, in Thailand and the Philippines) and in many Latin American countries, has not been practised in Malaya. There are four main reasons why Malaya avoided this type of tax. First, there was no tradition of such practices in the United Kingdom or in other British colonies. Second, the central feature of the Currency Board mechanism of currency creation was the maintenance of a single, fixed rate of exchange between the Malayan dollar and the pound sterling. Third, the Currency Board mechanism eliminated any need for central control over foreign exchange transactions, a prerequisite for effective multiple exchange rate manipulation. Finally, Malaya had developed a structure of export and import duties in the pre-war period which proved to be most remunerative in the post-war period, with the result that there was no need to emulate trade tax innovations introduced in other less developed countries.

In the post-war period, many less developed countries, including several British colonies in Africa, imposed export taxes on specific commodities and later instituted marketing boards which were responsible for maintaining a high degree of stability in the domestic price of these commodities, and thus in the income of producers. It is perhaps surprising that a similar board was not instituted to cover the marketing of rubber produced in Malaya. Several factors, however, explain why this

was not done. First, in contrast to most less developed countries, Malaya has had a long history in the use of export taxes, and the levies have been accepted as a permanent part of the fiscal system. Because the taxes are adjusted to price on a sliding scale, part of any windfall profits accrue to the government but, equally important, the tax burden falls as price falls. The government has considered tax relief to be a sufficient contribution to producers on the part of the government in periods of depressed export trade; until quite recently, it has not contemplated the possibility of domestic price support. Second, while the price of rubber fluctuated widely, it remained substantially above that received in the pre-war period during the whole of the decade after 1950. Consequently, in the period when the popularity of marketing boards reached its zenith, there was no need to consider special marketing and price support arrangements for rubber. Third, the Malayan government has been reluctant to interfere with the free functioning of the price mechanism, particularly where a large sector of the economy was involved and, partly because of the post-war prosperity of the export sector and the concentration of a substantial amount of British investment in this field, British interests actively dissuaded the domestic government from considering intervention. Finally, because domestic consumption of natural rubber is negligible, there was no demand by Malayan consumers for domestic price stabilisation.

The Malayan tax structure is principally designed to raise revenue, and attention has been concentrated on the easiest possible means of achieving this objective. No deliberate attempt has been made to manipulate the tax structure to achieve a more equitable distribution of wealth and income; the Malayan government appears to have appreciated not only the impossibility of this task in a country where the personal income tax net does not extend beyond 4% of the population, but also its undesirability in a country where a premium is placed on individual initiative. However, some measures have been introduced to influence the allocation of resources, particularly since the attainment of independence. Thus, at the same time as efforts have been made to raise more revenue to match expanding government commitment, increased tax concessions have been granted to encourage private capital formation and, more recently, to stimulate industrial development.

Deficit Finance

Budget deficits were small in the decade after 1950, capital expenditure being largely financed by a surplus of revenue over current expenditure (Table 8). However, since 1960 current expenditure has risen at a much

faster rate than revenue with the result that the surplus on current account has been converted into a small deficit. At the same time, a substantial increase has been recorded in the level of capital expenditure, so that considerably greater emphasis has been placed on deficit finance.

An Employees' Provident Fund, established by the government in 1951 to collect compulsory contributions from employees and employers in order to provide a gratuity to employees on retirement, has dominated the market for government securities. The Federal government has also activated the accumulated reserve of the Smallholder Rubber Replanting Cess Fund⁶ and, with the assistance of the Central Bank, has borrowed extensively from the banking system (primarily by way of Treasury bill issues) and from other financial institutions (the post office savings bank, private provident funds, insurance, and other finance companies).

The potential for continued expansion of domestic loan finance is good. Since its institution, the Employees' Provident Fund has been an expanding source of government finance, and there is every indication that its reserves will continue to expand for more than another decade. The Employees' Provident Fund has incessantly forced an expansion of the government's domestic debt and, in several years, the government used domestic borrowing to increase its external reserve balances. While a policy of withdrawing real purchasing power from the community is admirable during a period of domestic inflation, its adoption during periods of depressed activity (1959 and 1961) suggests that the government did not pursue countercyclical fiscal policies to the extent of its command over the community's resources. Apart from the Employees' Provident Fund, there is scope for additional borrowing from the commercial banks, but it is unlikely that the high levels recorded in 1965-6 can be maintained; there is a limit to the bank's ability to hold government securities. The Central Bank is attempting to widen the market for government securities, but its ability to do so is restrained by the fact that trading is limited, for the bulk of the debt is held in perpetuity by one body—the Employees' Provident Fund. Nevertheless, steady expansion of the market for government securities will continue, and this will help to ensure a high level of domestic loan finance for the government in ensuing years.

Little dependence has been placed on external borrowing as a source of finance. Malaya's external debt at the end of 1967 (\$700 million) was equivalent to 9% of gross domestic product, and the financing of the

⁶ A cess of 4.5 cents per pound is levied on exports of smallholder rubber to finance a smallholder replanting grant.

debt absorbed only 2% of export earnings. The government has attempted to increase the flow of external loan finance in recent years but, because of a lack of detailed blueprints of development projects, the attempt has not met with much success. Unless administrative changes are made to overcome existing practical limitations, external borrowing will continue to prove difficult, despite the extent of Malaya's credit-worthiness.

Like external borrowing, external grants have been a minor source of government finance. The grants, provided largely by the United Kingdom government, have been earmarked mainly for defence projects; limited assistance for specific economic and social development projects has been provided by Colonial Development and Welfare grants.

The Malayan government has pursued countercyclical fiscal policies since 1960. The main source of deficit finance has come from a significant increase in the level of domestic loan finance raised by the government, although some use has been made of the government's external balances, and endeavours are being made to raise the flow of external loan finance. The domestic use of the increasing flow of finance raised by the Employees' Provident Fund has had a countercyclical effect for, in the absence of the domestic government demand for such funds, it is likely that the Provident Fund would have invested its reserve balances abroad. Borrowing from the banking system has also had an important countercyclical effect for, as a result of Central Bank policies and persuasion, commercial bank lending since 1960 has increased substantially above the level that would otherwise have occurred. However, as has been indicated, the ability of the commercial banks to influence the level of advances is now limited; they have virtually exhausted their foreign balances and are operating on a reasonably low liquid assets ratio. Unless the Central Bank is prepared to increase the liquidity of the commercial banks and use part of its external balances to meet any resulting balance of payments problems (that is to reduce the external cover against the domestic currency issue), the commercial banks' ability to assist in the implementation of countercyclical fiscal policies will be more limited in the future—loans to the government will be made at the expense of loans to the private sector, so that it is only any net increase in spending on domestic resources which has a countercyclical effect. Thus, while the government's countercyclical fiscal policies have met with success since 1960, its ability to intensify such policies should the present trade recession deepen is now more limited. In consequence, the brunt of any deepening of the trade recession would have to be borne by the domestic economy—the more severe the recession, the greater would be the decline in real

Table 12 Malaya: State government finances, 1954-68

Item	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968
(\$ million)															
Revenue (A)															
Tax revenue	55	61	66	70	70	76	85	101	106	98	86	89	95	99	103
Land tax	22	24	23	23	24	25	26	30	31	32	28	31	36	40	41
Royalties	12	16	18	21	21	24	31	36	38	27	26	27	31	33	35
Entertainment duty	7	8	9	10	10	10	11	11	12	12	13	13	14	13	14
Excise tax	7	7	8	8	7	7	7	7	7	7	1	—	1	—	—
Licences	7	6	8	8	8	10	10	11	11	12	13	13	12	11	11
Other	—	—	—	—	—	—	—	6	7	8	6	5	2	2	2
Non-tax revenue	34	36	38	33	36	31	37	42	46	50	70	78	100	95	102
Total revenue	+89	+97	+104	+103	+106	+107	+122	+143	+152	+148	+156	+167	+195	+194	+205
Expenditure (B)															
Current expenditure	-226	-228	-247	-255	-118	-122	-142	-157	-166	-180	-192	-212	-221	-264	-268
Capital expenditure	-15	-16	-15	-15	-20	-31	-32	-81	-152	-136	-136	-168	-103	-103	-120
Total expenditure	-241	-244	-262	-270	-138	-153	-174	-238	-318	-316	-328	-380	-324	-367	-388
Deficit (A-B)	-152	-147	-158	-167	-32	-46	-52	-95	-166	-168	-172	-213	-129	-173	-183

per capita income and rise in urban unemployment to bring about a fall in the demand for foreign currency equivalent to the fall in its supply.

The sources of finance for State government expenditure are detailed in Table 12. During the period 1961-5, tax revenue averaged 63% of total revenue; non-tax revenue (receipts from land sales and charges for specific government services) is a relatively more important source of finance at the State than at the Federal level of government. Royalties (derived mainly from levies on forest products) and land rents are the main sources of tax revenue. There has been a slight decline in the level of State government tax revenue collected since 1961. During the period 1961-5, State revenue (tax and non-tax) covered only 49% of State expenditure. Federal grants are the main source of non-budgetary finance.

SINGAPORE

Apart from the absence of export taxes, Singapore's tax structure is similar to Malaya's. Import, income, and property taxes are the three main sources of tax revenue in Singapore (Table 13). The income tax structure in Singapore is virtually identical with that in Malaya. The property tax is levied on an annual value base and tax rates are graduated by area. Import duties are levied on tobacco, liquor, motor vehicles, and petroleum. While mainly revenue duties, the levies have provided a measure of protection to domestic producers. In the case of liquor, the extent of the protective effect has been reduced by the imposition of an excise tax on domestic production. To avoid any interference with entrepôt trade, Singapore was reluctant to impose tariffs for protective purposes. However, following the achievement of self-government in 1959, protective tariffs have been imposed, as the government realised that Singapore's future viability depended on its ability to industrialise. In addition, it was appreciated that, for many commodities, protection would not involve a significant loss of entrepôt income. The break with tradition occurred in October 1965 when the government imposed protective levies on some 154 products.

In aggregate, the public authorities (the Public Utilities Board which is responsible for electricity, gas, and water supplies, the Housing and Development Board, the Economic Development Board, the Telephone Board, and the Harbour Board) have consistently recorded a surplus on current account transactions even after allowance has been made for depreciation and interest charges. However, much of the surplus is derived from the Public Utilities Board. The increase in charges for a wide range of services provided by the public authorities announced in

Table 13 Singapore: government revenue and expenditure, 1950-65
(\$ million)

Item	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
Revenue																
Income tax	30	55	78	107	74	64	73	70	70	80	83	83	90	88	90	100
Import and excise taxes	56	76	81	83	81	94	104	119	126	122	127	129	138	149	152	190
Property tax	9	11	13	17	18	21	24	25	27	26	36	41	47	49	62	56
Revenue from property	5	10	11	11	8	4	2	2	3	4	5	21	5	8	5	10
Fees and charges for services	23	33	39	39	41	49	52	51	54	60	70	76	60	65	69	71
Surplus of commercial undertakings	21	26	25	28	28	36	37	42	47	56	68	65	69	72	75	76
Total revenue	144	211	247	285	250	268	292	309	327	348	389	415	409	431	453	503
Expenditure																
Current account	106	128	152	160	198	204	228	248	265	267	254	240	242	289	290	315
Capital account	32	57	84	79	92	89	84	118	118	74	67	92	120	165	212	251
Total expenditure	138	185	236	239	290	293	312	366	383	341	321	332	362	454	502	566

Source: Singapore 1952-67, 1967, and 1968.

the 1968 Budget will enhance the surplus achieved by the Public Utilities Board, but will also ensure that the other public authorities continue to record a surplus on current account transactions.

Government expenditure on current account has risen at a rate of almost 8% per annum since 1950. Expansion has been concentrated in the fields of education, health, and other social services. Attendance at primary and secondary schools has risen rapidly with population growth and with an increasing awareness of the need for education by the community as a whole. The main demand for additional current expenditure in the future will continue to come from the social services although, following the assumption of independence in 1965, a significant rise in expenditure on defence and external affairs can be expected.

Gross capital formation amounted to 14% of gross domestic product in 1957 and 1958. The government sector was responsible for 40% of capital expenditure during this period. Capital expenditure, however, fell sharply in 1959 and amounted to only 7% of gross domestic product in 1960. Following the attainment of self-government in 1959, the outgoing government decided not to bind its successor to any new capital expenditure commitments and, in response to general political uncertainty, the investment plans of the private sector were curtailed. The failure to increase government expenditure in 1960 was due to organisational difficulties, and to the government's desire to make a careful review of the public sector program. The concerted attempt to implement Singapore's first development plan (covering the period 1961-5) stimulated private investment activity and, by 1964, gross capital formation had climbed back to 15% of gross domestic product. Singapore's departure from Malaysia had an unsettling effect on investment activity, but a determined effort by the government to stimulate industrialisation has largely restored confidence in Singapore's future.

Public investment activity rose rapidly after 1950. In the early fifties, the increase in investment was concentrated on the expansion of public utility (particularly electricity), transport (wharves, road, and bridges), and communication facilities. The increase in expenditure in the second half of the decade was devoted primarily to housing, education, and health; in 1958 expenditure on social development absorbed 56% of total public sector investment, economic development 41%, and administration 3%. The brunt of the cut in expenditure in 1959 was borne by the social services; further retrenchment in 1960 forced a cut in the public authority investment program.

Singapore's first development plan was drawn up with three objectives in mind. The first was to lay the foundation for an accelerated expansion

of Singapore's industrial sector. Emphasis in the plan was given to reshaping Singapore's infrastructure from one reflecting the long domination of entrepôt trade to one more conducive to industrialisation. The second objective was to endeavour to maintain the standard of social services in the face of rapid population growth. The third was to ensure that growth in the public sector provided sufficient jobs to compensate for the expected slow growth of employment opportunities in the private sector.

During the plan period, public investment outlays rose from an average level of \$92 million per annum during the period 1956-60 to \$186 million per annum during the period 1961-5. Slightly more than 60% of total expenditure was allocated to economic development schemes, 36% to social development, and 2% to public administration. The main economic development projects were the establishment of an Economic Development Board to plan and promote industrial development and to provide loan finance to private investors, the development of an industrial estate at Jurong, and the expansion of public authority facilities (particularly in the fields of electricity, water, and port development). The vast social problems posed by rapid population growth were indicated by the high level of capital expenditure required to maintain existing social service standards. Housing, education, sewerage, and health were the main social expenditure heads. The project content of the plan conformed closely to Singapore's needs.

Between 1950 and 1965, the Singapore government raised sufficient revenue to finance its current and capital expenditure. In addition, Singapore's Central Provident Fund provided a growing and dependable source of domestic loan finance. Consequently, the government was able to build up a substantial level of external reserve balances. Since the government did not experience any financial strain over this period, facilities for raising domestic loan finance were not developed. In addition, Singapore did not need to explore the scope for raising external loan finance; at the end of 1965, the external debt amounted to less than 1% of gross domestic product.

Singapore's financial position is currently undergoing considerable change. The massive rise in government expenditure during the period 1963-8 has created substantial budget deficits and has led to a fall in external reserves. How long compensatory government action can be maintained depends on the government's ability to transfer more domestic resources to itself, on its willingness to draw on external reserve balances, and on its ability to raise external loan finance. While there is substantial scope for an increase in the yield of income taxation,

the government's ability to tap this source is conditioned by the Malayan income tax structure and by the need to grant tax incentives for industrialisation. In consequence, Singapore's ability to manipulate its tax structure is limited. Nevertheless it would seem that an increase in privately held domestic public debt would, in any case, offer the most promising means of increasing the government's command over goods and services. Every attempt should be made to develop financial institutions which could effectively tap domestic sources of loanable funds. Similarly, an earnest attempt should be made to explore the scope for raising external loan finance.

Income Taxation: General Considerations

Before 1947, world war was a necessary condition for the introduction of income taxation in Malaya and Singapore, and endeavours to maintain such a tax during periods of peace proved to be abortive. The division of Malaya into several separate political entities militated against the introduction of income taxation on a national basis.

Attempts to impose a tax on income were initiated in the Straits Settlements. Both Singapore and Penang had become increasingly dependent on entrepôt trade by 1910, and official government members¹ realised that the adoption of the Federated Malay States' import and export duty structure would adversely affect the future development of this trade. They therefore favoured the introduction of income taxation as a means of providing revenue which could be used to develop urgently required road, rail, and port facilities.

The first attempt to impose a tax on income in the Straits Settlements occurred in 1910, but powerful opposition from commercial interests led to its demise in 1911. A second attempt, made in 1916, was so extensively redrafted by the Legislative Council that the government preferred to withdraw the bill. After further protracted debates, the Straits Settlements' Legislative Council finally acceded to a tax on income in 1917 as a temporary war measure designed to provide a token contribution to imperial defence expenditure.

No similar tax was imposed in the Federated Malay States or in the several unfederated Malay States. As a result, commercial interests in the Straits Settlements argued that income taxation discriminated against

¹ The term 'official government members' refers to those members of the Legislative Council appointed by the Governor from the civil service. 'Unofficial members' were those appointed to represent business, commercial, and other community interests. Official government members normally voted together and were regarded as 'the government'.

them compared with other people undertaking similar activities on the mainland. In 1920, the government of the Straits Settlements varied the rate of taxation and abrogated the preamble which referred to the temporary nature of the tax. Concern that the tax had been implicitly converted into a permanent imposition heightened, and agitation by powerful commercial interests led to its repeal in 1922.

The issue of income taxation simmered beneath the surface of political activity after 1922 and did not emerge again until the commencement of World War II. Despite intense lobbying in the legislatures, the press, and through other media, a war tax on profits and income was reimposed in the Straits Settlements and introduced for the first time in the Federated Malay States in February 1941. The respective acts had to be renewed each year, and the revenue raised was to be used solely for imperial defence purposes. Because of export tax increases, rubber and tin producers were exempted from the tax. No income tax legislation was enacted in any of the unfederated Malay States. During the ensuing Japanese occupation, the war tax legislation lapsed from the statute books, and the British Military Administration, which took over in 1945, was faced afresh with the vexed issue of income taxation.

The Military Administration shelved a directive from the Colonial Office concerning the introduction of income taxation as a permanent feature of fiscal arrangements. However, the directive assumed greater significance in the hands of the Malayan Union government which was formed during 1946. Following an official report submitted by R. B. Heasman (Malayan Union 1947), an income tax bill was drawn up and presented to the Advisory Council in 1947. In introducing the bill, the Financial Secretary indicated that income taxation was no longer being considered as a temporary measure, but as a suitable basis for taxation policy. Additional revenue was required, but the principal object of the proposal was to achieve a more equitable distribution of the burden of taxation.

Unofficial members of the Advisory Council considerably outnumbered official members, and all but two strongly opposed the bill. The unofficial members, most of whom were Europeans, argued that the tax would bear most heavily on Malaya's major industries, rubber and tin, and that these industries were least able to bear an additional burden since they continued to suffer from the effects of war disruption. In addition, it was contended that the incidence of the tax would be inequitable in that it would vary not only with income but also with the ability to conceal income. The scope for tax evasion was considered to be substantial, and to differ among racial groups, forms of business organisa-

tion, and forms of income receipt. In general, it was argued that the tax would bear most directly on salary and corporate income, and on the European section of the community. Finally, it was considered that bribery and corruption would be enhanced, and that the resulting increase in revenue would merely tempt the government to be unnecessarily extravagant.

'Sectional pressure', Heasman argued, 'by the classes that can and should pay ought not to be allowed to divert the Governments from a course of action which is obviously in the common interest' (Malayan Union 1947: 13). In December 1947, the Governor, by virtue of his power of veto, enacted the proposed Malayan income tax bill. At the same time, similar legislation was enacted in Singapore so that income taxation, imposed at a national level and uniform in all essential features, was jointly introduced into the separate jurisdictions.²

STRUCTURE OF INCOME TAXATION

The Income Tax Ordinances of Malaya and Singapore are similar in all fundamental respects to the tax structure which prevailed in the United Kingdom in 1946. The tax code distinguishes two main groups of taxpayers: individuals and companies. The definition of individual taxpayers includes owners of businesses organised on the basis of single proprietorships and partnerships as well as persons. This group is subject to tax at rates which rise progressively with income. Both public and private companies are subject to a tax on profits levied at a single, proportional rate of 40%. The proportion of the company tax liability which falls on distributed profits is paid by companies but is shifted forward to shareholders, for the legislation provides that dividends should be taxed once only, and should be subject to personal rather than company income tax. To ease administrative problems, a withholding tax is collected on dividend payments at the company level, and adjustments are made at the personal tax level to ensure that the marginal rate of tax paid on dividend income corresponds to the marginal rate of personal income tax appropriate to the particular shareholder in question.³ Under this procedure, individuals are taxed on what they

² See Malayan Union, Income Tax Ordinance 1947, No. 48 of 1947, and Colony of Singapore, Income Tax Ordinance 1947, No. 39 of 1947. Existing constitutional provisions prevent State governments and/or local authorities from introducing separate income tax legislation.

³ A rebate can be claimed if the marginal rate of personal income tax appropriate to the chargeable income (defined to include dividends 'grossed up' at

receive and companies are taxed on what they retain, so that the company tax effectively amounts to a tax on undistributed profits.

In 1958 special legislation was introduced in Malaya to permit relief from tax on profits and on dividends paid out of profits earned by firms which are prepared to undertake the production of a product which is not currently being produced within Malaya on a commercial scale, but for which there are favourable prospects for development to meet domestic and/or export demand, and for which encouragement is considered to be expedient in the public interest (the Pioneer Industry, Relief from Income Tax, Ordinance). Relief was made retrospective to January 1957. Broadly similar legislation was introduced in Singapore in 1959, but no provision was made for retrospective relief. Both Ordinances have been revised since 1965, but the essential character of the legislation has not been altered. The pioneer industry legislation is discussed in detail in Chapter 4.

In response to the substantial rise in the price of tin that occurred in 1964, an additional tax was levied on the profits of Malayan tin producers at a rate of 10% on the profit made in excess of \$100 per picul of tin metal (provided such 'excess' profits exceeded \$10,000). This tax was a temporary measure, and was designed to draw off to the government part of the windfall gains that were accruing to tin producers. The tax was levied on unincorporate as well as on corporate firms.

In 1967, a separate 5% levy was imposed on the profits of all firms (corporate and unincorporate) in Malaya. This levy has been termed a development tax. In contrast to the provisions of the company tax legislation, shareholders cannot take account of that part of the development tax which falls on dividend payments in determining their personal income tax liability.⁴ The levy therefore amounts to a tax on total business profits (distributed as well as undistributed). No similar tax has been imposed in Singapore.

The Income Tax Ordinances implemented in Malaya and Singapore adopted the United Kingdom definition of taxable income in preference to any attempt to develop an all-embracing general definition. The United Kingdom definition consists of an established body of legal and administrative law built around the relevant income tax statutes. The first report of the Malayan Income Tax Department indicated the degree

the company tax rate) of the individual in question is less than the stipulated company tax rate, and vice versa.

⁴ Similarly, owners of unincorporate firms cannot take account of development tax payments in determining their personal income tax liability.

of dependence placed on the United Kingdom tax code when it stated that, where the provisions of the Malayan Ordinance and the United Kingdom Statutes correspond, 'a considerable measure of guidance and assistance [would be derived] from the long series of court decisions on taxation in the United Kingdom' (Federation of Malaya 1950b: 4).

The form of the United Kingdom tax law has been influenced primarily by lawyers interested in clarifying particular rather than general issues. Changes have been incorporated on an *ad hoc* basis, the guiding principle being that the tax is a levy on income as specified in the relevant statutes. While the need to develop a clear definition of income for taxation purposes has been averted, the responsibility for determining whether a particular receipt is or is not taxable depends partly on legal precedent and partly on administrative feasibility. One of the major problems of income taxation considered in the next two chapters concerns the relationship between the interpretation of income for taxation purposes and the aggregate increase in spending power between two points of time.

The Ordinances list six taxable sources of income. The first two sources, which relate to the gains or profits from any trade, business, profession or vocation, and the gains or profits from any employment, are by far the most important.⁵

The tax is applied to a global concept of income. Residents are taxed on income accruing in Malaya and on income arising outside of Malaya, whether that income is remitted to Malaya or not. (Prior to 1968, tax was only levied on that part of income arising outside of Malaya which was remitted back to Malaya.) Non-residents are taxed on income arising in Malaya. The position is identical in Singapore.

A family is considered by the Ordinances to constitute a single spending unit, the income of a taxpayer and his wife being aggregated for taxation purposes. Dependent child income must also be included in the tax return of the head of the household if such income exceeds the value of the corresponding child allowance. There is, however, a

⁵ The remaining sources of taxable income are:

- (a) rents, royalties, premiums, and any other profits arising from property;
- (b) dividends, interest, and discounts;
- (c) pensions and annuities; and
- (d) the net annual value of land and improvements used by the owner for residential purposes. In Malaya, owner-occupied property is exempt from tax but the exemption is restricted to one residence per taxpayer.

provision in the Singapore Ordinance which permits a wife to be assessed separately on her earned income (introduced in 1962).

The unit of time relevant to income taxation is one year; in the case of personal income taxation, a year is taken to be the calendar year. Assessments under all schedules are determined on the basis of the preceding year's income; in the case of personal income taxation, this principle contrasts with the position in many other countries in which the current year's income forms the basis of assessment.

The Ordinances distinguish three concepts of income: statutory income, assessable income, and chargeable income. Statutory income is defined as the aggregate of income from all sources. It includes investment income (interest, dividends, rent, and royalties) as well as earned income. In addition, statutory income includes certain non-monetary as well as monetary sources of gain or profit. Thus the value of food, clothing, or lodging provided or paid for by the employer is subject to tax in the hands of the recipient. Definitional and administrative difficulties, however, limit the effectiveness of such provisions as a means of taxing all forms of fringe benefit.

Certain defined categories of income receipt are expressly excluded from assessment. These include government and certain private transfer payments (for example, the official emoluments of rulers, retirement, injury and death gratuities, and war pensions) and the income of certain institutions, authorities, persons, funds, and private activities which the government desires to assist or encourage (for example, registered trade unions and co-operative societies, approved charitable organisations and friendly societies, approved pension and provident funds, pioneer industries, and specified lines of activity within the *entrepôt* trade). For some categories, all forms of income receipt are exempt; for other categories (registered trade unions, and approved pension and provident funds) investment income alone is exempt, income derived from trade or business activities being subject to taxation.

Statutory income, then, includes all monetary and non-monetary receipts specified by the Ordinances apart from those which are expressly exempt or which are of a capital or non-income nature (for example lottery winnings and other forms of casual receipt).

Assessable income is derived by deducting from statutory income all outgoings and expenses wholly and exclusively incurred in the production of income. Employee remuneration, rent, interest on borrowed capital, repairs and, for most forms of capital expenditure, depreciation, are permissible deductions.

The Ordinances do not apply a strict interpretation of the phrase 'in the production of income' to all forms of expenditure. Initial depreciation allowances and special concessions for certain forms of capital expenditure incurred on plantations and mines are provided to encourage investment rather than to enable a more accurate computation of annual profits. In addition, certain outgoings are deductible even though they do not bear a close relationship to the production of income. These include losses and bad debts incurred in the process of carrying on a trade, business, or profession, donations to public institutions, and contributions made by employers in respect of employees to approved provident and pension funds, provided that the total claim does not exceed 15% of the employee's remuneration. Apart from these allowances, certain deductions are permitted in an endeavour to encourage desired activities. Thus, in Singapore, legislation was introduced in 1967 which permitted firms to deduct a proportion of any increased income which followed fulfilment of certain minimum investment requirements, and a proportion of assessed income derived from export activities. In Malaya, legislation was introduced in 1968 designed to give added encouragement to investment activity (an investment tax credit, which is equivalent to an investment allowance, was introduced, and export firms were permitted to write their capital expenditure off at a considerably accelerated rate), to export activity, and to the use of domestic inputs in the production process. The details of these innovations, together with those of a number of more minor adjustments designed to encourage desired activities, are discussed more fully in Chapter 4.

If, in any year, assessable income is insufficient to permit full effect to be given to permissible deductions, the unclaimed balance may be set off against future income so long as the taxpayer continues in the relevant trade, profession, or business.

Assessable income is the base to which the proportional company tax rate is applied in determining the tax liability of companies. Assessable income is also the tax base for the development tax introduced into Malaya in 1967, but this tax is collected from unincorporate as well as corporate firms. In the case of personal income taxation, additional reliefs are provided in an endeavour to achieve a greater degree of fairness in the distribution of the tax burden as among individuals similarly situated with respect to income but differing in respect of family responsibilities and/or sources of income. While the range of relief is narrowly circumscribed, the value of each relief is substantial and, under a progressive system of taxation, is enhanced as individual income—and therefore marginal tax rates—increases.

Permissible deductions are granted for the taxpayer, his wife,⁶ and a maximum of five dependent children, for earned income, and for contributions to life assurance and approved provident and pension funds. Allowances for life assurance premiums paid is limited to 7% of the capital sum assured and the maximum relief that can be claimed for contributions to life assurance and approved provident and pension funds in any one year of assessment is limited to \$3,000. In contrast to the situation in Australia, the United States, and many other countries, no relief is provided for dependent relatives, and there is no provision made for medical, dental, funeral, or other general expense deductions.

The progressive personal tax rate structure is applied to chargeable income. It is possible that, owing to tax exemptions, tax avoidance, and tax evasion, individuals possessing the same taxable capacity may be assessed differently for taxation purposes. However, the application of the various marginal tax rates to total chargeable income, regardless of the sources from which it is derived, does ensure that individuals with the same chargeable income will be taxed equally. This is certainly more equitable than the schedular system of taxation in force, for example, in Vietnam and Hong Kong, where different marginal tax rates are applied to several enumerated forms of income receipt, with the result that individuals with the same total chargeable income may well bear different tax burdens. A distinction is, however, made in Malaya and Singapore between the tax treatment of earned and unearned income, a measure of relief being granted to the former source of income.

PERFORMANCE OF INCOME TAXATION

Following its introduction in 1947, income taxation has developed into a major source of tax revenue in Malaya and Singapore. In Malaya, domestic income subject to taxation rose from almost 10% in 1950 to 20% in 1965, income tax revenue increased from \$46 million to \$231 million (see Table 9), and the share of income tax in total tax revenue rose from 13% to almost 25% (Table 10). In Singapore, income assessed

⁶ The wife allowance in Singapore is equal to the excess of a prescribed amount (presently \$1,000) over the earned income charged in the wife's own name. In contrast, the wife allowance in Malaya is a fixed amount regardless of her earned income. There is, however, no provision for separate assessment of husband and wife in Malaya, but the taxpayer can claim a further deduction equal to nine-tenths of the wife's earned income or \$500, whichever is the smaller.

for taxation represented 26% of domestic income in 1965, and income tax revenue accounted for 20% of total tax revenue raised.

Personal income amounted to 66% of total income assessed in Malaya in 1964 (the latest year for which detailed statistics were available at the end of 1968, statistics for 1965 being preliminary information), and accounted for 70% of the rise in total assessed income between 1950 and 1964 (Table 14A). Consequently, although the level of assessed corporate income increased over the same period, its share of total assessed income fell from 48% to 34%. Yet, despite the relative importance of personal income, the contribution of individuals to total income tax payable amounted to only 30% in 1964; permissible personal deductions cause a considerable reduction in the value of personal income subject to taxation. The major part of income tax payable is derived from the corporate sector of the economy. The position is broadly similar in Singapore, but the contribution of individuals to total tax payable is higher—individuals contributed 45% in 1964 (Table 14B). This difference is due partly to a higher level of average assessed personal income per taxpayer in Singapore compared with Malaya (\$8,954 as against \$8,728) and partly to a slightly more progressive marginal tax rate structure. Overall, average tax payable per individual taxpayer was \$752 in Singapore compared with \$620 in Malaya (Table 15A and B). Despite the higher contribution of individuals to total tax payable in Singapore, it has been the growth and fluctuations of company income and the periodic increases in the company tax rate that have been the principal determinants of the course of income tax revenue in both Malaya and Singapore.⁷ Since company tax is levied at a flat rate, the course of company tax revenue varies proportionately with the course of company income.

Additional features of income taxation are clarified by analysing both personal and company taxation with respect to the following three questions. First, which sectors of the economy (and which sections of the community) pay income taxation? Second, what factors have accounted for the growth and fluctuations in income tax revenue since 1947? Third, what is the future prospect for income tax revenue assuming no change in marginal tax rates or permissible allowance levels?

Company Income Tax

Sources of Taxable Income. The statistics published by the Income Tax Departments of Malaya and Singapore do not permit an accurate deter-

⁷ The company rate of tax was increased from 20% to 30% in 1951 and to 40% in 1959.

Table 14A Malaya: distribution of assessed income and tax payable
by source, 1952-65
(\$ million)

Item	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
Assessed income (1) ^a	1,026.6	705.6	583.5	585.0	749.4	790.6	754.5	709.5	1,073.2	1,233.1	1,304.3	1,277.6	1,402.6	1,444.3
Individuals	384.1	322.7	299.6	319.1	381.4	425.6	437.4	446.7	690.0	721.9	806.7	803.0	919.4	932.7
Companies	615.9	370.5	278.3	259.5	358.0	355.1	307.3	255.3	374.6	501.6	488.0	464.0	469.4	483.2
Resident	225.5	126.9	101.7	92.7	120.0	141.7	128.0	122.3	171.3	237.0	264.1	321.9	311.5	314.5
Non-resident	390.4	243.6	176.6	166.9	238.0	213.4	179.3	133.0	203.3	264.6	223.9	142.1	157.8	168.7
Trusts, clubs, etc.	26.6	12.4	5.6	6.4	10.0	9.9	9.8	7.5	8.6	9.6	9.6	10.6	13.8	8.4
Assessed income (2) ^a	1,026.6	705.6	583.5	585.0	749.4	790.6	754.5	709.5	1,073.2	1,233.1	1,304.3	1,277.6	1,402.6	1,444.3
Individuals	407.3	346.2	327.0	341.0	421.1	465.8	483.7	481.6	736.8	776.7	873.8	874.7	998.3	1,031.5
Companies	592.7	347.0	250.9	237.6	318.3	314.9	261.0	220.4	327.8	446.8	420.9	392.3	390.5	404.4
Trusts, clubs, etc.	26.6	12.4	5.6	6.4	10.0	9.9	9.8	7.5	8.6	9.6	9.6	10.6	13.8	8.4
Tax payable ^{b,c}	225.0	139.2	104.6	96.9	130.5	132.3	113.8	125.6	186.1	240.6	241.3	232.9	239.3	259.7
Individuals	38.8	27.3	23.4	24.3	32.9	34.9	32.7	32.0	49.8	56.6	64.6	61.3	70.9	83.1
Companies	181.4	109.8	80.0	71.2	95.5	95.5	79.4	92.4	134.6	181.9	174.5	168.8	164.5	174.4
Resident	66.4	37.7	29.2	25.4	32.0	38.1	33.1	44.3	61.5	85.9	94.4	117.1	109.2	113.5
Non-resident	115.0	72.1	50.8	45.8	63.5	57.4	46.3	48.1	73.1	96.0	80.1	51.7	55.3	60.9
Trusts, clubs, etc.	4.8	2.1	1.2	1.4	2.1	1.9	1.7	1.2	1.7	2.1	2.2	2.8	3.9	2.2

Percentage distribution

Assessed income (1)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Individuals	37.4	45.7	51.3	54.5	50.9	53.8	58.0	63.0	64.3	58.5	61.8	62.9	65.5	66.0
Companies	60.0	52.5	47.7	44.4	47.8	44.9	40.7	36.0	34.9	40.7	37.4	36.3	33.5	33.5

Resident	22.0	18.0	17.4	15.8	16.0	17.9	17.0	17.2	16.0	19.2	20.2	25.2	22.2	21.8
Non-resident	38.0	34.5	30.3	28.5	31.8	27.0	23.8	18.7	18.9	21.5	17.2	11.1	11.3	11.7
Trusts, clubs, etc.	2.6	1.7	1.0	1.1	1.3	1.3	1.3	1.0	0.8	0.8	0.7	0.8	1.0	0.6
Assessed income (2)	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Individuals	39.7	49.1	56.0	58.3	56.2	58.9	64.1	67.9	68.7	63.0	67.0	68.5	71.2	71.4
Companies	57.7	49.2	43.0	40.6	42.5	39.8	34.6	31.1	30.5	36.2	32.3	30.7	27.8	28.0
Trusts, clubs, etc.	2.6	1.7	1.0	1.1	1.3	1.3	1.3	1.0	0.8	0.8	0.7	0.8	1.0	0.6
Tax payable	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Individuals	17.2	19.6	22.4	25.1	25.2	26.4	28.7	25.5	26.8	23.5	26.8	26.3	29.6	32.0
Companies	80.6	78.9	76.5	73.5	73.2	72.2	69.8	73.6	72.3	75.6	72.3	72.5	68.7	67.2
Trusts, clubs, etc.	2.1	1.5	1.1	1.4	1.6	1.4	1.5	1.0	0.9	0.9	0.9	1.2	1.6	0.8

^a Dividends represent part of company income but are subject to tax in the hands of recipients. To observe the source of income, dividends should be included in company income and excluded from individual income. The line 'Assessed income (1)' shows this presentation. To observe the source of income tax payable, dividends should be included in individual income and excluded from company income. The line 'Assessed income (2)' shows this presentation. Unfortunately no breakdown is available to indicate the proportion of dividend income distributed by companies (a) to individuals and (b) to other companies. In consequence, it has been assumed that all dividend income is distributed to individuals. This procedure leads to some understatement of individual income (and concomitant overstatement of company income) in the breakdown provided under 'Assessed income (1)', and the reverse in the case of the breakdown provided under 'Assessed income (2)'.

^b The tax collected on dividend income at the company level is a withholding tax, dividends being subject to tax in the hands of recipients. To obtain the figure for tax payable, tax rebates claimed by individuals in respect of tax paid at the company level on dividend income (as shown in Abstract C of States of Malaya 1950-68) has been deducted from company tax payable as shown in Abstract B of States of Malaya 1950-68. Thus, tax payable on dividend income is included once only in the figure for the total tax payable in this table.

^c The figures for income tax payable differ from those for income tax collected as shown in Table 9 for several reasons. First, because the tax is levied on income earned in the preceding year, income tax collection in any one year is related to tax payable in the preceding year. Second, income tax collection in any one year includes arrears collected from preceding years of assessment.

Source: States of Malaya 1950-68: Abstracts B, C, and D.

Table 14B Singapore: distribution of assessed income and tax payable by source, 1952-65
(\$ million)

Item	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965
Assessed income (1) ^a	537.4	468.7	420.1	425.5	510.7	515.1	538.0	506.3	518.8	558.8	620.0	669.1	746.4	794.5
Individuals	236.9	247.0	244.3	256.8	294.2	316.4	337.3	323.0	356.5	355.9	440.5	489.4	563.8	606.7
Companies	294.6	217.8	172.3	165.4	213.2	194.5	196.8	180.3	159.0	198.8	174.9	175.2	177.2	182.2
Resident	220.6	155.8	131.4	131.9	163.3	145.3	147.3	131.9	119.3	151.3	134.6	138.8	141.0	141.2
Non-resident	74.0	62.0	40.9	33.6	49.8	49.2	49.5	48.4	39.7	47.4	40.3	36.4	36.2	41.0
Trusts, clubs, etc.	5.9	3.9	3.5	3.3	3.3	4.2	3.9	3.0	3.3	4.1	4.6	4.5	5.4	5.6
Assessed income (2) ^a	537.4	468.7	420.1	425.5	510.7	515.1	538.0	506.3	518.8	558.8	620.0	669.1	746.4	794.5
Individuals	263.5	276.4	269.8	286.8	337.7	347.2	368.0	360.4	391.3	386.1	473.4	534.4	608.6	663.1
Companies	268.0	188.4	146.8	135.4	169.7	163.7	166.1	142.9	124.2	168.6	142.0	130.2	132.4	125.8
Trusts, clubs, etc.	5.9	3.9	3.5	3.3	3.3	4.2	3.9	3.0	3.3	4.1	4.6	4.5	5.4	5.6
Tax payable ^{b,c}	117.7	92.7	70.6	67.9	82.3	82.0	82.5	98.9	92.2	106.4	101.0	105.0	113.3	119.7
Individuals	28.4	27.1	25.0	25.6	32.2	30.3	30.4	34.2	39.0	35.2	41.0	44.7	51.1	55.6
Companies	88.1	64.8	44.7	41.5	49.3	50.6	51.0	63.7	52.1	69.5	58.2	58.5	60.1	62.2
Resident	66.0	46.3	34.1	33.1	37.8	37.8	38.1	46.6	39.1	52.9	44.8	46.3	47.8	48.2
Non-resident	22.1	18.5	10.6	8.4	11.5	12.8	12.9	17.1	13.0	16.6	13.4	12.2	12.3	14.0
Trusts, clubs, etc.	1.3	0.8	0.9	0.8	0.8	1.1	1.1	1.0	1.1	1.7	1.8	1.8	2.1	1.9

Table 15A Malaya: personal income tax statistics, 1964

Individual taxpayers by residence and race	Number of taxpayers		Assessed income		Assessed tax		Assessed income per head		Assessed tax per head	
	No.	%	\$m.	%	\$m.	%	\$		\$	
Residents	111,404	97.4	984.3	98.6	65.3	92.1	8,835.4		586.2	
Chinese	67,574	59.1	575.2	57.6	36.6	51.6	8,512.1		541.6	
Malay	19,188	16.8	132.2	13.2	4.5	6.4	6,889.7		234.5	
Indian and other	19,285	16.8	158.3	15.9	7.8	11.0	8,208.5		404.5	
Non-Asian	5,357	4.7	118.6	11.9	16.4	23.1	22,139.3		3,061.4	
Non-residents	2,980	2.6	14.0	1.4	5.6	7.9	4,698.0		1,879.2	
Total	114,384	100.0	998.3	100.0	70.9	100.0	8,727.6		619.8	

Source: States of Malaya 1950-68: Abstract B.

Table 15B Singapore: personal income tax statistics, 1964

Individual taxpayers by residence and race	Number of taxpayers		Assessed income		Assessed tax		Assessed income per head		Assessed tax per head	
	No.	%	\$m.	%	\$m.	%	\$		\$	
Residents	65,618	96.5	597.1	98.1	46.5	91.0	9,099.6		768.6	
Chinese	49,088	72.2	405.0	66.5	26.9	52.6	8,250.5		548.0	
Malay	3,095	4.6	21.0	3.5	0.6	1.2	6,785.1		193.9	
Indian and other	9,551	14.0	84.1	13.8	5.2	10.2	8,805.4		544.4	
Non-Asian	3,884	5.7	87.0	14.3	13.8	27.0	22,399.6		3,553.0	
Non-residents	2,354	3.5	11.5	1.9	4.6	9.0	4,885.3		1,954.1	
Total	67,972	100.0	608.6	100.0	51.1	100.0	8,953.7		751.8	

Source: Singapore 1950-68: Abstract B.

mination of the sources of company or personal income assessed for taxation. The information that is available is summarised in Tables 16 and 17. Table 16 shows the allocation of assessed income by activities for a selected number of years in Malaya and in Singapore respectively. Income earned under the first two heads, employment and professional activities, would be subject to personal income taxation. For Malaya, income assessed under these two heads amounted to \$691 million in 1964, which is equivalent to 70% of total income assessed for personal income tax purposes in Malaya in that year. This means that income earned under the remaining head, trading activities, includes some 30% of assessed personal income (consisting of dividend payments made by corporations to individuals and a substantial part of the income of unincorporate firms) as well as the total amount of assessed corporate income.

Table 16A Malaya: allocation of assessed income by activities, selected years^{a,b}

Activity	1955		1958		1961		1964	
	\$m.	%	\$m.	%	\$m.	%	\$m.	%
Employment	225.2	38.5	297.7	39.4	491.8	39.9	661.0	47.1
Government	123.7	21.2	143.7	19.0	226.6	18.4	288.1	20.5
Non-government	101.6	17.4	154.0	20.4	265.2	21.5	372.9	26.6
Professions	12.2	2.1	16.0	2.2	19.8	1.6	30.0	2.1
Trades	347.0	59.4	440.8	58.4	721.5	58.5	711.6	50.7
Rubber planting	122.7	21.0	152.7	20.2	275.5	22.3	160.2	11.4
Other planting	15.0	2.6	11.1	1.5	26.5	2.1	24.8	1.8
Tin mining	85.1	14.6	83.3	11.1	87.0	7.1	122.3	8.7
Other mining	1.1	0.2	11.9	1.6	18.0	1.5	29.2	2.1
Manufacturing	17.7	3.0	31.1	4.1	44.0	3.6	83.7	6.0
Contractors and repairers	6.2	1.1	9.1	1.2	15.4	1.2	34.1	2.4
Commerce	79.0	13.5	113.1	15.0	219.8	17.8	201.0	14.3
Other services	20.2	3.4	28.5	3.8	35.3	2.9	56.2	4.0
Total	584.4	100.0	754.5	100.0	1,233.1	100.0	1,402.6	100.0

Source: States of Malaya 1950-68: Abstract D.

Table 16B Singapore: allocation of assessed income by activities, selected years^{a,b}

Activity	1955		1958		1961		1964	
	\$m.	%	\$m.	%	\$m.	%	\$m.	%
Employment	185.2	43.5	249.4	46.3	277.4	49.6	453.2	60.7
Government	44.6	10.5	53.9	10.0	52.8	9.4	99.2	13.3
Non-government	140.6	33.0	195.5	36.3	224.6	40.2	354.0	47.4
Professions	15.0	3.6	16.6	3.1	13.8	2.5	22.6	3.0
Trades	225.3	52.9	272.0	50.6	267.6	47.9	270.6	36.3
Rubber planting	5.9	1.4	8.8	1.6	10.4	1.9	3.7	0.5
Other planting	0.4	—	0.1	—	0.1	—	1.2	0.2
Tin mining	0.2	—	1.2	0.2	0.8	0.1	2.2	0.3
Other mining	7.7	1.8	3.7	0.7	5.2	0.9	1.1	0.1
Manufacturing	41.5	9.7	54.0	10.0	58.7	10.5	65.8	8.8
Contractors and repairers	6.8	1.6	9.1	1.7	6.6	1.2	12.7	1.7
Commerce	137.4	32.3	160.8	29.9	161.2	28.9	150.2	20.1
Other services	25.4	6.0	34.4	6.4	24.6	4.4	33.7	4.5
Total	425.5	100.0	538.0	100.0	558.8	100.0	746.4	100.0

Source: Singapore 1950-68: Abstract D.

^a To avoid double counting, dividend income, which is shown separately in Abstract D of States of Malaya 1950-68, has been excluded, for this income is already included in trade income.

^b Rent income, which is shown separately in Abstract D of States of Malaya 1950-68, has been included in trade income.

Despite the inability to separate corporate and unincorporate income, it is nevertheless clear that, in Malaya, assessed company income is derived principally from three sources: rubber, tin, and commercial activities. Table 17A shows income derived from trading activities for the period 1950-65. Assessed rubber income has fluctuated widely from year to year but, apart from a slump in 1953 and 1954 following the peak rubber price levels recorded during the Korean War boom, income from rubber consistently accounted for between 35% and 45% of total assessed trading income during the period 1951 to 1961. Since 1961, however, assessed rubber income has fallen substantially despite a significant rise in rubber production, and its share of total assessed trading income amounted to only 23% in 1964. Like rubber, assessed tin income has fluctuated from year to year, but the fluctuations have not been as extreme as those experienced in the case of rubber. Up until 1961, assessed tin income tended to fluctuate in step with assessed rubber

income, thus magnifying the influence of fluctuations on the course of total assessed income derived from trading activities. However, the influence of tin income steadily declined after 1953 as its share of total trading income fell from 31% to less than 7% in 1960. Since 1960, tin income has risen, and it has steadily increased its share of total assessed income derived from trading activities towards 20%. This increase has partly offset the effect of the fall in rubber income on the course of total assessed trading income.

While the share of rubber and tin in total trading income fell from 60% in 1955 to 40% in 1964, there was a steady rise in the share of total trading income derived from manufacturing and commercial activities. Assessed manufacturing income fluctuated marginally around \$20 million during the decade 1951 to 1960, but it has since increased substantially, and amounted to \$84 million in 1964. Abstracting from the abnormal circumstances which surrounded the Korean War period, commercial income (comprising income from finance, commerce, and other service activities) has expanded steadily, and has increased its share of assessed trading income from 29% in 1955 to 36% in 1964. The level of income derived from commercial activities has benefited from the general expansion of domestic activity, particularly since 1960. Nevertheless, it can be said that the course of total assessed trading income in Malaya (and thus, by inference, the course of total assessed company and unincorporate business firm income in Malaya) has been dominated by the fortunes of the rubber and tin industries since the inception of income taxation in 1947.

Resident companies accounted for 80% of all companies subject to tax in Malaya in 1964. However, the average assessed income of non-resident companies far exceeds that of resident companies (\$437,000 compared with \$210,000) so that, although non-resident companies represent only 20% of the total number of companies subject to taxation, their contribution to total company tax payable amounts to almost 34%. Non-resident companies are mostly European owned and controlled. While the majority of resident firms are Chinese concerns, many of the large resident companies are also European owned. Consequently, almost one-half of total company tax revenue is collected from non-Asian taxpayers, the balance being paid principally by the Chinese community. The number of non-resident companies has fallen steadily since 1956, while the number of resident companies has risen substantially. As a result, the share of resident companies in total company tax payable has risen, and this suggests that the share of total company tax paid by

Table 17A Malaya: allocation of income derived from trading activities, 1950-65

Income source	1950	1951	1952	1953	1954	1955	1956	1957
Value (\$m.)								
Rubber planting	54.2	262.1	400.2	158.2	99.4	122.7	214.2	188.3
Other planting	14.5	27.6	28.5	10.2	10.7	15.0	12.2	22.1
Tin mining	53.4	87.9	163.2	153.6	111.7	85.1	95.9	102.3
Other mining	1.9	1.6	12.7	5.2	6.0	1.1	2.9	2.2
Manufacturing	10.5	27.3	30.2	21.9	14.8	17.7	26.1	28.6
Contractors and repairs	2.8	4.4	9.6	10.7	8.6	6.2	6.4	8.0
Finance	14.6	19.1	34.0	27.4	20.1	17.4	22.8	22.9
Commerce	51.9	114.7	123.8	84.9	60.2	61.6	75.6	85.5
Other services	11.2	19.1	28.7	26.9	23.5	20.2	26.9	27.8
Total trading income	215.0	563.8	830.9	499.0	355.0	347.0	483.0	487.7
Percentage distribution								
Rubber planting	25.2	46.5	48.2	31.7	28.0	35.4	44.4	38.6
Other planting	6.8	4.9	3.4	2.0	3.0	4.3	2.5	4.5
Tin mining	24.9	15.6	19.6	30.8	31.5	24.5	19.9	21.0
Other mining	0.9	0.3	1.5	1.0	1.7	0.3	0.6	0.4
Manufacturing	4.9	4.8	3.6	4.4	4.2	5.1	5.4	5.9
Contractors and repairs	1.3	0.8	1.2	2.2	2.4	1.8	1.3	1.6
Finance	6.8	3.4	4.1	5.5	5.7	5.0	4.7	4.7
Commerce	24.1	20.3	14.9	17.0	17.0	17.8	15.6	17.5
Other services	5.2	3.4	3.5	5.4	6.6	5.8	5.7	5.7
Total trading income	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total assessed income	318.9	674.6	1,026.5	705.6	583.5	584.5	749.5	790.6
Total trading income	215.0	563.8	830.9	499.0	355.0	347.0	483.0	487.7
Trading income as per cent of assessed income	67.4	83.6	80.9	70.7	60.8	59.4	64.4	61.7

Table 17A (continued)

Income source	1958	1959	1960	1961	1962	1963	1964	1965
Value (\$m.)								
Rubberplanting	152.7	130.7	230.3	275.5	205.9	262.9	160.2	159.5
Other planting	11.1	19.2	33.3	26.5	16.6	21.9	24.8	10.3
Tin mining	83.3	40.3	39.0	87.0	126.1	133.1	122.3	142.2
Other mining	11.9	17.5	16.8	18.0	16.4	8.6	29.2	49.2
Manufacturing	31.1	13.3	21.2	44.0	50.8	51.1	83.7	75.7
Contractors and repairs	9.1	10.4	13.4	15.4	17.7	23.2	34.1	33.3
Finance	24.8	17.1	17.0	27.9	27.5	30.5	43.5	38.6
Commerce	88.3	104.6	179.5	191.9	220.7	209.5	157.5	170.8
Other services	28.5	22.2	31.4	35.3	42.1	35.3	56.2	45.9
Total trading income	440.8	375.3	581.9	721.5	723.8	776.1	711.5	725.5
Percentage distribution								
Rubber planting	34.6	34.8	39.6	38.2	28.4	24.1	22.5	22.0
Other planting	2.5	5.1	5.7	3.7	2.3	3.2	3.5	1.4
Tin mining	18.9	10.7	6.7	12.1	17.4	19.7	17.2	19.6
Other mining	2.7	4.7	2.9	2.5	2.3	1.3	4.1	6.8
Manufacturing	7.1	3.5	3.6	6.1	7.0	7.6	11.8	10.4
Contractors and repairs	2.1	2.8	2.3	2.1	2.4	3.4	4.8	4.6
Finance	5.6	4.6	2.9	3.9	3.8	4.5	6.1	5.3
Commerce	20.0	27.9	30.9	26.6	30.5	31.0	22.1	23.5
Other services	6.5	5.9	5.4	4.9	5.8	5.2	7.9	6.3
Total trading income	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total assessed income	754.5	709.5	1,073.2	1,233.1	1,304.3	1,277.6	1,402.5	1,444.2
Total trading income	440.8	375.3	581.9	721.5	723.8	776.1	711.5	725.5
Trading income as per cent of assessed income	58.4	52.9	54.2	58.5	55.5	60.7	50.7	50.2

Source: As for Table 16A.

Table 17B Singapore: allocation of assessed income derived from trading activities, 1950-65

Income source	1950	1951	1952	1953	1954	1955	1956	1957
Value (\$m.)								
Rubber planting	1.8	12.2	20.0	7.8	4.7	5.9	12.2	11.1
Other planting	—	0.1	0.2	0.1	0.1	0.4	0.2	0.2
Tin mining	1.5	1.8	4.2	3.2	1.1	0.2	2.5	2.2
Other mining	—	0.9	1.3	1.6	1.7	7.7	3.7	4.8
Manufacturing	26.0	66.2	76.9	43.5	42.6	41.5	48.5	44.1
Contractors and repairs	3.2	4.6	6.6	6.2	9.0	6.8	8.5	7.1
Finance	20.9	39.6	58.7	51.0	38.7	37.8	58.2	54.6
Commerce	85.1	133.9	185.8	145.2	109.1	99.6	122.3	116.8
Other services	15.0	17.9	27.1	31.3	26.7	25.4	30.7	27.9
Total trading income	153.5	277.2	380.8	289.9	233.7	225.4	286.8	268.8
Percentage distribution								
Rubber planting	1.2	4.4	5.3	2.7	2.0	2.6	4.2	4.1
Other planting	—	—	0.1	—	—	0.2	0.1	0.1
Tin mining	1.0	0.6	1.1	1.1	0.5	0.1	0.9	0.8
Other mining	—	0.3	0.3	0.6	0.7	3.4	1.3	1.8
Manufacturing	17.0	23.9	20.2	15.0	18.3	18.5	16.9	16.4
Contractors and repairs	2.1	1.7	1.7	2.1	3.9	3.0	3.0	2.7
Finance	13.6	14.3	15.4	17.6	16.6	16.7	20.3	20.3
Commerce	55.4	48.3	48.8	50.1	46.7	44.2	42.6	43.5
Other services	9.7	6.5	7.1	10.8	11.4	11.3	10.7	10.4
Total trading income	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total assessed income	244.5	394.2	537.3	468.8	420.2	425.6	510.7	515.0
Total trading income	153.5	277.2	380.8	289.9	233.7	225.4	286.8	268.8
Trading income as per cent of assessed income	62.8	70.3	70.9	61.8	55.6	52.9	56.2	52.2

Table 17B (continued)

Income source	1958	1959	1960	1961	1962	1963	1964	1965
Value (\$m.)								
Rubber planting	8.8	7.7	7.8	10.4	6.7	4.9	3.7	3.1
Other planting	0.1	—	—	0.1	0.1	0.1	1.2	0.9
Tin mining	1.2	0.2	0.3	0.8	1.4	1.5	2.2	2.6
Other mining	3.7	2.9	3.1	5.2	2.0	1.0	1.1	1.6
Manufacturing	54.0	47.5	49.5	58.7	55.7	58.8	65.8	70.1
Contractors and repairs	9.1	9.0	8.7	6.6	8.3	10.1	12.7	11.4
Finance	53.4	45.6	43.4	54.5	45.2	42.3	43.8	43.6
Commerce	107.4	91.9	96.8	106.8	110.3	104.5	106.4	96.1
Other services	34.4	29.7	28.3	24.6	31.9	32.4	33.7	31.8
Total trading income	272.1	234.5	237.9	267.6	261.6	255.6	270.6	261.2
Percentage distribution								
Rubber planting	3.2	3.3	3.3	3.9	2.6	1.9	1.4	1.2
Other planting	—	—	—	—	—	—	0.4	0.3
Tin mining	0.5	0.1	0.1	0.3	0.5	0.6	0.8	1.0
Other mining	1.4	1.2	1.3	1.9	0.8	0.4	0.4	0.6
Manufacturing	19.9	20.3	20.8	21.9	21.3	23.0	24.3	26.9
Contractors and repairs	3.3	3.9	3.7	2.5	3.2	3.9	4.7	4.4
Finance	19.6	19.4	18.2	20.4	17.3	16.6	16.2	16.7
Commerce	39.5	39.2	40.7	39.9	42.2	40.9	39.3	36.8
Other services	12.6	12.7	11.9	9.2	12.2	12.7	12.5	12.2
Total trading income	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total assessed income	538.1	506.3	518.8	558.6	620.0	669.2	746.3	794.7
Total trading income	272.1	234.5	237.9	267.6	261.6	255.6	270.6	261.2
Trading income as per cent of assessed income	50.6	46.3	45.9	47.9	42.2	38.2	36.3	32.9

Source: As for Table 16B.

Chinese taxpayers has increased relative to that paid by Europeans since 1956.⁸

In Singapore, commercial income has consistently accounted for 70% of total assessed trading income, reflecting the importance of entrepôt and related service activities (Table 17B). Manufacturing is the only other important source of trading income, and its share of trading income has also remained constant at approximately 20%, though it has risen slightly above this level since 1962. Resident companies accounted for more than 85% of all companies subject to tax in Singapore in 1964 and, in contrast to the situation in Malaya, the average assessed income of non-resident companies does not markedly exceed that of resident companies (\$192,000 compared to \$130,000). Consequently, resident companies accounted for almost 80% of company tax payable. Although some of the larger resident companies in Singapore are subsidiaries of European firms, most are owned and controlled by Chinese businessmen. Considerably more than one-half of total corporate tax payable in Singapore is therefore paid by the Chinese section of the community, the balance being derived principally from non-Asian, non-resident, taxpayers.

Fluctuation and Growth in Company Tax Revenue. In Malaya, company income has been subject to particularly wide annual fluctuations. This has been due to the fluctuating fortunes of the rubber and tin industries which have affected not only income from those sources, but also the level of commercial income. As already indicated, the prosperity of the rubber and tin industries has, on most occasions, fluctuated in the same direction at the same time, thus accentuating the effect on company income and so on company tax revenue. The only significant exception has occurred since 1961 when rising tin income just managed to compensate for a decline in rubber income.

The course of non-resident company income has closely paralleled the course of rubber and tin income. In the case of resident companies, the degree of correlation is high, but less marked; resident company income depends to a larger extent on other sources of income (particularly manufacturing and commercial income). As a result, the income of resident companies has fluctuated less than that of non-resident companies. The increase in the relative importance of resident companies

⁸ Precise evaluation is not possible as no statistics are available on the ownership by race of resident and non-resident companies subject to tax. It should also be emphasised that part of the tax burden may be shifted forward to consumers or backward to factor inputs.

since 1956 has served to dampen the impact of the wide fluctuations in the level of non-resident income on the course of total company tax revenue. Excluding the abnormal Korean War period, the fluctuations in total corporate tax revenue have occurred around a rising trend since 1950.

In Singapore, commercial and manufacturing incomes have fluctuated broadly in step with the fortunes of the natural rubber industry but, compared with Malaya, the fluctuation in total company tax revenue has been less marked. In Malaya, assessed company income rose at an annual average rate of 6% during the decade 1955-64. In Singapore, the annual average growth rate of assessed company income during this period was less than 1%. In consequence, company tax revenue has risen at a faster rate in Malaya (almost 9% per annum during the period 1955-64) than in Singapore (almost 4% per annum over the same period).

Future Prospect for Company Tax Revenue. There is no clear evidence that the degree to which company income is dependent on external circumstances will decline in the future. Some indications, however, point to less severe annual fluctuations. First, income derived from commercial and manufacturing activities has been a more stable source of company income, and the recent increase in the relative importance of these sources should act as a stabilising influence. Second, the range within which rubber prices are expected to fluctuate in the future is much narrower than has been the case in the past. Third, resident company income has increased relative to non-resident company income since 1956, and this change has exercised a dampening effect on the magnitude of fluctuations in the level of company income. There is, however, one important destabilising influence. In response to a price increase, the level of tin income has risen substantially since 1960, and a material change in the fortunes of this industry would significantly affect the course of company tax revenue.

Malaya's company tax revenue has fallen slightly since 1961. The new taxes introduced in 1965 and 1967 (one on windfall tin profits, the other on the total profits of business firms) have increased the level of tax revenue collected from the corporate sector of the economy. Two additional factors suggest that there will continue to be moderate expansion in company tax revenue. First, increases in rubber production after 1965 should be sufficient to offset the effect of additional price falls on total rubber income and contribute towards a steady expansion of income after 1970. Second, income derived from commercial and manufac-

turing activities should expand, partly as a result of positive government encouragement to domestic manufacturing activity and partly because of favourable environmental conditions—a rapid population growth rate, combined with the maintenance of a high level of income per head. A significant fall in the price of tin or restriction on tin production would, however, jeopardise the prospect for expansion at present tax rates and allowance levels.

The factors which will dominate the future course of company tax revenue in Singapore are the prosperity of entrepôt trade and the success of endeavours to expand manufacturing activity. Although direct trading in rubber between Malaya and world markets is expected to increase, the expansion in production, particularly after 1965, should expand the volume exported through Singapore. This expansion should partly offset the effect of a fall in the price of rubber on tax revenue derived from rubber trading. Rubber trading cannot, however, be expected to provide the basis for a significant expansion of corporate tax revenue in Singapore. Manufacturing activity offers the best prospects for growth. The contribution of manufacturing to total assessed corporate income in 1964 amounted to approximately 30%. While a rise in income derived from manufacturing activity can be expected, increased tax concessions to encourage this type of activity may prevent any significant rise in tax payable by this sector. The expansion of manufacturing activity will expand commercial activities, but most commercial income is derived from entrepôt trade. The expected stagnation in the level of entrepôt trade will slow the growth of commercial income and thus tax payable by this sector. In summary, the prospect for an increase in company tax revenue will be limited.

Personal Income Tax

Sources of Taxable Income. Only 4% of the adult population in Malaya and 6% in Singapore were subject to personal income tax in 1964; the coverage of the tax net is extremely narrow. In Malaya, resident taxpayers accounted for 97% of total assessed personal income; a small number of non-residents receive dividend and other income from Malaya (Table 15A). Of total taxpayers in Malaya in 1964, 59% were Chinese, 17% Malays, 17% Indians and other Asians, and 7% resident non-Asians and non-resident taxpayers. In Singapore, 72% were Chinese, 5% Malays, 14% Indians and other Asians, and 9% were resident non-Asians and non-resident taxpayers (Table 15B).

Most non-residents are non-Asians. For both Malaya and Singapore, the average assessed income of non-Asians (defined to include resident

non-Asian and non-resident taxpayers) was almost double that of Asian taxpayers in 1964. Because personal tax rates rise progressively with income, non-Asians are subject to higher marginal and average rates of tax than Asians and, within the Asian community, Chinese pay at a higher rate than either Malays or Indians. Consequently, although non-Asians account for only 7% of all individual taxpayers in Malaya and for little more than 13% of total assessed personal income, their tax liability amounted to 31% of total personal income tax liability in 1964. Chinese taxpayers were responsible for 52%. In Singapore, non-Asians accounted for 9% of total individual taxpayers, for 16% of assessed personal income, and for 36% of total personal income tax liability; Chinese taxpayers were responsible for a further 53%. Thus, in both countries, personal income tax is primarily a levy on non-Asian and Chinese taxpayers. Because of a fall in non-Asian relative to Asian taxpayers, the share of non-Asian income in total assessed income and in personal income tax payable has fallen, particularly since 1956.

Income from employment accounted for 66% of total personal income assessed in Malaya in 1964. Dividends, rent, and interest accounted for a further 12%, so that the income of professional persons, of individual proprietorships, and of partnerships amounted to less than 22% of the total. In Singapore, income from employment accounted for 74% of total assessed personal income, dividends, rent, and interest for 11%, and the income of professional persons, individual proprietorships, and partnerships for only 15% of the total. The administrators of income taxation have succeeded in taxing those sources of income which are readily identifiable and which are easily cross-checked—the income, for example, of government employees and of employees of large business organisations. Despite intensified enforcement measures, evasion (particularly on the part of professional persons, single proprietorships, and partnerships) is still a serious problem; the average assessed income of professional people, for example, is not significantly greater than that of the lower echelons of the public service in Malaya and Singapore.

Fluctuation and Growth in Personal Income Tax Revenue. Apart from the disturbance during the Korean War boom, personal income tax revenue has risen steadily in both Malaya and Singapore since 1950, although there was a sharp increase in the level of collections in 1960 as a result of increased tax rates and reduced allowance levels. During the period 1960–4, assessed personal income rose more rapidly in Singapore than in Malaya (9% per annum in Singapore compared with 6% per annum in Malaya), but personal income tax payable rose more rapidly in Malaya

(7·3% per annum compared to 5·6% per annum). A determined effort to reduce the degree of tax avoidance and tax evasion in Malaya since 1960 largely explains the difference in performance.

Minor fluctuations have occurred in the level of assessed personal income. These fluctuations have been caused by changes in the level of individual proprietorship and partnership income, much of which is derived from or is dependent on rubber and tin activities. Fluctuations have been less pronounced in Singapore because fluctuations in business income (derived mainly from commercial and manufacturing activities) have been less severe.

Future Prospect for Personal Tax Revenue. Assuming constant tax rates and permissible allowance levels, personal income tax revenue should continue to increase steadily as government commitments rise and the private sector expands. Nevertheless, it is unlikely that there will be any significant increase in total income tax revenue (corporate and personal) over the decade 1966–75. While there is considerable scope for an increase in income tax revenue as a result of a reduction in the extent of tax avoidance and evasion, revenue needs may require some adjustment of tax rates and of permissible allowance levels. The number of possible adjustments which may be made is unlimited. There is, however, a need to avoid adjustments which would raise more revenue but at the same time conflict with other objectives of government policy. For this reason, it is necessary to consider adjustments in the light of criteria considered to be important to the future welfare of Malaya and Singapore. Such criteria are suggested in the final section of this chapter.

CRITERIA FOR ADJUSTMENT IN THE STRUCTURE OF INCOME TAXATION

The difficulty of defining income for taxation purposes necessitates a complex tax code. In many countries, the structure of permissible deductions and of tax rates adds to these complexities. In the United Kingdom, personal income is subject to income tax and, beyond a certain exemption level, to surtax. A similar situation prevails in India but, in addition, nominal surcharges are added to both income and super-tax payable, while in Ceylon effective tax rates can be determined only after a surcharge and national development tax have been added to the value of income tax payable. Corporate taxation is no less complex in these countries; taxes on total profits are supplemented by surcharges on undistributed profits and private companies are subject to special levies designed to prevent tax avoidance.

In both Malaya and Singapore, qualified income tax administrators are scarce. First priority should be given to the development of a simple tax code, one which does not involve excessive routine administration, which can be clearly and easily understood by taxpayers, and which avoids the need for complicated provisions to prevent tax avoidance.

Fortunately, the tax structure in both Malaya and Singapore has avoided many of the complications grafted on to the income tax system in other countries. As far as possible, the present simplicity of the tax code should be maintained.

It is generally accepted that the structure of personal income taxation should be influenced by two criteria. First, the tax structure should be adjusted to ensure that individuals similarly situated with respect to capacity to pay should bear similar tax burdens. Second, as among individuals differently situated, it is considered desirable that the tax burden should increase as an individual's capacity to pay increases.

Several factors, however, reduce the need to adjust the personal tax structure in Malaya and Singapore in order to ensure a close approximation to the fulfilment of these criteria. First, personal income taxation accounted for less than 10% of total tax revenue raised in both countries in 1964. A progressive personal income tax structure can at best achieve the fulfilment of the above criteria only with respect to a small part of the total tax burden borne by individuals. The *ad hoc* but largely regressive impact of import and export duties detracts from the need to establish a structure of income tax rates and allowances finely graduated in relation to small increases in income. Second, the determination of which receipts are 'receipts of income', and the valuation of certain receipts, involve considerable conceptual and administrative difficulties. If a receipt represents income in the hands of the recipient but, for conceptual or administrative reasons, is exempt from taxation, a progressive structure of income taxation will only partially achieve fairness in the distribution of the tax burden among individuals. Finally, principles of equity do not provide any guide as to the level and the rate at which the tax burden should increase as capacity to pay increases.

Three principles do, however, seem to be important. First, the personal tax structure should be progressive. This does not imply that the tax structure should be designed to achieve a high degree of equality in the distribution of income. Depending on the expected long-term state of the economy, other considerations, such as the desire to encourage investment activity and to prevent any serious inhibition of personal savings, may have a greater influence on the level of tax rates and permissible allowances. Second, at low levels of income, a measure

of relief should be granted in recognition of differing family responsibilities. As income rises, the need for such relief decreases, and the form of allowances should recognise this tendency. Third, the structure of personal taxation should not place an excessive burden on unincorporate businesses relative to that borne by corporate businesses under company taxation.

Changes in the structure of income taxation will have some effect, direct or indirect, on most economic relationships within the economy. An increase in tax rates, for example, will increase revenue, increase the sensitivity of the tax structure to fluctuations in the level of economic activity, alter the composition of production, and affect the distribution of income. Within the constraints set by requirements for revenue and a fair distribution of the burden of the tax, it is desirable to determine to what extent the tax structure should be manipulated to assist in the achievement of specific economic objectives. Views as to the forms of economic activity which should be fostered differ widely. However, as indicated in the preceding chapters, the most pressing requirement for Malaya and Singapore during the forthcoming decade is the need to encourage enterprise, capital formation, and an expansion of domestic value added. The income tax structure should be designed to assist in the realisation of these goals.

The form of tax incentive used to stimulate investment activity may be direct (accelerated depreciation allowances) or indirect (incentives to savings), and may be applicable to the majority of businesses (depreciation allowances) or to a select few (pioneer industry relief).

Advantage can be taken of direct investment incentives only if a firm undertakes capital investment. In contrast, concessions designed to encourage savings may change the form rather than the level of savings, and cannot guarantee that any increase in savings will be invested productively. The availability of finance does not appear to be a serious restraint on investment activity in either Malaya or Singapore. The retention of low maximum marginal tax rates may well provide sufficient indirect assistance to savings. The tax structure should not discriminate against savings, but tax incentives should be restricted to the direct stimulation of investment activity.

It is often argued that, where there is a possibility of a substantial and continuing rise in the level of unemployment as is the case in Malaya and Singapore, the tax structure should be designed to stimulate labour rather than capital intensive forms of investment. There is no proof, however, that the long-term contribution of capital intensive industries to employment opportunities is less than that which would arise from

an equal stimulation of labour intensive industries. Account must be taken of what Hirschman (1959) has termed 'backward and forward linkage effects'. The possibility of developing industrial complexes (large and small) around a small number of initial firms might be greater if the emphasis in investment policy were placed on capital rather than on labour intensity.

It may be desirable to single out certain forms of investment activity for encouragement. Depreciation allowances can be manipulated to provide such encouragement but, in the granting of such allowances, care should be exercised to ensure that the tax base is not unnecessarily narrowed. Further, given the importance of individual proprietorships and partnerships in Malaya and Singapore, the tax structure should not discriminate excessively between unincorporate and corporate saving and investment activity. Incentives should be available on a broad rather than on a narrow basis.

It may be argued that, where wealth is privately owned and unevenly distributed, continued economic growth combined with low marginal tax rates will accentuate inequality. In a less developed country where endeavours are being made to stimulate economic growth, it is questionable whether the principal goal of the tax structure should be to redistribute wealth. Low tax rates combined with incentives for investment activity will achieve only a modest degree of wealth redistribution, but this combination will assist in stimulating economic activity which will not only raise community income but will permit more attention to be given to redistributive policies in the future.

4

Company Income Taxation

Company taxation is the most important source of income tax revenue in Malaya and Singapore. It is appropriate therefore that attention be directed to an appraisal of this tax first. The discussion has been divided into two parts: the first seeks to determine the form of company tax most appropriate to the requirements of Malaya and Singapore, the second assumes the form of tax to be given and proceeds to analyse specific problems of company taxation. Many of the problems of income taxation are relevant to both personal and company taxation. To avoid duplication, discussion of general aspects such as administration has been deferred to the chapter on personal taxation.

As indicated in the preceding chapter, two taxes are levied on company profits in Malaya. The major tax is that effectively imposed on undistributed profits. Introduced in 1947, this tax is currently levied at a fixed rate of 40% and shall be referred to as the company tax. An additional levy was imposed in 1967 on the total profits (distributed and undistributed) of all firms. This levy has been termed a development tax, and it is currently collected at a fixed rate of 5%. The tax on undistributed profits alone is applicable in Singapore. As in Malaya, this tax is levied at a fixed rate of 40%.

FORM OF COMPANY TAX

Part of the net income of companies may be distributed to shareholders and, as such, will be subject to personal income tax. The central problem of company taxation therefore concerns the tax treatment of undistributed profits. The retention of profits increases corporate wealth and normally produces capital gains (in the form of higher share valuations) which are not taxed in Malaya or Singapore. In this way, undistributed profits tend to increase the income of shareholders. Since the total

profit of an unincorporate firm is subject to personal income tax, it can be argued that the failure to tax undistributed company profits prevents an equitable distribution of the tax burden among individuals receiving income from different sources.

To correct this anomaly, it may be suggested that undistributed company profits should be subject to personal income tax in the same way as the undistributed profits of unincorporate firms. This could be achieved by imputing undistributed company profits to shareholders and by taxing them, like dividends, at the personal income tax rate applicable to each shareholder. However, equity in the distribution of the tax burden among individuals would only be crudely achieved by this approach, for there is no precise relationship between capital gains and undistributed profits. In fact, the United Kingdom Royal Commission on the Taxation of Profits and Income went so far as to argue that the value of securities depends more on dividend payments than on earnings cover: 'the market makes little difference in valuation for differences in the earnings cover of dividends if [this cover is] plainly adequate' (United Kingdom 1955: 17). Moreover, shareholders normally have little direct control over the disposal of undistributed profits. Further, since shareholders do not hold the shares of a particular company indefinitely or buy and sell shares on the day a company finalises its accounts for the year, difficult problems would be encountered in the administration of this method of taxing undistributed company profits. The argument that the retention of profits increases corporate wealth and thereby creates the possibility of capital gain provides a case for a capital gains tax rather than a tax on undistributed profits. There would therefore appear to be no argument based on the principle of achieving equity in the treatment of individuals which would support the maintenance of a close relationship between personal and company taxes. In consequence, several writers (e.g. Kaldor 1956: 94-6, Prest 1960: 329) have argued for the formal separation of the two taxes, so as to permit one to be varied independently of the other as circumstances require.

The complete bifurcation of company and personal taxation would, however, overlook the fact that the line of demarcation between unincorporate firms and private companies, while legally valid, is largely fictitious in economic terms. Thus, if the burden of company tax is lighter than the burden of personal income tax, an incentive exists for conversion of partnerships and individual proprietorships to the corporate form of business organisation. By imposing different burdens on different forms of business organisation, the tax structure would auto-

matically discriminate among firms. In these circumstances, it is difficult to escape the conclusion of the United Kingdom Royal Commission on Taxation that company tax is 'part of the one system and it cannot safely proceed on altogether different principles' (United Kingdom 1955: 127). As far as possible, diversity in the tax treatment of different forms of business organisation should be avoided; the structure of company taxation should be influenced by the structure of personal income taxation, and vice versa. The intimacy of this relationship is based on the principle that the tax system should not influence policy decisions in the private sector of the economy except where such influence is deliberately intended; the tax structure should not accidentally play a key role in determining the form of business organisation.

In choosing an appropriate tax base, a major objective then should be to ensure a close relationship between the tax treatment of corporate and unincorporate firms. Assuming that dividends are to be taxed as personal income and that a given amount of revenue is to be raised by the government from the company sector regardless of the form of tax, company taxation may assume one (or a combination) of the following three forms: (a) a tax on undistributed profits; (b) a tax on distributed profits which cannot be claimed as a deduction from personal tax payable; or (c) a non-refundable tax on total company profits.

A tax on *undistributed* profits permits separate treatment for tax purposes of distributed and undistributed profits; distributed profits are subject to personal income tax, undistributed profits to company tax. A tax on *distributed* profits is equivalent to a double tax on dividend payments; a non-refundable tax is collected at the company level and income tax is paid at the personal level. A tax on *total* profits possesses features similar to a tax on distributed profits except that part of the non-refundable tax falls on retained profits, the proportion depending on the ratio of distributed to undistributed profits. A tax on total profits therefore contains elements of both a distributed and an undistributed profits tax. It is, in effect, a compromise tax.¹

If a tax is placed on total profits (or on distributed profits alone), the effective rate of tax on undistributed profits will vary among companies

¹ Alternative profit measures may be suggested as a better means of assessing a company's ability to pay tax. One such measure would be the rate of return on capital invested. But the administrative problems of determining capital invested as well as net profits argue against such an innovation. Moreover, such a tax would bear most heavily on expanding firms, large or small. Prevailing circumstances in Malaya and Singapore suggest that such firms should be encouraged rather than inhibited.

according to the proportion of profits distributed. In these circumstances, it is possible that the marginal rate of tax paid on undistributed profits will bear little relationship to the personal income tax rate structure, and thus to the tax burden borne by unincorporate firms. If, for example, a 40% tax is levied on total profits, the effective rate of tax on undistributed profits will vary from 200% to 50% depending on whether the firm distributes 80% or 20% of profits.

In contrast, it is possible to integrate a tax on undistributed profits with the structure of personal income taxation for, regardless of the ratio of company profits distributed to shareholders, an undistributed profits tax sets one effective tax rate on retained company profits. If problems of deliberate tax avoidance through the retention of company profits are to be avoided, it would seem necessary to set the undistributed profits tax rate close to the maximum marginal rate of personal income tax. Many countries have been unable to do this, for marginal personal income tax rates rise to between 70% and 80%, with the result that the tax on undistributed profits would have to be inordinately high, and corporate activity would be discouraged. This problem does not, however, arise in Malaya or Singapore, for the maximum personal income tax rate is only 50% (55% in Singapore). Since the rate of undistributed profits tax is 40%, there is already a close relationship between personal and company income taxes and, provided the maximum personal income tax rate is not raised (and suggestions are made in the following chapter which, if implemented, would increase the personal income tax burden without raising the maximum tax rate), it should be possible to maintain this close relationship. A large number of single proprietorships and partnerships are taxed at rates less than the rate of undistributed profits tax, thus granting a concession to such forms of business organisation. But this problem assumes significant dimensions in Malaya and Singapore partly because personal income taxpayers are taxed very lightly, and partly because there is considerable tax evasion on the part of unincorporate firms. Both these problems can be overcome. The former problem, for example, could be corrected by narrowing the income brackets to which different marginal personal income tax rates are applied, and the latter problem is currently being tackled by the Income Tax Departments in both Malaya and Singapore. If these discrepancies were corrected, the extent of the problem arising from the lighter tax treatment of unincorporate relative to corporate firms would be reduced.

The administrative advantages which result from a close relationship between the rate of undistributed profits tax and the maximum rate of

personal tax are considerable. There is no need, for example, to establish a differential between the tax treatment of public and private companies. The conversion of a personally-controlled firm into a private company would not confer any tax benefit on the particular firm, and the difficult administrative problem of ensuring that private companies do not deliberately avoid tax through profit retention—a problem which has assumed significant proportions in many countries—is completely avoided.

The problem of delineating distributed and undistributed profits suggests that an undistributed profits tax may be difficult to administer. If the tax were not accompanied by a withholding tax on dividends, the government would have to rely on individuals to declare dividends for personal income taxation, and would also have to await the convenience of companies concerning the date of distribution of declared dividends. These problems are overcome if, as in Malaya and Singapore, a withholding tax is collected on dividends at the same rate as the undistributed profits tax. A single proportional tax is collected by the government on total company profits, part of which is passed forward by the companies to shareholders when profits are distributed. By taxing dividends at source at a rate which is similar to the maximum rate of personal income taxation, the responsibility is placed on the individual taxpayer to declare dividends and to claim rebates. Undeclared dividends represent a gift of revenue to the government if the rate of personal income tax applicable to shareholders is less than the rate of withholding tax. Compared with other forms of company tax, the administrative simplicity of a single-tier tax on total profits is apparent. There is no need to distinguish between distributed and undistributed profits, and tax is paid on dividends when profits are made. Such a tax also commends itself to taxpayers, as the burden of the tax on undistributed profits is clearly exposed.

It could be argued that, by stipulating a need to retain a close relationship between company and maximum personal tax rates, the government's ability to vary the impact of one tax independently of the other is eliminated. In reference to this issue, Prest contended that 'to deny the State the power to steer the economy in one direction or the other . . . seems an unnecessary restriction' (1960: 330). Three arguments may be advanced against this contention. First, as indicated above, a wide discrepancy between company and maximum personal tax rates will produce a significant degree of discrimination among firms according to the form of business organisation. Second, a reduction in the company tax rate may increase corporate savings, but cannot guarantee the fruitful utilisation of the increase in savings. If the objective of changes in the company tax rate independently of the structure of personal taxation were to

stimulate or retard investment activity, changes in the value of accelerated depreciation allowances may be found to be more effective. Third, the principles which have been suggested as a guide to the structure of income taxation do not rule out the possibility of changes in the company tax burden independently of the structure of personal taxation (and vice versa). Rather, the principles place restraint on the extent of divergence between the company tax rate and the maximum rate of personal taxation—a much more limited issue. As indicated in the following chapter, manipulation of the structure of personal taxation can be achieved by other methods apart from adjusting the maximum marginal tax rate. Similarly, there are other methods of altering the amount of undistributed profits tax collected from the business sector of the economy apart from adjusting the tax rate—business expense deductions may, for example, be narrowed. Moreover, the suggested relationship between personal and company income taxes does not preclude the imposition of additional levies on all firms, corporate and unincorporate. The government of Malaysia followed this course of action when it introduced a tax on business profits in 1967 in order to raise more revenue (the development tax). If the undistributed profits tax alone had been increased, corporate firms would have been discriminated against relative to unincorporate firms. The government realised that, because of considerable tax evasion on the part of unincorporate firms, there was already a significant difference in the tax treatment of the two forms of business organisation, and it did not wish to widen this difference. Yet because it was raising the tax burden borne by individuals in Sabah and Sarawak in order to harmonise the structure of personal income taxation within the Malaysian territories, an increase in personal income tax rates, which would have automatically increased the tax burden borne by unincorporate firms, had to be ruled out. Faced with this predicament, an administratively sensible answer was to impose a non-refundable tax on the total profits of both corporate and unincorporate firms.

In countries which endeavour to attract overseas capital inflow, it may be necessary to adjust the tax structure to ensure that investment in these countries is as attractive as investment in other countries which are competing closely for a share of the total flow of foreign capital. If this requirement is to be satisfied, it may not be possible to maintain a close relationship between the company tax rate and the maximum rate of personal income tax. But, compared with most neighbouring countries, the company tax rate is low in Malaya and Singapore. Moreover, expanding prospects for profitable investment and the continued assur-

ance of political stability appear to be more important than tax considerations in determining the flow of overseas capital to Malaya and to Singapore.

Compared with an equal revenue-raising tax on distributed or on total profits, it may be argued that a tax on undistributed profits would discourage profit retention and that this is an undesirable feature, for retained profits represent a significant source of funds for capital formation.² However, as the United Kingdom Royal Commission on Taxation pointed out, measures designed to expand the availability of finance from internal sources do not necessarily guarantee the investment or the best use of such funds: 'although there is indeed a connection between the feeding of reserves and a flow of fruitful investment, the point of economic importance is not the negative act of refraining from distribution but the positive act of the creation of new assets' (United Kingdom 1955: 25). If reserves exceed requirements, an incentive may be provided for wasteful forms of expenditure. This problem is intensified in Malaya and Singapore because of the limited effectiveness of the capital market in relation to the economy as a whole. Moreover, if such reserves were accumulated by subsidiaries or branches of foreign parent companies, a strong incentive may be given to their remittance overseas.

There is, however, no clear evidence that the present tax on undistributed profits has seriously discouraged profit retention by firms in Malaya or Singapore. Dividend and interest payments amounted to less than 17% of corporate sector profits assessed for income tax purposes in Malaya in 1964 (25% in Singapore), so that the proportion of profits retained for reinvestment or for other purposes (including remittance overseas) is high. It would seem that the problem of ensuring that a high proportion of retained profits is constantly reinvested in Malaya and Singapore is a more pressing issue than that of attempting to raise the ratio of retained to total corporate profits. It is concluded, then, that there is no reason for changing the present structure of company taxation.

² Assuming in each case that tax paid is not fully passed on to the market; that is the tax payment is absorbed to the same extent by profits regardless of the form of company tax. There does not seem to be any reason why, if market conditions permit, any tax on corporate activity cannot be passed backwards or forwards to the same extent.

PROBLEMS OF COMPANY TAXATION

Apart from the question of the form and rate of company taxation, two further aspects deserve attention. The first concerns problems involved in the determination of taxable income and the second the question of pioneer industry tax relief. The first issue is best approached by separating the analysis of allowances for depreciation from the analysis of other deductions permitted in the determination of taxable company income.

*Determination of Taxable Income**Tax Treatment of Business Expenses*

The definition of permissible deductions for business expenses in Malaya and Singapore differs in two respects from its United Kingdom counterpart. First, the United Kingdom Income Tax Act allows any expenses 'wholly and exclusively laid out or expended *for the purposes of* the business (United Kingdom 1965: Section 137).³ In Malaya and Singapore, the Income Tax Ordinances state that 'there shall be deducted all outgoings and expenses wholly and exclusively incurred during [the relevant] period . . . in the production of the income' (Malaysia 1966 and Singapore 1965: Part IV, Section 14[i]). The difference in wording amounts to a significant legal difference in the determination of expenses which qualify as permissible deductions. The phrase 'for the purposes of' may be interpreted to cover expenses not only incurred in the production of income during the relevant period (as is the case in Malaya and Singapore), but also expenses associated with maintaining and improving the earning power of a business. The definition of permissible business expense deductions is therefore much narrower in Malaya and Singapore.

Second, in contrast to the treatment of business firms, British legislation permits individual taxpayers to deduct only expenses incurred in the production of income. The same expenses clause, however, is applied to both individuals and business firms in Malaya and Singapore. A literal interpretation of this clause would reduce the importance of one of the basic tax problems of expense allowances—the more generous treatment of business relative to personal expenses. However, in practical application, the Income Tax Departments of Malaya and Singapore have chosen to follow British precedent in respect of the determination of permissible

³ The relevant clause is stated negatively and reads, 'any disbursements or expenses, not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation'.

business expenses, so that the tax code has inherited the injustice which exists in the United Kingdom in the treatment of taxpayers similarly situated with respect to income, but differing in respect of sources of income.

One way of eliminating this injustice would be to broaden the definition of expenses which may be offset against the income of individuals so as to include expenses incurred in the maintenance and improvement of earning capacity. This approach would, however, lead to a serious erosion of the income tax base, for a wide range of personal expenditures could be construed as necessary for maintaining or improving earning capacity—expenditure on food, clothing, and housing, for example.

A second possibility would be to narrow the broad administrative interpretation presently placed on the definition of expenses allowed as business deductions. But, given the desire to encourage private enterprise in Malaya and Singapore, it would seem that expenditure on maintaining and improving the earning power of firms as well as expenses incurred in the production of current income should be deductible.

A third possibility would be to allow deductions in full for expenses directly incurred in the production of income (wages, salaries, raw material costs, maintenance expenditures, capital depreciation, and transport costs) and in part (say 50%) for other expenses (fringe benefits provided to directors and employees, domestic advertising expenditure and a host of miscellaneous deduction claims). This possibility would not eliminate inequity in the treatment of taxpayers, but it would reduce excessive abuse of the more liberal deduction provisions extended to business firms. By increasing the relative cost of expenditures not directly incurred in the production of income, the system would stimulate the production of physical output and reduce the extent of distortion in the allocation of resources due to excessive expenditure on fringe benefits for directors, employees, etc. Further, this approach does not suffer from the defect of completely disallowing a concession for certain expenses which, even though only indirectly related to the production of income, qualify at least in part as a charge to be set against gross income in the determination of taxable income. Moreover, this method of treating business expenses can be manipulated to encourage expenditure on desired activities (for example, expenditure on research, on the marketing of new products, or on overseas market development).

Tax Treatment of Capital Expenditures

(a) *Present Position.* The existing provisions for capital deductions in Malaya and Singapore appear to be complex, but a description of the

structure can be simplified by considering separately allowances for the purchase of new assets, allowances for the purchase of second-hand assets, and finally special investment provisions. In respect of these latter provisions, the position in Malaya and Singapore will be considered separately.

An initial allowance is given for industrial buildings, plant, and machinery in the year in which such assets are acquired. In the case of industrial buildings, the allowance is equal to 10% of original cost, and in the case of plant and machinery, 20%. An annual allowance is also given in the year in which the capital expenditure is incurred, and for each subsequent year until the whole cost of the asset is written off. In the case of industrial buildings, the annual allowance is equal to 2% of the original cost net of the initial allowance claimed. For machinery and plant, the annual allowance rate varies with the nature of the equipment, and it is applied on a reducing balance basis to the net value of capital equipment (that is original cost less initial and annual depreciation allowances claimed). Unabsorbed allowances may be carried forward indefinitely. No deductions, however, are provided for non-industrial buildings. When an asset is sold or scrapped, a balancing allowance is granted if the sale price is below the original cost of the asset as reduced by initial and annual allowances claimed. If the sale price exceeds the expenditure so reduced, a balancing charge is added to the vendor's income for taxation purposes. But the balancing charge cannot exceed the total value of capital deductions claimed.

On purchasing second-hand plant and machinery, initial and annual allowances may be claimed, the allowances being calculated by reference to the purchase price. The allowance rates are identical to those ruling for the purchase of new assets. No initial allowance, however, is granted for the purchase of second-hand industrial buildings, and annual deductions for such buildings continue to be based on the original rather than on the second-hand purchase price.

In Malaya, special investment allowances are extended to plantation and mining activities, and to commercial projects which the government wishes to encourage.

With respect to plantations, expenditure on replanting is deductible in the period in which it is incurred, expenditure on new planting may be written off at a rate of 50% per annum, and expenditure on the construction of buildings on plantations is deductible at a rate of 10% per annum. In the latter two cases, the reducing balance method of depreciation is used.

With respect to mining, expenditure associated with abortive prospecting may be claimed as a deduction in the year in which it is incurred, and an initial allowance equal to 60% may be claimed for other capital expenditure. Expenditure on acquiring deposits and on any works which will have little or no value when mining ceases may be written off at a rate determined by dividing the expenditure by the number of years the deposits are expected to last. Similar balancing charges and allowances apply in the case of plantation and mining activities as for other activities.

Special legislation introduced in 1958 provided relief from income tax for profits earned by approved pioneer firms. Although the period of tax relief varied according to the size of the capital outlay incurred by the pioneer firm, this concession did not introduce any change in the tax treatment of capital expenditures. For this reason, pioneer industry tax relief is considered separately below. More recently, however, the pioneer industry legislation has stimulated an important change in the tax treatment of capital expenditures in Malaya. The only firms able to take advantage of the pioneer industry legislation were newly established firms producing goods which were not hitherto produced on a suitable commercial scale in Malaya, but for which there were favourable prospects for development. It was increasingly realised that many existing firms undertook the production of new goods and that, in any case, expansion of existing lines of production may well be in the national interest. In consequence, investment tax credit provisions were introduced in 1968. The credit is to be granted at a rate of 25% calculated by reference to the capital expenditure incurred on factories, plant and/or machinery for an approved project. The relief is to be granted only to firms which are unable to take advantage of pioneer industry relief and, like pioneer industry relief, is restricted to corporate firms. In addition to the 25% investment tax credit, a further 5% can be claimed if the company sets up its factory in an area specified by the government as a 'development area', a further 5% if it produces a priority product, and a further 5% (making 40% altogether) if it incorporates a specified percentage of Malaysian inputs in its end product. Unlike the other capital expenditure provisions discussed above, there is a time limit on the period that a company can take advantage of the tax credit provisions—from the date of initial application for a tax credit, advantage can be taken of the relevant provisions for five consecutive years. Provision has, however, been made for the carry forward of any unabsorbed part of the investment tax credit eligible to a firm.

Finally, under new investment incentive provisions introduced in 1968, companies which are exporting 20% or more of the value of their

total production will be permitted to write off capital expenditure incurred to acquire plant and machinery to modernise production techniques at a rate of 40% per annum. This allowance cannot be claimed by exporters of primary commodities, by non-resident firms (firms the control and management of which is exercised outside of Malaysia), by companies enjoying pioneer status or taking advantage of the investment tax credit provisions, or by unincorporate firms.

In Singapore, several adjustments have been made since 1959 to encourage investment activity. First, special legislation was introduced in 1959 to permit a tax credit to be claimed for capital expenditure of not less than \$10,000 incurred for the manufacture of any 'approved' product by an enterprise designated as an 'approved' enterprise. The tax credit was to be given for five years, and was to be calculated by reference to the original capital outlay at the following rates:

<i>Value of New Capital Expenditure</i>	<i>Investment Allowances</i>
\$	%
10,000-19,999	11
20,000-29,999	12
30,000-39,999	13
40,000-49,999	14
50,000 or above	15

This legislation, inspired by increased competition between Malaya and Singapore in the field of industrial development, was designed to encourage firms to expand in Singapore rather than establish branch plants in Malaya. Because of administrative difficulties, the legislation is not, as yet, effective.

Second, legislation was introduced in 1966 to permit key industries (particularly export-oriented industries) to write off expenditure on plant and equipment within three years and, in special cases, within one year.

Finally, new legislation was introduced in 1967 to exempt from taxation part of the profits derived from the use of an expanded capital stock, provided that the expenditure on new capital equipment exceeds \$100,000 and amounts to 30% or more of the original cost value of all of the productive equipment of the company prior to the expansion (this latter provision not applying if new capital expenditure exceeds \$1 million).⁴

⁴ Expenditure on second-hand equipment can be included in the capital expenditure base provided it can be shown that the purchase of such equipment is economically justifiable, and provided it can be shown that the purchase price represents a fair open market price.

Advantage can be taken of this concession only to the extent that the income of the firm increases following the expansion, and the amount of such increased income exempt from tax is restricted to the ratio that the new capital expenditure bears to the cost value of the productive equipment of the firm after the expansion. The exemption can be claimed for three years if the capital expenditure is less than \$250,000, and for five years if it exceeds this figure.

(b) *Justification for Capital Deductions.* Capital deductions may be justified as allowances for depreciation over time in the value of assets used in the production of income. The annual allowance, for example, takes account of depreciation through wear and tear; balancing allowances provide compensation for depreciation through obsolescence. But the granting of incentive capital allowances to stimulate investment activity distorts the relationship between capital deductions for taxation purposes and depreciation in an accounting sense. Since incentive capital allowances are not designed to facilitate a more accurate determination of taxable income, the justification for such allowances must rest on the desire to negate the adverse effect of income taxation on business investment activity. Accepting this justification, the problem is to determine the form of incentive capital allowance most appropriate to the requirements of Malaya and Singapore.

(c) *Form of Capital Deductions.* Two forms of incentive capital allowance may be distinguished. The first relates to deductions which postpone but do not relieve businesses of tax liability. This form of an incentive capital deduction is referred to as an *accelerated depreciation allowance*. It may assume one of two basic forms—an initial allowance combined with annual allowances, or accelerated annual allowances. Under the first approach, an initial allowance is given in addition to the annual allowance in the year of asset acquisition, the annual allowance in the following years being based on the cost of the asset written down by all capital deductions claimed (initial and annual) so that the total possible allowance is restricted to the purchase price of the asset. The central feature of initial allowances is that they alter the distribution of capital deductions through time by increasing the amount which may be claimed in the year of asset acquisition. Until 1968, this was the main form of incentive capital allowance provided by the Income Tax Ordinances of Malaya and Singapore. Under the second approach, the annual allowance is raised so that the asset is written off for tax purposes well in advance of its potential economic life. (The normal non-accelerated annual depreciation allowance for various types of assets is listed in the respective

Income Tax Ordinances, and the rate for each type of asset is set so that the asset is written off over the period that is considered to broadly correspond to the asset's potential economic life.) The new concession introduced in Malaya in 1968 which permits approved export firms to write part of their capital expenditure off for tax purposes at a rate of 40% per annum (so that, after five years, more than 90% of the value of such capital expenditures has been written off) is an example of accelerated annual allowance provisions. An extreme example of the accelerated annual allowance is where firms are permitted to write capital outlays off for tax purposes in the year of acquisition. The adjustment to the Singapore Income Tax Ordinance in 1966 opened the way for such a concession to be granted to firms based in Singapore in certain instances.

The second form of incentive capital allowance consists of deductions which involve a form of outright subsidy; tax revenue is not postponed, but forgone. This form of subsidy is termed an *investment allowance*. Unlike initial allowances, investment allowances are not taken into account in computing subsequent annual allowances, or in calculating balancing charges or allowances on the disposal of an asset. In effect, more than 100% of the purchase price of an asset may be written off over the life of the asset. The Singapore amendment which permits a firm to claim part of any increased income following an expansion of its capital stock as a deduction in determining taxable income is a form of investment allowance—this relief can be claimed in addition to initial and annual depreciation allowances. Similarly, since company tax is levied at a fixed rate in Malaya, the investment tax credit introduced in 1968 amounts to an investment allowance.

There are two fundamental characteristics of accelerated depreciation allowances and investment allowances. First, by increasing the proportion of capital expenditure which may be claimed in the year of acquisition, they reduce the degree of risk associated with investment activity. Second, the allowances increase the liquidity of businesses at the time of acquiring capital assets. The concessions therefore have a beneficial effect on two of the main determinants of investment decisions; risk and liquidity. The incentive provided to investment activity is greater the higher are income tax rates, and the lower is the degree of tax shifting, tax avoidance, and tax evasion. The firms which benefit from incentive capital allowances are, of course, those which are investing and, in particular, those which are rapidly expanding their capital stock. Firms that utilise a high ratio of fixed to inventory capital have the potential to gain more than firms that use a lower ratio; that is industrial enter-

prises generally benefit more than commercial enterprises. In addition, the allowances tend to favour firms which earn a low rate of return on capital relative to firms which earn a higher return; assuming that two firms are identical in all respects except with regard to the rate of return on capital, the allowances will exempt the same absolute amount of profits from taxation in both cases and thus favour the low-profit-rate firm relatively more than the high-profit-rate firm. Finally, by reducing the risk of investment activity, the allowances assist the more venture-some firm.

Not all of the forms of encouragement provided by incentive capital allowances may be judged to be desirable, but the principal attribute of the allowances is that they increase the attractiveness of investment activity. The economic performance of Malaya and Singapore in the past decade indicates that the opportunities for sound investment activity are substantial, and every attempt should be made to exploit these opportunities. The tax structure could be adapted in several other ways to provide an incentive for investment activity. Tax rates, for example, could be reduced or, if the value of money is falling, the basis of depreciation allowances may be changed from original cost to current replacement value. Both approaches facilitate an increase in investible funds; they do not, however, ensure the investment of such funds. Moreover, a tax rate reduction would extend a concession to past as well as to new investment. If the object of the concession is to stimulate investment activity, there is no need to grant a concession for past investment and, to the extent that this is done, part of the aggregate value of the concession is wasted. The advantage of incentive capital allowances is that an increase in liquidity is dependent on the initial act of investing. By combining company taxes with incentive capital allowances, resources are transferred from firms with a low ratio of investment to profits to firms with a higher ratio. Stimulus is therefore given to a form of activity which should be given maximum encouragement in Malaya and Singapore at the present moment.

Investment allowances suffer two shortcomings compared with accelerated depreciation allowances. First, they grant a permanent reduction in tax liabilities to any firm which invests. The retention of tax relief is not dependent on continuous reinvestment.

Second, investment allowances involve the payment by the government of subsidies to a selected group of taxpayers. In consequence, the tax base is narrowed and the tax burden borne by other taxpayers may have to be increased or the value of concessions granted in other directions reduced. The justification for the granting of investment subsidies must

be established on the basis that the nation can afford such concessions, and that subsidies would be more beneficial in terms of the long-run national interest than alternative concessions. Neither of these arguments can easily be substantiated. The present state of government finances in both Malaya and Singapore is not sufficiently buoyant to justify the granting of outright subsidies to all firms which undertake investment activity. While not as generous, accelerated depreciation allowances achieve results broadly similar to investment allowances and possess the added advantage that tax revenue is not forgone; tax payments can be perpetually postponed only by firms which continue to invest. It is considered that the present combination of initial and annual allowances can be adapted to provide sufficient stimulus to investment activity.

(d) *Suggestions for Change.* Both the Malayan and Singapore governments are determined to increase the contribution of manufacturing activities to national product and to export earnings. Income tax relief is but one of several methods being used by the respective governments to achieve this objective. Pioneer industry tax relief represents one of the major forms of income tax relief. Incentive capital deductions represent another major form of income tax relief. The purpose of this section is to consider whether any amendments need be made to the existing structure of permissible capital deductions.

Following the argument of the preceding section, it would seem to be more difficult to justify investment allowances than it is to justify accelerated depreciation allowances—one involves a permanent sacrifice of revenue, the other a delay in the collection of due revenue. For this reason, it is considered that thought should be given to the replacement of the investment tax credit recently introduced into Malaya by accelerated depreciation allowances. Three suggestions are made. First, it is suggested that the initial allowance for plant and machinery should be raised from 20% to 40%, and for industrial buildings from 10% to 20%. Since this change would represent a substantial rise in permissible depreciation deductions, it is suggested that no annual depreciation allowance should be permitted in the year of asset acquisition. If these adjustments were introduced, there would appear to be no need to continue to grant separate depreciation allowances for replanting activities.

Second, for firms which, after operating their new equipment for two years, add a certain minimum percentage (say 40%) to the free market value of their purchased inputs of raw materials and of intermediate-use goods, it is suggested that the annual allowance for plant and machinery

(which would be claimed for the first time in the second year of operation) should be set at 40%, and for buildings at 20%. In effect, such firms would be able to write their fixed capital expenditure off for tax purposes at a constant, but vastly accelerated, rate. The same concession could be claimed in ensuing years, provided that the firm continued to add at least 40% to the free market value of its purchased inputs of raw materials and of intermediate-use goods. If the firm failed to maintain this value added percentage in any one year, then the depreciation claim for that year would fall back to the non-accelerated annual depreciation level which would otherwise be applicable. This concession would be available to corporate and unincorporate firms.

Third, the provision of accelerated annual depreciation allowances should be made more freely available to newly established firms. Thus it may be provided that such firms could claim an annual allowance of 40% for plant and machinery and 20% for buildings if, during their second year of operation, they managed to add, say, 20% to the free market value of their purchased inputs of raw materials and of intermediate-use goods. Accelerated annual depreciation allowances would be available to such firms in ensuing years, but the value added requirement may, perhaps, be raised by five percentage points each year so that, at the end of the sixth year of operation, such firms would be treated in the same way as other, well established, firms.

Under the present investment tax credit provisions in Malaya, a company can claim additional tax credit over and above the minimum 25% level if it sets up a factory in a declared 'development area' (5%), if it produces priority products (a further 5%), and if it incorporates a minimum percentage of Malaysian content in its final product (a further 5%). The Malaysian Federal and State governments have spent a substantial amount of their limited resources on the development of industrial estates. If, in addition, tax incentives have to be offered to encourage entrepreneurs to locate in these estates, it may be time to question the principles behind the planning and location of these estates. The concession for producing priority products raises the thorny issue of determining precisely what is and what is not a priority product. Finally, given the desire to increase the domestic demand for locally-produced raw materials and intermediate-use goods, it would seem more appropriate to relate any tax credit to the share of Malaysian inputs in the final sale value of the firm's output rather than to past capital outlays. This is the type of action the government may wish to encourage permanently; relating the concession to capital outlays would give only a temporary incentive.

The advantages of the proposed forms of relief are fivefold. First, relief would be available to all firms—corporate and unincorporate. Second, the form of relief is standardised—the administrative decisions involved in determining whether a firm qualifies for relief or not would be minimal. Third, the proposals would not only stimulate investment activity, but would also encourage firms to increase the share of domestic value added in their final product. Fourth, compared with investment tax credits, the more venturesome firms would receive less encouragement as would firms which earn a low rate of return on capital. These are the firms which are likely to need further government assistance when they have exhausted their capital deduction allowances. Decisions which involve substantial capital outlays relative to the resources of a firm require careful evaluation in terms of the long-term prospects of the particular business. Accelerated depreciation allowances may not avoid the need for the granting of additional concessions by way, for example, of tariff protection when the claim period has finished but, in a large measure, they do avoid the problem of granting incentives to speculative firms which merely seek to take advantage of the period of tax relief. Fifth, it is possible to extend special treatment to newly-established firms. As an incidental by-product the provisions may encourage firms to declare more fully the value of their gross sales, for concessionary treatment beyond the year of asset acquisition is tied to domestic value added. So far as the collection of due revenue is concerned, an incentive which encourages firms to make a more complete declaration of sales value is worthwhile, since obtaining this information has been one of the major problems of tax collection in Malaya and Singapore.

If accelerated depreciation allowance rates were increased, a determined effort should be made to avoid varying the allowance rates with fluctuations in the state of the economy. A decline in the level of activity due, for example, to external factors such as a fall in the price of rubber, would affect decisions to invest. In addition, such a recession would adversely affect the state of government finances. Hence an incentive would be provided for a reduction in the value of accelerated depreciation allowances to ease the impact of the recession on government finances. In circumstances where investment is essential to the future health of the economy, it is debatable whether a downward revision of expectations should be intensified by a reduction in the rate at which accelerated depreciation allowances are granted. The allowances should be designed to provide a stimulus to long-term rather than to short-term expansion.

Allowances for the depreciation of plant and machinery are based on the purchase price of such equipment. Depreciation allowances are

therefore provided in full to the person who undertakes the risk of operating the equipment. This is an admirable arrangement, and the same incentives should be extended to the purchaser of second-hand industrial buildings. There is no valid reason for a distinction between the tax treatment of machinery and plant on the one hand, and industrial buildings on the other. If industrial development is to be encouraged, a similar incentive should be provided for both forms of investment activity, as one is complementary to the other.

If depreciation allowances are based on purchase price, it follows that the seller should be taxed on the full excess of the sale price over the purchase price as reduced by depreciation deductions claimed by him. The current practice is to restrict the balancing charge to the value of depreciation deductions claimed by the vendor; any excess is considered to be a capital gain and is ignored for taxation purposes. There is no separate tax on capital gains in Malaya or Singapore, but some forms of capital gain are subject to income taxation. Effect should be given to proposals which extend this form of coverage without adding significantly to administrative problems. The subjection to income taxation of the full excess of the sale price over the tax depreciated purchase price of assets would reduce administrative problems by eliminating the incentive to sell assets at fictitious prices in order to achieve capital gains for the seller and higher depreciation allowances for the purchaser, and would reduce an element of subsidy in the tax system which does not contribute to the stimulation of desired activities—there is no need to provide a tax concession to persons who sell second-hand equipment.

Considerations of equity in the distribution of the tax burden among individuals deriving income from different forms of activity favour an extension of capital deduction provisions to commercial and other non-industrial buildings. If it is considered that there is no need to encourage such forms of activity, then no case can be made for granting accelerated depreciation allowances. There is, however, an *a priori* case in favour of granting annual allowances even though the rate of depreciation may be nominal (say 2% per annum). It may be argued that many non-industrial buildings appreciate rather than depreciate in value. In the preceding paragraph it was argued that, on the sale of building and equipment subject to depreciation provisions, the balancing charge should not be restricted to the aggregate value of depreciation allowances claimed by the vendor. In effect, the vendor would be subject to tax on the full value of capital gains accumulated between the date of purchase and the sale of any particular asset. The capital appreciation of buildings, particularly in urban areas, argues in favour of the taxation of such gains.

The rates at which annual depreciation allowances may be claimed vary by industry, and have remained unaltered since 1948. Compared with the industrial classification currently used by the Department of Statistics, the income tax classification is most inadequate. The real issue, however, is whether it is necessary to differentiate the allowances by industry. It is considered that fairness in the treatment of different industries and administrative simplicity would be facilitated if the basis of allowances were converted from an 'industrial' to an 'expected life of machinery' classification.

To encourage the more intensive use of capital equipment, firms undertaking multiple shift operations should be permitted to write capital expenditure off at a faster rate; for such firms, the annual depreciation allowance rate may, for example, be set at 200% of the normal non-accelerated rate. This concession would be granted in addition to any other accelerated depreciation claims the firm may be making, but the aggregate allowance for depreciation claims in respect of any single asset would be limited to the purchase price of that asset.

Finally, several difficult administrative problems surround the moribund Singapore Industrial Expansion (Relief from Income Tax) Ordinance of 1959. A high degree of discretion is involved in determining 'approved products', 'approved industries', and the respective subsidy levels. If the suggestions made in the preceding paragraphs were adopted, it would seem reasonable to bring Singapore's allowances for capital expenditure into line with Malaya's.

Pioneer Industry Relief

It is appropriate at this stage to consider the form of relief granted to pioneer industries in Malaya and Singapore in order to determine, first, the extent to which the basis of relief is in need of revision and, second, the form that such relief could assume. Pioneer industry relief was introduced in Malaya in 1958 to encourage the establishment and development of manufacturing companies (the Ordinance was revised in 1968 to cover the encouragement and development of any commercial company). Pioneer status is granted at the discretion of the Minister of Commerce and Industry to companies which are prepared to undertake the production of a good (or of a series of goods) which is (are) not currently being produced within Malaya on a commercial scale, but for which there are favourable prospects for development to meet domestic and/or export demand, and for which encouragement is considered to be expedient in terms of the public interest. Relief initially assumed the

form of a remission of tax on profits and on dividends paid out of profits for a period of two years.⁵ The period of tax relief was extended to three years if fixed capital expenditure undertaken up to the end of the first two years after the day at which the factory commenced to produce in marketable quantities amounted to not less than \$100,000, and to five years if, after three years, such expenditure amounted to not less than \$250,000. Fixed capital expenditure was defined as expenditure incurred by the pioneer enterprise on its factory, and on any plant and machinery used in connection with the production of the pioneer product. At the end of the pioneer period, initial and annual allowances could be claimed on the total value of fixed capital expenditure incurred to that date.

In 1965, the fixed capital expenditure prerequisites were revised upwards, for it was recognised that the previous provisions were so low that almost all firms qualified for the maximum period of relief. Thus it was provided that no tax would be levied on profits or on dividends paid out of profits earned:⁶

(a) in the first two years after the day at which a factory granted pioneer industry status commenced to produce in marketable quantities if fixed capital expenditure was not less than \$250,000;

(b) in the first three years if fixed capital expenditure incurred in the first three years was not less than \$500,000; and

(c) in the first five years if fixed capital expenditure in the first three years was not less than \$1,000,000.

In addition, it was provided that pioneer companies would be exempted from the payroll tax introduced in 1965.

Further revisions were effected in 1968. It is now provided that no tax would be levied on profits or on dividends paid out of profits earned:⁷

(a) in the first two years (a reversal back to the no fixed capital expenditure prerequisite of the 1958 Ordinance);

(b) in the first three years if fixed capital expenditure undertaken in this three-year period is not less than \$250,000;

⁵ Except on that part of total dividend payments distributed to companies.

⁶ But see footnote 5 above.

⁷ Provision was also made for the exemption from personal income tax of dividends paid by companies out of tax free dividend payments received from pioneer companies.

- (c) in the first four years if fixed capital expenditure undertaken in this period is not less than \$500,000; and
- (d) in the first five years if fixed capital expenditure undertaken in this period is not less than \$1,000,000.

In effect, the revisions have given industrialists an extra year in which to incur expenditure to qualify for extensions of pioneer status. Under the previous legislation, companies had to incur their qualifying expenditure before being granted additional tax relief. Under the new ordinance, companies can incur their qualifying expenditure during the year in which they are seeking an extension of tax relief.

In addition, companies can obtain an extension of relief for one year if they establish in an area declared by the government to be a 'development area', for another year if they manufacture products declared to be priority products, and yet another year (making a maximum of eight tax free years altogether) if they incorporate into their products the percentage of Malaysian content specified by the government. Apart from these amendments, provision was made for pioneer firms to carry forward to the post-pioneer period any losses incurred during the pioneer period. Pioneer firms continue to be exempted from payroll tax liability.

Pioneer industry legislation was introduced in Singapore in 1959. In its original form, a firm declared to be a pioneer firm was exempt from income taxation for five years after the date of commencing production regardless of the amount of capital expenditure outlayed. However, amendments introduced in 1967 made the period of tax relief dependent on capital outlay. Thus it was provided that a firm was exempt from tax for two years if its fixed capital expenditure were less than \$250,000, for three years if its fixed capital expenditure were greater than \$250,000 but less than \$500,000, for four years if its fixed capital expenditure were greater than \$500,000 but less than \$1,000,000, and for five years if its fixed capital expenditure exceeded \$1,000,000. Unlike the new Malayan Ordinance, companies have to incur the necessary qualifying expenditure before being granted additional relief. In most other respects (the treatment of capital expenditures, losses, and dividends, for example), the Singapore and Malayan Ordinances are identical. As in Malaya, companies alone can take advantage of the relief from income tax provided by the pioneer industry legislation.

Six basic arguments can be advanced in favour of the form of pioneer industry tax relief granted in Malaya and Singapore. First, a tax on income discriminates against risk investment. By withdrawing the tax, the range of potential investment opportunities is increased. Second, the

remission of tax liabilities increases the availability of internal funds. If the funds materialise and are invested, firms will be able to establish themselves more quickly than would otherwise be the case. Third, funds are made available free of interest and without the necessity of recourse to the capital market. Where the capital market is embryonic and interest rates on borrowed funds are high, as in Malaya and Singapore, this represents a substantial gain. Fourth, the concession is of limited duration and can be enjoyed only by firms which make profits. The drain on government revenue is not, therefore, continuous. Fifth, the concession has a significant psychological impact on the decisions of entrepreneurs to establish firms. Finally, the granting of similar concessions by other countries has forced Malaya and Singapore to follow suit in order to retain their competitive position *vis-à-vis* overseas capital inflow.

These arguments cannot, however, be accepted without qualification. In fact, the qualifications are so extensive that the very basis of the present form of relief is open to question.

While the withdrawal of taxation reduces the riskiness of investment, the reduction may not be sufficient to convert previously uneconomical production possibilities into economic propositions. Tax arrangements are only one of many factors which influence decisions to invest. There are, moreover, other means by which the tax structure may be adapted to reduce the risk associated with investment activity; as indicated in the preceding section, incentive capital allowances may be granted as an alternative. The complete remission of taxation does represent the largest possible concession in this direction, but does not necessarily encourage the forms of activity which may be deemed most expedient in terms of the national interest.

The present form of pioneer industry relief creates the possibility of an increase in the availability of investible funds, but does not ensure the investment of such funds. The availability of financial reserves is one of many factors which condition the will to invest; by itself, however, it is not necessarily a sufficient condition.

In so far as the remission of taxation increases the availability of internal finance, funds are provided free of interest, free of the obligation of future repayment, and free of the difficulties inherent in recourse to a rudimentary capital market. But a broadly similar result can be achieved by other adjustments in the tax structure. The problem is to balance the gains and losses to the community of one form of concession against the gains and losses associated with alternative concessions.

Restrictions on the period of time during which firms can avail themselves of the full benefit of a particular concession does not neces-

sarily imply a once-and-for-all drain on government revenue. At the end of a pioneer period, it may be found that a firm cannot continue to survive without further assistance in the form of, for example, tariff protection. Moreover, from a Treasury viewpoint, pioneer industry tax concessions represent a continuing and possibly expanding loss of revenue as long as new pioneer firms are created.

The fifth argument in favour of the present form of relief merely states that a tax concession has some psychological value in itself. It is an argument in favour of retaining the term 'pioneer industry relief', but not necessarily the present form of relief.

The success of concessions in attracting overseas capital inflow depends on the attractiveness of investment opportunities in Malaya and Singapore compared with investment opportunities in other parts of the world, the form and value of tax concessions granted, and the existence of double taxation arrangements with the principal sources of overseas capital inflow (the United Kingdom, Japan, Hong Kong, and Taiwan). The continued strong inflow of private overseas capital suggests that the profitability and security of investment in Malaya and Singapore compare favourably with other, particularly less developed, countries. The form and value of tax relief influences the type of capital inflow. Just as there are different types of domestic investment (speculative and non-speculative; short-term and long-term; consumer- and capital-goods investments), so there are different streams of international capital movement. The conditions which are conducive to an inflow of speculative capital, for example, differ from those which would attract long-term investment. Malaya and Singapore do not need to attempt to attract all streams of international capital movement. Rather, emphasis should be concentrated on attracting those flows which contribute most to economic development. The form of concessions granted by other countries are relevant only in so far as they influence the distributional pattern among countries of these particular flows. Finally, it is important that overseas investors reap the full value of the concession granted. Personal and company tax rates are higher in the United Kingdom than in Malaya or Singapore. But, until recently, the investment of United Kingdom funds in pioneer firms did not qualify for any additional relief from British taxation in recognition of the special tax concessions granted by the governments of Malaya and Singapore. However, following a revision of double tax agreements with the United Kingdom, British investors are now able to gain the full value of the concession, and a similar double taxation agreement was signed with Japan in 1963. Since tax rates are substantially lower in Hong Kong and Taiwan, the same

problem does not arise in respect of investment from these countries.

The present form of pioneer industry concessions favours firms which can make profits quickly. The firms best able to take advantage of the concessions are those which function with a high ratio of inventory to fixed capital equipment, particularly speculative firms and light consumer-good industries. To offset a bias in favour of small, light industries, the period of tax remission has been made dependent on the value of fixed capital investment. A second bias has therefore been created, preferential treatment being given to large relative to small firms, even though both types of firm may operate with the same ratio of fixed to variable capital and may be equally in need of encouragement.

The granting of relief from personal tax for dividends paid out of profits earned during the pioneer period provides a strong incentive in favour of distribution and therefore against the retention and reinvestment of profits. Further, tax relief permits firms to manipulate transactions among branch plants to take unfair advantage of the concession. The form of pioneer industry relief granted in Malaya and Singapore leaves much to be desired.

Given these shortcomings, consideration may well be given to alternative forms of relief. Incentive capital allowances have three advantages over the present form of relief when considered in terms of entrepreneurial decisions which may be judged to be in the long-term national interest. First, such allowances provide a positive stimulus to investment activity. A firm cannot take advantage of tax relief unless it is prepared to invest. Instead of merely making funds available for investment or other uses, incentive capital allowances provide funds which may be used to pay for capital equipment only after the equipment has been purchased and installed.

Second, incentive capital allowances avoid the problem of discriminating among firms according to size. The allowances confer an advantage on all firms which invest. Given the numerical importance of small firms in Malaya and Singapore, and the contribution of such firms towards an expansion of the supply of entrepreneurial skill and of the employment of labour, this attribute of incentive capital allowances should be considered most desirable.

Third, incentive capital deductions can be adjusted to give special relief to newly established firms (called 'pioneer firms', if desired). A scheme which gives effect to this idea has already been outlined. The life of a firm would be determined by reference to its date of registration. In this way, one of the less desirable features of the present pioneer industry legislation would be avoided—the problem of selecting pioneer firms.

As a separate point, it is suggested that dividend payments made by firms out of profits earned during the pioneer period should not be exempted from personal income taxation. The object of the concession is to encourage domestic investment activity, and to enable firms to establish themselves quickly. The form of concession should be tailored to this objective. The exemption of dividend payments from taxation favours distribution in preference to retention and reinvestment during the critical formative years. Moreover, the value of dividend payments is arbitrarily inflated during the relief period, a factor which may weigh heavily in the determination of future distribution policy and which may, in the longer term, affect a company's investment program. Maintenance of the established dividend rate in the post-relief period may reduce the internally generated supply of finance for investment purposes; a reduction in the dividend rate would increase the internal flow of funds compared with the case where the dividend rate is maintained, but may make it more difficult for the firm to raise additional equity capital.

The criticisms of the present form of pioneer industry relief apply with equal force to the decision by the Singapore and by the Malayan governments to reduce the tax levied on profits derived by corporate firms from the export of domestically manufactured goods. In both countries, this concession was part of a series of amendments introduced to encourage manufacturing activity in general, and exporting activity in particular. Since the Singapore legislation preceded the Malayan legislation, it shall be considered first.

The Singapore legislation provided that, where the proportion of profits derived from the export of domestically manufactured goods in a base period amounts to 20% or more of total profits and where aggregate export sales exceed \$100,000, a deduction could be claimed for export profits in the determination of assessable income, the base to which the company tax rate is applied.⁸ Export profits were to be determined by multiplying the gross income of the firm (income before any allowance has been made for permissible capital expenditure deductions) by the ratio of export sales to total sales. In the case of firms exporting to well-established markets, the deduction is limited to 90% of the excess of export profits so calculated over the average level of export profits of the preceding five years. In the case of firms exporting to markets to

⁸ Provision was made for the relaxation of the requirement that export sales should amount to at least 20% of total sales in the base period if the Minister of Finance is satisfied that the failure to reach this proportion was due to factors beyond the control of the firm, or if he considered it reasonable and expedient in the public interest to grant the concession.

which Singapore had exported very little in the past (that is to new export markets) the deduction is equal to 90% of total export profits. In effect, permitting corporate firms to claim a deduction for export profits is equivalent to reducing the tax rate on such profits by 90%—that is from the existing level of 40% to 4%. Provided export sales continue to exceed \$100,000 each year, concessionary tax treatment can be claimed for a period of at least fifteen years.

This concession raises several difficult administrative problems. There is, for example, a need to separate export sales from total sales. Since export profits are determined by multiplying gross income by the ratio of export sales to total sales, an incentive is provided to firms to inflate the value of their export sales and to understate the value of their total sales. Apart from the problem of determining export profits, the administrators need to ensure that two other conditions are fulfilled: first, that goods for which a tax concession is claimed are in fact exported from Singapore (it is possible, for example, for firms to 'export' goods to agents in Malaysia and re-import them for domestic consumption in Singapore) and second, that the profits are actually derived from value added in Singapore—this problem could prove to be troublesome where domestic firms are branches of overseas parent companies. The requirement which must be satisfied to receive the concession (export sales equal to at least 20% of the value of the firm's total sales and in excess of \$100,000) may exclude many exporters who require assistance. In addition, the legislation discriminates between firms, for the concession is not available to unincorporate businesses.

It may be argued that, because the manufacturing sector of the economy is small and because the tax concessions would principally be confined to this sector, the administrative problems would not be unmanageable, since only a relatively small number of firms would be affected, and it would be possible to scrutinise the transactions and accounts of these firms more closely than those of other firms. While this is true, it is not clear that firms taking advantage of the concessions would welcome such close scrutiny by tax collectors.

In addition to the decision to reduce the tax on profits derived from the export of domestically manufactured goods, the Singapore government has introduced five other concessions since 1966, and modified the pioneer industry legislation in an endeavour to encourage manufacturing activity. The changes in the pioneer industry legislation have already been considered. In addition, two of the other five concessions have been discussed above: provision for the accelerated write-off of capital

expenditure within three years in certain instances, and the exemption from company tax of a part of income derived from new investment activity. The other three concessions are:

(i) provision for firms to make a double deduction for expenses incurred in developing new export markets;⁹

(ii) provision for a reduction in the tax rate charged on payments made to non-residents in respect of royalties, technical assistance, and research, from 40% to 20%, provided that it can be shown that this concession does not increase the tax liability of the non-resident in his country of residence. Tax liability in respect of such payments is eliminated if such funds are used to purchase equity shareholdings in approved Singapore based companies; and

(iii) exemption from taxation of interest paid on loans raised from non-residents and used to purchase productive equipment, provided such loans exceed \$200,000 and that the concession does not increase the tax liability of the lender in his country of residence. It was also provided that the productive equipment so purchased could not be sold, transferred, or otherwise disposed of without the prior written permission of the Minister of Finance.

Provision for the double deduction of expenses incurred in developing export markets has been pungently criticised by McKinnon who pointed out that the concession 'very likely encourages cavalier attitudes towards overseas promotional expenses' (1966:13). While this criticism is correct, there is a need to provide some assistance for such activity and, provided the Income Tax Department makes a thorough check of claims made under this provision, the loss of revenue would appear to be justifiable. The two last mentioned provisions also appear to be justifiable in terms of Singapore's industrialisation objective; sufficient safeguards appear to have been introduced to protect government finances.

In 1968, the Malayan government modified its pioneer industry legislation and introduced a range of investment incentives. The special export allowance is one of these incentives. The size of the allowance is dependent on three variables: the amount of wages paid to employees whose basic wage does not exceed \$500 per month, the amount of

⁹ Firms which are able to and do take advantage of the provision to deduct a proportion of export profits from assessable income are not permitted to take advantage of this provision.

Malaysian materials used in the manufacture of products for export, and the increase in the value of export sales in the current year over the annual average of the preceding three years. The allowance assumes the form of a deduction from statutory income in the determination of assessable income, the base to which the company tax rate is applied. Examples of how this allowance works are set out in the appendix to this chapter. In short, expenditure on qualifying wages and on purchases of domestically produced raw materials and intermediate-use goods are added together, and the claim is restricted to 20% of this sum. To get the permissible deduction for tax purposes, this claim is multiplied by the ratio of (i) the excess of export sales in the current period over the average of export sales in the preceding three years, to (ii) total sales (domestic and export) in the current period. The tax credit is equivalent to 40% of this deduction. The deduction cannot be claimed by exporters of primary commodities, by non-resident firms, or by unincorporate firms. In addition to this deduction, provision has been made for import and excise duty drawback for export firms, for a measure of payroll tax relief,¹⁰ for the deduction of expenses incurred in overseas promotion,¹¹ for investment allowances, and for accelerated annual depreciation allowances on the part of eligible exporting firms.¹²

The object of the special export allowance is twofold: to encourage firms to export, and to encourage firms to embody a higher ratio of domestic inputs (raw materials, intermediate-use goods and low-priced, largely unskilled labour) in their product. It seems to be a final, sweeping effort to make sure that the tax structure embodies some incentive to encourage all those activities the government deems to be in the national interest.

The potential success of this measure is open to considerable conjecture. No claim, for example, could be made by an otherwise eligible firm if its export sales in the current year are slightly less than the average of those recorded in the previous three years. Similarly, the claim that could be made would be negligible if export sales in the current year were only marginally above the average of those recorded in the previous

¹⁰ Payroll tax relief is granted to companies at a rate determined by the ratio of their export turnover to total turnover, provided that the companies export 20% of the value of their total production.

¹¹ The list of qualifying expenses includes overseas advertising, the supply of free samples overseas, the supply of technical information from overseas, export market research, and expenditure associated with the preparation for overseas tenders and the negotiation of overseas contracts.

¹² See above p. 104 for details.

three years. Apart from these problems, the amendment encounters several administrative difficulties: there is a need to separate domestically produced raw material and intermediate-use goods from imported inputs, and a need to separate export sales from total sales. An incentive is provided to firms to classify imported inputs as domestic inputs and, as in the case of the Singapore export tax credit, to overstate foreign sales and to understate total sales. Further, as discussed below, it is debatable whether countries with a small domestic market base need deliberately extend incentives to encourage export activities; it may be better to encourage domestic production as such and allow any excess of domestic production over domestic demand to spill over on to the world market. Finally, it must be questionable whether the measure would encourage export firms to increase their use of low-priced, largely unskilled labour, and whether such encouragement is desirable in any case. Export firms compete for a share of a world market which is increasingly demanding goods which embody larger and larger amounts of technology, and goods which consistently meet a uniform standard. In these circumstances, it would seem desirable to encourage export firms to use more capital rather than more labour intensive production techniques; the latter type of encouragement may, in relative terms, simply spell export market stagnation, if not decline, in the face of a continued expansion of world trade in manufactures. Moreover, while rates for cheap labour may be the same in Malaya as in Hong Kong, the quality of Malayan labour as an input in the manufacturing process is much lower than that of similar priced labour in Hong Kong. This difference is no reflection on the potential of Malayan labour—it is simply due to the fact that Malayan labour has not been brought up under the rigours (in terms of specific working hours, attendance at work, and attitude to overtime, for example) of a dominantly manufacturing climate. In consequence, the ability of Malayan export firms to compete in the field of cheap, labour intensive, manufactured goods with countries like Hong Kong would be severely restrained. At present, the contributions which must be made by employers in respect of their employees under the provisions of the semi-governmental provident fund discriminate against the use of low-priced labour (see Chapter 9). At most, this new concession restores the balance in respect of those firms which are able to increase their export sales each year. But, in general, it is not at all clear that this innovation would have a perceptible effect on the demand for low-priced labour, or whether an increase in the use of such labour by export firms is desirable.

There is a need to provide special incentives to manufacturing activity in Malaya and Singapore. The need is particularly urgent in Singapore for, in the absence of an increase in the contribution of manufactured goods to domestic product, Singapore's ability to maintain the current level of per capita income in the face of a continued increase in population would be seriously jeopardised.

It would be difficult to make an amendment to the existing tax code designed to stimulate domestic manufacturing activity and to encourage continued investment activity within that sector without creating some administrative conundrums. It is, however, possible to devise some amendments which are less cumbersome than others. One such possibility has already been outlined: the provision of significantly increased accelerated depreciation allowances.

Another innovation which may be worthy of consideration would be the introduction of a tax credit related to the domestic value added by corporate and unincorporate firms. Thus it may be provided that tax payable be reduced by 10% if a firm adds 40% to the free market value of their purchased inputs of raw materials and of intermediate-use goods. In the case of companies, this would represent a reduction in the company tax rate from 40% to 36%. The tax credit may be increased to 15% if the value added by the firm exceeds 50%, to 20% if the value added by the firm exceeds 60%, and to 25% if the value added by the firm exceeds 70%. In the case of companies which added 70% or more to the free market value of their purchased inputs of raw materials of intermediate-use goods, the effective rate of company tax would be reduced from 40% to 30%. The application of this concession should be restricted to manufacturing firms.

Apart from this innovation, three other suggestions are made. First, manufacturing firms should be permitted to make a double deduction for payroll, provident fund and property tax payments. Second, liberal provision should be made for the carry-forward of any unabsorbed allowances. Third, tariffs would remain, but some attempt should be made to standardise tariff rates at one level (say 25% *ad valorem*).

The advantages of the accelerated depreciation allowance proposal have already been discussed.

It would seem that the principal objective of the pioneer industry legislation and of the special export incentive provisions recently introduced by the Malayan and Singapore governments is to increase the domestic value added by the manufacturing sector of the economy. The proposed tax credit is directly designed to achieve this objective. If this objective were achieved, an increase in the export of manufactured

goods would be a corollary development, for the domestic market in Malaya and Singapore is too small to absorb by itself a significant increase in domestic value added by the manufacturing sector. In consequence, there would not be any need to add additional fancy frills to the suggested tax credit to encourage this or that particular type of activity. It is suggested, therefore, that the proposed tax credit be substituted for pioneer industry tax relief and for the special export incentive legislation provided in Malaya and Singapore. Firms could take advantage of the tax credit provided they met the minimum domestic value added requirements—unlike the special export incentive legislation recently introduced in Malaya, the allowance would not necessarily disappear or be reduced to a negligible figure if the firm suffered a reversal in any particular year. Moreover, the credit could be claimed by unincorporate as well as by corporate firms. It may, however, be necessary to impose higher domestic value added requirements on unincorporate firms before the various graduated levels of tax credit could be claimed, for unincorporate firms are small and generally labour intensive so that their domestic value added is normally high. No corresponding adjustment would be needed in the case of granting accelerated depreciation allowances, for the objective of this innovation is to encourage modernisation as well as the expansion of capital equipment and, within small firms, the need for modernisation is paramount.

Although no detailed survey has been undertaken, labour costs are high in Malaya and Singapore compared with the major exporters of manufactured goods in Asia. For most categories of labour, wage rates in Malaya and Singapore are more than twice as high as those ruling in Hong Kong, Taiwan, mainland China, Japan, and South Korea. In addition, productivity is lower, partly because of a particularly enervating climate and partly because the labour force is only beginning to acquire manufacturing skills and to appreciate the strict regimentalisation required on the factory floor for high productivity. Provident fund and payroll tax payments add to labour costs. While it is possible that, in the longer term, a large part of these payments would be passed backward on to labour, the extent and the speed with which backward shifting occurs is by no means clear. The double deduction of provident fund and payroll tax payments would mean that, at the ruling company tax rate of 40%, manufacturing firms would pay only 20% of the total value of these levies, the government contributing 80%. Double deduction would ensure that provident fund and payroll tax payments do not significantly affect the cost of labour to the manufacturing sector of the economy. There does not, however, appear to be any

reason why such payments should be lowered for firms outside of the manufacturing sector.

Similarly, by comparison with other countries in Asia which export manufactured goods, property tax rates are high in Malaya and Singapore. Provision to permit manufacturing firms to make a double deduction for this levy would extend further assistance to domestic industry, and would improve the competitive position of domestic manufacturing firms on the world market. However, as in the case of provident fund and payroll tax payments, there does not appear to be any reason for extending similar concession to firms outside of the manufacturing sector of the economy.

While the suggested innovations do not change the tax structure ruling in Malaya and Singapore, they do raise some additional administrative problems. Six such problems deserve mention. The first is the definition of a manufacturing activity. The various manufacturing surveys conducted in Malaya and Singapore would provide a guide in this respect. The second problem is the definition of a manufacturing firm. Given the desire to encourage domestic manufacturing activity, the definition of a manufacturing firm would need to be broad. Thus it may be provided that a manufacturing firm is one which derives at least two-thirds of its gross income from manufacturing activities.

The third problem centres on the meaning of value added. Value added may be defined as a gross or as a net concept. As a gross concept, value added comprises wages, salaries, interest, rent, and gross trading profits (net trading profits plus an allowance for capital consumed during the period). Broadly, gross value added is the difference between the market value of total output produced during any period and the value of raw materials and intermediate-use goods used to produce that output. Net value added is equal to gross value added less an allowance for capital used during the period; it is the difference between the market value of total output produced during any specified period and the value not only of raw materials and intermediate-use goods but also of capital goods used to produce that output. If expenditure on raw materials and intermediate-use goods is alone deducted from the value of total sales, then the value of capital goods used up during the period is included in the base used for determining the tax credit. If two firms are identical in all respects except that one is more capital intensive than the other, then the more capital intensive firm could claim a larger tax credit than the other firm. This may provide an added stimulus to domestic investment activity, but a cost is involved in that a concession is extended to past as well as to new investment activity. To a large extent, the state of

government finances would determine whether capital used during the period should or should not be included in the base for the tax credit (that is whether the base should be gross or net value added).¹³

The fourth problem is that of determining value added. There are two parts to this problem: an accurate statement must be obtained by the tax authorities from the various firms of both the value of gross sales and of the value of inputs of raw material, intermediate-use and capital goods used during the period in question. A problem of administering the present income tax is that there is a tendency for firms to understate the value of their gross sales. If accelerated depreciation allowances and a tax rebate are tied to value added, the incentive to understate the value of gross sales would be reduced; the more a firm illegally avoids income tax by understating its gross sales, the less advantage it could take of the tax concessions tied to value added. In general, the advantage to be derived from not fully declaring sales receipts is reduced but the risk of being detected remains. The reverse problem has arisen in respect of permissible expense deductions—the income tax administrators have generally had to pare claims to those which the Ordinances permit. If special concessions are tied to value added, an incentive may be given to firms to understate the value of purchased raw material and intermediate-use good inputs. If the firm arranges its accounts so that the resulting increase in value added is said to consist entirely of an increase in wage payments (profits remaining unchanged), then the firm will have increased the tax rebate it can claim without increasing its income tax liability. The respective Income Tax Departments would need to watch for such forms of tax evasion. They would probably need to check employment and wage statistics for firms claiming a tax rebate, and would need to apply the rule that expenses other than those directly incurred in the production of income be deducted in part rather than in full. If this were done, then the major part of any deliberate undervaluation of purchased raw material and intermediate-use good inputs would show up in the form of increased profits, and thus in increased income tax liability. Provided tax rates and tax credit provisions are properly adjusted, the gain by way of increased tax credit as a result of understating the value of purchased raw material and intermediate-use good inputs would be offset by a corresponding rise in income tax liability. It should, perhaps, be emphasised that the determination of value added does not involve the respective Income Tax Departments in the collection of any additional information.

¹³ This problem also arises in determining whether a firm is eligible for the accelerated annual depreciation allowance suggested in the preceding section.

Fifth, it would need to be provided that firms are able to take full advantage of both the accelerated depreciation provisions and the tax credit. If a firm were taking advantage of the accelerated depreciation allowances, its tax liability would be reduced and, in consequence, the extent of the tax credit it could claim would be reduced. It is suggested that the tax credit should be determined by reference to the notional tax liability that would arise if the capital expenditure were being written off at a non-accelerated depreciation rate. (Account should, however, be taken of initial depreciation allowance claims.)

Finally, it will be noted that the suggested tax concessions do not provide any direct stimulus to export activities; the concessions would be extended to firms producing manufactured goods *per se*. Admittedly the domestic market in Malaya and Singapore is small. Nevertheless, it does provide a base for domestic manufacturing activities and its exploitation should not be ignored. Firms normally need a domestic market base before contemplating expansion into export markets; in the initial phase, domestic activities may have to subsidise export activities. The industrialisation experience of Malaya and Singapore since 1957 appears to support this point; having satisfied domestic demand, many firms have recently been forced to consider the prospect of exporting in order to ensure economical levels of production. For this reason, it is not considered necessary that special incentives be extended to those firms which are able to export.

If the proposed amendments to the existing tax code were implemented, tax revenue would continue to be collected from the export of manufactured goods. It is suggested that this revenue could be devoted to the development of a semi-governmental market research bureau. In conjunction with business firms, this bureau could explore foreign markets in order to secure and disseminate information about products which could be manufactured in Malaya or Singapore, and for which there is an assured export market or for which a trade opening could be negotiated.

Two final issues deserve mention. First, it may be argued that the suggested amendments involve a significant erosion of tax revenue. In the case of accelerated depreciation allowances, this statement is not true except in the case where a firm is continually modernising and expanding its industrial buildings, plant and machinery. In general, tax revenue is postponed under this provision rather than forgone. In the case of the tax credit, the loss of revenue may partially be compensated for by a decrease in the amount of evasion which would tend to follow the introduction of this amendment.

Second, following the separation of Singapore from Malaysia, a spate of incentive legislation has occurred in both countries. While not openly stated, it does seem that there is growing competition between the two territories in the granting of incentives to industrialists. If the competition continues, it could have an unfortunate effect on government finances in both territories. As in the monetary field, there is a need for co-ordination of tax incentive policies between the two countries. However, the desired degree of co-ordination is unlikely in the near future. For this reason, an attempt has been made in this chapter to develop an incentive system which could be uniformly adopted by both countries.

APPENDIX

THE MALAYAN EXPORT ALLOWANCE

The following shows how the export allowance introduced by the Malayan government in 1968 is calculated. Four examples are given: that where a firm has been exporting for three or more years, for two years, for one year, and where the firm is just beginning to export. The allowance is the final figure given in each example. The tax credit is equal to 40% of this figure (40% being the ruling company tax rate). The allowance cannot be claimed by unincorporate firms. The examples are taken from the Malaysian Department of Information document on investment incentives in Malaysia.

CASE I

(a) General information

Extracts from 1967 accounts
(\$)

Expenses		Sales	
Wages (less than \$500 per month)	1,000	Export	5,000
Domestic materials purchased	2,000	Local	2,000
Imported materials purchased	3,000		
	<u>\$6,000</u>		<u>\$7,000</u>

(b) Additional information

Export Sales	
1964	1,000
1965	1,500
1966	2,000
	<u>4,500</u>

Average value of export sales 1964-1966 = \$1,500

(c) Export deduction

$$\frac{[\text{Export sales 1967}] - [\text{Export sales 1964-1966}]}{\text{Total sales 1967}} \times \frac{20}{100} \text{ of the value of qualifying wages plus domestic materials}$$

$$\left[\frac{(5,000 - 1,500)}{7,000} \right] \times \left[\frac{20}{100} \times \frac{3,000}{1} \right] = \$300$$

CASE II

(a) General information: as for Case I.

(b) Additional information:

Export sales	
1964	nil
1965	1,500
1966	2,000
	3,500 ÷ 3 = 1,167

(c) Export deduction

$$\left[\frac{(5,000 - 1,167)}{7,000} \right] \times \left[\frac{20}{100} \cdot \frac{3,000}{1} \right] = 329$$

CASE III

(a) General information: as for Case I.

(b) Additional information:

Export sales	
1964	nil
1965	nil
1966	2,000
	2,000 ÷ 3 = 667

(c) Export deduction

$$\left[\frac{(5,000 - 667)}{7,000} \right] \times \left[\frac{20}{100} \cdot \frac{3,000}{1} \right] = 371$$

CASE IV

(a) General information: as for Case I.

(b) Additional information

Export sales	
1964	nil
1965	nil
1966	nil
1967	5,000

Average value of export sales 1964-1966 = 0

(c) Export deduction

$$\left[\frac{(5,000 - 0)}{7,000} \right] \times \left[\frac{20}{100} \cdot \frac{3,000}{1} \right] = 428$$

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Personal Income Taxation

The problems of personal income taxation may be classified into three groups. The first group relates to the determination of taxable income (that is the tax base), the second to the rate structure of taxation, and the third to problems of administrative feasibility. To a large extent, the problems are interdependent; the degree of progression in the tax structure, for example, is a function of marginal tax rates and of the tax base.

By international standards, marginal tax rates are moderately progressive in Malaya and Singapore. The high value of deductions permitted in the determination of taxable income, however, reduces the average rate of progression, narrows the tax net, and involves a substantial loss of tax revenue. The concern of this chapter is to consider the avenues for erosion in the tax base and the degree of progression in the tax structure. Suggestions for change have been guided by the need to raise more revenue, to distribute the burden of the tax fairly, to encourage productive investment activity without granting undue preference to any particular form of business organisation, and to ensure administrative feasibility.

PROBLEMS IN THE DETERMINATION OF TAXABLE INCOME

The level of taxable personal income is dependent on the interpretation of income for taxation purposes, the structure and value of permissible allowances, and the scope that exists for tax avoidance and evasion. The first two of these variables are considered in this section. Both are potentially significant sources of erosion in the tax base. To ensure fairness in the distribution of the tax burden and to seek avenues for increased tax revenue, it is necessary to determine and evaluate the reasons for existing concessions.

The Definition of Income

Malaya and Singapore face similar difficulties in respect of the definition of income as arise in other countries which have based their income tax on the British system. Personal income has been defined by Simons as 'the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question' (1938: 50). However, conceptual and administrative difficulties have restricted the interpretation of income for taxation purposes to something less than 'income' as defined by Simons. Thus, in both Malaya and Singapore, the Income Tax Ordinances explicitly exempt certain forms of income from taxation and implicitly exempt other forms (for example many types of capital gain and non-monetary receipt).

Since the tax base does not include all forms of income, individuals similarly situated with respect to capacity to pay may bear different tax burdens, and the tax may fail to achieve the degree of vertical equity among individuals intended by the legislature. As in most other countries, the gaps in the interpretation of income for taxation purposes in Malaya and Singapore are considerable, and they create a measure of unfairness in the treatment of individuals. To what extent is it possible and desirable to remedy this situation?

All forms of monetary receipt which are of a recurring nature and which are not expressly exempt from taxation are subject to assessment. Definitional problems arise in connection with those receipts which are not clearly of a recurring nature, or which take the form of a non-monetary receipt or an accretion of wealth. The leakages from income assessed for taxation purposes assume four forms: exempt income, capital gains, non-monetary receipts, and expenses incurred in the production of income.

The problems of exempt income and of permissible expense deductions are less intractable than those which concern capital gains and non-monetary receipts. The income tax structure can be adapted to tax some of the more important forms of capital gain (for example, transactions in urban land). Non-monetary receipts, however, are less susceptible to taxation, and a tax on monetary income tends to stimulate the growth of such receipts—firms, for example, are encouraged to increase the real income of directors and employees by providing non-monetary assistance in the form of low cost accommodation, free medical care, transport assistance, and other fringe benefits. Moreover, in an economy dominated by agricultural activities, non-monetary transactions account for a

significant proportion of total transactions. As the tax net is extended to cover more individuals, the importance of this particular problem will increase.

Exempt Income

Some categories of income receipt are exempted from taxation in Malaya and Singapore in order to prevent unnecessary transfer transactions: the income of government authorities, the official emoluments of State rulers, and the emoluments of resident persons paid by and taxed in other countries (foreign diplomatic and military personnel). Other categories are exempted to encourage or assist specific forms of activity—charities, co-operative societies, and approved pension and provident funds. It is in respect of this latter category that potentially serious problems of erosion in the tax base arise.

In recent years, the government has increased its role in the provision of social service facilities. Nevertheless, considerable dependence is still placed on the provision of such facilities by the private sector. Two factors suggest that this dependence will not be reduced in the foreseeable future. First, the expected increase in the total population, concentrated particularly in the younger age-groups, will continue to place an excessive burden on all available educational, health, and social welfare facilities. Second, the difficulties faced by the government in providing a basic social service infrastructure are considerably magnified in a multi-racial society. A degree of standardisation and assimilation is necessary. But at the same time, the diverse needs of the different racial communities deserve recognition. A strong case can be made, therefore, for the granting of relief to activities undertaken by the private sector which are considered to be in the social interest.

Care should, however, be exercised in the granting of exemptions. At present, the purposes for which exemptions are granted can be determined only by a perusal of the diverse list of exempt activities. Considerable discretionary power is exercised by the Comptroller of Income Tax and by the Minister of Finance. It is quite possible that, in certain circumstances, relief may be granted as a result of political or other pressures. The effective operation of income taxation, particularly in a multi-racial society, requires a minimum of discretionary power to prevent charges that the tax structure possesses a racial bias or discriminates in other ways against certain groups of taxpayers. It is considered, therefore, that the reasons for granting exemptions should be made explicit.

There is also a need to establish machinery designed to assess at regular intervals the continued relevance of existing exemptions. The present list includes each of the original thirty exemptions permitted in 1947, one of which is the Union Jack Club! J. R. Hicks and S. Gates have aptly described such concessions as a 'blind and hidden subsidy contributed by the State; . . . [a] subsidy [which] is never investigated or weighed' (United Kingdom 1955: 352). Although no statistics are available, the extent of tax revenue forgone due to the operation of exemptions in Malaya and Singapore should not be underrated. Each exemption should be kept under constant review to ensure that the reason for relief is achieved.

Capital Gains

Theoretically, taxable income includes profits arising from a single isolated transaction if the intention of the vendor is to profit by sale. In practice, it is difficult to detect isolated transactions and even more difficult to assess whether the vendor deliberately sought to 'profit by sale'. Consequently, the income tax code does not extend effectively beyond those individuals who regularly deal in property. Since the scope for achieving capital gains tends to vary positively with income, a failure to tax such gains reduces the degree of progression and stealthily redistributes the tax burden away from the rich.

The tax treatment of capital gains may be approached in one of two ways. First, all capital gains and losses may be assessed and subjected to taxation. Second, an attempt may be made to assess more thoroughly certain major sources of capital gain.

It would be impracticable to attempt to tax capital gains which have accrued during a financial period but which have not been realised. Moreover, for many sources of realised gain, the revenue raised may barely offset related administrative expenses. Given the present shortage of skilled tax administrative staff in Malaya and Singapore, a shortage which may be expected to continue into the foreseeable future, it would appear to be neither desirable nor rewarding to direct administrative effort towards a full assessment of all capital gains and losses.

Considerable progress can, however, be made towards incorporating some of the major sources of capital gain into the existing structure of income taxation. The major forms of capital gain in Malaya and Singapore arise from equity holdings in land, buildings, and machinery, and they accrue primarily to business firms—corporate and unincorporate. The suggested structure of company taxation outlined in the preceding chapter was influenced by the need to tax such capital gains accruing to

companies, and it is suggested that unincorporate firms should be treated similarly in this respect. The main proposal was that balancing charges should extend to the full excess of the sale price over the written-down value of industrial or commercial buildings, plant, machinery, and land. Similarly, on the sale of businesses, the excess of the sale price over the written-down value of tangible assets would be subject to tax. In this way, business goodwill would be caught within the tax net. The retention of original cost depreciation and of the valuation of inventories by the first-in-first-out method would ensure that capital gains (and losses) arising as a result of price fluctuations were subject to taxation. By reducing the effective tax rate, initial depreciation allowances facilitate the growth of capital gains, but permanent advantage can be taken of these provisions only by firms which continually reinvest. On grounds of economic expediency, the consequent reallocation of resources may be judged to be desirable.

Experience in advanced countries suggests that share transactions are an important source of capital gain. However, one of the objectives of government policy in Malaya and Singapore is to develop broader and more effective money and capital markets. The imposition of a tax on share transactions could hinder this objective and, for this reason, cannot easily be justified at this stage.

The suggested selective treatment of capital gains is a second best approach to the problem. Tax avoidance is not eliminated, and encouragement may be given to activities which, judged in terms of the national interest, compare less favourably with the existing forms of encouragement; in the field of tax avoidance, the thirst for new avenues is insatiable and the responsiveness to changed circumstances is quick. The effective implementation of this form of taxation depends on the initiative of the Income Tax Departments. The departments should be aware of significant changes in the avenues of tax avoidance applicable to capital gains, and should be prepared to suggest statutory amendments designed to close such loopholes as they emerge.

A further problem which arises is whether capital gains should be subject to the same tax rates as other forms of income receipt. It is normally argued that since capital gains represent an accrual of income over a period of years, the gain should be spread and taxed accordingly. The annual accrual value prior to realisation was not, however, subject to taxation. During this period, an interest-free loan was granted by the government to the recipient of the capital gain. Partial compensation for this loan can be achieved by subjecting realised gains to the full rate of income taxation.

A corollary argument is that, because capital gains may be bunched together (occurring on a large scale, for example, during an export boom period), a taxpayer's marginal rate of tax will be forced up above the rate at which he would pay if the gains were spread evenly through time. But, in all probability, a bunching of gains is likely to be due to fortuitous circumstances beyond the control of individual taxpayers (a rise, for example, in the price of Malaya's main exports, rubber and tin). The government has a right to share in such fortuitous gains and, if effective countercyclical policies are to be pursued, it has a right to share in such gains on a progressive basis.

It is interesting to note that an attempt was made to introduce a tax on capital gains in Malaya and Singapore in 1965. Gains achieved on assets disposed of within six months of acquisition were to be treated as income for tax purposes. Other gains were to be taxed at a rate of 20%, although a taxpayer could opt to have such gains classified and taxed as income. Special concessional tax rates applied to capital gains achieved on assets acquired before 1965. Gains from the sale of domestic government securities and owner-occupied residences or business premises were exempted from taxation. In addition, a general exemption was granted to individuals for the first \$5,000 of taxable gains. Because of legal and administrative difficulties and an adverse effect on the development of domestic money and capital markets, the tax was not enforced, and it was withdrawn in both countries in 1966.

Non-monetary Receipts

The tax treatment of payments in kind and other forms of non-monetary receipt is a major problem in Malaya and Singapore. The problem can be divided into two parts: first, the tax treatment of payments in kind which arise within the business sector of the economy and, second, the tax treatment of the non-plantation agricultural sector of the economy.

Both Ordinances provide that the value of food, clothing, or lodging paid or partly paid by an employer is to be considered part of the assessable income of an employee. These non-monetary receipts represented significant fringe benefits to European personnel serving in Malaya and Singapore at the time when the Ordinances were drafted (1946), and it was assumed that comparable benefits were important within the Asian business community. Unfortunately, the success of this provision has been very limited. Fringe benefits are not easily discovered, let alone assessed, and the close intermingling of private and business life within the Asian sector of the economy has increased administrative

difficulties. Moreover, fringe benefits are able to find expression in many forms. While most of these varied forms originate in countries where marginal tax rates are high, experience in Malaya and Singapore demonstrates that successful tax avoidance avenues are readily exploited in countries possessing a similar tax code regardless of the relevant marginal tax rates. Most fringe benefits therefore remain outside the tax net, and those which are caught receive favourable tax treatment. The growth of fringe benefits has reduced the value of declared taxable income as a guide to taxable capacity, and has surreptitiously eroded the yield of income tax.

The problem of subjecting fringe benefits to taxation may be approached in one of two ways. First, the tax net may be extended to cover additional forms of fringe benefit. This approach suffers from the difficulties of discovering fringe benefits, valuing non-monetary receipts, and keeping abreast of new developments in the field of fringe benefit tax avoidance.

The second approach is to tax fringe benefits at source. Thus, as suggested in the previous chapter, it may be stipulated that in the determination of the taxable income of both corporate and unincorporate firms, expenses not directly incurred in the production of income may be deductible in part rather than in full. This approach would increase the cost of fringe benefits relative to wage and salary payments and an incentive would be provided for their conversion into a form which may be assessed more easily for taxation purposes—that is into wage or salary increments.

The non-plantation agricultural sector in Malaya is virtually exempt from taxation. Most farmers combine cash cropping and subsistence farming. Cash income is potentially subject to income taxation, but the value of food produced and consumed on the farm and the value of transfer payments made in kind, which together account for a substantial proportion of total income, completely escape the tax net.

In areas where records of income receipt are grossly inadequate and where the supply of skilled tax administrators is limited, the present form of income taxation cannot be expected to become a mass tax. If the non-plantation agricultural sector is to be taxed, attention could be given to the development of a simplified form of direct taxation which would be administratively feasible and which would supplement the present income tax structure. One possibility would be to impose a moderately graduated poll tax at low rates on all males over the age of eighteen who are not receiving full-time education. The base tax rate might, for

example, be set at \$50 per annum (equal to approximately 5% of per capita income and 1% of average annual household income). If a taxpayer can prove that the annual income (monetary and non-monetary) of his household net of expenses directly incurred in the production of that income is less than, say, \$3,000, the tax might be reduced to \$40. Similarly, if a taxpayer's annual net income is less than \$2,000, the tax may be set at \$30. Complete exemption might be granted to married individuals who earn less than \$500 per annum, and to single individuals who earn less than \$250 per annum. No allowance need be made for refinements such as provision for personal and family deductions.

This tax is a very crude form of direct taxation. Considerations of equity are advanced only in broad terms. However, the tax has several advantages. First, the direct tax net is extended to the non-plantation agricultural sector of the economy. Government expenditure is being increasingly directed to this sector, and a strong case can be made for encouraging the government to extract a small part of the resulting benefits. Second, account would be taken, if only in rough terms, of non-monetary receipts. Third, up to the stage where an individual enters a higher tax bracket, the burden of direct taxation can be reduced by earning more income. Since the tax brackets are wide, an incentive would be given to increased effort. Fourth, the tax could be incorporated into the present income tax structure without affecting the degree of progression by permitting it to be offset against income tax payable. Finally, the tax would be easy to administer, the onus for a reduction in tax liability being placed on the taxpayer. Given that there are more than one and a half million adult males in Malaya and assuming that each pays tax at an average rate of \$40 per annum, the revenue yield of such a tax would approximate the current yield of personal income taxation.

Allowances for Expenses of Earning Income

As in the United Kingdom, personal expenses are deductible only if they have been wholly, exclusively, and necessarily incurred in the performance of the duties of the office or employment. The interpretation of personal expense deductions is narrower than that applicable to business expenses. Nevertheless, if adjustments are made to ensure that business expenses not directly incurred in the production of income are deductible in part rather than in full, no amendments to the present interpretation of personal expense deductions need be contemplated.

Permissible Allowances

In calculating chargeable (taxable) income, individuals are permitted to deduct specified personal and family allowances together with other general deductions from their assessed income. Permissible personal, family, and general deductions reduced the value of personal income declared for taxation purposes in Malaya and Singapore by almost 50% in 1964. The deductions represent a significant source of erosion in the tax base. In fact, the amount of tax forgone in the transition of assessable income into chargeable income approximates the amount of personal income tax actually paid. The reasons for these deductions and their respective values require consideration.

There are three main categories of permissible deductions: personal and family allowances, allowances for contributions to specified activities, and earned income relief. Personal and family allowances represent the most important form of relief, accounting for almost 78% of the total value of permissible deductions claimed in Malaya in 1964. Earned income relief, introduced in 1961, accounted for a further 14%. The remaining allowances amounted to just over 8% of the total value of deductions claimed. In Singapore, personal and family allowances accounted for 72% of total permissible deductions claimed in 1964, earned income relief for 20%, and allowances for contributions to specified activities for 8%.

The deductions may be divided into two groups: those which are fixed in value (personal and family allowances) and those which are not (allowances for gifts and for life assurance premiums).¹ Since the latter group accounts for only a small proportion of the total value of permissible deductions, it would appear that attempts on the part of the wealthy to convert income into tax deductible allowances have not significantly affected the tax structure in either Malaya or Singapore. However, given progressive tax rates, the amount of tax relief derived from fixed value allowances increases as income increases. It must be questioned whether the distributional effects of the present allowance structure are desirable.

Personal and Family Allowances

(a) *Present Situation.* A basic exemption of \$2,000 is provided for the taxpayer and declining amounts, as set out in Table 18, may be claimed

¹ Earned income relief may be classified in the first group although the value of relief does, within limits, vary with income. The relief is equal to 10% of earned income (20% in Singapore) to a maximum value of \$1,000.

for a dependent wife and for a maximum of five dependent children. No allowance is provided for other dependants such as parents and invalid relatives. A single individual is not liable to tax until his income exceeds twice the national per capita income. The permissible deduction for a married couple with two children is equivalent to five times the national per capita income. Thus, in relation to per capita income, personal and family allowances are generous.

Table 18 Malaya and Singapore: personal and family allowances, 1966

Allowance in respect of	Actual allowance		Cumulative allowance	
	Value (\$)	% of total possible allowance	Value (\$)	% of married couple no child allowance
Taxpayer	2,000	37.38	2,000	66.67
Wife	1,000	18.69	3,000	100.00
First child	750	14.01	3,750	125.00
Second child	500	9.34	4,250	141.67
Third child	500	9.34	4,750	158.33
Fourth child	300	5.60	5,050	168.33
Fifth child	300	5.60	5,350	178.33
Sixth child	—	—	5,350	178.33

Source: United Kingdom 1967: Appendix to Malaysia and Singapore section.

The high value of permissible deductions has severely restricted the coverage of income taxation in Malaya and Singapore. In Australia, 40% of the total population was assessed for taxation purposes in the income year 1965. The combined population of Malaya and Singapore is slightly less than that of Australia, but only 4% of the population was subject to income taxation in 1964. What factors, then, have influenced the value of permissible allowances?

Two considerations govern the value of the personal allowance. First, the low level of per capita income implies that many individuals do not receive a level of income sufficiently above conventional subsistence levels to be subject to income taxation. Second, given the present complexities involved in the determination of taxable income, it can be argued that the return from assessing low income recipients would not be sufficient to justify associated administrative costs. In general, both factors combine to favour some form of personal allowance set at a level which will exclude from taxation the low income segment of the population.

Allowances for dependants are influenced by a different set of factors. As between two individuals receiving the same amount of income but differing in respect of family responsibilities, there is a case on grounds of equity for a degree of differential tax treatment. As the burden of dependency rises, medical, dental, educational, and other essential expenditures also rise. The capacity to pay tax of a person with a wife and five dependent children is obviously less than that of a single person enjoying the same income.

The structure of allowances in Malaya and Singapore has been conditioned by the desire to achieve a degree of horizontal equity in the tax system, and by the desire to avoid a substantial and indeterminate loss of revenue. But the influence of the colonial heritage continues to be dominant. At the commencement of income taxation, it was realised that the class of people least able to avoid the direct impact of the tax on the whole of their earnings consisted of individuals receiving a fixed wage or salary. This group included a small band of administratively dominant and politically influential European personnel serving in Malaya and Singapore. Tax rates and the structure of allowances were adjusted to ensure that the personal income tax burden borne by individuals within this group would be lighter than that which would be borne by individuals earning similar levels of income in the United Kingdom. In endeavouring to satisfy this requirement, the income tax net was effectively adjusted so as to exclude the greater part of the potential taxpaying Asian population. The departure of expatriate personnel following the granting of independence in 1957 has reduced the relevance of this consideration, but adjustments in allowance levels have not yet taken account of this factor.

(b) A Critique of the Prevailing Allowance Structure. The validity of the reasons for the existing level of relief must be appraised to determine whether adjustments in the structure and value of allowances are warranted.

In 1959, allowance levels were revised for the first time since the inception of income taxation in 1947. The value of the personal and of the wife allowance was reduced, and the number of deductions for dependent children was cut from nine to five. The revisions reduced the total possible level of personal and family allowances by 34%. Within the new total, the respective shares of the taxpayer and of dependent children were increased at the expense of the share attributable to dependent wives. The changes improved the position of single

persons and of persons with families relative to that of married persons without children.

Between 1959 and 1960, the number of taxpayers in Malaya doubled, income assessed for taxation rose by 54%, and personal income tax payable by 60%. Part of the rise in tax payable was due to an improvement in economic conditions in 1960 compared with 1959. However, between 1950 and 1959, personal income tax revenue increased slowly and fluctuations in economic activity did not significantly affect the level of tax revenue. It may be assumed that the greater part of the substantial rise recorded during 1960 was due to the reduction in allowance levels.

Low income taxpayers, defined to include those with an assessed income of less than \$6,000 per annum, accounted for 72% of the increase in the number of taxpayers, but for only 17% of the increase in tax payable. The greater part of the increase in tax revenue was derived from individuals who would have been subject to taxation at pre-1960 allowance levels. The total increase in administrative costs, however, amounted to only 16% of the increase in tax payable by the low income group. The administrative argument against an extension of the tax net, which claimed that the return from assessing low income recipients would not justify the additional administrative expense incurred, was not substantiated.

Given the success of the 1959 revision of permissible allowance levels, three questions arise. First, would a further reduction in allowance levels be desirable and practicable? Second, what relation should the various personal and family allowances bear to each other? Third, should allowances assume the form of deductions from declared assessable income (the present practice) or tax rebates?

Although the increase in the coverage of income taxation accounted for only a small proportion of the total increase in tax payable, the extension did not overburden the Income Tax Departments (there was, for example, no significant increase in tax assessment or tax payment arrears), and it was more than justified in terms of revenue raised per unit of related administrative expense. By Asian standards, income per head in Malaya and Singapore is high. In Japan, the major semi-developed country in Asia, the personal allowance amounts to only 60% of average per capita income. A case could be made for a further reduction in the value of the personal allowance granted in Malaya and Singapore from \$2,000 towards the average level of per capita income (\$1,000). Administrative considerations would condition the speed at which the allowance level is reduced, but this problem should not be permitted to delay revision indefinitely.

If the relative position of taxpayers with different family responsibilities were to be preserved, a reduction in the value of the personal allowance would entail a proportionate decrease in the value of each dependent allowance. There is, however, no way of determining the most equitable relationship of each dependent allowance to the personal allowance. In fact, the final decision is likely to be influenced by revenue considerations.

The difference in the capacity to pay tax of a single person and of a married couple with no children is not marked. The expenditure incurred by a married couple will be higher but not necessarily double the level of expenditure incurred by a single person living alone for, in both cases, certain overheads which vary little with conjugal circumstances (house rent and rates, for example) must be met. Moreover, although a reduction in capacity to pay tax may result from marriage, the non-assessed output of a dependent wife partly offsets this reduction. There does not appear to be a strong case, therefore, for a substantial difference in the tax treatment of single persons and of married persons with no children.

The value of deductions for a dependent wife varies widely among countries. In Pakistan there is no wife allowance. In Ceylon the wife allowance amounts to 25% of the personal allowance, in Malaya and Singapore 50%, and in India 75%. The allowance granted for a dependent wife in Australia is almost equal in value terms to the allowance granted in Malaya and Singapore but, since there is no personal allowance, the value of deductions which may be claimed by a married couple with no children in Australia amounts to only one-third of the corresponding value which may be claimed in Malaya and Singapore. While the personal allowance exists, a case can be made for a reduction in the value of the wife allowance in step with any decrease in the value of the personal allowance. If this relationship were held, there would not appear to be any need for the value of the wife allowance to be reduced below 50% of the value of the personal allowance.

The effect of child allowances on family size is not clear. A graduated decline in the value of allowances and an absolute limit to the number of deductions may, however, be more effective in placing a restraint on family size—an objective of government policy in Malaya and Singapore—than constant value allowances for each dependent child.

Child allowances granted in Malaya and Singapore decrease in value as the number of qualifying children increases, and there is an absolute limit to the number of deductions which may be claimed. But the revision of allowance levels in 1959 increased the share of child allow-

ances in the maximum possible value of personal and family allowances. Given the desire to avoid any encouragement to population growth, it may be questioned whether this improvement was intended; in fact one would have thought that a reduction in this share would have been more appropriate. In Pakistan, child allowances represent only 7% of the total level of permissible deductions, and the ratio is only slightly higher in India. There would appear to be a case for a reduction in the value of each of the child allowances granted in Malaya and Singapore to levels which restore the pre-1960 relationship. This would be achieved if each child allowance were reduced by 20%. If, as suggested, the personal and wife allowances were then reduced by 25% or 50%, each child allowance would need to be reduced proportionately.

Child allowances are granted principally to make some provision for the cost of education and medical expenses. There is no reason why an allowance need be provided in the case where a child is in full-time employment. It is suggested that relief should be provided for children over the age of ten only if such children are receiving full-time education.

The most contentious issue associated with personal and family allowances centres on the form of relief. At present the allowances are deducted from assessable income in the determination of chargeable income. Given a progressive tax structure, the value of a fixed allowance in terms of tax savings² increases as income increases (Table 19). Permissible personal allowance levels in Malaya and Singapore are already high. It may be questioned whether it is intended that the value of tax savings derived from personal and family allowances should increase as income increases. If a wealthy person desires to spend more on the education of his children than a less wealthy individual, this represents a personal decision which should not be subsidised from government revenue. Personal and family allowances are designed to achieve a degree of horizontal equity in the tax structure; they should not be permitted to affect the average degree of tax progression. It is suggested, therefore, that the allowances should assume the form of tax rebates, the value of the rebate being determined by multiplying the allowance level by the minimum personal tax rate (6%), or, to ease administrative problems, by say 10% (the rebate payable to individuals subject to marginal tax rates below 10% being obtained by multiplying the aggregate value of their personal and family allowances by the marginal rate of tax applicable to the last dollar of their assessable income). Under this

² Measured as the difference between tax payable on assessable income and tax payable on chargeable income (that is assessable income net of personal and family allowances claimed).

Table 19 Malaya: tax savings due to personal and family relief, 1966^a
(\$)

Assessable income \$	Single person ^b		Married person no child ^b		Married person 1 child ^b		Married person 2 children ^b		Married person 3 children ^b		Married person 5 children ^b	
	1	2	1	2	1	2	1	2	1	2	1	2
2,500	120	—	—	—	—	—	—	—	—	—	—	—
5,000	180	225	255	285	300	330	330	360	—	—	—	—
7,500	240	323	345	413	413	480	458	525	503	555	546	591
10,000	300	435	435	555	525	645	585	698	645	743	707	797
15,000	400	600	600	800	750	950	850	1,038	950	1,113	1,053	1,203
20,000	460	690	690	920	863	1,093	978	1,200	1,093	1,300	1,220	1,420
25,000	500	750	750	1,000	938	1,188	1,063	1,308	1,188	1,423	1,331	1,561
30,000	600	900	900	1,200	1,125	1,425	1,275	1,563	1,425	1,688	1,588	1,838
40,000	800	1,200	1,200	1,600	1,500	1,900	1,700	2,075	1,900	2,225	2,105	2,405
50,000	800	1,200	1,200	1,600	1,500	1,900	1,700	2,100	1,900	2,300	2,140	2,540
60,000	1,000	1,500	1,500	2,000	1,875	2,375	2,125	2,625	2,375	2,875	2,675	3,175
100,000	1,000	1,500	1,500	2,000	1,875	2,375	2,125	2,625	2,375	2,875	2,675	3,175

^a Tax savings is calculated by subtracting tax payable by individuals in different family circumstances from tax payable on assessable income without any allowance for personal and family deductions.

^b Columns denoted '1' refer to tax savings without earned income relief (that is it is assumed the income is entirely unearned income), and '2' to tax savings with earned income relief (that is it is assumed that all of the income is classified as earned income).

Source: Derived from a manipulation of Tables 18 and 20.

system, the relative value of the various concessions would decline as income increases. The advantage of the tax credit method over the deduction from income method is that it provides equal benefits in amount of tax saved to taxpayers in the same family circumstances regardless of income levels and marginal tax rates.

Contributions to Specified Activities

Contributions to specified activities assume two main forms: gifts and life assurance premiums (including provident fund contributions). Gifts to approved institutions and, in certain cases, *inter vivos* gifts, may be deducted from assessable income in the determination of chargeable income. There is no upper limit to the value of allowances which may be claimed in any particular year, but there is no provision for the carry-forward of unabsorbed allowances.

Gifts account for only a small proportion of the total amount of tax revenue forgone due to the operation of permissible deductions. Nevertheless, the provisions constitute a potentially significant source of erosion in the tax base. Deficiencies in the existing form of relief deserve attention.

Three problems arise in respect of gifts to approved institutions. First, the definition of 'institution of a public character' is very broad, relief being granted for gifts to any benevolent institution, and to any fund established and maintained for the relief of public distress. It is suggested that the definition and administrative interpretation of 'institution of a public character' should be construed more narrowly.

Second, there is a need to establish machinery responsible for continually reassessing the relevance of tax deductions for contributions to the various approved institutions and funds in the light of changing circumstances. At present, the government forgoes revenue, but is unable to exercise any control over the direction and extent of expansion of approved institutions and funds.

Finally, the ability to take advantage of this particular tax concession tends to vary positively with income. In addition, given a progressive tax structure, the amount of tax savings associated with a particular deduction increases as a taxpayer's income increases. This section of the Ordinances provides not only generous encouragement to philanthropists, but also ample scope for the arrangement of income in order to reduce the burden of income taxation. To encourage the charity of personal sacrifice, it is suggested that a specified percentage (say, 50%) rather than the total value of gifts to approved institutions and funds should be permitted as a deduction, and that the relief should assume the

form of a tax rebate, calculated on the same basis as that suggested for personal and family allowances. Donations should be made more at the expense of individuals than of government revenue.

The aim of tax relief for life assurance premiums and provident fund contributions is to achieve what Downing has referred to as 'a community-wide improvement in the allocation of personal resources over time, in the face of human improvidence and short-sightedness' (1962: 309). Encouragement should be given to this form of saving, particularly as it indirectly represents an important source of government loan finance in both Malaya and Singapore. It is therefore suggested that such payments should be deducted in full, even though it is recognised that wealthier individuals will be able to take greater advantage of this concession than other individuals. However, relief should once more assume the form of a tax rebate calculated on the same basis as that suggested for personal and family allowances and for gifts.

Earned Income Relief

Tax relief for earned income was introduced into Malaya and Singapore in 1961. It was provided that individuals could deduct 10% of earned income (20% in Singapore) to a maximum value of \$1,000 in determining chargeable income. Because almost 90% of personal income assessed for taxation consists of earned income, the greater part of the taxpaying public has been able to take substantial advantage of this concession; the average value of earned income relief claimed in Malaya in 1964 was \$600, and in Singapore, \$860. Average tax rates in Malaya and Singapore are low compared with other countries. The introduction of earned income relief lowered average tax rates still further and involved the government in a substantial loss of revenue. There does not appear to be any need for this form of relief. If a differential is desired in the tax treatment of earned and unearned income, it should assume the form of a surcharge on unearned income. Such a surcharge would indirectly assist in taxing capital gains derived from the ownership of property.

TAX RATES

Marginal tax rates in Malaya rise steadily to a maximum rate of 50% on income in excess of \$50,000. In Singapore, the maximum rate of tax is 55% applicable to income in excess of \$100,000 (Table 20). Personal and family allowances, however, considerably reduce the average rate of tax progression; the average tax burden borne by a single person in Malaya earning \$50,000 per annum is 25% and by a married person with three children 23%.

Table 20 Personal tax rate structure

Chargeable income		Tax rate structure			
Total \$	Increase \$	Marginal tax %	Amount of change of marginal tax rate %	Increase in tax payable \$	Total tax payable \$
(a) Malaya, 1966					
2,500	2,500	6		150	150
	2,500	9	3	225	
5,000					375
	2,500	12	3	300	
7,500					675
	2,500	15	3	375	
10,000					1,050
	5,000	20	5	1,000	
15,000					2,050
	5,000	23	3	1,150	
20,000					3,200
	5,000	25	2	1,250	
25,000					4,450
	10,000	30	5	3,000	
35,000					7,450
	15,000	40	10	6,000	
50,000					13,450
	Excess	50	10		
(b) Singapore, 1966					
1,500	1,500	5		75	75
	500	6	1	30	
2,000					105
	1,000	7	1	70	
3,000					175
	1,000	8	1	80	
4,000					255
	1,000	10	2	100	
5,000					355
	2,000	12	2	240	
7,000					595
	3,000	15	3	450	
10,000					1,045
	5,000	18	3	900	
15,000					1,945
	10,000	25	7	2,500	
25,000					4,445
	10,000	30	5	3,000	
35,000					7,445
	15,000	40	5	6,000	
50,000					13,445
	50,000	50	5	25,000	
100,000					38,445
	Excess	55	5		

Source: As for Table 18.

The principal characteristics of the tax structure in Malaya and Singapore can be revealed most clearly by comparing tax rates applicable to various income levels in a selected group of countries. The tax burden borne by a single person and by a married person with three children in each of the selected countries is indicated in Table 21. The comparisons have been made on a common currency basis and, in the computation of tax rates, no provision has been made for deductions apart from personal and family allowances.

Average tax rates applicable to a single person at low levels of income are higher in Malaya and Singapore than in Pakistan and India, but lower than in Australia and Ceylon (Table 21A). The low tax burden at low levels of income in Pakistan and India is due to the high value of personal allowances granted in these countries.³ Beyond a level of income equal to \$15,000, average tax rates in each of the selected countries are

Table 21A Average and marginal tax rates in a selected group of countries:^a
single person^b
(per cent)

Income \$ Mal.	Malaya		Singapore		Pakistan	
	Average	Marginal	Average	Marginal	Average	Marginal
5,000	3.9	—	3.5	—	—	—
7,500	5.8	9.6	5.5	9.6	1.8	5.5
10,000	7.5	12.6	7.5	13.2	5.4	16.0
15,000	11.0	18.0	10.6	16.8	11.4	23.5
20,000	13.7	21.8	13.5	22.2	15.8	29.1
25,000	15.8	24.2	15.8	25.0	20.1	36.9
30,000	17.8	28.0	17.8	28.0	25.0	50.0
40,000	21.6	33.0	21.6	33.0	34.7	63.8
50,000	25.3	40.0	25.3	40.0	42.1	71.4
60,000	29.1	48.0	29.1	48.0	48.4	80.0
100,000	37.5	50.0	37.5	50.0	61.0	80.0

³ Expressed in terms of Malayan dollars the value of personal allowances in each of the selected countries was:

Pakistan	\$5,120	Malaya	\$2,000
India	\$2,560	Ceylon	\$1,920

No personal allowance is granted in Australia. There is, however, an exemption limit; in 1965 an individual was not subject to taxation until his income exceeded \$1,410.

Table 21A (continued)

Income \$ Mal.	India ^c		Ceylon ^d		Australia		Proposal ^e	
	Average	Marginal	Average	Marginal	Average	Marginal	Average	Marginal
5,000	1.5	—	8.0	—	7.6	—	4.0	—
7,500	3.6	8.0	13.7	25.0	11.0	17.8	6.7	12.0
10,000	5.7	11.7	19.2	35.6	14.8	26.0	8.8	15.2
15,000	10.6	20.6	29.7	50.7	21.7	35.4	12.0	18.4
20,000	17.5	38.0	38.1	63.3	24.7	34.0	14.8	23.2
25,000	23.4	47.2	45.2	73.5	28.4	43.0	17.6	28.8
30,000	28.4	53.2	50.3	76.0	31.6	47.6	20.3	33.6
40,000	37.1	63.4	56.7	76.0	37.1	53.6	25.5	41.2
50,000	44.2	72.4	60.6	76.0	40.4	53.6	30.4	50.0
60,000	49.2	74.3	64.3	82.7	44.2	62.7	33.7	50.0
100,000	59.2	74.3	74.6	87.5	51.6	62.7	40.2	50.0

^a Tax rates: Malaya, 1966; Singapore, 1966; Australia, 1964-65; Pakistan, India, and Ceylon, 1962-3. Exchange rates \$ Mal. 1 = Rs. 1.56 = \$A0.28.

^b No allowance has been made for deductions apart from personal allowances.

^c Account has been taken of surcharges, supertax, and surcharge on supertax in addition to income tax.

^d Account has been taken of surcharge, national development tax, and surtax in addition to income tax.

^e The column which shows the proposed tax structure for Malaya and Singapore is based on the marginal tax rate structure set out in Table 22 and the following personal and family allowances:

Allowance	Value (\$)	Tax rebate (\$)
Personal	1,500	180
Wife	750	90
First child	450	54
Second child	300	36
Third child	300	36
Fourth child	180	22
Fifth child	180	22

The tax rebate is calculated by multiplying the value of the allowance by 12%, the marginal tax rate applicable to chargeable income in excess of \$4,000, but less than \$8,000.

Source: As for Table 18.

higher and increase more rapidly than average tax rates in Malaya and Singapore. This implies that marginal tax rates rise very slowly in Malaya and Singapore compared with each of the selected countries.

In Pakistan and India, the tax burden of a married couple with three children is only slightly lighter than that of a single person—little tax relief is granted for dependants. But in Malaya and Singapore, dependent deductions significantly reduce average tax rates at all levels of income (Table 21B). Although dependent deductions are high in Ceylon, the tax burden of a married person with three children is lower at each level

Table 21B Average and marginal tax rates in a selected group of countries:^a
married person with three children^b
(per cent)

Income \$ Mal.	Malaya		Singapore		Pakistan	
	Average	Marginal	Average	Marginal	Average	Marginal
5,000	0.3	—	0.3	—	—	—
7,500	2.3	6.3	2.1	5.8	1.3	4.0
10,000	4.1	9.3	3.9	9.1	4.6	14.5
15,000	7.3	13.9	7.3	14.1	10.8	23.1
20,000	10.5	20.1	10.0	18.4	15.2	28.3
25,000	13.1	23.1	13.0	25.0	19.3	35.8
30,000	15.1	25.3	15.1	25.3	24.4	50.0
40,000	18.8	30.3	18.9	30.3	34.1	63.3
50,000	23.1	40.0	23.1	40.0	41.5	71.0
60,000	26.8	45.3	26.8	45.3	47.9	79.8
100,000	36.1	50.0	36.1	50.0	60.7	80.0

Income \$ Mal.	India ^c		Ceylond		Australia		Proposals ^e	
	Average	Marginal	Average	Marginal	Average	Marginal	Average	Marginal
5,000	0.5	—	3.9	—	1.2	—	—	—
7,500	2.9	7.9	6.4	11.5	4.4	10.9	3.8	—
10,000	5.1	11.7	8.8	16.0	7.6	17.0	6.6	15.2
15,000	10.6	21.6	14.7	26.4	13.9	26.6	10.6	18.4
20,000	17.5	38.0	18.2	28.5	19.2	34.9	13.7	23.2
25,000	23.4	47.2	22.7	41.1	23.4	40.3	16.7	28.8
30,000	28.4	53.2	27.2	49.5	27.0	45.0	19.5	33.6
40,000	37.1	63.4	35.3	59.4	33.3	52.2	25.0	41.2
50,000	44.2	72.4	41.7	67.7	37.9	56.5	30.0	50.0
60,000	49.2	74.3	48.9	84.8	41.4	58.6	33.3	50.0
100,000	59.2	74.3	65.3	90.0	49.8	62.7	40.0	50.0

Notes and Source: As for Table 21A.

of income in Malaya and Singapore than in any of the other selected countries.

The fact that the structure of personal income taxation in Malaya and Singapore is only moderately progressive does not necessarily imply that marginal tax rates should be increased. But the comparative analysis does suggest that the income tax authorities have much room within which to manoeuvre in order to correct any existing anomalies in the tax structure. If adjustments are made in the structure of permissible deductions as suggested above, the need for an increase in marginal tax rates in order to raise more revenue would be considerably reduced.

Two aspects of the present structure of marginal tax rates do, however, deserve attention. First, there are several abrupt changes in the marginal tax rates (see column 4 of Table 20). Given a large number of tax brackets (ten altogether) and moderate marginal tax rates, it should be possible to avoid any unevenness in the structure of marginal tax rates. The second problem concerns the width of the income bracket to which each marginal tax rate is applied. At present the brackets vary between \$2,500 and \$15,000. There does not appear to be any fundamental reason why the size of the income brackets to which higher marginal tax rates are applied should vary.

An alternative marginal tax rate structure is set out in Table 22. The first two brackets of chargeable income are set at \$2,000 but, beyond a level of chargeable income equivalent to \$4,000, the brackets to which the marginal tax rates are applied have been held constant at \$4,000. In addition, marginal tax rates increase steadily (see column 4). The maximum marginal rate of tax, 50%, is applicable to chargeable income in excess of \$40,000 instead of \$50,000 as at present.

The suggested tax rate schedule retains the two principal advantages of the present tax structure—moderate tax rates and a close relationship between the company tax rate and the maximum rate of personal taxation. High marginal tax rates have been avoided because of their potentially adverse effect on incentives and on work effort, and because problems of tax avoidance and evasion tend to increase as marginal tax rates rise. By maintaining a close relationship between the company tax rate and the maximum personal income tax rate, the incentive to avoid heavier personal taxation by converting partnerships into private companies would be reduced. It can be argued that, if the tax credit proposed in Chapter 4 were introduced, a wider margin would exist between the maximum personal income tax rate and the minimum company tax rate (30%). In this case, it may be advisable to reduce the maximum personal income tax rate to 45%, applicable to income in

excess of \$36,000. Whether this adjustment would be necessary would depend on the number of individual taxpayers subject to marginal personal income tax rates in excess of 30%—the greater the number, the stronger is the case for a reduction. The loss of revenue from such an adjustment would be more than compensated for by the effect of the suggested adjustments in permissible personal allowances, tax brackets, and marginal tax rates on the yield of personal income tax revenue.

Table 22 Proposed tax rate structure

Chargeable income		Tax rate structure			
Total	Increase	Marginal tax rate	Amount of change in the marginal tax rate	Increase in tax payable	Total tax payable
\$	\$	%	%	\$	\$
2,000	2,000	5		100	100
	2,000	8	3	160	
4,000					260
	4,000	12	4	480	
8,000					740
	4,000	16	4	640	
12,000					1,380
	4,000	20	4	800	
16,000					2,180
	4,000	24	4	960	
20,000					3,140
	4,000	28	4	1,120	
24,000					4,260
	4,000	32	4	1,280	
28,000					5,540
	4,000	36	4	1,440	
32,000					6,980
	4,000	40	4	1,600	
36,000					8,580
	4,000	45	5	1,800	
40,000					10,380
	Excess	50	5		

Under the suggested tax structure, marginal tax rates would increase gradually and smoothly, most individuals would be taxed more heavily, and the number of individuals subject to the maximum tax rate would be increased. More revenue would be raised, and the tax structure would become more responsive to fluctuations in economic activity. Finally, the simplicity of a single-tier tax structure has been retained. A taxpayer

can readily determine his tax burden and the marginal tax rate applicable to any increase in income. In India and Ceylon, the imposition of surcharges and development taxes in addition to income tax unnecessarily complicates the structure of taxation.

Assuming that the proposed marginal tax rate structure is adopted, that each child allowance is reduced by 20% to restore the pre-1960 relationship between the various personal and family allowances, that the taxpayer, dependent wife, and dependent children allowances are then each reduced by 25%, and that the allowances assume the form of a tax rebate, the value of the rebate being determined by multiplying the applicable allowance level by 12%, the effect of these proposed amendments is illustrated in the last two columns of Table 21. For all taxpayers, average tax rates are lower for married persons with children. But, as income rises, this difference disappears. Most individuals in Malaya and Singapore would be taxed more heavily than they are at present but, apart from at low levels of income, the proposed tax structure continues to impose a lower burden on taxpayers than its counterpart in Pakistan, India, Ceylon, or Australia.

ADMINISTRATIVE PROBLEMS

Shortly after its introduction in 1947, income taxation joined import duties as the most important and dependable sources of tax revenue in Malaya and Singapore. In the first report of the Income Tax Department, R. B. Heasman, the Comptroller-General, ventured to predict that time would show that the income tax edifice had been built on sound foundations (Federation of Malaya 1950b: 5). After severe pressure in the initial years, particularly during the Korean War boom, tax arrears were gradually reduced and administrative arrangements consolidated. In 1960, the tax net was extended, indicating the growing confidence of the tax administrators in their ability to administer income taxation. Overall, the record of the Income Tax Departments of Malaya and Singapore has been one of commendable progress and achievement, particularly since 1960.

Problems of tax avoidance are less acute in Malaya and Singapore than in most other countries possessing a similar tax structure. The close relationship between the company tax rate and the maximum rate of personal income taxation has eliminated one major source of tax avoidance: the conversion of a partnership into a private company does not give rise to any significant tax advantage. It has been recommended that this close relationship should be retained.

It has also been recommended that, in the determination of chargeable income, business expenses not directly incurred in the production of income should be deductible in part rather than in full. Such an amendment would reduce the tax gain derived from the conversion of applications of income into expenses incurred in the production of income. The adoption of the suggested amendments in the structure of personal, dependent, and other permissible deductions, and the taxation of selected categories of capital gain, would further reduce the incentive for deliberate tax avoidance practices.

The extended form of family relationships in the Asian community presents a more difficult problem. A businessman, for example, is able to distribute income throughout a broad kinship group without any loss of control over the utilisation of such funds. The greater the dispersion, the greater is the scope for permissible deduction claims, and the greater is the reduction in actual tax payable. The Income Tax Departments are attempting to tackle this problem by checking the kinship relation and the authenticity of partners and employees, particularly of sole proprietorships and of partnerships.

In contrast to the problem of tax avoidance, illegal evasion has proved to be the most intractable problem of income tax administration in Malaya and Singapore. In the 1966 Budget Speech, the Malayan Minister of Finance stated that evasion was costing the government of Malaya \$100 million per annum in lost revenue, the equivalent of almost 35% of total income tax revenue collected in 1966. The investigation units of the Income Tax Departments of Malaya and Singapore have been strengthened considerably since 1965, and investigation effort has been concentrated on reducing the incidence of non-compliance among professional people and unincorporate businesses. Without any change in tax rates or permissible personal allowance levels, personal income tax has risen substantially since 1964, a fact which reflects the growing success of the anti-evasion campaign. It is possible that, by tying a tax credit and accelerated annual depreciation allowances to value added, an incentive may be provided to firms to declare more fully the value of their gross sales. With the aid of data processing equipment, with more detailed tax return information,⁴ and with the use of other sources of income and expenditure data, more detailed attempts could be made

⁴ Taxpayers could, for example, be asked to detail major contractual payments such as house rent, land rent, etc., indicating the number of the taxpayer to whom such payments were made. (Following the Australian practice, tax numbers have been issued to all taxpaying units in Malaya.)

to cross-check the accuracy of returns. Penal provisions, amended and strengthened in 1960, appear to be adequate.

Although the problem of arrears in the payment of tax was significant in the early years of the short history of income taxation in Malaya and Singapore, much progress has been made, particularly since 1959. The problem of tax payment arrears is now of minor importance.

6

Import and Excise Taxation

Trade taxes were the principal source of government finance in each of the separate States of the Malay peninsula before World War II. The introduction of income taxation in 1947 reduced the degree of dependence of the newly-formed governments of Malaya and Singapore on such revenue. Nevertheless, during 1961-5, the contribution of trade taxes to total tax revenue amounted to 65% in Malaya and 40% in Singapore.

In Malaya, trade taxes consist of import and export duties and, for the period 1961-5, import duties accounted for almost 70% of total trade tax revenue. To preserve and encourage the development of entrepôt trade, no export duties have been imposed in Singapore and, until quite recently, the range of import duties was narrow. However, a determined effort is now being made to stimulate industrial development, and tariff protection is being used in conjunction with other forms of assistance in an endeavour to achieve this objective. Attention in this chapter is directed to import duty taxation. The analysis has been extended to include excise duties levied on domestic production, for the imposition of such taxes has been directly influenced by the structure of import duties. The number of commodities subject to excise taxes is small, but the revenue importance of such taxes has increased substantially since 1960. No general sales tax is levied in either Malaya or Singapore.

PRE-WORLD WAR II

Although seven of the eleven Malay States had been grouped into two loosely centralised political units by 1900 (the Federated Malay States and the Straits Settlements), the structure of customs and excise duties continued to develop separately in each of the several States. In 1907, initial steps were taken to remove taxes on interstate trade within the

Federated Malay States, and to establish a uniform structure of customs and excise duties. These goals were achieved by 1912, but customs barriers between the Federated Malay States, the Straits Settlements, and each of the unfederated Malay States continued until the end of World War II.

The desire to provide a contribution to Imperial defence expenditure led to increases in customs duties and an extension of coverage after the commencement of World War I. Most of the additional imposts were removed at the end of the war and, until 1930, import duties were restricted to liquor, tobacco, and petroleum, and excise duties to liquor.

The catastrophic fall in rubber and tin prices during the period 1929–32 focused attention on the vulnerability of an economy dependent on the export of two products, rubber and tin, for the import of food and other consumer and capital good necessities. In response, duties were imposed on the import of rice and other foodstuffs in an endeavour to stimulate domestic production and increase the extent of self-sufficiency.¹ Moreover, the depression clearly indicated the severe limitations of attempting to finance government expenditure from a narrowly based structure of customs duties. The slump in export earnings reduced the level of both export and import duty revenue, and the emergence of substantial budget deficits stimulated the first significant extension of the customs duty schedule apart from the transitory war duties. By 1932, thirty-six items were subject to import duty taxation and, for many items, the rate of tax had been revised upwards on several occasions.

The period from 1933 until the commencement of World War II was characterised by further extensions in the coverage of import duties, and by a degree of co-ordination of duty rates among the various Malay States. By 1940, each State levied an identical duty on imports of liquor, tobacco, and petroleum, the three principal sources of import duty revenue. The tariff schedule in the Straits Settlements did not extend beyond these three commodities. In contrast, an additional ninety commodities were subject to import taxes in most of the other Malay States.

¹ The import duty on rice was later removed in the Federated Malay States but continued to be effective in the northern rice growing States (Kedah, Perlis, Kelantan, and Trengganu) until the end of World War II. The post-war requirement that importers purchase a minimum quantity of domestic rice for each ton of imported rice has effectively placed an indirect levy on rice imports. The appendix to this chapter discusses this levy.

POST-WAR PERIOD

During the period of Japanese occupation, external trade virtually ceased. Although the Japanese endeavoured to enforce the structure of customs and excise duties prevailing before occupation, the yield of import duty revenue fell, and increasing dependence was placed on excise duties.

Following liberation in 1945, customs and excise duty unification was recognised as one of several prerequisites for the amalgamation of the separate States of the Malay peninsula into a Malayan Union. At the beginning of 1946, the customs tariff of the Federated Malay States was extended to the unfederated Malay States, Malacca and Penang. In response to considerable agitation by commercial and trading interests, the entrepôt status of Penang was recognised in May 1946 and all customs duties apart from those levied on liquor, tobacco, and petroleum were removed. For customs purposes, Malaya was divided into two areas: the Principal Customs Area and Penang. Singapore, politically separated from the mainland, retained the pre-war Straits Settlement schedule of import and excise duties.

Before 1957 most import duties were imposed for revenue purposes or for the control of domestic supplies of certain products. The uncertain future for rubber in Malaya and for entrepôt trade in Singapore has since led both countries to explore the potential of import duties as an instrument of economic policy.

Table 23 allocates total import and excise duty revenue raised in Malaya in 1965 by forms of expenditure. Almost two-thirds of total revenue was derived from levies on end-product consumption goods, the remaining one-third being borne by imported and domestically

Table 23 Malaya: import and excise duty revenue by forms of expenditure, 1965

Items of expenditure	Import duty revenue \$m.	Excise duty revenue \$m.	Import and excise duty revenue		Imports		Import duty revenue as a per cent of imports
			\$m.	%	\$m.	%	
Consumption goods	250	71	321	60.1	1,308	45.3	19.1
Intermediate goods	168	30	198	37.1	777	26.9	21.6
Capital goods	5	—	5	0.9	246	8.5	2.0
Unspecified	10	—	10	1.9	558	19.4	1.8
Total	433	101	534	100.0	2,889	100.0	15.0

Source: Derived from material supplied by the Malaysian Department of Statistics.

produced goods subject to further processing before final marketing (intermediate-use goods). Levies on capital goods are of negligible importance. A similar situation prevails in Singapore.

One striking feature of the composition of import and excise duty revenue is the high proportion of revenue collected from intermediate-use goods. In both Malaya and Singapore, however, duties on three products—unmanufactured tobacco, petroleum (including heavy fuel oils), and motor vehicles account for 80% of this revenue.² The duty on unmanufactured tobacco, increased by a mark-up percentage, is passed directly on to consumers. It is likely that a high proportion of the revenue raised from levies on petroleum, motor vehicles, and other goods used as inputs in the production and marketing process is also passed forward in the form of higher prices for a wide range of consumer goods.

As in the case of intermediate-use goods, revenue raised from end-product consumption goods is derived from a small number of products. In Malaya, duties levied on three items—beverages, tobacco, and motoring (defined to include duties on both motor vehicles and petroleum)—each contribute 20% to total duty revenue raised directly from households, levies on food providing a further 12%, and on textiles, 8%. The tax net is even narrower in Singapore, duties on three products—beverages, tobacco, and motoring—accounting for the major part of revenue derived from end-product consumption goods.

Thus, despite the substantial expansion in the range of protective duties levied, particularly since 1960, the bulk of the import and excise duty revenue raised continues to be derived from a relatively small number of goods. Levies on intermediate-use and consumer goods account for more than 95% of total duty revenue. Most of this revenue is derived either directly or indirectly from consumers. In 1965, import and excise duties absorbed 11% of total private consumption expenditure in Malaya and 6% in Singapore. The amount of government revenue raised, however, is an incomplete measure of the burden borne by consumers as a result of the levies. In the distribution of dutiable goods, a percentage mark-up is normally added to the import price including duty. Available data on mark-up percentages applied in different sectors of the Malayan economy amount to little more than informed guesses. For Malaya, a conservative estimate would increase the relative importance of import and excise duties in total private consumption expenditure

² The levy on motor vehicles is imposed at the point of sale rather than at the point of importation. Since there is no domestic production, this levy has been classified as a tax on imports.

for the year 1965 from 11% to 14%. The corresponding ratio in Singapore would increase from 6% to 7%.

The virtual absence of levies on capital and most intermediate-use goods was more an accidental by-product of the influence or revenue considerations on the choice of dutiable commodities than a conscious act of policy. Levies on a limited range of commodities—liquor, tobacco, motor vehicles, petroleum, textiles, and sugar—proved to be lucrative sources of revenue. The need to extend the tax net further was not pressing. In Singapore, entrepôt trade considerations represented an additional force restraining an extension of the tax net. The narrowness of the tax net in Singapore indirectly influenced both the coverage and the rate of duty taxation in Malaya. In particular, the desire to avoid any significant incentive to smuggling between the two territories led to the imposition of low duties on commodities which possess high value but low weight (watches and jewellery, for example).

Although the absence of taxes on producer goods was largely a historical accident, policy priority has been given to this attribute following the shift, particularly after 1957, in the emphasis of development policy towards greater encouragement of manufacturing activity. There is no clear line of distinction, however, between producer and consumer goods; petroleum, air-conditioning units, and typewriters, for example, may well be either. Inevitably, duties designed mainly to tax consumer goods involve some levy on producer goods. To assist in overcoming this problem, Malaya and Singapore have introduced a system of exonerations which permit manufacturers to apply for exemption from duties levied on intermediate-use and capital good imports. Exemption is normally granted, except where the materials for which duty remission is sought can be provided adequately by local manufacturers.

The exonerations assume various forms. In some cases, the duty is removed so that all importers of the particular product benefit. In other cases, full or partial exemption is granted to specific manufacturers. In addition, there may be restrictions on the period for which the exemption is effective, or a requirement that a certain proportion of the value of goods in their finished state should be the result of labour performed or materials produced locally.

The levies on dutiable commodities are either stated in *ad valorem* or specific terms. *Ad valorem* duties are set as a fixed percentage of the import price (including freight and insurance) of taxed commodities; specific duties are set as a fixed sum per unit of import. No use has been made of duties which combine both *ad valorem* and specific duties

(for example, duties set at 20% of import price plus 10 cents per unit), nor of duties which vary according to an established formula whether over a period of time or with fluctuations in import price. In the case of piece-goods, apparel, and other textile imports, duty rates are specified in both *ad valorem* and specific terms, the relevant duty being that which yields the higher revenue. The operative duty is normally the *ad valorem* duty, the specific duty being designed to raise more revenue from low-priced (sometimes dumped) textile imports than would occur if the levy were expressed solely in *ad valorem* terms.

Most dutiable imports entering Malaya pay duty at *ad valorem* rates, but more than 60% of total import duty revenue is derived from specific levies. The principal sources of import duty revenue—liquor, tobacco, petroleum, and sugar—are subject to specific duties. In Singapore, specific duties account for an even higher proportion of total import duty revenue.

Most *ad valorem* duty rates are set at 10%, 15%, 20%, or 25%, the last three rates being the most common. Apart from the revenue duties on products such as liquor, tobacco, and petroleum, it is reasonable to assume that most specific duty rates also fall within the range 10% to 25%. The spread of duty rates is therefore narrow, and the average rate of duty is low.

The preferential treatment that was extended to imports of certain goods from Commonwealth countries was abolished in 1966. This change did not, however, lead to a substantial rise in revenue collected. There were three reasons for this. First, the difference between preferential and full duty rates had been steadily reduced after 1957 and, in many cases, eliminated. Second, in levying new duties after 1957, a trend against any differential in the duty charged on Commonwealth and non-Commonwealth imports had been established. Finally, the pattern of demand for dutiable imports had shifted towards goods possessing lower preferential margins (as, for example, in the shift from imports of cigarettes to imports of unmanufactured tobacco following the expansion of domestic cigarette production), and towards non-Commonwealth imports.

Apart from minor setbacks in 1952-3 and 1958, import and excise duty revenue raised in Malaya has increased continuously since the war, collections in 1965 trebling the level of collections raised in 1950 (Table 24). At first sight it is tempting to conclude that the increase in import and excise duty revenue collected is due to the substantial rise in the value of imports since 1950. However, by ignoring one fundamental characteristic of import duty taxation in Malaya, notably that duty

	1958	1959	1960	1961	1962	1963	1964	1965	1966	1967	1968
Value (\$m.)											
Tobacco	103	104	106	109	106	111	111	111	118	121	124
Liquor	41	42	47	47	47	50	51	55	50	52	53
Petroleum	59	68	89	92	97	106	111	122	133	170	181
Motor vehicles	39	44	55	62	67	68	76	108	130	142	153
Textiles	18	21	21	20	20	19	19	20	18	19	20
Sugar	19	16	20	21	23	21	24	24	30	42	44
Other	51	58	78	76	80	81	85	95	96	102	109
Surtax	—	—	—	—	—	—	—	—	—	36	41
Total import and excise duty revenue	330	353	416	427	440	456	477	534	575	683	725

Percentage distribution

Tobacco	31.2	29.5	25.5	25.5	24.1	24.3	23.3	20.7	20.5	17.7	17.1
Liquor	12.4	11.9	11.3	11.0	10.7	11.0	10.7	10.3	8.7	7.6	7.3
Petroleum	17.9	19.3	21.4	21.6	22.0	23.2	23.3	22.8	23.1	24.9	25.0
Motor vehicles	11.8	12.5	13.2	14.5	15.2	14.9	15.9	20.2	22.6	20.8	21.1
Textiles	5.5	5.9	5.0	4.7	4.6	4.2	4.0	3.7	3.2	2.8	2.7
Sugar	5.8	4.5	4.8	4.9	5.2	4.6	5.0	4.5	5.2	6.1	6.1
Other	15.4	16.4	18.8	17.8	18.2	17.8	17.8	17.8	16.7	14.9	15.0
Surtax	—	—	—	—	—	—	—	—	—	5.2	5.7
Total import and excise duty revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: As for Table 9.

revenue is derived from a small number of products, this argument obscures more important developments.

The first development of significance is that total revenue derived from levies on tobacco and liquor has barely increased since 1951, the share of these two commodities in total duty revenue having fallen from 62% in 1950 to 31% in 1965 (Table 24). The causes of stagnation in these two sources of duty revenue are threefold. First, expenditure on liquor and tobacco has not expanded as rapidly as total expenditure since 1950. Second, there has been no increase in the rates of duty charged on imports of liquor and tobacco since 1953. Third, increases in the domestic production of cigarettes, particularly in recent years, has led to a significant switch from imports of cigarettes to imports of unmanufactured tobacco, the latter bearing a slightly lower duty per unit of import.

While there has been an increase in revenue derived from levies on imports of piece-goods, apparel, and other textiles, the relative importance of this source of revenue has also declined since 1950. Textile imports have increased and have maintained their share of total imports. The decrease in the relative importance of this source of revenue is attributable to the absence of duty rate adjustments since the pre-war period (apart from a small increase in 1956).

In marked contrast, revenue derived from levies on motor vehicles and petroleum has risen continuously since the end of World War II. Between 1950 and 1965, the share of these two duties in total duty revenue rose from 20% to 43%. Levies on motoring have replaced liquor and tobacco as the principal sources of duty revenue. Two factors have contributed to the substantial rise in motor vehicle and petroleum revenue. By far the most important has been the fivefold increase since 1950 in the number of registered motor vehicles. The second factor has been the upward adjustment of duty rates; relative to retail price, the duty on regular grade petroleum rose from 34% in 1950 to 60% in 1965. Following the establishment of domestic refineries, excise levies have accounted for an increasing part of total revenue raised from the domestic consumption of petroleum and fuel oils since 1963.

The duty on imports of refined sugar is the most important source of revenue obtained from food imports; its importance as a source of import and excise duty revenue has expanded slightly since 1950. Neither cane nor beet sugar is produced locally. The major part (almost 90%) of sugar imports is sold directly to households. Malays tend to spend a higher proportion of their income on sugar and confectionery than do other races. As a result, the tax on imports of refined sugar

bears more heavily on Malays than on other racial groups. Since sugar is an item of mass consumption, it is questionable whether such a high tax should be levied on this commodity. The single advantage of the tax is that it succeeds where most other taxes fail: it imposes a levy on the Malay community. But it is an extremely regressive levy, and one on which the government could afford to place less reliance.

The last development of significance has been the rise in the relative importance of duties on commodities other than liquor, tobacco, petroleum, motor vehicles, textiles, and sugar. The main sources of revenue may be grouped under three headings; processed food imports (dried fruits, condensed milk, canned foods), consumer durables (sewing machines, refrigerators, air-conditioning units), and luxury goods (cosmetics). An expansion of demand for such dutiable commodities and an extension in the coverage of import duties account for the rise in the importance of these sources of duty revenue.

In 1965, a turnover tax was introduced into Malaya. The tax was levied at a rate of 0.5% per annum on the turnover of all trades, businesses, professions, and vocations, turnover being defined to include the value of sales and the gross value of earnings derived from the provision of services. Because of a growing list of exemptions and numerous administrative difficulties, the turnover tax was replaced by a surtax on imports in 1967. The surtax is currently levied at a rate of 2% on all imports, including imports into Penang Island. Goods exempted from import duties under ruling exemption orders, goods imported directly by Federal and State governments and by the Diplomatic Corps, goods in transit and in bond, goods moving within Malaysia, rice, salt, crude petroleum, and certain import items whose duty levels have been bound as a result of trade agreements with Australia and New Zealand, were not liable to surtax. Rice and salt were exempted because they were items of mass consumption. Crude petroleum was exempted because this exemption improved the margin of protection provided for internally refined petroleum *vis-à-vis* imported refined petroleum which was liable to surtax. The exemptions provided for items bound by trade agreements with Australia and New Zealand (cheese, wheat and wheat flour, bran and pollard, tallow, meat, milk, butter, newsprint in rolls, and zinc) were extended to similar imports from other sources. The surtax is levied on the value of imports excluding any local import duty. Import duty drawback provisions have been extended to include surtax as well as import duty.

Total import and excise duty revenue raised in Singapore trebled between 1950 and 1965 (Table 25). The duty on petroleum is the most

Table 25 Singapore: allocation of import and excise duty revenue by source, 1950-66

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966
Value (\$m.)																	
Liquor	13.5	20.1	22.4	22.2	21.6	23.9	27.6	29.1	26.1	24.6	24.8	27.3	28.3	31.7	34.3	38.2	41.1
Tobacco	25.3	32.3	33.8	34.4	33.2	33.8	34.3	39.3	40.6	37.1	41.5	41.9	46.3	45.3	45.4	47.1	46.8
Petroleum	10.7	12.6	14.7	16.0	17.2	19.4	22.7	27.2	34.5	34.2	37.8	37.2	37.9	38.9	41.7	53.2	55.7
Protective duties	—	—	—	—	—	—	—	—	—	—	—	0.2	0.5	0.7	0.7	4.1	16.9
Other revenue duties	—	—	—	—	—	—	—	—	—	—	—	—	—	—	0.4	13.1	14.3
Total import & excise duty revenue	49.5	65.0	70.9	72.6	72.0	77.1	84.6	95.6	101.2	95.9	104.1	106.6	113.0	116.6	122.5	155.7	174.8
Percentage distribution																	
Liquor	27.3	30.9	31.6	30.6	30.0	31.0	32.6	30.4	25.8	25.7	23.8	25.6	25.0	27.2	28.0	24.5	23.5
Tobacco	51.1	49.7	47.7	47.4	46.1	43.8	40.6	41.1	40.1	38.7	39.9	39.3	41.0	38.9	37.1	30.3	26.8
Petroleum	21.6	19.4	20.7	22.0	23.9	25.2	26.8	28.5	34.1	35.6	36.3	34.9	33.5	33.4	34.0	34.2	31.9
Protective duties	—	—	—	—	—	—	—	—	—	—	—	0.2	0.5	0.5	0.6	2.6	9.7
Other revenue duties	—	—	—	—	—	—	—	—	—	—	—	—	—	—	0.3	8.4	8.1
Total import & excise duty revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Singapore 1952-67; also 1968: Table 10.9.

important of the three main duties. In recent years, levies have been placed on a wide range of imports as a measure of protection for domestic industries. The revenue derived from these levies is small but expanding. The duties are significant for they represent a break with the traditional notion that, to protect entrepôt trade, duties should not be placed on imports other than liquor, tobacco, and petroleum.

It may be argued that the expected stagnation in the level of export earnings would restrain the growth of import duty revenue in the future. But a closer inspection of the main sources of duty revenue reveals that this conclusion does not necessarily follow. First, the demand for liquor and tobacco imports is largely insensitive to price changes. In addition, the effect of population growth on the demand for these products must be taken into account. During the decade after 1950, population growth (averaging more than 3% per annum) was concentrated in the young age-groups, the non-drinking and non-smoking section of the community. But the swell has now extended to the working-age population. As a result, an absolute increase in the demand for liquor and tobacco products can be expected and the level of import and excise duty revenue should at least be maintained. Second, although expenditure on motor vehicles and petroleum products rises as income rises, it is less clear that such expenditure falls to the same extent when income falls. When allowance is made for the influence of changing taste factors—the increasing preference for road rather than rail transport, and the growing element of prestige associated with car ownership—it is likely that duty revenue derived from taxes on motoring will continue to expand. Finally, a significant fall cannot be expected in revenue obtained from items of mass consumption such as sugar and textiles. Imports of liquor, tobacco, petroleum, motor vehicles, sugar, and textiles represent only 16% of total imports, but taxes on these commodities account for 80% of duty revenue. Fluctuations in the value of imports will not markedly affect the gradual upward course of total import and excise duty revenue in either Malaya or Singapore.

One final issue which needs to be considered before we turn to consider future guide-lines for the development of import and excise duty taxation is the problem of administration. The Customs and Excise Department, a portfolio within the Ministry of Finance in both Malaya and Singapore, is responsible for the administration of import and excise duties. Adjustments in the coverage and rates of duty taxation are the prerogative of Parliament.

The administration of import and excise duties involves several difficult problems. The first is that of classification. Before 1960, wide

definitions were used in framing tariff items and increasing difficulties were encountered in determining the correct classification of many articles for tariff purposes. This problem was most serious in Malaya, and was partly overcome by correlating the tariff with the detailed Malayan trade classification in 1960. But there continues to be scope for importers and customs administrators to differ on the classification of particular commodities.

The second problem centres on the valuation of imports for *ad valorem* duty purposes. Valuation for customs purposes is based on the open market sale price of goods to buyers increased by freight, insurance, and other transport costs. In Malaya, a central valuation branch regularly disseminates values for a wide range of dutiable *ad valorem* imports to all assessing stations. In addition, special price reporting arrangements have been made for textiles, a particularly complex and troublesome commodity from the point of view of duty taxation. The main problems centre on the sale price of goods sold by overseas firms to subsidiaries (including importing houses) at interfirm prices,³ the valuation of imports subsidised by governments in the country of origin, and the detection of undervaluation, deliberate or otherwise.

Finally, smuggling is a time-honoured activity in both Malaya and Singapore; annual reports of the Customs and Excise Departments regularly testify to the magnitude and intractability of this problem. The incentive to smuggle is enhanced by three factors. First, imports of certain products (opium, morphine) into both countries are prohibited. The black market price for opium is very high with the result that handsome profits can be made by successful traffickers. Second, many commodities dutiable in Malaya are not taxed in Singapore or Penang (nor in other neighbouring countries, for example Thailand), and thus an incentive is provided for smuggling goods into Malaya. This incentive has been enhanced in recent years by the extension of duty coverage in Malaya. Third, differences in the tax rates on imports dutiable in both Malaya and Singapore provide a further incentive to smuggling. The most that can be expected of preventive services is that smuggling is kept within reasonable bounds.

³ An experimental 35% *ad valorem* duty on imported cigarettes was imposed by the Singapore government during 1958 but was later abandoned because importers, in collusion with overseas suppliers, reduced the landed price of cigarettes to a point where revenue yield was threatened.

GUIDE-LINES FOR THE FUTURE

Despite a steady increase in the relative importance of income taxation and considerable scope for adjustments which would significantly expand its role, heavy dependence on trade taxes is likely to continue. The prospect for an expansion of export duty revenue is slender; the expected, prolonged decline in the price of rubber may largely, if not completely, offset the effect of production increases on revenue. In these circumstances, the government cannot afford to relax emphasis on the revenue attribute of import and excise duties. At the same time, the need to stimulate industrial development and to maintain balance of payments equilibrium suggest that greater attention may have to be given to the protective and control of foreign exchange attributes of these duties.

In their report on taxation in Jamaica, J. R. and U. K. Hicks state that 'the protective purpose of a tariff is always fighting against the revenue purpose; the more successful . . . [a tariff] is in one direction, the less successful it will be in the other' (1955: 58). If the gradual extension of the range of protective tariffs granted in Malaya and Singapore succeeds in reducing the level or rate of growth of imports, it would seem necessary to impose an equally comprehensive network of excise duties if the total revenue yield of import and excise duties is to be maintained. There is, however, a danger of overemphasising the importance of this conflict between the revenue and protective attributes of import duties. In Malaya, more than 80% of total import duty revenue is derived from levies on six products (liquor, tobacco, petroleum, motor vehicles, sugar, and textiles) and, in Singapore, the tax net is even narrower. If tax rates on all other imports subject to duty were increased, the loss of revenue which would result from any reduction in the level of imports would not be significant. In fact, for almost one-half of imports into Malaya and for more than two-thirds of imports into Singapore, there is no conflict between the revenue and the protective attributes of duties, for the potential to raise revenue has not been explored. The real problem is to determine whether free importation or the use of tariffs to restrict imports is the best method of achieving national objectives other than that of raising revenue.

While increasing use has been made of tariff protection in Malaya since 1957, the emphasis in industrial incentive policy has been placed on:

- (a) pioneer industry and other forms of income tax relief;
- (b) the development of industrial sites;
- (c) the duty free import of producer goods;
- (d) anti-dumping duties;

- (e) assurances to foreign investors of freedom in the remission of profits and the repatriation of capital;
- (f) guarantees against nationalisation; and
- (g) guarantees of exchange rate stability.

Each form of incentive assists in creating an environment conducive to investment activity, but all are essentially passive forms of inducement.

The limited role played by tariffs in the encouragement of manufacturing activity has been due to two factors. The first has been the continued influence of the policies of the colonial government on the present government. Free trade, qualified only by the levy of duties for revenue purposes, has been accepted as one of the factors which contributed to the prosperity of the colonial period. Politically influential pressure groups, with interests centred on import trade, have succeeded in retaining the essential features of the pre-independence structure of trade relationships. Their case has been strengthened by the argument that tariffs tend to redistribute income from the rural to the urban centres of population—from the Malay to the Chinese community.

The inadequacy of the present tariff machinery has been the second contributing factor. Long delays have occurred in the consideration of applications for tariff protection and, in general, emphasis has been placed on the easier task of determining whether a firm qualifies for specific import duty exonerations. The void created by the ineffectiveness of the tariff machinery has thrust income tax relief to the forefront of concessions available to intending entrepreneurs.

If the tariff is to play a more active role in stimulating industrial development, the government should be prepared to ignore the short-run interests of the commercial sector, and to evaluate more carefully the effect of tariffs and other incentives to manufacturing activity on the rural community. A Household Budget Survey conducted in Malaya in 1957–8 revealed that, for all surveyed income groups, expenditure on food, liquor, tobacco, rent, and services accounted for 76% of total expenditure, the ratio varying inversely with income and being higher at each income level in rural relative to urban areas. Two points follow. First, as indicated by Wheelwright (1963: 232), if the tariff on *all* imports apart from food, liquor, and tobacco were increased 25%, the cost of living would rise by only 6%. It may be added that the rise would be proportionately greater for upper relative to lower income groups and for urban relative to rural dwellers, as these groups spend a higher proportion of their income on items apart from food, liquor, tobacco, rent, and services. The cost of industrialising behind a tariff barrier would

therefore be distributed in broad, equitable terms. Wealthier people would bear a proportionately greater share of the cost than poorer people. Urban dwellers (who benefit directly from industrialisation) would contribute, in relative terms, more than rural dwellers. Finally, a levy would be placed on the poorer members of the community (both urban and rural) in recognition of the fact that, in the long run, the whole community should benefit from industrialisation.

The second point is that levies on food and other basic non-durable consumer goods (soap, toothpaste, etc.) require detailed justification, for they involve a regressive increase in the cost of living. Pioneer industry tax relief has largely stimulated the growth of consumer good industries: matches, detergents, toothpaste, pharmaceutical preparations, and plastic articles being some examples. If, at the end of the period of tax relief, such firms require and are granted tariff protection, the associated increase in the cost of living will be borne more heavily by the poorer section of the community and by rural relative to urban consumers. There is, then, a need to exercise care in the choice of commodities for which tariff protection is granted.

The need to prevent any interference with *entrepôt* trade has long been the mainstay of arguments against any extension of the schedule of import and excise duties in Singapore. Curiously, this argument was accepted without question during the decade after 1950 despite a growing appreciation of the compelling need to stimulate industrialisation. But, since 1960, a new dimension has been given to the question of tariff protection following the establishment of a very efficient and effective Economic Development Board (EDB). Research undertaken by the EDB revealed that, while *entrepôt* trade accounted for 65% of Singapore's imports, such trade was dominated by two products: rubber and oil. While not overlooking the importance of other products in *entrepôt* trade, the EDB indicated that the domestic value added of such trade was a relatively small part of Singapore's total national income, and that for many products it was necessary to question whether domestic production behind a tariff barrier might not add more to employment and national income.

Apart from industries where there is a high degree of natural protection, it cannot be expected that entrepreneurs will establish firms without an assurance of a protected domestic market particularly as, by Asian standards, labour costs are high in both Malaya and Singapore, and well-established, alternative outlets are available for the use of capital: rubber, tin, and *entrepôt* trade. Thus, if the industrial sector in Malaya and Singapore is to be expanded, it would seem that more

positive assistance in the form of tariff protection will be required. But such a change in emphasis raises the problem of determining the level of protection.

Levies on most dutiable imports into Malaya and Singapore are set at between 10% and 40% of c.i.f. import value, the main exceptions being the levies on the principal sources of duty revenue. It is difficult (if not impossible) to discern the systematic use of any particular principles in the determination of duty rates. Most of the duties have been imposed for revenue purposes; they have not been designed to provide a significant margin of protection to existing or potential domestic manufacturers. Moreover, the dispersion of duty rates is very narrow. From an administrative viewpoint, it would be simpler if rates on dutiable imports other than the main sources of duty revenue were standardised at one level, for example, 25% of import value.

If, as duties are extended to more imports, rates are set at one level, an approximation may be made towards a uniform tariff. Several advantages accrue from this form of tariff. Foremost among these advantages are its effects on domestic demand and production. On the demand side, the imposition of a uniform tariff on all imports would restrict most the import of those goods which possess a high price elasticity of demand; goods which, as Corden has stated, 'consumers or consuming industries can most do without' (1958: 332). On the production side, the industries stimulated most would be those for which domestic supply elasticities are high; the uniform tariff provides an incentive for greater expansion on the part of those industries which are able to produce output with the least excess cost over the price of competing imports. The uniform tariff, then, automatically restricts inessential imports more than essential imports and stimulates a low cost expansion of domestic production.

The advantages of applying the uniform tariff principle to the schedule of import duties applicable in Malaya and Singapore should not be overlooked. By depending more heavily on an automatic device in determining which industries should expand most behind a protective barrier, tariff boards are relieved of much pressure and are able to concentrate attention on considering whether, and for what reasons, specific industries deserve additional protection (or exoneration from import duty taxation). Second, by restricting inessential imports, foreign exchange is freed for the import of goods essential to growth behind a tariff barrier. By varying the uniform tariff rate above a specified minimum level, imports may be restricted and foreign exchange conserved without disturbing emphasis on the expansion of firms able to produce output

with the least excess cost over the price of competitive imports. There is no need to determine by administrative decree which imports should be restricted most; the uniform tariff does just this on the basis of essentiality. Finally, since most duty rates are set within a narrow range (10% to 40% of import value), the adjustments needed to achieve rate uniformity within the existing schedule of dutiable commodities would appear to be neither politically nor administratively difficult.

Nevertheless, endeavours to extend the uniform tariff principle to all imports entering Malaya and Singapore would confront several difficulties. Four issues have been singled out for discussion.

It may be argued, first, that entrepôt trade considerations prevent the imposition of a tariff on all imports. It would be possible to exempt the main entrepôt products—rubber and oil—from the provision of the tariff. But, in general, entrepôt traders should be expected to pay duty, the justification being that some contribution to the provision of harbour, road, and other facilities should be obtained from this trade. If the trade cannot bear such a levy, it must be decided whether, in the longer term, a stimulation of domestic manufacturing activity behind a tariff barrier might not provide a greater contribution to employment, national income, and government finance.

Second, a case could be made for exempting basic consumer good imports from duty taxation. Levies on such goods would bear more heavily on the poorer section of the community and on rural relative to urban consumers. By exempting these goods, the increase in the cost of living associated with the imposition of a uniform tariff would be distributed more in accordance with ability to pay; the cost of stimulating industrial growth behind a tariff barrier would bear more heavily on richer relative to poorer people and on urban relative to rural dwellers. It may be argued that, by excluding the basic items of consumption expenditure from duty taxation, the potential to levy a tax on the mass of the population is forgone. But before taxing goods which possess both a low price and income elasticity of demand, it should be questioned whether revenue needs cannot be satisfied by more equitable forms of taxation.

Third, the imposition of duties on capital and intermediate-use good imports would tend to offset the incentive provided to investment activity by tariffs and income tax concessions. A uniform tariff on all imports is designed to discourage the import of goods which consumers *and* consuming industries can most do without. Emphasis is concentrated on the import of essential consumer, capital, and intermediate-use goods. In static equilibrium analysis, there is no real conflict between the extension of the uniform tariff to producer goods and the stimulation

of industry able to produce output with least excess cost over the price of competing imports. However, when account is taken of the urgent need to stimulate industrial activity in Malaya and Singapore, a strong case can be made for a lower duty, say at a rate of 10%, on intermediate-use good imports, and for the exemption of capital good imports from taxation. Many firms in Malaya and Singapore make considerable use of imported goods in producing their output. If the duty levied on imported intermediate-use and capital goods is less than the duty levied on imports which compete with the final goods produced by domestic firms, the effective degree of protection granted to domestic firms will exceed the level expressed by the tariff on the final product (25%). This form of assistance would provide a further incentive to expansion on the part of those firms able to produce goods at least excess cost over the price of competing imports. As firms increase the domestic value added component of their products, the prospect of inducing linkage effects which would stimulate the local production of additional products would be enhanced.

The final problem centres on the issue of smuggling. If the tariff level were not set too high on goods of high value but low weight and bulk, the incentive to smuggling would not be great.

What points emerge as a guide to the future development of import duty taxation? The first is that basic consumer goods should, as far as possible, be exempt from taxation. Second, other end-products should be subject to taxation and, apart from the principal revenue levies, tax rates on these imports should be standardised at one level. Additional protection should be granted only if the existence of potentially significant external economies could be proved beyond doubt. Third, capital good imports should enter Malaya and Singapore duty free. This provision effectively increases the value of protection granted to producers, but provides a greater stimulus to the more capital intensive industries. The arguments in favour of encouraging capital intensive rather than labour intensive production techniques were outlined in Chapter 5. Fourth, intermediate-use good imports should be taxed more lightly than end-product imports to encourage firms to increase the domestic value added component of their products. Fifth, if there is a need to impose restrictions on imports to conserve foreign exchange, it is the duty on final product imports which should be varied up from a base level. Finally, levies on a small number of commodities (liquor, tobacco, petroleum) would continue to be the main sources of duty revenue, and tax rates on these commodities would be set with this objective in view. Additional revenue would be derived from levies on

other end-product imports, but the principal purpose of such levies is to grant a measure of protection to domestic producers and to restrict the import of inessential consumer and intermediate-use goods. Since the main revenue duties are levied on goods which possess a high income and low price elasticity of demand, it is likely that duty revenue derived from this source will rise as income rises.

As the domestic production of goods which were the main sources of import duty revenue has expanded, the governments of Malaya and Singapore have imposed excise duties in order to recoup revenue losses. Excise taxes are levied only on that part of output destined for the domestic market; export sales are exempt from the tax. If the proposed semi-uniform *ad valorem* tariff provides a significant stimulus to domestic productive activity, a more extensive use of excise taxes may be required. This possibility raises two issues. First, should consideration be given to the replacement of import and excise duties by a comprehensive tax at the retail or wholesale stage? Second, should consideration be given to the replacement of existing taxes levied on business firms by a single tax on value added?

The advantages of retail taxation are many. First, taxes are applied to final sale price. There is no scope for tax pyramiding as in the case of import and wholesale taxation. Since retail margins are included in the tax base, retail taxes can raise the same amount of revenue at lower tax rates than other commodity taxes. Second, the problem of applying tax rates to hypothetical prices is avoided. Third, consumers can clearly distinguish the prices of goods before and after taxation. Finally, exports can easily be exempted from retail taxes. But the use of retail taxation in Malaya and Singapore would be impracticable, for the dominance of small establishments in retail trade would magnify administrative problems and create opportunities for a substantial degree of tax avoidance and evasion. Moreover, adequate business records, particularly in small business establishments, are generally not available.

While, in some respects, wholesale taxation is preferable to dependence for revenue on import duties—the scope for tax pyramiding, for example, is less—administrative considerations favour continued dependence on import and excise duty taxation in a country where imports form a high proportion of total domestic supplies.

The desirability of introducing a value added tax raises issues which extend beyond the confines of import and excise duty taxation. In fact, its consideration questions the whole basis of the existing tax structure in Malaya and Singapore. It would be better, therefore, to consider this issue separately in the next chapter.

APPENDIX

THE RICE SUBSIDY

No import duty is levied directly on rice imports into Malaya, but the requirement that importers purchase a minimum proportion of their needs from a government stockpile effectively increases the price of imported rice to consumers.

The government maintains a stockpile of rice to ensure the availability of rice supplies to the domestic market for a period of six to twelve months (should external supplies be cut off), a minimum level of price support for domestic rice producers, and a measure of stability in the domestic price of rice.

The government guarantees rice growers in Malaya a minimum price of \$16 for each picul of paddy rice sold to the stockpile.⁴ But finance and storage space is restricted, and it is not advisable to store rice longer than six to nine months. To rotate the stockpile, importers are required to purchase one ton of rice from the stockpile for each one ton of imported rice.

High quality domestic rice commands a higher price on the free market than the guaranteed government price. Consequently, only low quality rice is sold to the stockpile. In 1965, the buying price to importers of milled rice from the stockpile averaged \$28 per picul. The selling price of low quality rice to consumers was \$24 per picul, so that importers suffered a loss of \$4 per picul on rice bought from the stockpile. This loss is passed forward to consumers of higher quality imported rice for which the income elasticity of demand is high. Since the stipulated ratio of imports to purchases from the stockpile was 1:1, purchases from the stockpile approximated the quantity of imported rice (293,000 tons). The indirect tax on rice imports is therefore estimated to be \$19.6 million (293,000 tons multiplied by a net loss per ton of \$67, which is equivalent to a net loss per picul of \$4).

In theory the scheme is admirable. Purchasers of high quality imported rice are taxed to provide a direct subsidy to domestic rice producers. But the scheme has many shortcomings. Because the support price is below the free market price for high quality rice, the scheme has provided assistance only to producers of low quality rice. By guaranteeing one fixed price for any type of

⁴ In the Korean War boom (1950-2), rice growers found it profitable to shift emphasis from rice cultivation to rubber tapping. To offset the widening price differential between rubber and rice, the government increased the value of rice support to \$17 per paddy picul. The value of support fell to between \$12 and \$14 per picul during the period 1953-5 but rose to \$15 as the price of rubber increased late in 1956. No further changes occurred until 1964 when the value of support was increased to \$16 per paddy picul. There is no limit on the amount of rice that domestic producers may sell to the stockpile at the guaranteed market price.

rice sold to the stockpile, the scheme has not encouraged producers to grow rice varieties more closely related to internal demand requirements. Price support has enhanced the position of low-quality rice producers; emphasis has been placed on the quantity rather than on the quality of rice output. Rice output is expected to rise 30% between 1965 and 1970; off-season paddy is estimated to account for 55% of this increase. But off-season paddy consists mostly of a glutinous, easily broken, rice variety. In contrast, consumers (particularly outside the northern rice-growing States) prefer highly polished, long-grained rice.

Apart from the need to develop a quick-growing off-season variety of rice which satisfies consumer requirements more closely, there is a need to ensure that producers attempt to grow varieties of rice demanded by consumers. To induce this shift, the stockpile support price should vary with the quality of rice. It is normally argued in Malaya that the lack of grading facilities prevents the introduction of price differentials for the various types of rice sold to the stockpile. This is a circular argument. If price differentials were introduced, endeavours to take advantage of higher prices would stimulate the growth of grading facilities. The more important issue is to ensure that middlemen do not absorb the price differentials and so distort the pattern of incentives meant for producers.

The Singapore government also maintains a rice stockpile but, since little rice is grown in Singapore, there has been no need to develop a price support scheme for domestic producers. The stockpile consists wholly of imported rice, and since much of this rice is bought on favourable government to government terms, it has been an additional source of government revenue. In contrast to the position in Malaya, the stockpile in Singapore has financed its own expansion in line with population growth.

A Value Added Tax?

In an article published in 1966, McKinnon forcefully argues the case for replacing the existing conglomeration of levies paid by business firms in Singapore (company income tax, property tax, provident fund levies, payroll tax, import duties, and miscellaneous excise taxes) by a single tax on value added.¹ Because his proposal appears to be most realistic, it is of value to recapitulate its main features in order to assess, first, the economic effects of such a far-reaching change in the tax structure and second, the feasibility as well as the desirability of introducing such a change in Malaya as well as in Singapore.

As a preliminary, it is necessary to define the meaning of the term 'value added' and to distinguish two basic types of value added tax (VAT). Before any deduction is made for capital expenditure, value added is defined as a gross concept; that is it comprises wages, salaries, interest, rent, and net trading profits (the sum of which equals net value added), plus an allowance for capital consumed during the period in question (that is depreciation). The distinction in the types of VAT is due to differences in the tax treatment of capital expenditure. Capital expenditure may either be written off against gross value added over several periods on the basis of some estimate of capital consumed during each period until the aggregate deduction claimed equals the initial capital outlay, or the total capital outlay may be deducted from gross value added in the year in which it is incurred. According to the first approach, the tax base is effectively equal to net value added. Assuming that no tax is levied on government transactions, this tax base is equal to the sum of private sector sales of domestically produced end-use consumer and capital goods sold to residents and to foreigners, less deprecia-

¹ See McKinnon 1966; see also subsequent discussion in McKinnon 1967a, Bird 1967, and McKinnon 1967b.

tion. Following Shoup's (1956) terminology, this form of tax may be referred to as an 'income' VAT.² According to the second approach, the tax base in any one period consists of gross value added less total capital outlays made during the period in question. Assuming again that no tax is levied on government transactions, this tax base may alternatively be expressed as being equal to total sales by the private sector of domestically produced end-use consumer goods to residents and to foreigners. This type of tax is known as a 'consumption' VAT.³ If a given amount of revenue is to be collected by means of a VAT, an 'income' VAT will tend to be less regressive (in the short term at least) than a 'consumption' VAT, for it includes net capital expenditure as well as consumption expenditure in its base. But, because its base does include capital expenditure, an 'income' VAT may inhibit long-term growth more than a 'consumption' VAT would.

As its name suggests, a VAT is a tax on value added originating in the country where the tax is levied; tax is paid on the domestic production of goods and services, regardless of whether the goods are destined for domestic consumption or for export. However, following the imposition of such a tax, the competitive position of imports *vis-à-vis* domestically produced goods would be improved. If such a result were not desired, a separate tax would need to be imposed on imports.

If exports were exempted from both the VAT and the import duty, the tax would effectively be converted from a levy on the supply of goods and services within a country (domestic production plus imports) to one on the domestic demand for goods and services.

THE PROPOSAL

McKinnon's proposal assumes the form of a 'consumption' type VAT combined with a uniform tariff on imports. A 'consumption' type VAT requires that tax be levied on the sum of wage, salary, rent, and interest payments, plus gross trading profits, less capital outlays made during the period. However, difficult administrative problems arise if an attempt is made to levy a tax directly on these components. For example, would fringe benefits provided to employees be treated as a business expense (and thus be offset against gross income in determining gross profits) or

² If no tax is levied on government transactions, only part of total income produced during any period in question is subject to tax. In these circumstances, the tax is not a complete income VAT.

³ If no tax is levied on government transactions, the tax is a partial rather than a complete consumption VAT.

as part of wage and salary income (and thus part of value added)? Would applications of income, such as contributions made to charitable organisations, be permitted as a deduction from gross income in determining gross profits? If the VAT is to involve fewer problems of interpretation and administration than the present income tax, the method of collecting the tax needs to be simplified.

An alternative approach would be to base the tax on a firm's gross sales net of purchases of capital and intermediate-use goods. This raises the problem of ensuring that firms do not understate the value of gross sales nor overstate the value of their purchases of capital and intermediate-use goods.

Recognising these difficulties, McKinnon favours adoption of the French method of collecting VAT revenue. Under this approach, tax is levied on the value of a firm's gross sales, and the firm is then permitted to deduct from this tentative tax liability all taxes that have been paid on inputs purchased from other firms. To claim a tax credit, a firm must receive an invoice from the supplying firm which shows the tax paid as well as the total value of materials purchased. This method of collection provides the tax authorities with, as McKinnon (1966:3) puts it, 'an automatic cross-auditing system of verification' which ensures that firms do not overstate the value of their purchases of capital or intermediate-use goods. However, apart from firms which sell producer goods only, this method of collection does not reduce the incentive for firms to understate the value of their gross sales. This point is elaborated in a discussion of administrative issues below.

In order to prevent any erosion of government revenue collected in Singapore following the tax switch, McKinnon estimates that the VAT would need to be levied at a rate of 10%. Imports would be subject to tax at the same rate, but the import tax would be levied on the landed price of imports marked up by the 10% VAT; in order to equate the import duty with the domestic VAT rate, a marginally higher levy would need to be imposed on imports, because the landed (c.i.f.) value of imports would not include any local VAT component, whereas the sales value of domestically processed goods (the base for the domestic VAT) would include a mark-up for VAT paid on purchased inputs. Under this suggested tax structure, firms would pay tax at a rate of 10% on the value of their gross sales, but would be allowed to deduct from the resulting tentative tax liability all taxes paid on purchased inputs, whether domestically produced or imported. In this way, firms would be subject to tax at a rate of 10% on their domestic value added. In addition, the government would collect a levy on imports on entry.

Having established the broad nature of the tax base, the method of collection, and the tax rate, McKinnon proceeds to manipulate the proposed tax structure in order to provide incentives for export activities, for new (pioneer) firms, and for the production of new (pioneer) products by existing firms.

In the non-pioneer sector, McKinnon provides that firms producing for export should be exempt from the tax on gross sales and, in addition, should be permitted to claim a credit for tax paid on purchased inputs, regardless of whether the inputs were produced in Singapore or purchased abroad. Thus, compared with firms producing goods for the domestic market, export firms would be given a 10% subsidy on their domestic value added. Firms which produced output for both the domestic and the export market would be granted the same concession as export firms in respect of the export part of their total output.

Pioneer firms producing for the domestic market would be exempt from the tax on gross sales for a period of five years. However, during this period, such firms could not claim a rebate for tax paid on purchased inputs. This adjustment effectively limits the tax exemption provision to the value added by the pioneer firm. If the value of inputs purchased by the pioneer firm equalled its value added, the pioneer firm would be subject to a 10% tax on its domestic value added. If, however, the value of the purchased inputs amounted to less than the firm's value added, the pioneer firm would be taxed at a lower rate (and vice versa). Thus, compared with other firms producing for the domestic market, a pioneer firm would be in an advantageous position if its value added exceeded its purchased inputs, but in a disadvantageous position if its value added were less. Should the pioneer firm produce intermediate-use goods, domestic firms purchasing the resulting output would be permitted to deduct the tax that would have been paid on such inputs in the absence of the pioneer concession, thus enhancing (potentially, at least) the competitiveness of the pioneer firm as a supplier of intermediate-use goods *vis-à-vis* non-pioneer firms.

Pioneer firms producing for export would be treated more favourably than other firms producing for export; no tax would be levied on the value of gross sales of such firms, and a credit could be claimed not only for tax paid on purchased inputs (whether purchased from domestic suppliers or from abroad), but also for tax that would have been paid on the firm's value added if it were not a pioneer firm and if it sold the whole of its output to the domestic market. This latter concession would not be extended to non-pioneer firms engaged in export activities. Compared with the latter, pioneer firms producing for export would

effectively be given a 10% subsidy on their domestic value added; if this comparison were extended to non-pioneer firms producing for the domestic market, the effective subsidy would be 20%. At the end of the 5-year special concession period, pioneer firms would be treated in the same way as non-pioneer firms. Established firms which undertook the production of new (pioneer) products would be granted the same concessions as pioneer firms in respect of the pioneer part of their total output. The tax credit granted for the export of both pioneer and non-pioneer products could be claimed in the form of a tax rebate up to 10% of the gross value of export sales in any one period. Unabsorbed credits could be carried forward. The object of this provision is to tie the tax rebate to actual export performance. The different tax treatment of pioneer and non-pioneer firms proposed by McKinnon is summarised in tabular form in the appendix to this chapter.

Having manipulated the tax base to provide incentives for export activities and for the production of new products, McKinnon's next problem is to define the tax net. If the VAT were levied on all manufacturers, wholesalers, and retailers of goods and services, the effect would be similar to levying a retail tax at the same rate on purchases by consumers of end-use consumption goods and services.⁴ It would appear to be easier to administer a retail sales tax than a VAT, since it would be a single rather than a multi-stage tax. McKinnon, however, disputes this in the case of Singapore, arguing that a substantial part of total revenue would be raised at the import stage under the VAT-uniform tariff proposal. Nevertheless, McKinnon does admit that it would be difficult to administer a comprehensive VAT in a country where there is an enormous number of small retailers (many of whom are simply roadside hawkers) who do not keep adequate accounting records. To overcome this problem, McKinnon seeks to narrow the VAT net by exempting a part of retail activity. The adjustments made are based on French practice. Firms whose gross sales of goods and/or services to final consumers amount to less than \$20,000 are to be exempt from the VAT.⁵ Firms whose gross sales to final consumers exceed \$20,000 are to be permitted to deduct either \$20,000 or 20% from the value of such sales in determining their VAT base. Thus, should a firm sell \$100,000 worth of goods and services to final consumers, its base for VAT purposes would be \$80,000 and its tax liability \$8,000. If the

⁴ The effect would not be identical, because the duty on imports may be subject to a cascade effect as the goods are passed forward to final consumers.

⁵ Such firms would, however, be subject to the VAT provisions on any manufacturing or wholesaling activities.

firm's inputs were \$80,000 and if the full domestic VAT had been paid on such inputs (\$8,000), the firm would not have to pay any VAT. If the firm's inputs were \$90,000, the firm should get a rebate of \$1,000. Remaining loyal to the French, McKinnon prefers not to grant such rebates, though he recognises that this might involve some discrimination in the treatment of retailers.

Apart from those retail activities exempted under these special provisions, all activities would be taxed with one exception. To prevent a rise in the price of basic consumer goods and to reduce the regressiveness of the tax, domestically produced unprocessed food products would be exempt from the VAT. For similar reasons, imports of unprocessed food products would be exempt from the import duty. Since the former provision would exempt the produce of much agricultural land from the VAT, McKinnon provides that such land should remain subject to property taxation.

Finally, McKinnon makes several additional adjustments designed to encourage desired activities. To encourage investment activity, firms within the VAT net could claim a rebate for taxes paid on capital good imports. To reduce any discouragement of the use of labour, firms would be permitted to offset provident fund and payroll tax payments against VAT liability in determining net tax liability (a rebate could be claimed for unabsorbed payments).⁶ In order to tax rental income, firms would not be permitted to make any deduction for taxes paid on the purchase, maintenance, or rental of buildings or furniture. To prevent the discouragement of tourist trade, tourists would be permitted to claim a rebate for tax paid on purchases made in Singapore on their departure. The main revenue-earning import and excise duties (those on liquor, tobacco, and petroleum) and personal income tax would remain and, in determining personal income tax liability, no allowance would be made for VAT paid. Firms not subject to the VAT would pay property tax. In addition, a 10% tax would be collected on remittances abroad of dividends, interest, and capital gains. A significant addendum that McKinnon proposes is that the VAT should be collected every two months.

⁶ Most firms in Malaya and Singapore are required to pay a contribution to government provident funds in respect of their employees. The contribution is equal to approximately 5% of an employee's wage if the employee earns less than \$500 per month and \$25 per month if the employee earns more than \$500 per month. For further details, see Chapter 9. A payroll tax, levied at a rate of 2% on the total payroll of each firm, was introduced into Malaya and Singapore on 1 January 1965.

The numerous adjustments made to the tax base indicate that McKinnon does not intend that the VAT should be either a complete or a pure 'consumption' VAT. Domestically produced goods sold to foreigners, a considerable part of value added at the retail stage, and domestically produced unprocessed foods would be exempt from the tax. The tax base therefore amounts to only part of total sales of domestically produced consumer goods. Moreover, some capital expenditure outlays would be taxed; firms outside of the VAT net would not be permitted to claim a rebate for tax paid on their capital good purchases, and firms within the VAT net would not be permitted to make any deduction for tax paid on purchases of buildings and furniture. The fewer the exemptions for tax paid on capital outlays, the more a 'consumption' VAT will approximate an 'income' VAT. But, because the domestic production of capital goods is small, the proposed tax is, in essence, a 'consumption' VAT. Similarly, the uniform tariff is not to be imposed on all imports; imports of unprocessed food products would enter duty free, and a rebate could be claimed for duty paid on imports of capital goods and of goods re-exported.

Given the stagnation in the contribution of entrepôt trade to domestic product in Singapore, a small domestic market which restrains the scope for an industrialisation program based on import replacement activities, and little scope for increased agricultural production, McKinnon emphasises that the tax structure should be adjusted so as to provide a significant stimulus to export activities, and particularly to the export of domestically produced or processed manufactured goods. Partly because labour costs are high in Singapore compared with other countries in Asia which export manufactured goods, and partly because the manufactured goods demanded by foreigners are those which embody increasing amounts of modern technology, McKinnon argues that the tax structure should encourage Singapore to specialise in the large-scale production of a few manufactured goods which it could export in large quantities to the rest of the world and which would embody high labour productivity.

McKinnon criticises the existing tax-subsidy structure in Singapore, claiming that it is not adapted to achieve these objectives. Tariff protection permits production for the domestic market but, because the domestic market is small, firms will remain small, worker productivity will remain low and, as a result, Singapore firms will be unable to break into world markets. Thus, while a preference for import replacement activities may stimulate industrial development in the short term, it will not permit continued growth of the industrial sector in the long term. More-

over, protection for domestic producers against imports tends to reduce the premium that should be placed on productive efficiency, and tends to attract resources away from potentially profitable export activities. The existing pioneer industry legislation does not encourage efficiency and, like tariff protection, tends to encourage the proliferation of small firms producing for the domestic market. Company income tax provides further breathing space to less efficient firms. The burden of company tax is borne primarily by firms which are highly profitable; firms which earn low profits pay little tax. In the intensely competitive conditions which prevail in Singapore, the highly profitable firms are also the most efficient firms. Consequently, apart from directing resources away from export activities, McKinnon argues that the existing combination of taxes and subsidies tends to encourage inefficiency in the domestic production of goods and services.

The tax switch which McKinnon proposes aims at a structure of taxes and subsidies more suited to the long-term development goals of the Singapore economy. Exempting export activities from both the domestic VAT and the import duty would, McKinnon claims, boost such activities substantially. Exempting capital expenditure from both taxes would encourage investment activity. Permitting firms to deduct provident fund and payroll tax payments from their VAT liability would offset any tendency to use more capital intensive production methods. Stimulating investment while maintaining the capital-labour ratio would expand employment opportunities. Tax concessions designed to stimulate export activity and the domestic production of new products would be extended to all firms interested, rather than to a select few. The tax switch would improve the allocation of resources, for a neutral tax would be substituted for the existing tax-subsidy structure which tends to give encouragement to inefficiency in the domestic production of goods and services. Finally, McKinnon claims that the tax switch would ease the burden of administration, and would improve the lot of taxpayers subject to overlapping taxes.

AN ASSESSMENT

The advantages which McKinnon claims would result from the proposed tax switch are so extensive and significant that they deserve careful assessment. Because consideration should be given to the introduction of a VAT in Malaya as well as in Singapore, the assessment which follows has been extended to include Malaya. The first point which needs to be explored is the effect of the tax switch on tax payments made by firms.

Company tax is levied at a rate of 40% on a base which, for a going

corporate concern, consists of the gross profits of the preceding period less initial and annual depreciation allowances claimed in respect of that period. In the Income Tax Ordinances, this tax base is referred to as assessable income. That part of the company tax which is collected from dividend payments simply amounts to a withholding tax, for dividends are taxed at the income tax rate applicable to the recipients. Interest payments made by companies may be deducted from gross income in determining assessable income. Such payments are subject to income tax in the hands of the recipients, but, unlike dividends, a withholding tax is not collected at the company level (except in the case where the lender is a non-resident foreigner).

Property tax rates vary in Malaya and Singapore. Most urban property is subject to tax at rates of between 30% and 36% of estimated annual rental value; rural land is taxed more lightly. Property tax can be deducted from gross income in determining the assessable income of both corporate and unincorporate firms. Since the company tax rate is 40%, the effective tax on the annual rental value of property held by companies is reduced by 40% (that is from 30%–36% to 18%–22%). Most unincorporate firms are subject to lower maximum marginal income tax rates than companies, so that the effective tax on the annual rental value of property held by unincorporate firms is reduced by a smaller amount.

Finally, under the existing tax system, most firms pay a 7% levy on their total wage bill (consisting of provident fund and payroll tax payments)⁷ but, as in the case of property tax payments, firms are permitted to deduct this outlay from gross income in determining assessable income. Thus, for companies, the tax on the firm's wage bill is effectively reduced by 40% (that is from 7% to fractionally more than 4%), and the extent of the reduction is somewhat less for most unincorporate firms.

In essence, McKinnon proposes that a VAT combined with a uniform tariff should be substituted for company income tax, for property tax, for levies on labour costs, and for a small range of protective tariffs. The VAT would be levied on a base which, for any one period, consists of gross corporate and unincorporate profits less capital outlays, plus rent, interest, wages, and salaries.

What then would be the effect of the tax switch on tax payments made by corporate firms? In each year for which statistics are available, capital expenditure in Malaya and in Singapore has exceeded depreciation allowances (initial and annual). The tax switch would, therefore, reduce

⁷ See footnote 6.

the amount of corporate profits subject to tax in any one period, and the reduction in the tax rate from 40% to 10% would further reduce tax payments made on the profit component of total value added by corporate firms. However, since the personal income tax structure would not be affected by the tax switch and since no credit would be given for VAT payments in determining personal income tax liability, dividend and interest payments made by companies to individuals would be subject to an additional 10% levy. Further, while the tax switch would almost halve the tax on the annual rental value of property held by corporate firms, it would increase the levy on wage and salary payments from approximately 4% to 10%; apart from making provident fund and payroll tax payments (equal to 7% of total wage and salary payments), firms would pay VAT at a rate of 10% on the wage and salary component of total value added but they would be permitted to offset provident fund and payroll tax payments made against their VAT liability ($7\% + [10\% - 7\%] = 10\%$).

How would the tax switch affect unincorporate firms? Since unincorporate firms are subject to personal income tax, the income accruing to the owners of unincorporate firms would be taxed more heavily following the tax switch. In addition, the tax switch would increase the levy on wage and salary payments but, because most unincorporate firms pay tax at a lower maximum marginal rate than corporate firms, the increase would be less than that which would occur in the case of corporate firms. Finally, the tax switch would reduce the tax paid on the annual rental value of property held by unincorporate firms.

Against this brief outline of the effects of the tax switch on tax payments made by firms, the issues which need to be considered are the effects of the tax switch on (1) the distribution of the tax burden, (2) incentives to invest and the form investment takes, (3) export activity, (4) the size of firms, (5) the level of domestic activity, and (6) the task of administration.

While it would be difficult to determine the precise distribution of the burden of a particular tax, a crude approximation (which could be refined by further research) can be made in most instances. Attention is directed first to company income tax, the objective being to provide an approximate answer to the question: who bears the burden of company income tax in Malaya and Singapore? In answering this question, some indication will be given as to the effect of company income tax on the domestic price level.

The conventional theory of price determination dictates that a firm will increase its output to the point where the cost of producing an

additional unit equals the addition to total revenue which would result from the sale of that unit for, at this point, the difference between total revenue and total cost (which equals total profit) is maximised. Since no profit is earned on the last unit of output produced, the imposition of a tax on profits would not affect the cost of producing this unit and would not therefore affect the total level of output produced or the market price. Consequently, the tax would be paid out of profits earned on intra-marginal units. This conclusion follows if it is assumed that firms seek to maximise profits. But if market conditions are not highly competitive, firms may attempt to achieve additional objectives and be content to maximise profits within the restraints set by these objectives. In these circumstances, it is difficult to determine the effect of the imposition of a profits tax on the level of output and thus on the price level; some firms may be content to pay the tax out of profits while others may attempt to pass some part of the tax liability forward to consumers by restricting output and thus raising prices, even if such action significantly reduced post-tax profits.

What is the likely situation in Malaya and Singapore? Rubber planting and processing, tin mining, and commercial activities account for a very high proportion of company income subject to company taxation in Malaya. Malayan producers of rubber and tin sell their output on the world market and are essentially price-takers rather than price-setters; they cannot therefore pass the company tax forward to consumers. Even if they could, the tax burden would be borne by foreign rather than by domestic consumers. Thus, apart from indirect effects, the domestic price level is not affected by company tax payments made by rubber and tin producers. While there is intense competition among small corporate and unincorporate commercial firms, the degree of competition is less intense among large corporate commercial firms. It is possible that these large firms could pass part of their company tax payments forward to domestic consumers but, in general, the major part of company tax levied in Malaya would be borne by the firms subject to the tax, so that the levy would appear to have only a marginal effect on the domestic price level.

Company tax raised in Singapore is derived principally from commercial firms, a small contribution being made by industrial firms. Competition in all fields is more intense in Singapore than in Malaya and, for this reason, it would appear that the burden of company tax would be borne principally by the corporate sector, and the levy would not, therefore, have any significant effect on the domestic price level in Singapore.

Apart from company tax, McKinnon proposes that the VAT should replace property tax and the existing levies on labour costs. Who bears the burden of these levies? Since property tax payments do not vary with the level of output, they will not be taken into account in determining the cost of a marginal unit of output. Thus, under competitive market conditions, the price which maximises profits will not include any allowance for property tax payments, and the incidence of property tax will therefore be broadly similar to that of company tax. In a labour surplus economy, it is possible that firms may shift part of the tax on labour costs back on to employees in the form of lower wage rates or a slower rise in wage rates than may otherwise have occurred. Moreover, since the tax is a variable cost which affects all firms, it is possible that some part of the burden would be shifted forward to consumers. Thus, it would seem that only a small part of the tax on labour costs would be borne out of the profits of the firms which make the payments. In summary, while it is likely that the tax on labour costs would be shifted, a high proportion of the tax on profits and on property would be borne by the firms which make the payments, so that changes in these taxes would not appear to have a significant direct effect on the domestic price level.

Let us now consider the effect on the domestic price level in Malaya and Singapore if the alternative, a VAT combined with a uniform tariff on imports, were substituted for the taxes which McKinnon proposes to abolish. Because of a high propensity to spend on imports in Malaya and Singapore, a significant part of total revenue raised would be collected from importers as goods pass through customs. McKinnon estimates that the uniform tariff would raise more than two-thirds of the total revenue collected under the VAT-uniform tariff proposal in Singapore, and it seems that customs officials could be responsible for collecting a similar proportion in Malaya. Imports consist of three broad categories of goods—consumer goods, capital goods, and intermediate-use goods. Under McKinnon's proposal, capital goods and intermediate-use goods processed for re-export would be exempt from the import tax. Thus two-thirds of total revenue would be raised from imports of end-use consumer goods and of intermediate-use goods destined to be processed for sale to domestic consumers, the remaining one-third being raised by the tax on domestic value added. There can be little doubt that the major part of the tax levied on imported goods (whether end-use consumer goods or intermediate-use goods) would be passed forward to consumers; indeed, to the extent that firms apply a standard mark-up percentage to total production costs (inclusive of any taxes paid), the

impact of the import duty on the domestic price of imported goods would be magnified by cascade effects.

Before turning to consider who bears the burden of the VAT, it is important to emphasise a central point which has emerged, namely that VAT revenue would amount to only one-third of the total revenue currently raised by the taxes McKinnon proposes to abolish. Because company and property taxes levied on the corporate sector are largely paid out of profits, their abolition would not lead to any significant fall in the price of goods sold by this sector. Thus, in Malaya, the abolition of company and property taxes would increase the income of corporate firms: rubber and tin producers, commercial firms, and industrial establishments. While the concession extended to companies producing manufactured goods would be of significance to each individual firm, the major part of the concession granted would be absorbed by rubber and tin producers, and by commercial firms, as the existing taxes principally amount to a levy on these firms. Following the imposition of a VAT combined with a uniform tariff, the tax burden on consumers would rise, since the duty on imports would be passed forward to consumers. Assuming initially that firms are unable to pass their VAT liability forward, the amount of tax relief given to corporate firms would be reduced. In fact, the tax liability of corporate firms which earned low profits and thus paid little company tax would, in many cases, increase. Some of these firms would be relatively inefficient, but others would be rapidly growing and perhaps highly efficient firms which, because of investment concessions, were largely relieved of company tax liability. In addition, the tax payments made by unincorporate firms would increase. In Singapore, the tax switch would reduce the tax burden on most corporate commercial and industrial firms, and increase that borne by consumers and by unincorporate firms. While the proportion of the total concession which is granted to corporate industrial firms would be relatively greater in Singapore than in Malaya, the major part of the concession would be extended to commercial firms.

To what extent would the VAT be passed forward? The VAT can be broken down into three parts: VAT levied on labour costs, on property, and on profits. In an earlier paragraph, it was argued that provident fund and payroll tax payments made by firms would largely be shifted back on to labour, although some part may be shifted forward to consumers. The tax switch would increase the tax paid by corporate firms on labour costs from approximately 4% to 10%, the relative increase being slightly less in the case of most unincorporate firms. In the short term, it is reasonable to assume that a substantial part of this incremental tax on

labour costs would be passed forward to consumers. In the longer term, it would seem more likely that most of this levy would be passed backward to labour in the form of lower wage rates or a slower increase in wage rates than may otherwise have occurred. Efficient firms would probably absorb the remaining part of their VAT liability (that levied on property and on profits), but the rise in the price of imports would permit producers subject to higher tax liability as a result of the tax switch (marginal corporate firms and the host of unincorporate firms) to pass the major part of their tax liability forward to consumers. This reaction would enable the more efficient corporate firms to expand their markets. Imports, however, represent the main source of competition to domestic suppliers, and the rise in the price of these goods would act as a shield to permit the continued existence of many firms which may otherwise have been forced to cease production. In addition, the proposed method of collecting VAT revenue would tend to encourage forward shifting; domestic firms producing intermediate-use goods would add the tax on to the supply price because, as they would readily point out to purchasing firms, a credit can be claimed for tax paid on such inputs.

While subject to a degree of conjecture, it would seem that some part (perhaps as much as one-half) of the VAT revenue collected from firms would be shifted forward to consumers. Adding to this the tax on imports, it would seem that a very high proportion (equal to approximately seven-eighths) of the total amount of revenue raised from business firms under the VAT-uniform tariff proposal would be passed forward to consumers, and the domestic price level would rise.⁸ This result contrasts sharply with that recorded for the existing bundle of taxes which McKinnon proposes to abolish. Moreover, the tax switch would substantially reduce the tax burden borne by profitable corporate firms in Malaya (which comprise mostly rubber and tin producers and commercial firms) and in Singapore (mostly commercial firms). It may be questioned whether the government would desire, let alone need, to grant a sizeable tax concession to these firms.

⁸ It seems that monetary conditions would not preclude a price rise, for it is probable that the tax switch would improve the balance of payments and added incentives for domestic investment activity would encourage banks to expand advances. Thus, if the tax switch left the volume of transactions largely unchanged (demand being switched away from imports towards home-produced goods), an increase in the domestic money supply, combined if necessary with an increase in the velocity of circulation of money, would permit the domestic price rise to take place.

To what extent would the tax switch encourage investment activity? By lowering the tax burden of corporate firms, the tax switch would have two effects. First, it would increase the availability of internal funds within the corporate sector of the economy (an effect which may be strengthened by the increase in tax payable on dividend payments). Second, the tax switch would raise the post-tax return on corporate investment activity. Assuming no change in the rate of interest, one would expect that this latter effect would stimulate investment activity on the part of the main beneficiaries: corporate rubber, tin, and commercial enterprises.

Encouraged by government assistance for investment activity, corporate rubber and tin enterprises have invested heavily in the past decade. With the fall in the price of rubber and the uncertain outlook for tin, it is doubtful whether additional assistance would enhance the level of investment undertaken by these firms, particularly if assistance simply assumes the form of tax relief. Compared with industrial firms, commercial firms require little capital and, because the demand for commercial services appears to be adequately satisfied in Malaya and Singapore, it would seem that tax relief would not significantly stimulate investment activity in this sector. Would tax relief encourage corporate rubber, tin, and commercial enterprises to develop manufacturing activities in Malaya and Singapore? While there are some exceptions, such firms have generally shown little desire to invest locally outside of their existing line of activity, and there does not appear to be any innovation in the tax switch which would significantly alter this attitude. To a large extent, the firms which would gain from the tax switch are subsidiaries or branches of overseas firms, and such firms normally remit a high proportion of their profits to their parent company. It should, however, be noted that, if a high proportion of the enhanced profits were simply remitted overseas, part of this outflow would be recouped by the separate tax on the remittance of profits abroad which McKinnon recommends.

Apart from enabling corporate firms to increase overseas profit remittances, the tax switch would engender other effects which may negate part of the stimulus given to domestic investment activity. First, if prices rise but wages remain constant, real purchasing power will fall and there will be some reduction in the demand by resident consumers for goods and services which could discourage domestic investment activity. Second, if wage rates rise in response to the price rise, profits available for reinvestment may be reduced. Third, the imposition of an additional tax on unincorporate firms, and the decision not to give any rebate for tax paid on capital goods used by the firms outside the VAT

net, would discourage investment activity on the part of these firms. Finally, of any given level of investible funds, a larger proportion would now be required to meet working capital needs in order to finance tax payments which have to be made bi-monthly instead of once a year.

Let us now consider the effect of the tax switch on production methods used by corporate and unincorporate firms. Assuming that firms are able to shift the increased tax on labour costs forward to consumers and/or backward to labour, the tax switch would enhance the return on investment activity within the corporate sector of the economy but leave the cost of labour unchanged. Thus one would expect the tax switch to encourage corporate firms to use more capital intensive production methods. The greater the proportion of the increased tax on labour costs that cannot be shifted and the larger any rise in wage rates induced by the rise in the domestic price level following the tax switch, the greater would be the encouragement extended to the use of more capital intensive production methods. In the context of McKinnon's article, the fact that the tax switch would encourage the use of more capital intensive production methods is surprising, for McKinnon opposes the implementation of special legislation designed to provide subsidies for investment activity in Singapore on the basis that such subsidies would tend to encourage the use of capital intensive production techniques in a labour surplus economy. However, it is possible that the tax structure is not an important factor in determining production methods, particularly in the case of large corporate firms. Firms are generally faced with a limited rather than a wide choice of production techniques and base their choice on actual rather than shadow prices. While the opportunity cost of labour may be low in Malaya and Singapore, its actual cost is relatively high by Asian standards, and corporate firms in particular have long tended to adopt capital rather than labour intensive production methods.

The increase in the tax burden borne by unincorporate firms would lower the return on investment activity undertaken by these firms. At the same time, the tax switch would increase the cost of labour to such firms. However, the increase in the cost of labour (equal to less than 6% of total wage and salary payments made by unincorporate firms) would be less than the increase in the tax on the profits of such firms (10%). Moreover, it is likely that a large part of the incremental tax on labour inputs would be shifted. The tax switch would, therefore, tend to encourage unincorporate firms to use more labour intensive production techniques. In a labour surplus economy, one is tempted to conclude that this is an admirable result. But, by increasing the tax burden for

unincorporate firms, the tax switch may force many such firms to cease production. Thus, from an employment viewpoint, what may be gained on the one hand is lost on the other. Still more important, however, is the fact that the capital equipment used by most small firms in Malaya and Singapore is antiquated and, as a result, highly inefficient by modern standards. The quality of output varies significantly not only among firms, but also within any one firm; product standardisation is not easily achieved and yet this is what both domestic and overseas consumers desire. The urgent need is to modernise capital equipment used by unincorporate firms. The proposed tax switch would tend to delay, if not discourage, the requisite modernisation.

One of the major advantages which McKinnon claims for the tax switch is that the new tax could easily be adjusted to exempt exporters and it would thus 'provide a great incentive to shift economic resources into export activities for world markets' (1966: 2). How important would this concession be? The first point which needs to be noted is that many firms in Malaya and Singapore have reported that profits on that part of their output which has been exported have been pitifully low. This phenomenon appears to be due to one (or a combination) of three factors. First, competition in the field of manufactured exports is intense; manufacturers are forced to produce a better product and to sell at a lower price in export markets than is necessary for sales to the domestic market. Second, the tax liability on profits earned from manufactured exports has often been substantially reduced by accelerated depreciation allowances and other expense claims associated with producing and marketing the manufactured exports. The last and seemingly most important factor is that many firms exporting manufactured goods from Malaya and Singapore are subsidiaries of overseas firms and, as a result, are able to arrange export prices so that there is little scope for profits to be earned in Malaya or Singapore. In fact, because the company tax rate is higher in Malaya and Singapore than in Hong Kong, Taiwan, or Japan, losses seem to be the order of the day. Consequently, firms producing for export pay very little in the way of company tax. They are subject to property tax but this is a relatively negligible expense, especially when its deductibility for income tax purposes is taken into account. Thus many existing exporters would not gain substantially from the tax switch. The advantage of the proposed switch, however, would be that a concession for exporting would be extended to all firms rather than to those firms which are able to manipulate their transactions so as to avoid paying tax in Malaya or Singapore.

Regardless of the profitability of export activities, would the tax switch provide a substantial concession to production for export compared with production for the domestic market? This question needs to be considered in two parts: first, the effect of the tax switch on the performance of non-pioneer export firms and, second, the incentive offered by the tax switch to the export of new (pioneer) products. If firms producing for the domestic market are able to pass forward a large part of their VAT liability as well as the tax levied on imported goods, and it would seem that this is the most likely outcome, the value of the concession granted for the export of non-pioneer products would be reduced. If, in these circumstances, the price of non-pioneer export products is lowered in step with any reduction in the tax burden borne by such goods, the relative profitability of producing for export may even decline compared with the profitability of producing goods for sale on the domestic market. The precise effect would depend on the response of domestic and foreign consumers to the price changes. By the same reasoning, part of the substantial concession which would be granted for the export of pioneer products would be eliminated. Further, it may be questioned whether firms would gain much from the proposed pioneer product concessions. Existing pioneer firms producing for the domestic market have found that it takes several years to achieve full production levels, so that it is not until the end of the pioneer period that they are able to take reasonable advantage of the special tax concessions extended to them. It is possible that the delay would be still longer in the case of firms which have to find and nurture export markets rather than produce to satisfy a protected domestic market.

Apart from these considerations, the tax switch may generate indirect effects which would tend to erode the value of concessions granted for export activities. It is, for example, probable that some part of the domestic price rise would seep through to raise the domestic cost of producing manufactured exports. Two examples will serve to illustrate this point. First, following the general price rise, wage rates may increase. Second, many firms would be beyond the VAT net. These firms would, however, pay tax on their purchased inputs and would attempt to push this tax burden forward to their customers. If exporters purchase inputs from such firms (which include service activities), they cannot claim any credit for the VAT component incorporated in the price of these goods. Both of these points would adversely affect the competitive position of exporters of manufactured goods.

Noting that the existing structure of taxes and subsidies appears to have fostered a proliferation of small firms, McKinnon argues that the

tax structure should be adjusted so as to encourage the large-scale production of a few manufactured goods which could be exported in large quantities and which would embody high labour productivity. Would the proposed tax switch achieve this objective? Assuming that the VAT is not completely passed forward, such a tax would bear no more heavily on large than on small firms; that is the proposed tax embodies no bias against firms according to size. In marked contrast, a turnover tax confers an advantage on large, vertically-integrated enterprises at the expense of small firms. Second, the special tax provisions extended to pioneer products would seem to encourage the proliferation of the production of commodities rather than specialisation. Third, the tax treatment of retail firms may encourage such firms to split up into smaller units to take advantage of a loophole set up for administrative purposes. The tax switch would not, therefore, appear to accord with one of the main advantages claimed. The tax switch would, however, increase the tax burden borne by unincorporate firms and this may force some of these firms to cease production, a result which would indirectly increase the average scale of production for the economy as a whole. But it is debatable whether this is a desirable aspect of the tax switch. Of the total number of firms assessed for income tax purposes in Malaya in 1964, 95% were either sole proprietorships or partnerships, and the assessed income of these unincorporate firms amounted to 40% of the total assessed income of corporate and unincorporate firms; the corresponding percentage figures in Singapore were 90% and 47% respectively. The importance of these firms as employers of labour, as sources of entrepreneurial skill, and as a ground for the training of a skilled labour force, cannot be overlooked. Moreover, by modernising this sector of the economy, it is probable that a very substantial boost would be given to domestic production.

We shall now consider the extent to which the tax switch would stimulate domestic production. First, the switch would most probably provide some stimulus to the production of manufactured goods for export, particularly of pioneer products. The switch would not, however, extend a greater concession to firms which embody a high proportion of domestic value added in their production relative to those which embody little domestic value added; export firms can claim a rebate for tax paid on all inputs regardless of source. Nevertheless, the increase in production for export would increase the demand by such firms for inputs (whether domestically produced or imported) and spending out of the additional income earned in the export sector would also increase the demand for home-produced goods and imports. Since the major part of

domestic demand is met by imports, it is likely that a high proportion of any increase in demand would also spill over on to imports. The multiplied rise in domestic production following the increase in the production of manufactured goods for export would therefore tend to be small.

How, then, would the tax switch affect import replacement activities? Under McKinnon's proposal, an 11% tariff would be placed on all imported goods. It is unlikely that such a low degree of protection would extend a significant stimulus to import replacement activities, particularly in a country where imported goods are held in high esteem and where, in many cases, the market is too small to justify domestic production. Moreover, the more firms are able to pass forward the VAT, the less is the price differential between imported and domestically produced goods, and thus the lower is the incentive given to domestic consumers to switch their demand from imports to home-produced goods. In fact, domestic firms which currently receive protection against imports would be forced to cut back production, as the tax switch would reduce the protection extended to them on domestic value added from between 60% and 70% to 11%. This change would adversely affect existing pioneer firms, for they are the firms which have so far succeeded in getting substantial tariff protection. McKinnon is forced to adopt a cavalier approach to this problem, arguing that pioneer firms would not be drastically affected, for they

can now take up export opportunities which had not been profitable heretofore . . . [so that] . . . the total amount of protection given to firms under the pioneer industries programme need not fall much—if at all—although its distribution will be drastically changed in favour of successful export-oriented enterprises and against high-cost firms confined to producing in the local market. (1966:8)

The success of McKinnon's proposals in stimulating pioneer firms to export has already been questioned. Apart from the immediate impact on existing pioneer firms of a sizeable reduction in the level of protection already granted, the administrators would have to reappraise the pioneer program or reintroduce tariff protection for specific commodities if McKinnon's proposals failed to expand the export activities of pioneer firms significantly. Moreover, the provision that pioneer firms producing for the domestic market would be penalised relative to other firms if less than one-half of their gross sales value were added domestically would possibly discourage many potential pioneer firms from establishing production units in Malaya or Singapore. In addition, the tax switch would eliminate many unincorporate firms and the more inefficient

corporate firms. In all, it is not clear that the expansion of export activities would compensate for the effect on the level of income and employment of the contraction of domestic activities. This is particularly true in the short term. Since, however, an expansion of manufactured exports may be a protracted exercise, the short-term effects may continue for a long period of time. The tax switch would reduce the encouragement given to inefficiency in the domestic production of goods and services by the existing tax-subsidy structure, but the cost may be high—the level of unemployment may rise. The question which then arises is whether it is better to have resources employed in a manner which is not completely efficient or not employed at all.

The final issue that needs to be considered is whether it would be easier to administer McKinnon's bundle of taxes than it is to administer the existing bundle. McKinnon abolishes company income tax, property tax paid by firms subject to the VAT, and a relatively small range of import duties. In their place, he imposes a uniform duty on all imports apart from unprocessed food imports and a tax on domestic value added. Firms continue to make provident fund and payroll tax payments, the personal income tax is retained, and property tax continues to be collected from firms outside the VAT net. How then do the two alternatives compare?

The decision to abolish company tax does not involve a substantial administrative saving. The administration of personal income tax is much more difficult than that of company tax, for whereas unincorporate firms often maintain (at least, for tax purposes) only sketchy accounts of the year's transactions, companies are required by law to submit audited accounts to shareholders, and the tax authorities can use these accounts as a basis for determining company tax liability. There are three major problems in computing company tax liability: the determination of gross sales value, the determination of business expenses which are to be permitted as deductions from gross income in determining assessable income, and the tax treatment of inventories. The first problem, which is the most difficult, is not reduced by the tax switch except in the case of firms which produce intermediate-use goods and which sell these goods to other firms within the VAT net. Firms purchasing the output of producers of intermediate-use goods would request sales invoices which specified separately gross sales value and tax paid. The selling firms would realise that, by using a computer, the tax authorities could cross-check the accuracy of their statements of gross sales value, and would thus be discouraged from understating this figure. But, in general, such firms would account for only a small part of total VAT liability. As in

the case of company tax, the tax authorities would have no means by which they could cross-check the accuracy of statements of gross sales made by firms which sold their output directly to consumers, or to firms outside the VAT net. In general, the tax would encourage firms to understate the value of their gross sales, but pioneer firms producing goods for export would be encouraged to overstate the value of gross sales, for a subsidy would be paid to such firms on the basis of domestic value added (calculated by subtracting the value of purchased inputs from the value of gross sales). While the tax authorities could check the quantity exported, they would find it extremely difficult to determine the actual price at which the goods were sold on the world market, particularly where the domestic firm is a subsidiary of an overseas parent company. McKinnon's VAT proposal would, however, eliminate one of the present avenues of company tax avoidance. Since tax credits for exporting are tied to export performance, firms would be prevented from offsetting losses on export sales against profits on domestic sales.

So far as the corporate sector of the economy is concerned, the great advantage of McKinnon's proposal is that problems of calculating annual depreciation allowances, of determining which outlays shall and shall not be permitted as deductions in determining assessable income, and of valuing inventories, are avoided. This does represent a sizeable administrative saving. But, since no change is to be made in the structure of personal income taxation, these problems still have to be tackled in the case of unincorporate firms and, as indicated above, the problem of taxing unincorporate firms is far more complex and time-consuming than that of taxing corporate firms.

If the abolition of company taxation does not involve any significant administrative saving, what can be said of the partial abolition of property taxation? The first and obvious point to note is that McKinnon does not propose to dismantle the property tax administrative machinery. Second, the major problems of administering property taxation centre on the assessment and collection of revenue from agricultural land, from residential land, and from small commercial and industrial establishments. All of these categories (apart from small industrial establishments) are outside the VAT net. Stated another way, the collection of property tax from large commercial and industrial concerns is not a particularly difficult task, so that the administrative saving resulting from a decision not to collect revenue from these firms is small.

Given that the administrative saving following the tax switch is small, what are the administrative costs? This question can be broken down into two parts by considering the VAT and the import duty separately.

Under the VAT, a tax is assessed on all firms (apart from small retail firms) every two months. McKinnon claims that a VAT is easy to administer and that 'the French tax authorities have found that it places no great administrative burden on . . . firms . . . and such a system is considerably easier to enforce than most other taxes' (1966: 4). After an exhaustive study of the French VAT, Clara Sullivan concludes that 'the application of the French value-added tax is undoubtedly complicated and requires considerable effort on the part of administrators and taxpayers' (1965: 123). One cannot disregard Sullivan's authoritative assessment. Since tax is to be paid bi-monthly, the tax switch would involve an enormous increase in the amount of clerical work done by the tax authorities and by business firms. Moreover, if the system is to work efficiently, speed and a large amount of co-operation would be required between the tax department and the taxpayers. This is asking for a substantial amount in a country where most firms keep inadequate records, and where a tradition of co-operation between the taxpayers and the tax collector is embryonic.

Apart from the increase in administrative work, some new administrative problems would be created. As McKinnon indicates in a subsequent note (1967a: 36-8), the tax authorities would have to ensure that firms which produced pioneer and non-pioneer products allocated inputs correctly between the various potential lines of activity (production of both pioneer and non-pioneer products for the export market and for the home market respectively). If this were not done, firms would be encouraged to understate the value of inputs used in producing the pioneer part of their output, for such action would enhance domestic value added associated with pioneer activities and would thus increase the amount of tax relief that could be claimed. This problem is in addition to that of ensuring that firms do not understate the value of their gross sales of non-pioneer products to domestic markets, nor overstate the value of their export sales of pioneer products. In the case of firms producing either pioneer or non-pioneer products, the problem of ensuring that inputs are correctly allocated to one activity or the other does not arise. For example, if a firm produces non-pioneer products only and sells such goods to domestic consumers and to foreigners, it does not matter whether the credit which can be claimed for tax paid on purchased inputs is used to reduce tax paid on domestic sales or to increase the tax relief granted on export sales. There is, however, one side problem. Under McKinnon's proposal, the tax credit for the export of non-pioneer products could only be claimed in the form of a tax rebate up to 10% of the gross value of export sales in any one period. Firms would be

permitted to carry unabsorbed credits forward, the central objective of these provisions being to tie the tax rebate to actual export performance. However, firms which produced for both the domestic and the export market could circumvent this objective by arbitrarily allocating a higher ratio of purchased inputs to domestic sales than actually existed.

In addition to these difficulties, there is the administrative problem of determining which firms are not subject to the VAT. This is a particularly difficult problem at the border where firms may be subject to the tax for two months, exempt for the next two months, and so on. How do the administrators ensure that firms come within the tax net when the gross value of their sales indicates that they should? Does it possibly mean that the tax department has to keep a bi-monthly check on most exempt firms as well as on firms within the VAT net?

A further major problem is that, because there is no change in the structure of personal income taxation, the corporation would become a means by which individuals could avoid part of their personal income tax liability; the maximum personal income tax rate is 50% in Malaya and 55% in Singapore, whereas the VAT rate would be 10%. One cannot afford to ignore this problem, particularly in countries where there is a large number of unincorporate firms.

The uniform tariff which McKinnon proposes would be collected on all current account imports apart from unprocessed food imports (and 'invisible' service imports); that is the duty would have to be paid whether the import was a capital or a consumer good and whether it was intended for domestic consumption or for re-export. The administration of such a levy would necessitate a substantial increase in the number of customs officials. Customs officials cannot be trained overnight, especially if they have to determine the value of imports, and endeavour to detect cases of fraud due, for example, to an understatement of price and/or quantity, or to a mis-statement of contents. It may be argued that this is not a serious problem, for any inaccuracy in the statement of import value would be caught when importers sell their goods to domestic firms. But this double-check is provided only in the case where the importer sells his goods to a domestic firm subject to the VAT. There is no such check in the case of sales by importers directly to consumers or to firms outside the VAT net. For such transactions, malpractices at the import stage would not easily be detected and, in consequence, corruption and graft could become a serious problem.

Apart from the demand for more trained customs officials, a host of new administrative problems would emerge. The import duty might encourage firms selling goods to Malaya and Singapore to reduce prices

and this would raise difficult questions of dumping. If the import duty net is not the same in neighbouring countries, an incentive would be given to smuggling. Further, there would seem to be room for a considerable amount of doubt as to whether a tax on all imports which could be claimed back if imports are re-exported would be easier to police and more convenient to entrepôt traders and to bona fide tourists than would bonded warehouses and specified free trade area enclosures.

This brief survey does not exhaust all of the administrative problems which would result from the tax switch, but it has gone far enough to cast a shadow of doubt on McKinnon's statement that the tax switch would ease the burden of administration. Many of the taxes which were to be abolished (the property tax, provident fund, and payroll tax) stumble back into the picture, and the tax switch would inevitably create some new administrative problems of its own.

AN ALTERNATIVE APPROACH

In essence, McKinnon's tax proposal is designed to encourage the manufacturing sector to increase its exports, to produce more efficiently, and to embody high labour productivity in its products. However, in both Malaya and Singapore, the manufacturing sector is small; the change in the tax structure suggested by McKinnon would extend substantial benefits to other sectors of the economy which cannot easily be justified, especially when the cost to consumers and to unincorporate firms is taken into account. Moreover, it is by no means clear that the tax switch would, as McKinnon argues, provide 'a powerful incentive to shift resources into export-oriented enterprises and their suppliers' or would encourage specialisation 'in the production of relatively few manufactured goods . . . [for export] . . . in large quantities to the rest of the world' (1966: 5, 1). In fact, a substantial amount of uncertainty surrounds the effects of such a significant change in the tax structure. By how much would the domestic price level rise following the tax switch? What would be the effect of the tax switch on the level of employment, and on real and money wage rates in the short term and in the long term? To what extent would manufactured exports be stimulated? Would the tax relief extended to most corporate firms increase local investment activity or simply permit a sizeable increase in overseas profit remittances? For, while the tax switch would increase the return on investment activity, tax relief is not dependent on domestic investment activity. If, as in the European Common Market countries, the VAT replaced cumbersome sales taxes (such as turnover taxes), it is most

likely that the favourable effects of the tax switch which McKinnon emphasises would follow. However, due principally to differences in the pattern of tax incidence, it is by no means certain that similar results would follow if a VAT were substituted for income and property taxation in Malaya and Singapore. If the tax switch failed to provide a significant stimulus to domestic investment activity, to the export of manufactured goods, and to employment opportunities, it might be necessary to make further changes to the tax structure (including, perhaps, the reimposition of substantial tariff protection). As Indian experience has indicated, the expectation of continuous major changes in the tax system would tend to increase uncertainty and, in consequence, adversely affect the level of domestic activity.

There is, however, a need to provide special incentives to manufacturing activity in Malaya and Singapore. But, before more far-reaching changes in the tax structure are considered, it may be asked whether it would be possible to manipulate the existing tax structure to provide added encouragement to such activity. As indicated in Chapter 4, the Malayan and the Singapore governments have attempted to do this. Many of the amendments made were, however, criticised in that chapter, and alternative proposals were put forward. The essential features of these proposals were:

1. An increase in the level of the initial allowance that could be claimed on buildings (other than commercial buildings) and on plant and machinery.
2. Provision for a significant increase in the level of the annual depreciation allowances provided that firms met a specified domestic value added requirement.
3. Provision for a tax credit related progressively to domestic value added (the value added requirement for tax relief would be greater in the case of unincorporate firms than in the case of corporate firms).
4. In determining taxable income, a double deduction could be claimed by all manufacturing firms for payroll, provident fund, and property tax payments.
5. Liberal carry-forward provisions.
6. The continuance of tariff protection on the lines suggested in Chapter 6.

The advantages and problems of these suggested amendments were discussed in Chapter 4. In essence, the measures are designed to increase domestic value added by the manufacturing sector in Malaya and

Singapore and to enhance the competitiveness of goods produced in these countries on the world market. The concessions were to be made available to both corporate and unincorporate firms.

The main problems centred on the definition of manufacturing activities and of a manufacturing firm, on the determination of value added, and on the failure of the suggested tax structure to give a direct stimulus to export activities. On the latter point, it was argued that firms normally need a domestic market base before contemplating expansion into export markets, and that experience in Malaya and Singapore appeared to confirm this point. Moreover, McKinnon appears to be in agreement here, having argued that 'it seems very likely that many old-established firms might well be in the best position to develop new export activities with the new incentives' (1966: 6). One of the problems with McKinnon's proposal, however, is that little protection would be given to domestic firms producing for the home market against imports. If a VAT were substituted for sales taxes in an advanced country with a well developed industrial sector, it is probable that a substantial stimulus would be given to the export of manufactured goods; not only would the tax switch stimulate the domestic production of manufactured goods on a more efficient basis, but existing output would be diverted from the home market to the export market. Sophisticated monetary and fiscal policies could be used to mitigate undesirable side effects resulting from the tax switch. But, in less developed countries, an adjustment to the tax structure designed to inhibit production for the domestic market in order to make exporting appear more attractive may simply inhibit manufacturing activity as a whole. It is interesting to note that the development of manufactured exports by Hong Kong was not dependent on special export incentives. The tax burden on the manufacturing sector in Hong Kong is, however, extremely low.

APPENDIX

McKINNON'S PROPOSALS

The following tables summarise the basic features of McKinnon's proposals. Three cases are distinguished on the basis of the ratio of domestic value added to total sales value. In the first case, domestic value added is equal to one-half of the total value of the firm's output, in the second it is equal to 70%, and in the third, 30%. In each of the three cases, four possibilities are considered:

- (a) a non-pioneer firm selling its entire output to the domestic market;
- (b) a pioneer firm selling its entire output to the domestic market;
- (c) a non-pioneer firm exporting its whole output; and
- (d) a pioneer firm exporting its whole output.

In the case of a non-pioneer firm selling its entire output to the domestic market, McKinnon's proposal is that the VAT be applied to the value of the firm's sales (\$100 in each of the examples considered) and that the firm then be permitted to claim a credit for tax paid on purchased inputs. In each of the other cases, no tax is to be levied on the value of the firm's sales. However, pioneer firms selling their entire output to the domestic market could not claim a credit for tax paid on purchased inputs, non-pioneer firms exporting their output could claim such a credit, and pioneer firms exporting their output could claim such a credit and, in addition, could claim a credit for the tax they would pay on domestic value added if they were not a pioneer firm and if they sold the whole of their output to the domestic market. It is assumed that the VAT is levied at a rate of 10%.

CASE I

A. *Non-pioneer firm selling output to the domestic market*

	Tax	Credit	Net tax liability
1. Purchased inputs (=\$50)	5	-5	0
2. Value added (=\$50)	5	0	5
3. Total	10	-5	5

Summary: Net tax liability (=\$5) is equal to 10% of domestic value added (=\$50).

B. *Pioneer firm selling output to the domestic market*

	Tax	Credit	Net tax liability
1. Purchased inputs (=\$50)	5	0	5
2. Value added (=\$50)	0	0	0
3. Total	5	0	5

Summary: Net tax liability (=\$5) is equal to 10% of domestic value added (=\$50).

C. *Non-pioneer firm exporting output*

	Tax	Credit	Net tax liability
1. Purchased inputs (=\$50)	5	-5	0
2. Value added (=\$50)	0	0	0
3. Total	5	-5	0

Summary: No tax is paid by this firm. Compared with a non-pioneer firm selling output to the domestic market (example IA), a non-pioneer firm exporting its whole output receives a subsidy equal to 10% of its domestic value added.

D. *Pioneer firm exporting output*

	Tax	Credit	Net tax liability
1. Purchased inputs (=\$50)	5	-5	0
2. Value added (=\$50)	0	-5	-5
3. Total	5	-10	-5

Summary: This firm receives a subsidy equal to 10% of its domestic value added. Compared with a non-pioneer firm selling output to the domestic market (example IA), a pioneer firm exporting its whole output receives a subsidy equal to 20% of its domestic value added.

CASE II

A. *Non-pioneer firm selling output to the domestic market*

	Tax	Credit	Net tax liability
1. Purchased inputs (=\$30)	3	-3	0
2. Value added (=\$70)	7	0	7
3. Total	10	-3	7

Summary: Net tax liability (=\$7) is equal to 10% of domestic value added (=\$70).

B. *Pioneer firm selling output to the domestic market*

	Tax	Credit	Net tax liability
1. Purchased inputs (=\$30)	3	0	3
2. Value added (=\$70)	0	0	0
3. Total	3	0	3

Summary: Net tax liability (=\$3) is equal to 4.3% of domestic value added (=\$70).

C. *Non-pioneer firm exporting output*

	Tax	Credit	Net tax liability
1. Purchased inputs (=\$30)	3	-3	0
2. Value added (=\$70)	0	0	0
3. Total	3	-3	0

Summary: No tax is paid by this firm. Compared with a non-pioneer firm selling output to the domestic market (example IIA), a non-pioneer firm exporting its whole output receives a subsidy equal to 10% of its domestic value added.

D. *Pioneer firm exporting output*

	Tax	Credit	Net tax liability
1. Purchased inputs (=\$30)	3	-3	0
2. Value added (=\$70)	0	-7	-7
3. Total	3	-10	-7

Summary: This firm receives a subsidy equal to 10% of its domestic value added. Compared with a non-pioneer firm selling output to the domestic market (example IIA), a pioneer firm exporting its whole output receives a subsidy equal to 20% of its domestic value added.

CASE III

A. *Non-pioneer firm selling output to the domestic market*

	Tax	Credit	Net tax liability
1. Purchased inputs ($=\$70$)	7	-7	0
2. Value added ($=\$30$)	3	0	3
3. Total	10	-7	3

Summary: Net tax liability ($=\$3$) is equal to 10% of domestic value added ($=\$30$).

B. *Pioneer firm selling output to the domestic market*

	Tax	Credit	Net tax liability
1. Purchased inputs ($=\$70$)	7	0	7
2. Value added ($=\$30$)	0	0	0
3. Total	7	0	7

Summary: Net tax liability ($=\$7$) is equal to 23.3% of domestic value added ($=\$30$).

C. *Non-pioneer firm exporting output*

	Tax	Credit	Net tax liability
1. Purchased inputs ($=\$70$)	7	-7	0
2. Value added ($=\$30$)	0	0	0
3. Total	7	-7	0

Summary: No tax is paid by this firm. Compared with a non-pioneer firm selling output to the domestic market (example IIIA), a non-pioneer firm exporting its whole output receives a subsidy equal to 10% of its domestic value added.

D. *Pioneer firm exporting output*

	Tax	Credit	Net tax liability
1. Purchased inputs ($=\$70$)	7	-7	0
2. Value added ($=\$30$)	0	-3	-3
3. Total	7	-10	-3

Summary: This firm receives a subsidy equal to 10% of its domestic value added. Compared with a non-pioneer firm selling output to the domestic market (example IIIA), a pioneer firm exporting its whole output receives a subsidy equal to 20% of its domestic value added.

8

Export Taxation

Export taxes have been levied in Malaya since the middle of the nineteenth century. Initially the duties were subordinate to excise, import, and land taxes as a source of government finance, but the extensive exploitation of tin-ore deposits dramatically reversed relative tax shares in the Federated Malay States after 1875. The upsurge in rubber production after 1900, and the imposition of a tax on rubber exports in 1907, further increased the dependence of the Federated Malay States on export duty revenue. At the same time, several of the unfederated Malay States imposed export taxes on rubber. Revenue buoyancy encouraged the State governments to expand expenditure commitments. The prudent measures designed to control expenditure and build up external reserves, which had been the rule in earlier decades, no longer seemed appropriate. The lessons of the extreme vulnerability of primary product exports had yet to be learnt.

The desire of the Federated Malay States to make a financial contribution towards the Imperial defence effort following the outbreak of World War I led to an increase in export duties on rubber and tin in 1914. Shortly afterwards, the rubber duty was converted from a flat rate charge to a variable (*ad valorem*) levy dependent on export price. Similarly, the duty on tin was converted to a graduated (specific) tax which increased as export price increased.

Government expenditure commitments rose rapidly in the decade after 1920. The buoyancy of export duty revenue eliminated the need to exploit alternative sources of government finance; ever increasing dependence was placed on the continued expansion of rubber and tin revenue. The unprecedented speed and severity with which the world depression struck late in 1929 shattered the Malayan economy and thrust the State governments into serious financial difficulties. The price of rubber fell from 35 cents per pound in 1929 to 7 cents in 1932 and,

despite little change in rubber production, the value of rubber exports from the Federated Malay States fell by almost 80% between 1929 and 1931. The price of tin fell less, but the value of tin exports was more than halved. The effect of this dramatic collapse on government revenue was intensified because the rate of export duty on both rubber and tin varied with export price. Budget deficits forced the State governments to retrench expenditure, and to explore the scope for the diversification of their tax structures. Most States attempted to extend the role of import duties, but a fall in the demand for imports negated the impact of increases in import duty rates on revenue yield. In February 1934, expenditure commitments forced the government of the Federated Malay States to raise the tax on rubber exports. Adjustments in 1936 increased the tax when price exceeded 35 cents per pound but reduced the burden when price exceeded 60 cents, the maximum rate of tax being cut from 5% to 3.25%.¹ The reduction in tax rates at high price levels was of no consequence, for the price did not exceed 60 cents in the pre-World War II period; rate changes after 1930 effectively increased the tax burden of rubber growers. As an emergency war measure, the export tax was converted to a flat rate charge and raised to 5% of export value in 1941.

Levies on rubber and tin dominated revenue yield in the central and southern States, but in all States the export tax net extended beyond these levies to a wide range of agricultural, forest, mineral, and sea products. Tax rates were harmonised within the Federated Malay States, but there were divergencies in both coverage and tax rates among the several unfederated Malay States. Nevertheless, a high degree of co-ordination had been achieved in the taxation of rubber and tin. No export taxes were levied in the Straits Settlements.

The main sources of export duty revenue in the post-war period are set out in Table 26. Before 1963 (when there was a substantial rise in iron-ore export duty revenue), rubber and tin consistently accounted for more than 90% of export revenue. Rubber has generally been the most important source of export tax revenue. A world tin shortage, which increased the price of tin after 1960, combined with a fall in the price of rubber, has led to a significant increase in tin's share of total export tax revenue in recent years.

The second main feature indicated in Table 26 is the extreme variability of export revenue. Rubber has dominated the course of revenue yield; the average annual price variability of rubber in the decade after

¹ Changes in the rate of tax and other levies on rubber exports since 1930 are set out in Appendix I to this chapter.

1950 has been extremely high by international primary product standards. Tin revenue has fluctuated less but, with the exception of the period since 1960, variations in tin revenue have amplified the effect of rubber price fluctuations on the course of total export tax revenue.

Table 26 Malaya: major export duties, 1946-68

Year	Rubber (Schedule I) revenue		Tin revenue		Other export duty revenue		Total export duty revenue	
	\$m.	% of total	\$m.	% of total	\$m.	% of total	\$m.	% of total
1946	30.5	87.4	4.0	11.5	0.4	1.2	34.9	100.0
1947	31.9	66.6	13.8	28.8	2.2	4.6	47.9	100.0
1948	33.1	49.9	29.7	44.8	3.5	5.3	66.3	100.0
1949	28.1	39.3	38.5	53.8	4.9	6.9	71.5	100.0
1950	89.3	60.7	52.1	35.4	5.8	3.9	147.2	100.0
1951	214.1	71.9	76.2	25.6	7.3	2.5	297.6	100.0
1952	110.8	59.6	69.6	37.4	5.6	3.0	186.0	100.0
1953	54.7	48.8	51.3	45.7	6.2	5.5	112.2	100.0
1954	52.6	46.8	53.6	47.7	6.1	5.4	112.3	100.0
1955	174.1	74.0	55.8	23.7	5.5	2.3	235.4	100.0
1956	144.0	68.4	60.3	28.6	6.2	2.9	210.5	100.0
1957	120.3	66.7	54.2	30.0	5.9	3.3	180.4	100.0
1958	90.6	71.6	30.0	23.7	5.9	4.7	126.5	100.0
1959	184.4	81.3	35.6	15.7	6.7	3.0	226.7	100.0
1960	196.1	75.5	54.8	21.1	9.0	3.5	259.9	100.0
1961	118.1	61.5	65.4	34.1	8.4	4.4	191.9	100.0
1962	93.0	52.5	66.9	37.7	17.4	9.8	177.3	100.0
1963	82.7	45.5	71.3	39.2	27.8	15.3	181.8	100.0
1964	69.1	36.1	96.0	50.2	26.2	13.7	191.3	100.0
1965	78.0	34.0	118.0	51.5	33.1	14.5	229.1	100.0
1966	68.1	31.8	117.1	54.7	29.0	13.5	214.1	100.0
1967	45.0	23.5	114.3	59.7	32.1	16.8	191.4	100.0
1968	47.3	25.9	101.0	55.4	34.0	18.7	182.3	100.0

Source: Malaysia 1949-67, together with information supplied by the Treasury, Kuala Lumpur.

The levies on the export of rubber have been subject to numerous changes in the post-war period. The main objective of this chapter is to trace these changes in order to analyse the effect of the various levies on the rubber industry. The taxation of tin and other export products is

considered in less detail because these taxes are generally less important than taxes on rubber and are certainly less complex.

RUBBER DUTIES

The present structure of levies on the export of rubber reflects the response of the Malayan government to the fortunes and problems of the rubber industry in the immediate post-war period.

Post-World War II Structure of the Rubber Industry

In 1953, rubber covered more than half of the cultivated area in Malaya and accounted for two-thirds of export income, and approximately one-third of domestic product, employment, and government revenue. The interdependence between rubber and other sectors of the economy, the heavy reliance placed on imported supplies, and the close link between exports, imports, and the money supply, all helped to emphasise that the importance of rubber in the economy was far greater than direct contribution figures suggested. The fortunes of the rubber industry governed the level of domestic activity. Further, since rubber growing was considered to be far more profitable than potential alternative crops even at low prices, it was apparent that the high degree of specialisation on rubber was destined to continue into the future. Yet the emergence and rapid development of synthetic substitutes during World War II challenged the future of the natural rubber industry. As a result, Malaya was faced with the possibility of a steady deterioration in its most important industry at a time when a rapid expansion of national output was essential to keep pace with the high rate of population growth. It was appreciated that, for a large and growing share of the market, the relative price of the two products—natural and synthetic—would determine which would be used. Since the price of synthetic was well below that of natural rubber, the critical question was how much rubber Malaya could produce at a price which would compete with the synthetic product.

Latex yield per tree depends principally on the age and type of rubber tree. Compared with pre-war ordinary seedlings, improved material available in the post-war period doubled potential yield per acre (from approximately 250 to 500 pounds per acre), and provided the basis for a significant reduction in production costs. The experience of estates which had been able to follow active replanting programs in the post-war period suggested that replanting with high-yield material could reduce costs to levels which enabled natural rubber to compete with synthetic at or even below the selling price of the latter. The problem was that

more than 80% of Malaya's total rubber acreage was under low-yield, high-cost rubber. If, in these circumstances, the price of natural rubber fell towards that of synthetic, it was realised that a large part of Malaya's rubber industry would find it extremely difficult to compete. To ensure the continued survival of the industry, the most pressing need was to reduce production costs and, to achieve this objective, replanting with high-yielding strains was imperative.

The requisite replanting task was complicated by the division of the industry into two sectors—estates and smallholdings. Estates (defined to include holdings in excess of 100 acres) covered one-half of the planted acreage and accounted for 60% of total production in 1953. Seventy-five per cent of the estates were less than 1,000 acres in size, but these estates accounted for only 25% of planted acreage and 20% of estate production. A relatively small number of large estates, owned principally by Europeans, dominated the level and course of estate production.

Low-yield seedling trees covered two-thirds of estate acreage, and trees on most of this acreage were estimated to be over thirty years old. As a rubber tree ages, its latex yield declines until a stage is reached (normally after thirty-three years) when it is no longer economic to tap the tree. The ageing of Malaya's rubber trees was due to restrictions imposed on replanting prior to the war, to the impossibility of replanting during the war, and to problems of rehabilitation immediately after the war.

Renewal of rubber trees at the end of their economic life would require an annual rate of replanting equal to 3% of planted area. Since a rubber tree is immature and not tapped during the first seven years of its life, this objective would be fulfilled if 21% of the total planted area were consistently immature. Only 15% of estate acreage was immature in 1953. Moreover, there was considerable unevenness in the distribution of immature acreage. Replanting with high-yield seedlings had proceeded at an adequate rate on large, predominantly European-owned estates. But on small, mostly Asian-owned estates, little or no replanting had been undertaken since the war.

If the replanting problem on non-European-owned estates was serious, the position of smallholders was critical. Over 1.5 million acres had been planted with rubber by smallholders, the majority of holdings being less than six acres in size. Smallholder rubber trees were almost entirely old, low-yield trees—less than 10% of smallholder acreage was under high-yielding rubber. The average replanting rate during the period 1947–52 was 3,400 acres per annum; to maintain capital stock, replanting at a rate of 50,000 acres per annum (3% of total acreage) was

required. The starkness of this contrast is magnified when it is realised that the 3% replanting rate made no allowance for the replanting backlog which had been built up during the two decades after 1930.

Both estate and smallholder production rose rapidly after the war to levels which surpassed pre-war peaks. This increase was the result of the 'resting' that trees received during the period of Japanese occupation. The rapid rise in the price of rubber in the latter half of 1950 was accompanied by a small increase in smallholder production but a fall in estate production. Despite the maintenance of extraordinarily high price levels, both estate and smallholder production declined in 1951 due to a fall in yield per acre as a result of the gradual ageing of trees.

If the need to replant was the basic issue facing the rubber industry during this period, an important peripheral problem concerned the distorting effects on the domestic economy of violent fluctuations in the price of natural rubber. The spectacular price movements that accompanied the Korean War boom highlighted the extreme susceptibility of the Malayan economy to wide fluctuations in export proceeds. Short of complete confiscation, government policies could not effectively cushion the domestic impact of such rapid and large price fluctuations. But this argument could hardly be used to justify the absence of taxes designed to tap windfall profits. Domestic inflation, rising imports, and a massive exodus of private capital from Malaya finally convinced the government of the need to absorb an increasing share of export surpluses arising from rubber price increases.

Export Tax Developments

Pre-Korean War Period (1945-50). The rate of tax on the export of rubber during the period 1945-50 was influenced by the government's need to raise sufficient revenue to finance rising expenditure commitments. Stability in the price of natural rubber and the rapid rise in production after the war cast the export tax on rubber into the role of an important and dependable source of government finance. Peak production obscured the need to adapt the tax structure in order to encourage replanting, and price stability betrayed the need to maintain a graduated tax which would absorb a high proportion of windfall profits in periods of high rubber prices.

At the end of the war, the British Military Administration extended to the whole of Malaya (excluding Singapore) the pre-war Federated Malay States' export tax structure. Since the price of rubber was fixed during this period at 35 cents per pound, the rate of tax was effectively set at 3.25% *ad valorem* and was equivalent to a specific duty of 1.14

cents per pound. Rehabilitation programs necessitated heavy government expenditure in the immediate post-war years but, because the tax administration had to be reorganised on a national basis, revenue increased slowly. Rising budget deficits forced the government to seek additional finance. The narrowness of the tax base confined potential adjustments to changes in export and import duties. The quick recovery of the rubber industry suggested that it could best bear additional taxation and, in March 1946, the rubber export tax was converted from a variable levy dependent on price to a specific tax of 4 cents per pound. At the prices ruling during 1946 (40 cents per pound), the new levy represented a threefold increase in the burden of rubber export taxation; in relative terms, the tax was twice as high as the emergency war tax imposed in 1941 (Table 27). Rubber interests protested vehemently,

Table 27 Malaya: export tax and research cess expressed as a percentage of a rubber price equal to 40 cents, 1937-50
(per cent)

	Export tax	Research cess	Total
January 1937-February 1941	3.25	—	3.25
March 1941-November 1945	5.00	—	5.00
December 1945-February 1946	3.25	—	3.25
March 1946-October 1946	10.00	—	10.00
November 1946-January 1947	6.25	0.63	6.88
February 1947-September 1949	5.00	0.63	5.63
October 1949-June 1950	5.00	1.00	6.00
July 1950-December 1950	5.00	1.25	6.25

Source: Derived from material supplied in Appendix I to this chapter.

arguing that they would be forced to cut rehabilitation expenditure and postpone replanting plans. In the expectation of a sharp rise in import duty revenue in 1947, the government yielded to the protests and reduced the tax to 2.75 cents per pound in November 1946. The new tax included a 0.25 cent cess imposed for rubber publicity and research purposes. Rubber interests remained unsatisfied, as the effective tax rate was still more than twice as high as the pre-war levy. In partial compensation for the introduction of income taxation, the export tax was reduced further at low price levels in February 1947, the levy being converted from a specific duty to a 5% *ad valorem* charge. The steady rise in import duty and income tax revenue, and the achievement of budget balance in 1949, eliminated the need to seek additional revenue from the rubber export

duty after 1947. The research cess, however, was raised to 0.4 cents per pound in August 1949, and to 0.5 cents in June 1950. While the results of research could be expected to benefit the industry, many producers (particularly smallholders) could not expect a commensurate gain, for they had no idle land available for new planting with rubber and could not afford the loss of income over seven years, let alone the investment outlay involved in replanting with new high-yield material. To them the cess was equivalent to an additional tax on the export of rubber.

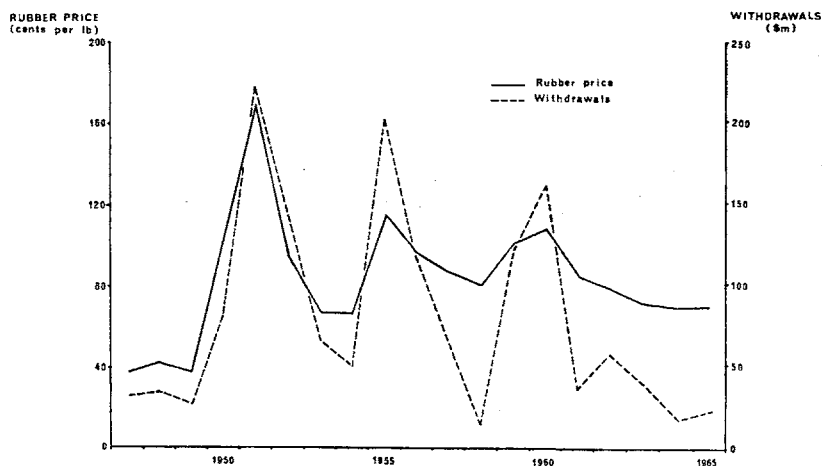


FIG. 1 *Net tax and cess withdrawals from the rubber industry compared with rubber price, Malaya, 1947-65*

Korean War Period (1951-3). After reaching a low level in June 1949, the price of rubber climbed steadily in the latter half of 1949 in step with American economic recovery, and reached a post-war peak of 54 cents per pound in March 1950. The expectation of war in Korea lifted the price to 80 cents in May 1950 and, following the outbreak of war, the price rose swiftly to 200 cents per pound by December 1950 (Fig. 1). Whatever the length of the boom, it was apparent that the substantial boost to incomes in Malaya would foster inflation unless the domestic policies of the Malayan government were countercyclical. The Malayan tax structure, however, was poorly adapted to tap windfall profits; income tax rates were low, and although the ruling export tax on rubber raised more revenue at high prices than preceding post-war levies (it was a fixed rate *ad valorem* rather than a specific levy), the tax amounted to little more than a token payment at the high prices ruling during the latter half of 1950.

The response of the Malayan government to the need to minimise the impact of the huge export surplus on the domestic economy, and to the prospect of raising (at minimal costs) substantial reserve balances which could be used to finance future economic and social development programs, was slow. Plans to increase the export tax on rubber were not announced until November 1950, and were not to be implemented until January 1951. By that time the damage had been done; inflation gripped the economy.

The new proposed export tax was grafted on to the old. The levy continued to be a flat 5% *ad valorem* charge up to a price of 60 cents per pound. Thereafter the duty rose steeply to a rate of 12% at a price of \$1.00, 26% at a price of \$2.00, and 39% at a price of \$3.00. Under the ruling Customs Enactment, the executive had power to alter duties without reference to Parliament. In an explanatory statement, the executive stressed that the duty increase was confined to adventitious profits, and that the major share of such profits was still left with the industry. The executive claimed that the new rate schedule had been determined after due consideration of all representations made by the industry, and was considered to be just and equitable and in the public interest. The statement concluded that while the executive was prepared to consider a modification in the mechanism of imposition, it was not prepared to revise its decision regarding the rate structure.

The vociferous outburst from rubber interests which followed the announcement of the new duty forced reappraisal. A document of protest, which purported to represent the interests of both estates and small-holders, charged that the new duty was an abuse of executive power, and argued that the failure to consult Parliament (which was dominated by rubber interests) was the very antithesis of democratic procedure.² It was felt that the duty would discourage replanting and encourage capital flight and large-scale smuggling. Moreover, rubber interests were quick to point out that the suggestion to increase the rate of export duty emanated from the United Kingdom. This suggestion, they argued, best served British interests for, if Malayan income tax rates were increased in lieu of the export tax adjustments, the British government would be forced to return to Malaya part of the very considerable amount of tax on profits derived in Malaya which flowed into the United Kingdom Treasury. An increase in income tax rates was in the interests of most rubber growers, for such an adjustment would not increase the

² The document has no title and is not generally available, but it is reproduced as an appendix in my doctoral thesis (Edwards 1967).

tax burden borne by British rubber companies which were effectively subject to British rather than Malayan income tax (the latter tax being permitted as an offset against the higher British income tax), nor that borne by smallholders, most of whom were outside of the income tax net. The authors of the document concluded that the rubber industry was prepared to consider any adjustment in taxation necessary to meet the government's properly assessed and declared needs, provided such taxation was levied fairly, and shared by all trades and industries in Malaya.

The government heeded the arguments of rubber interests; the company tax rate was raised from 20% to 30% in January 1951, and the increase in the export tax on 'adventitious rubber profits' was moderated. A novel development, however, was the imposition of a compulsory replanting cess (referred to as Schedule II duty, the export tax proper being listed as Schedule I duty) which was to be collected at a graduated rate when the price of rubber exceeded 60 cents per pound. The government had repeatedly expressed concern both at the failure of many estates and smallholders to build up reserves from high profits for future replanting and at the inflationary pressure generated by the dissipation of such profits. The new levy was designed to make a modest contribution towards solving replanting problems. Finally, the research cess (now referred to as Schedule III duty) continued to be levied, but the rate was reduced from 0.5 cents per export pound to 0.35 cents. This levy was raised to 0.4 cents in January 1952 and to 0.5 cents in March 1953.

The price of rubber continued to rise in the first quarter of 1951. Although the price fell sharply during the remainder of the year, the average price level during 1951 was high by comparison with preceding years. In addition to increased taxation, the government eased import controls and attempted to sell bonds to the public. The Emergency increased government expenditure, but sizeable budget surpluses were recorded in both 1950 and 1951. Nevertheless, inflationary pressures continued to gather strength. To neutralise the inflationary impact of high rubber prices, the government proposed a further increase in the export tax in mid-1951, but rubber planters successfully resisted the move.

The response of rubber production to high price levels revealed the dilapidated state of the industry—both estate and smallholder production declined in 1951. The final report of the Rubber Smallholdings Enquiry Committee (Federation of Malaya 1953a), which pointed out that trees on 67% of smallholder acreage were over thirty years old, convinced the

government of the need to take more positive action to encourage replanting. The government proposed an increase in the replanting cess early in 1952. Estate owners immediately objected, claiming that their replanting effort in 1951 had been adequate and the government agreed, despite the fact that the performance of most small estates was recognised to be far from satisfactory. The cess increase, operative from May 1952, was therefore confined to smallholder rubber, and was collected at a flat rate of 4.5 cents per export pound when price exceeded 75 cents. Since the cess did not vary with rubber price, it was listed separately from the Schedule II cess and was referred to as the Schedule IV smallholder replanting cess. The future of this cess was threatened by the continued price decline after May 1952. Recognition of the need to replant regardless of price encouraged the government to amend the Schedule in September 1952 so that the cess would be operative at all price levels.

Administrative arrangements for the disposal of funds collected under the two replanting cesses (Schedules II and IV) were finalised in the early part of 1952. Legislation, effective from May 1952, provided for the establishment of two funds: Fund A for estates and Fund B for smallholders. Replanting cess revenue was allocated between the two funds on the basis of monthly estate and smallholder production statistics.

Fund A Schedule IV cess revenue was unconditionally returned to estates every three months, the only requirement being the submission by estates of certified production statistics. This cess was confined to smallholder production, but the impossibility of distinguishing between smallholder and estate rubber at the export stage required collection from both. As pointed out by Lim Chong Yah (1961: 47), the only cost of this arrangement to estate owners was the inconvenience and delay in the utilisation of their own funds—the cess was not a tax on estate production. Fund A Schedule II cess, however, was credited to individual estates on the basis of verified production figures, and was refunded only against proof of replanting activity; this cess was deliberately designed to influence the pattern of estate expenditure. But since the cess was repayable against replanting done after 1946, its influence on the prospective utilisation of estate funds was limited.

In the case of smallholdings, both Schedule II and IV cess revenue was paid into Fund B. The revenue was not credited to particular holdings but was aggregated into a common pool. Refunds assumed the form of replanting grants.³ For smallholders who, for various reasons,

³ See Appendix II for details of the smallholder replanting schemes initiated by the government.

were unable to replant, the replanting (and research) cesses effectively increased the rate of export tax. The levies imposed a tax on the whole of the smallholder industry in order that those smallholders prepared and able to replant could be subsidised.

Rubber prices tumbled further in 1952 and reached pre-Korean War boom levels towards the end of 1953. The fiscal effort of the Malayan government during the boom did little to contain the inflationary consequences. As Meek has pointed out 'the government's measures proved "too little and too late". The remission of profits abroad and the massive exodus of private capital were far more important than government budget surpluses in preventing the full impact of the export surplus from reaching the internal economy' (1955: 29). The main achievement of this period was an awakening to the need for government action to encourage replanting activity and the translation of this awareness into legislative enactments.

Mudie Mission Report and its Consequences

Concern at the downturn in estate replanting activity in 1953 and persistent complaints of over-taxation from the rubber industry forced the government to set up an independent mission in May 1953 to investigate the problems and competitive position of the industry. The Mission (hereafter referred to as the Mudie Mission after its chairman, Sir Francis Mudie) considered two items in its terms of reference to be important. The first was the question of the adequacy of existing schemes to encourage replanting on estates and smallholdings; the second, the question of taxation (Federation of Malaya 1954: v). On the first issue the Mission emphasised the fact that the rate of replanting on small estates as well as on smallholdings was inadequate. It urged a more ambitious replanting effort in the next three years to make up for past inadequacies and to strengthen the competitive position of the industry as rapidly as possible. To assist, the Mission recommended the extension of Schedule IV cess to estates and the abolition of Schedule II cess. In relation to the size of the estate replanting problem, the Mission considered that the revenue derived under Schedule II cess would be inadequate at prevailing and expected price levels. When the price was below 60 cents per pound the cess vanished, yet, as the Mission pointed out, this was the very time when estates were least likely to make adequate provision for replanting. The Mission admitted that for estates with over 50% of their planted area under high-yielding material, a 4.5 cent replanting cess would be excessive. Yet such estates covered less than one-third of estate acreage; a cess had to be imposed on these

estates in the interests of their less prosperous neighbours. Provision was made for an automatic refund of an estate's balance in Fund A if the estate had a yield of 550 pounds per acre and had 21% of its area under immature rubber.

On the question of export taxation the Mission made three recommendations:

(a) The abolition of export duty at a price of 60 cents per pound and below. On the basis of its examination of production costs, the Mission concluded that, within this price range, a low-yielding estate could not pay export duty and set aside an adequate amount for replanting.

(b) Lower (but more steeply rising) tax rates at price levels above 60 but below 78 cents per pound. The export duty, the Mission argued, could not be passed forward to consumers nor backward to factor inputs to any significant extent. It therefore represented an addition to production costs and as such increased the difficulty of reducing costs to levels competitive with synthetic rubber. It also reduced the flow of funds available for reinvestment in the industry.

(c) Higher tax rates at prices equal to and above 78 cents per pound. In this range the price of natural rubber was not competitive with the price of synthetic rubber and the main problem was to cushion the impact on the domestic economy of high rubber prices.

Despite a reduction in tax rates at prices below 78 cents per pound and the abolition of Schedule II cess, the Mission's proposal to extend Schedule IV cess to estates increased the burden of statutory payments borne by estates at all price levels. For smallholdings, the reduction in tax rates and the abolition of Schedule II cess reduced the burden of statutory charges at prices below 80 cents per pound (Table 28).

The effect of the Mission's proposals is summarised in Table 29. At price levels below 70 cents per pound, tax relief and replanting cess charges provided sufficient finance to replant 3% of estate acreage (60,000 acres) and almost 3% of smallholder acreage (50,000 acres) each year. As rubber prices rose, the need for (and therefore the amount of) assistance fell. The proposals placed substantial emphasis on tax relief which it was assumed would release funds to finance replanting.

The Rubber Producers' Council (RPC) opposed the Mudie Mission's proposals for estates on three grounds: (a) the proposals introduced a principle of compulsion which the RPC held should and could be avoided; (b) the replanting cess increase for estates more than offset the remission of taxation at low price levels and would impose too heavy a burden on many estates; and (c) the scope of the scheme was considered out of

Table 28 Mudie Mission's proposals compared with the prevailing levies on rubber in the Federation of Malaya, selected price levels, 1954 (per cent)

Price in cents per lb	Estates							
	Existing levies				Mudie Mission's proposals			
	Tax	Replanting cess (Sch. II)	Research cess	Total	Tax	Replanting cess (Sch. II)	Research cess	Total
20	5.00	—	2.50	7.50	—	22.50	3.75	26.25
25	5.00	—	2.00	7.00	—	18.00	3.00	21.00
30	5.00	—	1.67	6.67	—	15.00	2.50	17.50
35	5.00	—	1.43	6.43	—	12.86	2.14	15.00
40	5.00	—	1.25	6.25	—	11.25	1.88	13.13
45	5.00	—	1.11	6.11	—	10.00	1.66	11.66
50	5.00	—	1.00	6.00	—	9.00	1.50	10.50
60	5.00	—	0.83	5.83	—	7.50	1.25	8.75
70	6.43	0.71	0.71	7.85	3.57	6.43	1.07	11.07
80	7.67	1.09	0.63	9.39	8.75	5.63	0.94	15.32
100	9.25	1.75	0.50	11.50	17.00	4.50	0.75	22.25
150	11.33	2.67	0.33	14.33	28.00	3.00	0.40	31.50
200	12.38	3.13	0.25	15.75	33.50	2.25	0.38	36.13
300	13.40	3.60	0.17	17.17	39.00	1.50	0.25	40.75

Price in cents per lb	Smallholdings							
	Existing levies					Mudie Mission's proposals		
	Tax	Replanting cess (Sch. II)	Replanting cess (Sch. IV)	Research cess	Total	Tax	Replanting cess (Sch. II)	Research cess
20	5.00	—	22.50	2.50	30.00	—	22.50	3.75
25	5.00	—	18.00	2.00	25.50	—	18.00	3.00
30	5.00	—	15.00	1.67	21.67	—	15.00	2.50
35	5.00	—	12.86	1.43	19.29	—	12.86	2.14
40	5.00	—	11.25	1.25	17.50	—	11.25	1.88
45	5.00	—	10.00	1.11	16.11	—	10.00	1.66
50	5.00	—	9.00	1.00	15.00	—	9.00	1.50
60	5.00	—	7.50	0.83	13.33	—	7.50	1.25
70	6.43	0.71	6.43	0.71	14.28	3.57	6.43	1.07
80	7.67	1.09	5.63	0.63	15.02	8.75	5.63	0.94
100	9.25	1.75	4.50	0.50	16.00	17.00	4.50	0.75
150	11.33	2.67	3.00	0.33	17.33	28.00	3.00	0.50
200	12.38	3.13	2.25	0.25	18.00	33.50	2.25	0.38
300	13.40	3.60	1.50	0.17	18.67	39.00	1.50	0.25

Source: As for Table 27.

Table 29 Assistance to estates and to smallholders at various rubber price levels under the Mudie Mission's proposals

A. ESTATES

Rubber price (cents)	Government Contribution (Tax Relief) (\$m.)	Estate contribution (\$m.)			Total assistance	
		Schedule II cess relief	Schedule IV cess	Total	\$m.	Replanted acreage potential ^a (acres)
40	15.46	—	34.78	34.78	50.24	62,800
50	19.32	—	34.78	34.78	54.10	67,625
60	23.18	—	34.78	34.78	57.96	72,450
70	15.46	—3.86	34.78	30.92	46.38	57,975
80	—6.76	—6.77	34.78	28.01	21.25	26,563
90	—33.81	—10.32	34.78	24.46	—9.35	—
100	—59.89	—13.52	34.78	21.26	—38.63	—

B. SMALLHOLDERS

Rubber price (cents)	Government Contribution (Tax Relief) (\$m.)	Smallholder contribution (\$m.)			Total assistance	
		Schedule II cess relief	Schedule IV cess	Total	\$m.	Replanted acreage potential ^a (acres)
40	10.31	—	23.18	23.18	33.49	41,863
50	12.88	—	23.18	23.18	36.06	45,075
60	15.45	—	23.18	23.18	38.63	48,288
70	10.31	—2.57	23.18	20.61	30.92	38,650
80	—4.51	—4.51	23.18	18.67	14.16	17,700
90	—22.54	—7.08	23.18	16.10	—6.44	—
100	—39.92	—9.01	23.18	14.17	—25.75	—

^a It has been assumed that the cost of replanting an acre of rubber land is \$800.

Source: Federation of Malaya 1955b: Tables XV and XVII.

Table 30 Assistance to estates and to smallholders at various rubber price levels under the Rubber Producers' Council proposals (\$ million)

A. ESTATES		Rubber Producers' Council proposals (\$ million)			
Rubber price (cents)	Government contribution (from export tax) (\$m.)	Estate contribution (Schedule II cess) (\$m.)		Total assistance \$m.	Total assistance Replanted acreage potential ^a (acres)
40	11.59	—	—	11.59	14,488
50	11.59	—	—	11.59	14,488
60	11.59	—	—	11.59	14,488
70	7.73	3.86	—	11.59	14,488
80	16.42	6.76	—	23.18	28,975
90	24.15	10.63	—	34.78	43,475
100	32.84	13.52	—	46.36	57,950
150	73.42	48.30	—	121.72	152,150
B. SMALLHOLDERS					
Rubber price (cents)	Government contribution (from export tax) (\$m.)	Smallholder contribution (\$m.)		Total \$m.	Total assistance Replanted acreage potential ^a (acres)
		Sch. II cess	Sch. II cess		
40	7.73	—	23.18	30.91	38,638
50	7.73	—	23.18	30.91	38,638
60	7.73	—	23.18	30.91	38,638
70	5.15	2.57	23.18	30.91	38,638
80	10.95	4.51	23.18	38.64	48,300
90	16.10	7.09	23.18	46.37	57,963
100	21.90	9.01	23.18	54.09	67,613
150	48.94	32.20	23.18	104.32	130,400

^a It has been assumed that the cost of replanting an acre of rubber land is \$800.

Source: Federation of Malaya 1955b: Tables XII, XIII, XV, and XVII.

all proportion to the magnitude of the problem which, the RPC held, was largely a matter of securing an adequate amount of replanting by estates comprising some 500,000 acres (out of 2 million acres worked by estates) which had done little or no replanting in post-war years. The Council preferred retention of the prevailing structure of statutory payments and suggested that a proportion of the present export duty (Schedule I) should be used for replanting.⁴ The proposals are summarised in Table 30.

The Mudie Mission's criticism of the Schedule II cess applies to the RPC's proposals. At a price of 70 cents and below (the expected future price range for rubber), the annual income of the estate replanting fund would be sufficient to replant to maturity only 14,500 acres per annum, which represented an overall estate replanting rate of 0.75% per annum as against the required 3% rate (60,000 acres). Moreover, more assistance was given to those estates which already achieved high per acre yields: at prices of 70 cents and below, estates which had done little replanting since the war (mostly estates with average yields of 300 pounds and less per acre) would receive an annual credit sufficient to replant only 0.5% of their acreage each year. In short, the proposals provided least assistance when and where it was most needed, and there was no assurance that replanting would be undertaken, particularly by backward estates, on a scale necessary to save the industry.

The IBRD Mission which visited Malaya in 1954 criticised the Mudie Mission's proposals on three different grounds. First, given existing and prospective commitments, the government could not afford a loss of tax revenue on the scale envisaged in the Mudie Report.⁵ Second, tax concessions were unlikely to have any significant influence on the rate of

⁴ This proportion, the Council proposed, was to be at the rate of $1\frac{1}{2}$ cents per pound when the price of rubber was below 70 cents, and at prices above this level the government's share of export duty revenue was to be limited to the equivalent of 5% *ad valorem*. (In its original form, the Council's proposal was that the government retain as revenue $2\frac{1}{2}$ % of the export duty at all price levels. See IBRD 1955: 249.)

⁵ Assuming annual production of rubber to be 575,000 tons per annum, the loss of revenue due to the reduction in tax rates suggested by the Mudie Mission at prices below 79 cents per pound would be:

- \$11 million at a price of 75 cents per pound;
- \$26 million at a price of 70 cents per pound;
- \$35 million at a price of 65 cents per pound;
- \$39 million at a price of 60 cents per pound;
- \$32 million at a price of 50 cents per pound.

replanting,⁶ and, third, the level of replanting cess balances of individual estates was dependent on current output rather than on need for help. Estates with low yield per mature acre needed most help, yet these were the very estates where replanting cess credits (measured on a per acre basis) would be lowest.

The IBRD Mission argued that, if the government were to make a contribution towards the cost of a satisfactory replanting program, the contribution 'should take such form as will best ensure that the program will be carried out' (IBRD 1955: 52). The Mudie Mission had indicated that, in the case of smallholdings and estates with less than 30% of their area under high-yielding rubber, investment in excess of the yield of a 4.5 cent cess would be required if a satisfactory replanting rate were to be achieved. Experience had shown that it was unlikely that such additional funds could or would be provided by planters within these sections of the industry even if tax rates were reduced. The IBRD Mission therefore concluded that there was a need for some form of selective assistance. The government suggested to the IBRD Mission that it was prepared to make a uniform per acre grant towards the cost of replanting a stipulated proportion of total planted acreage (estate and smallholder) within a prescribed period. The Bank Mission favoured this proposal and, in co-operation with the government, worked out blueprint details. The essential features of the scheme may be summarised under four heads: (a) direct assistance to estates; (b) direct assistance to smallholdings; (c) replanting cess adjustments; and (d) export tax adjustments.

(a) The government offered to pay \$400 per acre towards the cost of replanting 21% of the acreage of each estate. The grant was equal to approximately 50% of estimated per acre replanting costs. To take advantage of the grant, replanting had to be started within seven years from the commencement of the scheme (1955). Assistance assumed the form of instalment payments spread over five years. The life of the scheme was therefore eleven years and the estimated cost to the government \$168 million (\$400 multiplied by 21% of planted estate acreage—approximately 420,000 acres). Grants were available for planting commenced

⁶ The IBRD Mission pointed out that, in the case of smallholdings, part of the benefit of reduced tax rates was likely to be absorbed by middlemen. 'Any benefit received', the Report added, 'would of course be important, but it would be small in relation to a smallholder's total income, low as it is, and it is improbable that smallholders' decisions concerning replanting rest on such close accounting concepts that they would be materially affected' (IBRD 1955: 247).

since January 1953, for replanting with alternative crops, and for new planting. The total area of replanting and new planting by an individual estate was restricted to 21% of its planted acreage as at 31 December 1954.

(b) Since smallholder production was approximately two-thirds that of estates, the government grant to smallholders was set at two-thirds of the assistance provided for estate replanting (that is at \$112 million). The grant was available for replanting or new planting, and the legislation provided that assistance could assume the form of either monetary payments or payments in kind. Smallholder acreage, however, amounted to 84% of estate acreage. If acreage had been the base, the grant to smallholders would have been \$141 million.

(c) Both the Mudie and IBRD Missions recommended the abolition of Schedule II cess. The government accepted this recommendation. The Mudie Mission recommended the extension of Schedule IV cess to estates. The IBRD Mission agreed: 'we believe consideration should be given to making the refund to estates of the Schedule IV cess, now automatic, conditional on the maintenance of some minimum standard of replanting' (IBRD 1955: 55-6). However, the government, sensitive to the reaction of the RPC, decided against this change.

(d) In contrast to the Mudie Mission's proposals, the IBRD Mission argued that, in view of the financial burden imposed by the government's replanting grant, the present export duty schedule should be retained at prices below 75 cents but that its progression should be substantially steeper in higher price ranges. The IBRD Mission claimed that the latter adjustment was justified, first, by the fact that the government's contribution to replanting costs would be fixed regardless of price but the need for assistance would decline as price increased and, second, by the advantages derived from the standpoint of general economic and financial stability.

The government agreed in principle. The export tax on rubber was a regular source of revenue and its abolition at low price levels could not be contemplated. The government was prepared, however, to make some concessions. At prices below 60 cents per pound the tax rate was reduced from 5% to 4%. At prices between 60 and 80 cents per pound the tax rate was reduced, but not by as much as recommended by the Mudie Mission. At prices above 80 cents tax rates were increased, but again not by as much as recommended by the Mudie Mission. Moreover, part of the tax rate increase when price exceeded \$1 was to be channelled into an anti-inflationary cess fund which was to be returned uncondition-

ally to estates and smallholders when the price fell below \$1 for eight consecutive weeks.

The government's proposals are summarised in Table 31. The net contribution of the government to replanting activity (tax relief and/or grant assistance) under the three schemes is set out in Table 32. For estates, the amount of assistance provided under the Mudie and government proposals is comparable up to a price of between 70 and 80 cents per pound. The difference is that, under the Mudie Mission's scheme, government assistance was to be given solely by way of a reduction in export duty. Under the government's scheme, assistance was provided partly by a reduction in the export duty but mainly by a direct grant towards the cost of replanting. The gain from a reduction in taxation is a function of output; high-yield estates benefit more than low-yield estates. In contrast, a fixed per acre grant provides relatively greater assistance to low- rather than high-yield estates. The government's proposals therefore gave assistance where it was most needed. Moreover, under the Mudie Mission's proposals, government assistance in the form of tax relief did not necessarily ensure increased replanting activity. Under the government's scheme, advantage could be taken of the major part of assistance only if replanting were carried out. Finally, the government's proposals involved no compulsion; estates were merely encouraged to take advantage of the assistance offered. The criticisms made of the Mudie Mission's proposals for estates apply with equal force to its proposals for smallholders; tax and Schedule II cess relief would not have guaranteed increased replanting activity on a scale necessary to revitalise the industry.

Tax adjustments after the imposition of the government's proposals in April 1955 have been few. The anti-inflationary cess was collected for intermittent periods after June 1955. Revenue raised from estates was returned when price fell below \$1. Revenue raised from smallholders was transferred to Fund B and paid back by means of a reduction in the Schedule IV cess charge from 4.5 to 2 cents per pound during the period March 1956 to December 1959. The Schedule IV cess was raised back to 4.5 cents per pound from 1 January 1960, for at this stage the smallholders' share of anti-inflationary cess fund revenue had been exhausted. Anti-inflationary cess fund collections made in 1960 were not refunded, and therefore effectively increased the smallholder replanting cess charge above 4.5 cents per pound. From 1 January 1961, the anti-inflationary cess charge (collected at price levels above \$1 per pound) was merged into the export tax proper. At the same time the export tax was raised at price levels between 80 cents per pound and \$1.

Table 31 Assistance to estates and to smallholders at various price levels under the government's proposals
A. ESTATES

Rubber price (cents)	Government contribution (\$m.)			Estate contribution Sch. II cess (\$m.)		Total assistance	
	Grant	Export tax relief	Total			\$m.	Replanted acreage potential ^a (acres)
40	15.27	2.90	18.17	—		18.17	22,713
50	15.27	3.86	19.13	—		19.13	23,913
60	15.27	4.83	20.10	—		20.10	25,125
70	15.27	1.93	17.20	-3.86		13.34	16,675
80	15.27	—	15.27	-6.76		8.51	10,638
90	15.27	-12.56	2.71	-10.63		-7.92	—
100	15.27	-24.13	-8.86	-13.52		-22.38	—

B. SMALLHOLDERS

Rubber price (cents)	Government contribution (\$m.)			Smallholder contribution (\$m.)			Total assistance	
	Grant	Export tax relief	Total	Sch. II cess	Sch. IV cess	Total	\$m.	Replanted acreage potential ^a (acres)
40	10.18	1.93	12.11	—	23.18	23.18	35.29	44,113
50	10.18	2.29	12.47	—	23.18	23.18	35.65	44,563
60	10.18	3.22	13.40	—	23.18	23.18	36.58	45,725
70	10.18	1.29	11.47	-2.57	23.18	20.61	32.08	40,100
80	10.18	—	10.18	-4.51	23.18	18.67	28.85	36,063
90	10.18	-8.37	1.81	-7.08	23.18	16.10	17.91	22,388
100	10.18	-16.09	-5.91	-9.01	23.18	14.17	8.26	10,325

^a It has been assumed that the cost of replanting an acre of rubber land is \$800.

Source: Federation of Malaya 1955b: Tables XV and XVII.

Table 32 Net annual assistance to estates available from government
(\$ million)

Price	Under Mudie Mission scheme	Under RPC scheme	Under government scheme
40	15·46	11·59	18·17
50	19·32	11·59	19·13
60	23·18	11·59	20·10
70	15·46	7·73	17·20
80	-6·76	16·42	15·27
90	-33·81	24·15	2·71
100	-59·89	32·84	-8·86

Notes:

1. The annual assistance to estates by the government under the Mudie Mission's scheme was derived solely from the proposed change in the rate of export duty. At prices above 78 cents per pound there was a net gain to the government.

2. The annual assistance to estates by the government under the RPC scheme was derived solely from that part of the export duty transferred to the replanting fund.

3. The annual assistance to estates by the government under the government's scheme was \$15·27 million a year for eleven years, plus (or minus) the reduced (or increased) yield of export duty from the proposed change in the rate of export duty.

4. The minus signs appearing against the figures for assistance available at prices of 80 cents and above in the case of the Mission's scheme and at 100 cents in the case of the government scheme indicate a net gain to the government at those prices—that is at and above those price levels the government would receive more revenue than it would before the adoption of one or other of the proposals as a result of the change in the export duty rate. In the case of the government's scheme, the increase in revenue at these price levels would exceed its estimated outlay on assistance to replanting activity by the amount indicated.

Source: Federation of Malaya 1955b: Table XV.

How successful was the government's attempt to stimulate replanting activity? The object of the government's replanting scheme was to replant 21% of total estate and smallholder acreage over the 7-year period 1955-61. In the case of estates, the target acreage was 424,000 acres (giving an average replanting rate on estates of 61,000 acres per annum, this being equivalent to 3% of estate acreage as at the end of 1954); in the case of smallholders, the target was 357,000 acres (or 51,000 acres per annum).

Estate acreage replanted during this period amounted to 372,000 acres—equivalent to almost 90% of the target figure. Most estates of 500 acres and above replanted 21% of their planted area with government assistance. Moreover, many of these estates replanted acreage in excess of their eligibility for government assistance because they found it technically expedient to do so. The scheme achieved less success, however, in its attempt to encourage estates of less than 500 acres (which accounted

for 65% of all estates and 16% of planted acreage) to replant; the average annual replanting rate during the 7-year period for these estates was 1.5% compared with a required rate of 3%. Consequently, at the end of 1961, these estates still had a high percentage of low-yield material.

After a slow start, replanting on smallholdings rose rapidly and, for the 7-year period 1955-61, acreage replanted amounted to 420,000 acres, almost 20% in excess of the target figure. However, over this period, less than one-half of all rubber smallholders applied for replanting assistance; that is a majority of smallholders did not draw on the contribution they made to Fund B by way of Schedule II and IV cess levies, or take advantage of the government grant to smallholders. In addition, there was a significant difference in the method of financing replanting grants made to estates and replanting grants made to smallholders. In the case of estates, replanting was financed primarily from the government grant for replanting. At the end of 1961, the \$168 million granted to estates had been slightly overspent. In the case of smallholdings, replanting activity was largely financed from Schedule II and IV cess revenue collected from the smallholders; at the end of 1961, only 40% of the government grant to smallholdings (\$112 million) had been spent (for details, see the second appendix to this chapter). Moreover, smallholders had built up large reserve balances from cess collections for future replanting activity; in December 1961, Fund B reserve balances amounted to \$184 million, whereas the balance in the estates counterpart to Fund B—Fund A—amounted to a meagre \$21 million. In short, smallholders themselves financed the major part of their replanting activity during this period, and to those who did not apply for replanting assistance, replanting cess charges effectively increased their export tax payments.

At the end of 1960, 44% of total rubber acreage in Malaya was under high-yield material; more than one-half of the total acreage therefore continued to be under low-yield, mostly pre-war, material. In the case of estates, low-yield material covered 40% of total acreage; in the case of smallholdings, low-yield material covered almost 75% of total acreage. There remained, therefore, a substantial replanting backlog. A government committee was established in 1961 to consider the future role of the government in rubber replanting activity. While the committee recognised that the rubber price would fall to 50 cents per pound and that there was a need to diversify the economy, it emphasised one point: that rubber would continue to make a major contribution to the prosperity of the nation and to the employment of its peoples for several decades to come (Federation of Malaya 1962: 5-6). For this reason, the committee

favoured a continuation of government assistance for replanting activity, and a new scheme came into effect in January 1962.

The new scheme is a replica of the old scheme; the committee argued that the basic features of the old scheme should be retained because its provisions were well known and because the old scheme worked quite efficiently and effectively.

In the case of estates, government assistance is to be provided for replanting with rubber (or with some other approved crop) up to a further 15% of planted acreage (the original scheme provided assistance for replanting up to 33% of planted acreage). The amount of assistance was held constant at \$400 per acre. The 4.5 cent replanting cess levied on the export of estate rubber is to continue to be collected but, as before, it is to be unconditionally returned to estates against certified production statistics.

The committee considered the possibility of using revenue raised from this cess to finance either the whole or one-half of the \$400 per acre replanting grant, but dismissed use of this source of finance on three grounds. First, the committee pointed out that cess payments made by estates varied according to the productivity of estates. Some of the backward estates now averaged less than 500 pounds of rubber per acre per annum while the more progressive estates were producing in excess of 1,000 pounds per acre per annum. Use of this source of finance would therefore mean that high-yielding estates would pay into Fund A at least twice as much as inefficient estates, but would receive back in grants per acre exactly the same amount. In effect, the more progressive estates, which had ploughed back profits in the past, would be penalised to reward those which had not. Second, the committee pointed out that, under the old scheme, estates had voluntarily reinvested more than 4.5 cents of the return on each pound of rubber sold. Estates replanted with grant assistance 53,000 acres on average between 1955 and 1961. At a cost of \$900 per acre, estate replanting activity cost approximately \$48 million each year of which the government grant of \$400 per acre covered \$21 million and the balance, \$27 million, was paid by the estates themselves. Schedule IV replanting cess revenue collected and refunded to the estates between 1955 and 1961 approximated \$27 million per annum. Since Schedule IV cess was levied at a rate of 4.5 cents per pound, it appeared that estates voluntarily reinvested 4.5 cents per pound of rubber sold. Since many estates replanted in excess of their eligibility for the grant, acreage replanted each year exceeded 53,000 acres, so that estates effectively reinvested more than 4.5 cents per pound of rubber sold. On this basis, the committee considered that there was no need to compel

estates to reinvest cess revenue collected from them. Third, the committee felt that few estates could afford to pay a fixed cess charge of 4·5 cents per pound when rubber price was low. The cess was initially levied at the request of smallholders who considered that, without such an arrangement, they would not set aside sufficient funds for replanting. For administrative reasons, the cess was collected from the output of the whole industry on the understanding that that part collected from estates would be unconditionally returned to them. The committee felt that estates would regard a change in this arrangement as a breach of faith.

Fifteen per cent of estate acreage as at the end of 1961 amounted to 290,000 acres. A replanting grant of \$400 per acre meant that the government's contribution to estate replanting over the 7-year period 1962-8 would amount to \$112 million.

In the case of smallholdings the committee made three recommendations. First, that the per acre replanting grant be increased from \$600 per acre to \$800 for smallholdings of less than five acres (to \$750 for smallholdings of more than five acres). Second, that the grant be spread over five and a half years instead of over three and a half years. These two adjustments were designed to increase the level of smallholder replanting and to remove the necessity for tapping rubber trees before they attain sufficient girth, a practice which had seriously affected the yield of newly-grown smallholder trees in the past. The third recommendation was that the grant should be paid for replanting up to one-third of the smallholder's acreage as at the end of 1961.

Smallholder acreage at the end of 1961 was almost equal to estate acreage. Since the scheme envisaged a higher replanting rate on smallholdings than on estates (3% of smallholder acreage per annum compared with approximately 1·5% of estate acreage) one would expect that the sum set aside by the government for smallholder replanting would be double that granted to estates (\$112 million). Instead the grant to smallholders was determined by the ratio of smallholder to estate production. Since smallholder production amounted to approximately 80% of estate production, the government grant to smallholders for the period 1962-8 was set at \$88 million. Clearly the major part of the finance for smallholder replanting activity during this period was to be derived from the accumulated balance the smallholders held in Fund B at the end of 1961 (derived from Schedule II and Schedule IV cess collections made by smallholders before 1962) and from Schedule IV cess collections over the period 1962-8. In the case of estates, the government is prepared to

finance almost one-half of per acre replanting costs; in the case of smallholdings, the government contribution effectively amounts to less than one-third of per acre costs.

Both estates and smallholders have responded to this additional stimulus; estates have on average replanted at a rate in excess of 1.5% of planted estate acreage per annum since 1962, and smallholders have raised their annual replanting rate above 5%. The smallholder achievement deserves emphasis, for it had long been argued that it would be difficult to encourage smallholders to replant on a scale which would permit the continued survival of this sector in the face of increased competition from synthetics. For example, it was pointed out in the 1953 report of the Rubber Industry Replanting Board that

in the case of the true smallholder working a smallholding with his own and family labour, it is obvious that every rubber tree he destroys for replanting will cause some loss of income although that income is precarious and decidedly short term. His natural inclination is to secure subsistence cash, however small, for as long as possible and not to face up to the fact that within a foreseeable period his production of saleable rubber will be nil or so low as to leave him in a desperate economic condition. The case of the medium holder is only slightly better (Rubber Industry (Replanting) Board, Fund 'B', 1954:3).

The achievements of the two government-inspired replanting schemes indicate that the rubber smallholder is aware of his predicament, is prepared to innovate, and is prepared to accept a temporary fall in his income while newly planted rubber trees mature. He is not as tradition-bound or financially 'locked in' as is generally believed. The gradual expansion of extension work by the Rubber Research Institute and by the Rubber Industry Replanting Board combined with a financial inducement is encouraging more and more smallholders to replant more and more of their acreage with high-yielding rubber trees.

The proportion of estate acreage under high-yield material rose from 60% in 1960 to 80% in 1967 and that of smallholder acreage rose from 25% to 55%. Production figures are summarised in Table 33. Despite a fall in mature acreage, production rose after 1956 and is expected to be 52% above the 1960 level in 1970. Nevertheless, if the price remains at 50 cents per pound, the value of rubber exports will fall from \$1,691 million in 1960 to \$1,200 million in 1970, and export duty revenue from \$196 million to \$50 million. Thus, despite the massive replanting program, rubber will yield less to producers, to the Treasury, to the balance of payments, and to the nation, in 1970 than it did in 1960.

Table 33 Malaya: rubber production, 1951-70
('000 tons)

Year	Estates			Smallholders			Total	
	Production on high-yield acreage	Production on low-yield acreage	Total Production	Production on high-yield acreage	Production on low-yield acreage	Total Production	Production on high-yield acreage	Production on low-yield acreage
1951	135	193	328	—	604	604	135	797
1952	148	193	341	—	583	583	148	776
1953	153	188	341	—	573	573	153	761
1954	150	195	345	1	239	240	151	434
1955	160	192	352	2	286	288	162	478
1956	174	177	351	3	270	273	177	447
1957	199	169	368	4	264	268	203	433
1958	223	166	389	7	264	271	230	430
1959	248	159	407	10	278	288	258	437
1960	264	149	413	19	274	293	283	423
1961	294	135	429	28	278	306	322	413
1962	320	118	438	39	272	311	359	390
1963	353	105	458	56	272	328	409	377
1964	382	88	470	76	271	347	458	359
1965	406	85	491	119	260	379	525	345
1966 ^a	456	58	514	n.a.	n.a.	411	n.a.	n.a.
1967 ^b	n.a.	n.a.	528	n.a.	n.a.	398	n.a.	n.a.
1968 ^b	n.a.	n.a.	566	n.a.	n.a.	400	n.a.	n.a.
1969 ^b	n.a.	n.a.	591	n.a.	n.a.	421	n.a.	n.a.
1970 ^b	n.a.	n.a.	617	n.a.	n.a.	459	n.a.	n.a.

^a Revised estimate. ^b Estimate.

Sources: Malaysia 1961-6: Section 3; Malaysia 1968a: Table 7.1, p. 43; Paardekooper 1965: Tables 1, 2, and 3.

Rubber Export Levies and the Economy

Export Tax Burden. This section attempts to answer three questions: who bears the export tax burden, how heavy is the tax burden, and what effect do the levies have on domestic production?

Domestic producers export their products to a world market which is supplied by other sources besides Malaya. Although Malaya is an important producer of rubber, it supplied only 14% of world demand in 1965. Moreover, Malaya's output was produced by a large number of estates and smallholdings between which there is little collusion. Consequently, the world demand for Malayan rubber is elastic, and domestic producers are 'price-takers' rather than 'price-setters'. Malayan producers can pass the tax burden forward to consumers only at the risk of losing their share of the export market.⁷

If the tax burden cannot be shifted forward to consumers to any significant extent, can producers shift the burden back to factors of production? While this is possible, the extent to which this form of tax shifting occurs is limited by minimum wage regulations in the estate sector of the rubber industry, and by the fact that workers can move to alternative occupations. The extent of rural labour mobility is, however, limited. Moreover, the steady increase in Malaya's rural workforce has reduced the bargaining strength of employees, so that it is likely that part of the tax burden is shifted to workers in the form of a slower increase in real wages than might have occurred in the absence of the tax (the real wage being defined to include non-monetary supplements such as food, housing, and medical care). The major part of the export tax burden will, however, be borne by producers.

Table 34A sets out the net burden of the various rubber levies (taking into account the government grants for replanting) borne by estates and smallholders respectively from 1946 to 1965. Since the levies are based on output, one would expect estates to bear 60% of the burden (the percentage ratio which corresponds to their share of total production) and smallholders 40%. For most years after 1950, however, the burden borne by smallholders has been substantially greater than 40% (see column 5). The discrepancy can be explained by reference to Table 34. The major part of Schedule II and IV cess revenue raised from estates

⁷ What is implied here is that the proportion of the tax burden passed forward will be smaller the more elastic is the foreign demand for the export in question and the more inelastic is the domestic supply; the argument does not imply that none of the tax burden can be passed forward.

has been refunded to them and estates have taken full advantage of replanting grants offered to them by the government. In addition, most estates greater than 500 acres are subject to income tax relief (at a rate of 40%) for export tax payments. In the case of smallholders, only 66% of Schedule II and IV cess revenue collected since 1951 had been refunded by 31 December 1961. Moreover, at the end of 1961, smallholders had utilised only 40% of the government grant of \$112 million. The increase in the smallholder replanting rate since 1961 has, however, substantially reduced the tax burden borne by smallholders.

Table 34A Malaya: export levies borne by estates and by smallholders, 1946-65
(\$ million)

Year	Net burden borne by estates	Net burden borne by smallholders	Total burden	% total burden borne by smallholders
1946	18.3	12.2	30.5	40.0
1947	17.0	14.3	31.3	45.7
1948	17.8	14.8	32.6	45.4
1949	15.7	13.0	28.7	45.3
1950	46.4	38.6	85.0	45.4
1951	110.7	110.4	221.1	49.9
1952	75.2	73.5	148.7	49.4
1953	19.4	46.7	66.1	70.7
1954	7.3	43.9	51.2	85.7
1955	95.3	110.6	205.9	53.7
1956	51.2	64.4	115.6	55.7
1957	35.2	26.4	61.6	42.9
1958	-2.2	16.6	14.4	115.3
1959	56.8	67.1	123.9	54.2
1960	74.6	88.8	163.4	54.2
1961	18.2	18.1	36.3	49.9
1962	28.6	29.4	58.0	50.7
1963	29.6	8.0	37.6	21.3
1964	14.2	2.5	16.7	15.0
1965	20.2	2.2	22.4	9.8

Source: Derived from Tables 34.B and C.

Table 34B Malaya: export levies borne by estates, 1946-65 (\$ million)

Year	Export tax Sch. I	Sch. II replanting cess		Sch. II anti- inflationary cess		Sch. III research cess	Sch. IV small- holder replanting cess		Govt grant to estates	Income tax relief	Net burden borne by estates
		Cess	Refund	Net	Cess	Refund	Net	Cess			
1946	18.3	—	—	—	—	—	—	—	—	—	18.3
1947	19.1	—	—	—	—	—	—	—	—	—4.3	17.0
1948	19.9	—	—	—	2.2	—	—	—	—	—4.4	17.8
1949	16.9	—	—	—	2.3	—	—	—	—	—3.9	15.7
1950	53.6	—	—	—	2.7	—	—	—	—	—11.6	46.4
1951	128.5	—	—	—	4.4	—	—	—	—	—47.4	110.7
1952	66.5	12.0	—	—	2.8	—	—	—	—	—32.2	75.2
1953	32.8	3.0	—1.2	1.8	2.9	26.0	—	26.0	—	—8.3	19.4
1954	31.6	2.5	—30.8	—28.3	3.7	33.5	—44.1	—10.6	—	—3.1	7.3
1955	104.5	4.6	—4.6	—	3.8	33.8	—30.5	3.3	—	—40.9	95.3
1956	86.4	—	—9.0	—9.0	4.1	34.1	—35.5	—1.4	—	—22.0	51.2
1957	72.2	—	—1.2	—1.2	4.0	27.2	—31.4	—4.2	—9.8	—15.1	35.2
1958	54.4	—	—0.8	—0.8	4.1	15.9	—19.8	—3.9	—21.7	—1.0	—2.2
1959	110.6	—	—0.6	—0.6	6.1	16.6	—15.0	1.6	—29.5	—37.9	56.8
1960	117.7	—	—0.6	—0.6	7.3	18.9	—21.8	—2.9	—24.9	—49.8	74.6
1961	70.9	—	—0.5	—0.5	6.9	40.4	—32.8	7.6	—20.2	—12.2	18.2
1962	55.8	—	—0.4	—0.4	7.1	41.6	—41.4	0.2	—15.3	—19.0	28.6
1963	49.6	—	—0.3	—0.3	7.3	42.1	—41.7	0.4	—10.0	—19.7	29.6
1964	41.4	—	—0.4	—0.4	7.9	45.6	—43.5	2.1	—20.5	—9.5	14.2
1965	46.8	—	—0.2	—0.2	8.4	46.8	—52.0	—5.2	—20.0	—13.5	20.2
					8.7	47.3	—48.9	—1.6			

Notes:

1. Because estate production has consistently accounted for 60% of total rubber production, it has been assumed that estates pay 60% of total export tax and research cess payments.
2. The Schedule IV replanting cess collected from estates was refunded to them on the basis of certified production statistics. This cess was a levy on smallholders but, for administrative reasons, it had to be collected from estates as well.
3. Income tax relief has been calculated at the company tax rate on the total of columns 2, 5, 8, 9, 12, and 13.

Sources: Malaysia 1949-67: Revenue Statement (columns 2 and 9); Rubber Industry (Replanting) Board 1954-66: Appendix 1 (columns 3, 4, 10, and 11); Rubber Industry (Replanting) Scheme for Estates 1958-66 (column 13); Rubber Industry (Replanting) Scheme for Estates, No. 2 1966 (column 13); Rubber Industry (Anti-Inflationary Cess) Fund Board 1959-64 (columns 6 and 7).

Table 34C Malaya: export levies borne by smallholders, 1946-65 (\$ million)

Year	Export tax Sch. I	Sch. II replanting cess	Sch. II anti- inflationary cess		Sch. III research cess	Sch. IV replanting cess	Replanting/new planting grants		Net burden borne by smallholders
			Cess	Refund			Fund B	Government scheme	
1946	12.2	—	—	—	—	—	—	—	12.2
1947	12.8	—	—	—	1.5	—	—	—	14.3
1948	13.2	—	—	—	1.6	—	—	—	14.8
1949	11.2	—	—	—	1.8	—	—	—	13.0
1950	35.7	—	—	—	2.9	—	—	—	38.6
1951	85.6	22.9	—	—	1.9	—	—	—	110.4
1952	44.3	8.9	—	—	2.0	18.6	-0.3	—	73.5
1953	21.9	2.1	—	—	2.4	23.2	-2.9	—	46.7
1954	21.0	1.8	—	—	2.6	23.6	-5.1	—	43.9
1955	69.6	3.9	19.4	—	2.7	27.5	-12.5	—	110.6
1956	57.6	—	3.9	5.0	2.7	21.4	-12.7	-3.5	64.4
1957	48.1	—	0.6	14.9	2.7	11.4	-15.8	-5.7	26.4
1958	36.2	—	—	9.9	4.1	11.5	-17.5	-7.8	16.6
1959	73.8	—	7.0	—	4.8	13.3	-20.4	-10.4	67.1
1960	78.4	—	15.5	0.3	4.6	28.3	-34.2	-3.5	88.8
1961	47.2	—	—	25.1	4.8	29.7	-36.2	-2.3	18.1
1962	37.2	—	—	—	4.8	30.0	-39.6	-3.0	29.4
1963	33.1	—	—	—	5.2	33.0	-60.0	-3.3	8.0
1964	27.6	—	—	—	5.6	34.7	-62.9	-2.5	2.5
1965	31.2	—	—	—	5.8	37.2	-69.0	-3.0	2.2

Sources: Malaysia 1949-67: Revenue Statement (columns 2 and 7); Rubber Industry (Replanting) Board 1954-66, Appendix 2 (columns 3, 8, 9, and 10); Rubber Industry (Anti-Inflationary Cess) Fund Board 1959-64 (columns 4 and 5).

Export tax payments (net of grants and income tax relief) added approximately 2 cents to the cost of producing a pound of estate rubber in 1965. With the rubber price at 55 cents per pound and production costs (net of export tax payments) below 35 cents, the export tax burden on the estate sector does not appear to be too heavy. Table 35 shows the tax burden of a typical smallholder at different rubber price levels. At a price level of 50 cents per pound, the income of this smallholder is \$513 and his export tax burden is 7%. As has been indicated, the smallholder himself has largely financed the replanting grants made to him since 1952 from his contributions under Schedule II and Schedule IV cess provisions. Thus, in contrast to the position for most estates, replanting grants have not significantly reduced his export tax burden. If he does not take full advantage of his right to apply for replanting grants, then his effective tax rate increases above 7%, for replanting and research cess charges would, in this case, represent additional tax levies over and above the export tax proper. An individual is not subject to income tax until his income exceeds \$2,000. If he is married, the exemption limit rises to \$3,000, and if he has three children the limit is \$4,750. A married person with three children is not subject to an average income tax rate of 7% until his income exceeds \$15,000. By comparison, there can be little doubt that the burden of export levies on rubber smallholders is excessive.

In view of this conclusion, it is considered (a) that the Schedule IV cess should be abolished, and (b) that part of the export tax revenue derived from smallholders should be transferred to Fund B for the finance of future replanting activity. For example, it could be provided that at a price equal to or below 50 cents per pound, the whole of the export duty derived from the export of smallholder rubber could be paid into Fund B for smallholder replanting activity. At prices above 50 cents, the amount paid into Fund B could be limited to 2 cents per export pound of rubber produced by smallholdings, the balance representing government revenue.

The abolition of Schedule IV cess would not affect the tax burden borne by estates, for that part of total Schedule IV cess revenue collected from estates was unconditionally refunded to them. Abolition would, however, reduce administrative expenses; Fund A, which is merely a clearing house, could be eliminated.

The proposal to allocate a part of export tax revenue derived from smallholders into Fund B to be used for smallholder replanting assistance is similar to a suggestion made by the RPC in 1954. At the time, the Council's suggestion was dismissed on the ground that the rubber export

Table 35 Malaya: burden of export levies borne by rubber smallholder at selected rubber price levels, 1965

Rubber export price (cents per pound)	Smallholder income (\$)	Export duty (Schedule I)		Research cess (Schedule III)		Replanting cess (Schedule IV)		Aggregate value of levies	
		\$	% of col. 2 (4)	\$	% of col. 2 (6)	\$	% of col. 2 (8)	\$	% of col. 2 (10)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
40	337	32	9.5	18	15.3	81	24.0	131	38.9
50	513	36	7.0	18	3.5	81	15.8	135	26.3
60	686	43	6.3	18	2.6	81	11.8	142	20.7
70	833	77	9.2	18	2.2	81	9.7	176	21.1
80	979	110	11.2	18	1.8	81	8.3	209	21.3
100	1,193	257	21.5	18	1.5	81	6.8	356	29.8

Notes:

1. Assumes a holding of 4½ acres of tappable (mature) rubber.
2. Assumes production is 1½ pounds per acre per tapping day and that tapping is done twenty days per calendar month (output per month is therefore equal to 135 pounds).
3. Assumes cost of production per pound exclusive of labour is 4 cents and that grade differentials, moisture allowances, smoking charges, transport, freight, insurance, and commission reduce the market price by 20 cents.

tax was a regular source of revenue which the government could not afford to forgo. Since then, income taxation has been more extensively developed and, as indicated in Chapters 4 and 5, there is considerable scope for further development. In addition, the fall in the price of natural rubber has substantially reduced the importance of the export tax on rubber as a source of government finance. It would therefore appear to be an appropriate time for the government to dispense with the rubber export tax as a source of budget revenue, but the abolition of the tax would not be in the national interest for, should the price of natural rubber rise suddenly, the tax is set in such a way that it would act as an important anti-inflationary device. The suggested adjustment represents one way out of this problem: the tax is retained, but part of the export tax revenue derived from smallholders (all when price is below 50 cents) would be used in conjunction with the government grant to provide funds to continue a large-scale replanting program for smallholders. Export tax revenue derived from estates would continue to be a source of government revenue. This would mean that estates would bear a heavier export tax burden than smallholdings. Foreign-owned firms dominate estate production and these firms can claim income tax relief for export tax payments. Consequently, the effective burden of the export tax on estates is not as heavy as it would seem, and the change in the distribution of the rubber export tax burden between domestic and foreign producers may not be considered undesirable. However, with the further development of income taxation, consideration should be given to a reduction of export tax rates when the price of natural rubber is below 60 cents per pound.

To analyse the effect of the export tax on domestic rubber production, a distinction will be drawn between the two sectors: smallholders and estates. Figure 2 attempts to summarise the main results. DD is the foreign demand curve for natural rubber produced in Malaya (the curve is converted from foreign currency into Malayan currency at the ruling rate of exchange). The curve has a high elasticity in the relevant price range. Statistical research has indicated that, while smallholder production is not markedly responsive to short-term price changes, it is more responsive than estate production. In the presence of the export tax, we know that estate production is greater than smallholder production but, for purposes of analysis, let us ignore this point and assume that, in the absence of the export tax, both sectors produce the same level of output. The estates supply curve is S_e , the smallholders supply curve is S_s ; since smallholder production is more responsive to price changes than estate production, the smallholders supply curve is

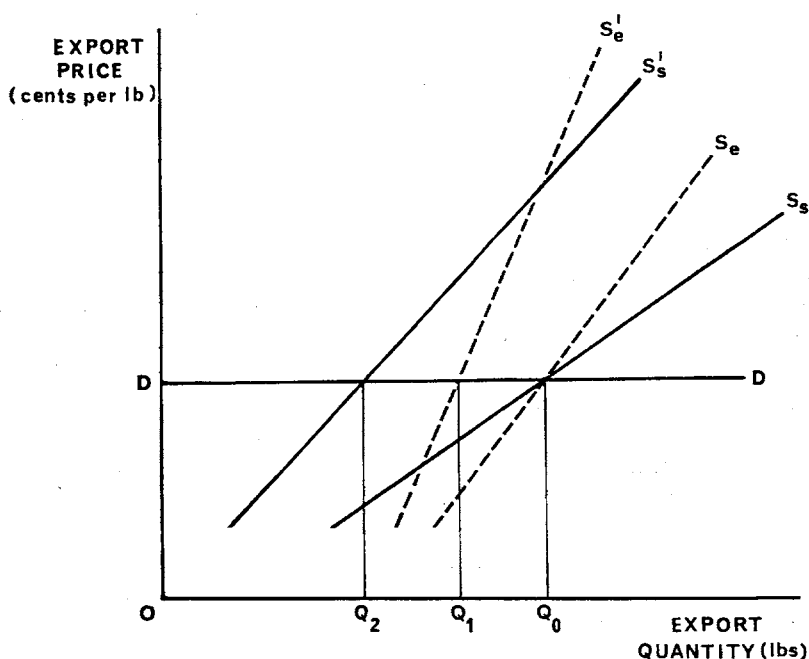


FIG. 2 *Effect of an export tax on domestic rubber production*

more elastic than the estates supply curve. Thus, in the absence of the export tax, both sectors produce OQ_0 and sell their output for OD per unit. An export tax, progressive with respect to price, is then imposed. The tax is a production cost and, as a result, the smallholders supply curve shifts to S_s^1 , the estates supply curve to S_e^1 . Part of the tax burden may, over time, be shifted back to labour with the result that the post-tax supply curves will move back towards their pre-tax position. However, compared with estates, the ability of smallholders to shift the tax burden back to labour is more limited, because many do not employ labour outside the household and, if they do, wage payments are normally so low that it is difficult to effect a further reduction. For a given demand curve, the greater the elasticity of the supply and the more difficult it is to shift the tax burden back to labour, the greater is the reduction in output following the imposition (or increase) of export taxes. The export tax therefore impinges more heavily on smallholder than on estate production. The fact that the government has subsidised estate replanting activity more than it has subsidised smallholder replanting activity further increases the impact of export taxes on smallholder

compared with estate production. Malayan experience offers a sharp contrast to Levin's thesis (1960: 263-70) which claims that, in the so-called 'export economies', domestic governments have used export taxes to absorb an increasing share of foreign factor incomes; the brunt of the Malayan export tax on rubber has in fact been borne by indigenous producers rather than by the largely foreign-owned estate sector. In the absence of the levies on the export of rubber, it is likely that smallholder production would more closely approximate (if not exceed) that of estate production.

Export Tax and Cyclical Fluctuations. The net withdrawal of spending power from the rubber industry by means of export levies is summarised in Table 34A. Cess collections and refunds increased the countercyclical character of the export tax proper. The anti-inflationary cess was not, however, completely successful. First, it was returned to smallholders regardless of the state of the economy. Second, the method of repayment to smallholders (a reduction in Schedule IV cess) effectively speeded up refunds of Schedule IV cess to estates and so added to inflationary pressures in 1959. Finally, the stipulation that the estates' share should be refunded when price fell below \$1 meant that refunds could be and were made during reasonably high price periods.

It is expected that the development of synthetic rubbers will set an upper limit of 60 cents per pound on the price of natural rubber, and that fluctuations in the price of natural rubber will be less severe in the future. Nevertheless, the possibility of exceptional circumstances requires that the tax should continue to be graduated with the price of rubber in order to withdraw excess purchasing power during high price periods.

OTHER DUTIES

Tin Export Duty

The export tax on tin concentrates and tin metal remained unchanged in the post-war period until January 1961 when the rate was raised slightly at prices above \$388.4 per picul (Table 36). The increase in the tax burden borne by the tin industry during this period has been made by means of income tax adjustments. Thus, in response to the high price prevailing after 1960, a special profits tax was imposed on the tin industry in 1965. The export duty taxes the prosperous and the marginal mine alike; income tax adjustments raise additional revenue from mines making the highest profits.

Table 36 Malaya: present duty on exports of tin concentrates compared with pre-1960 duty, selected price levels

Tin metal price (\$ per picul)	Pre-1960 tax rates		Post-1961 tax rates	
	\$ per picul	% of price	\$ per picul	% of price
100	9.48	9.48	9.48	9.48
150	15.48	10.32	15.48	10.32
200	21.48	10.74	21.48	10.74
250	27.48	10.99	27.48	10.99
300	33.48	11.16	33.48	11.16
350	39.48	11.28	39.48	11.28
400	45.48	11.37	47.76	11.94
450	51.48	11.44	53.76	11.95
500	57.48	11.50	59.76	11.95
550	63.48	11.54	65.76	11.96
600	69.48	11.58	71.76	11.96
650	75.48	11.61	77.76	11.96
700	81.48	11.64	83.76	11.96
750	87.48	11.66	89.76	11.97
800	93.48	11.68	95.76	11.97

Notes:

1. 16.8 piculs = 1 ton.
2. The export tax on tin metal is 33.3% higher than that on tin ore.

Sources: Federation of Malaya 1956; Malaysia 1965c.

The tin export tax is a specific levy which varies with price in such a way that, at prices above \$388.4 per picul, the tax on tin ore is effectively maintained at an *ad valorem* rate of 12%, and that on tin metal at a rate of 16%. (The tax on tin ore is set at 75% of the tax on tin metal, because the metallic content of tin ore is, on average, 75% tin metal.)

The slow recovery of the tin industry after the war, the imposition of income taxation, the desire to permit the exploitation of low-grade ground, and output restrictions under the International Tin Agreement from December 1957 until September 1960, were the main factors which precluded upward adjustments in the export tax.

At low price levels (\$550 per ton), the export tax absorbs more than 40% of net profits (Table 37). The percentage figure is higher for marginal mines where production costs per ton are higher than the accepted average of \$3,000. When account is taken of income tax and the fact that producers cannot shift the tax burden forwards or backwards, the

Table 37 Malaya: tin export tax payments as a percentage of profits at selected price levels, 1965

Price per ton		Duty per ton		Profit per ton ^a		Ratio of duty to profit (%)
£ Stg	\$	£ Stg	\$	£ Stg	\$	
490.65	4,200.00	53.93	461.66	90.65	776	59.49
588.79	5,040.00	65.71	562.46	188.79	1,616	34.81
686.92	5,880.00	77.48	663.26	286.92	2,456	27.00
785.05	6,720.00	93.73	802.37	385.05	3,296	24.34
883.18	7,560.00	105.51	903.17	483.18	4,136	21.84
981.31	8,400.00	117.29	1,003.97	581.31	4,976	20.18
1,079.44	9,240.00	129.06	1,104.77	679.44	5,816	19.00
1,177.57	10,080.00	140.84	1,205.57	777.57	6,656	18.11
1,275.70	10,920.00	152.61	1,306.37	875.70	7,496	17.43
1,373.83	11,760.00	164.39	1,407.17	973.83	8,336	16.88
1,471.96	12,600.00	176.16	1,507.97	1,071.96	9,176	16.43
1,570.09	13,440.00	187.94	1,608.77	1,170.09	10,016	16.06

^a Assumes production costs of \$3,500 per ton (=£ Stg 400 per ton).

Sources: As for Table 36.

industry has to bear a very heavy tax burden. Compared with income tax, which takes the same proportion of business profits, the export duty taxes all producers at the same rate per unit of export output. The export tax therefore bears more heavily on the marginal than on the intra-marginal producer, whether his high costs are due to managerial inefficiency or resource deficiency. The export tax, then, is regressive in impact (it falls more heavily on the producer with small profit per unit of output than on the producer enjoying a larger profit) and reduces the incentive to work high-cost production units. The reworking of tin mining lodes in Malaya during periods of exceptionally high prices indicates that the export tax on tin has forced domestic producers to by-pass lower-grade ores in less fortuitous years. The problem, as pointed out by Levin, is that export taxation 'may cause a country to forfeit a fraction of its otherwise economic mineral reserves—and revenues—and hasten the exhaustion of its exploitable mineral resources' (1960: 272). In contrast, a tax on income, by taking into account the higher cost of marginal production units, would not indiscriminately discourage marginal producers. A strong case can be made for export tax relief at low price levels. But because all tin producers are not subject to income tax, abolition of the export duty would be premature.

Minor Duties

There are a number of minor export taxes all of which, apart from iron ore, raise small amounts of revenue. Some of these taxes were abolished in 1957 (for instance, those on forest products). Most of the others should be abolished. The tax on coconut oil, for example, encourages the export of fresh coconuts and discourages domestic processing activities. Yet rehabilitation of the coconut industry is an objective of government policy! Apart from such anomalies, collection of these minor export taxes entails administrative costs which largely offset revenue yield.

APPENDIX I

EXPORT LEVIES ON RUBBER, 1930-68

(1) *January 1930 to January 1934*

Price (cents per pound)	Tax rate (per cent)
Less than 30	1
30 and less than 32	$1\frac{1}{2}$
32 and less than 33	$1\frac{3}{4}$
33 and less than 34	2
34 and less than 35	$2\frac{1}{4}$
35 and less than 50	$2\frac{1}{2}$
50 and less than 60	3
60 and less than 80	4
80 and over	5

(2) *February 1934 to September 1936*

Price (cents per pound)	Tax rate (per cent)
Less than 20	1
20 and less than 22	$1\frac{1}{2}$
22 and less than 24	$1\frac{3}{4}$
24 and less than 26	2
26 and less than 28	$2\frac{1}{4}$
28 and less than 30	$2\frac{1}{2}$
30 and less than 60	3
60 and less than 80	4
80 and over	5

(3) *October 1936 to December 1940*

Price (cents per pound)	Tax rate (per cent)
Less than 20	1
20 and less than 22	$1\frac{1}{2}$
22 and less than 24	$1\frac{3}{4}$
24 and less than 26	2
26 and less than 28	$2\frac{1}{4}$
28 and less than 30	$2\frac{1}{2}$
30 and less than 35	3
35 and over	$3\frac{1}{4}$

(4) *January 1941 to November 1945*

For this period the tax was set at a flat rate of 5% *ad valorem* at all price levels.

(5) *December 1945 to February 1946*

The tax collected from the industry during this period was identical with that collected from October 1936 to December 1940.

(6) *March to October 1946*

For this period the tax was fixed at 4 cents per pound at all price levels.

(7) *November 1946 to January 1947*

For this period the tax was fixed at 2.5 cents per pound plus a research cess (Schedule III) of 0.25 cents per pound.

(8) *February 1947 to September 1949*

For this period the tax was set at a flat rate of 5% *ad valorem* plus a research cess (Schedule III) of 0.25 cents per pound.

(9) *October 1949 to May 1950*

For this period the tax was set at a flat rate of 5% *ad valorem* plus a research cess (Schedule III) of 0.4 cents per pound.

(10) *June to December 1950*

For this period the tax was set at a flat rate of 5% *ad valorem* plus a research cess (Schedule III) of 0.5 cents per pound.

(11) *Government's November 1950 Proposal*

The government's November 1950 proposal was as follows:

1. When the price was 60 cents or less per pound, the duty was to be 5% *ad valorem*.

2. When the price exceeded 60 cents per pound but was less than \$3 per pound the duty was to be calculated according to the formula:

$$\frac{(P - 40)(P + 60)}{800}$$

(P representing the price in cents per pound)

3. When the price exceeded \$3 per pound the duty was to remain at the level applicable to a price of \$3 per pound.

(12) *January to December 1951*

The Customs Proclamation 1951 provided for the collection during this period of:

1. *Export Duty* (Schedule I)

- (a) When price (P) exceeded 60 cents per pound, the duty was calculated according to the formula:

$$\frac{1.55P - 63}{10}$$

- (b) When price was 60 cents per pound or less, the duty was set at a flat rate of 5% *ad valorem*.

2. *Replanting Cess* (Schedule II)

Applicable when price (P) exceeded 60 cents per pound and calculated according to the formula:

$$\frac{0.45P - 27}{10}$$

the proceeds of which were to be made available to the industry for replanting and new planting.

3. *Research Cess* (Schedule III)

Fixed at 0.35 cents per pound. The proceeds of this cess were to be paid into the Malayan Rubber Fund.

(13) *January to April 1952*

The levies collected from the industry during this period were identical with those collected from January 1951 to December 1951, except that the research cess (Schedule III) was raised from 0.35 cents per pound to 0.4 cents per pound.

(14) *May to August 1952*

In addition to the levies collected from the industry during the period January to April 1952, a replanting cess equal to 4.5 cents per pound was collected from the smallholder sector of the industry when price exceeded 60 cents per pound. This levy was referred to as Schedule IV cess.

(15) *September 1952 to February 1953*

In September 1952, the smallholder replanting cess of 4.5 cents per pound (Schedule IV) was made operative at all price levels.

(16) *March 1953 to May 1955*

In March 1953, the research cess (Schedule III) was raised from 0.4 cents per pound to 0.5 cents per pound.

(17) *Mudie Mission's Proposals, 1955*

The Mudie Mission's proposal was as follows:

1. *Export Duty* (Schedule I)

- | | |
|--|-------------------|
| (a) On first 60 cents of f.o.b. Singapore price | nil |
| (b) On next 5 cents of f.o.b. Singapore price | 20% of the excess |
| (c) On next 5 cents of f.o.b. Singapore price | 30% of the excess |
| (d) On next 5 cents of f.o.b. Singapore price | 40% of the excess |
| (e) On prices above 75 cents of f.o.b. Singapore price | 50% of the excess |

2. *Replanting Cess* (Schedule IV)

The cess was fixed at 4.5 cents per pound and collected from both estates and smallholdings at all price levels. The cess was refunded against replanting activity.

3. *Research Cess* (Schedule III)

This cess was fixed at 0.75 cents per pound.

4. *Replanting Cess* (Schedule II)

Abolished.

(18) *Rubber Producers' Council Proposal*

The Council proposed that the levies should be the same as those applicable during the period March 1953 to May 1955 except that part of the export tax should be paid into a replanting fund. This proportion was set at 1.5 cents per pound when price was below 70 cents, and at a price of 70 cents and above the government's share of the duty to be limited to the equivalent of 5% *ad valorem*.

(19) *June 1955 to February 1956*

The levies collected from the industry during this period were as follows:

1. *Export Duty* (Schedule I)

- | | |
|---|-------------------------------|
| At prices of 60 cents per pound and below | 4% <i>ad valorem</i> |
| At prices over 60 cents per pound and up to 80 cents per pound | $d = 0.18625P - 8.775$ |
| At prices over 80 cents per pound and up to 100 cents per pound | $d = 0.3125P - 18.875$ |
| At prices over 100 cents per pound | $d = \frac{x^2 + 3x + 50}{4}$ |

(where d = export duty, $x = \frac{P - 100}{10}$, P = price)

2. *Anti-Inflationary Cess* (Schedule II)

- | | |
|------------------------------------|--------------------|
| At prices over 100 cents per pound | $c = \frac{5x}{2}$ |
|------------------------------------|--------------------|

(where c = cess, $x = \frac{P - 100}{10}$, P = price)

(The anti-inflationary cess replaced the Schedule II replanting cess.)

3. *Research Cess* (Schedule III)

This cess was fixed at 0.5 cents per pound.

4. *Smallholder Replanting Cess* (Schedule IV)

This cess was fixed at 4.5 cents per pound at all price levels.

(20) *March 1956 to December 1958*

In March 1956 the smallholder replanting cess (Schedule IV) was reduced from 4.5 cents per pound to 2 cents per pound.

(21) *January to December 1959*

In January 1959 the research cess (Schedule III) was raised from 0.5 cents per pound to 0.75 cents per pound.

(22) *January to December 1960*

In January 1960 the smallholder replanting cess (Schedule IV) was increased from 2 cents per pound back to 4.5 cents per pound.

(23) *January 1961 to December 1967*

During this period the levies on the rubber industry were as follows:

1. *Export Tax* (Schedule I)

At prices of 60 cents per pound and below 4% *ad valorem*

At prices over 60 cents per pound and up to 80 cents per pound $d = 0.18625P - 8.775$

At prices over 80 cents per pound and up to 100 cents per pound $d = 0.4P - 25.750$

At prices over 100 cents per pound $d = 0.25(x)^2 + 3.375x + 14.250$

(where d = export duty, $x = \frac{P - 100}{10}$, P = price)

2. *Anti-Inflationary Cess* (Schedule II)

This cess was incorporated into Schedule I.

3. *Research Cess* (Schedule III)

This cess held steady at 0.75 cents per pound.

4. *Smallholder Replanting Cess* (Schedule IV)

This cess was fixed at 4.5 cents per pound.

(24) *January 1968*

In January 1968, the research cess (Schedule III) was raised from 0.75 cents per pound to 1 cent per pound.

APPENDIX II

SMALLHOLDER REPLANTING SCHEMES

Following reports by a Rubber Smallholders' Enquiry Committee (Federation of Malaya 1952 and 1953a) and by a smallholder replanting sub-committee of the RPC, two replanting cesses were levied on rubber producers. Schedule II cess, imposed in January 1951 and withdrawn in May 1955, was levied on a sliding scale depending on rubber price; Schedule IV cess, imposed in March 1952, was levied at a flat rate of 4.5 cents per pound. Revenue collected under both cesses from the export of smallholder rubber was paid into a smallholder replanting fund—Fund B. An interim replanting scheme (known as Scheme No. 1) was put into operation in September 1952. The intention of this scheme was to give interim financial assistance to smallholders who had made some progress with replanting during 1952.

Scheme No. 1 was replaced by Scheme No. 2 in January 1953. The object of this scheme was to assist smallholders to replant one-third of their estimated acreage as at the end of 1952 over the 7-year period 1953–9. Smallholder acreage at the end of 1952 was estimated to be 1.6 million acres, so that the replanting target was slightly in excess of half a million acres. Assistance at a rate of \$400 per acre payable in six instalments was made to smallholders for replanting not less than one acre but not more than one-third of their aggregate holdings. Smallholders owning 15 acres of rubber or less could claim assistance for replanting up to 5 acres. Apart from replanting with rubber, smallholders were permitted to replant with other approved crops such as fruit, coffee, pineapples, coconuts, rice, or tapioca.

The per acre replanting grant was raised from \$400 to \$500 in October 1954 (retrospective to January 1953).

In 1955 the Federal government set aside \$112 million for smallholder replanting. This grant was allocated between six new schemes:

The Rubber Industry (Replanting) (Smallholders') Scheme 1956. Of the total grant, \$47.5 million was allocated to this scheme. Under this scheme additional assistance was given to smallholders eligible for grants from Scheme No. 2. The assistance assumed two forms. First, part of this grant was used to raise the Scheme No. 2 replanting grant from \$500 to \$600. Second, the scheme provided a grant of \$600 per acre to enable smallholders owning not more than 30 acres and eligible for grants under Scheme No. 2 to replant a further 33% of their acreage or a further 5 acres, whichever was less.

The Rubber Industry Smallholders' Planting Material Scheme 1956. The object of this scheme was to provide high-yielding planting material at low cost to smallholders. A total of \$5 million was set aside for this purpose and

the administrators of this fund were expected to exercise their function so that, over a period of time, the annual revenue of the fund would be sufficient to meet expenditure on current account.

The Rubber Industry (Smallholders' Association) Scheme 1956. Under this scheme, a grant of \$75,000 was made to the Council of Malayan Smallholders' Associations. The object of this assistance was to enable the Council to achieve financial independence and to carry out its aims and functions as described in its constitution.

The Rubber Industry (Smallholders' New Planting) Scheme 1957. Under this scheme, a sum of \$30 million was provided to assist smallholders in the opening of new land under collective block schemes. A grant of \$400 per acre, spread over three years, could be claimed in cash or kind (fertilisers, seeds, etc.). The individual holdings in block schemes were not to have less than 6 acres under rubber and 2 acres under other crops. Holdings could not be leased, transferred, subdivided, or sold without permission for a period of ten years. This scheme was administered by the Federal Land Development Authority and State Government Development Boards. At a rate of \$400 per acre, the grant provided assistance towards planting 75,000 acres.

Rubber Industry (Smallholders' New Planting) Scheme, No. 2, 1959. Under this scheme a sum of \$20 million was set aside for the benefit of smallholders who own less than 5 acres. Eligible smallholders may receive a grant of \$400 per acre for new planting of rubber in supervised block schemes of not less than 100 acres. The grant provided assistance towards planting 50,000 acres.

The Rubber Industry (Smallholders') (Improved Supply) Planting Material Scheme 1959. This provided \$9 million for the establishment of seed gardens for the sole purpose of providing smallholders with approved high-yielding material at a low cost.

Scheme No. 2 covered the period 1953-9. During this period, smallholders replanted 318,000 acres with assistance from Fund B. This amounted to 66% of the replanting target set for Scheme No. 2.

The Rubber Industry (Replanting) (Smallholders') Scheme 1956 was amalgamated with Scheme No. 2 on 1 January 1960, the joint venture being renamed Scheme No. 3. From 1 January 1962, all smallholders who successfully replanted the first one-third of their holdings became eligible to receive grants for replanting a further one-third, subject to certain conditions. In addition, the replanting grant was raised from \$600 to \$750 per acre and cultivators holding not more than 5 acres of land under rubber on 1 January 1957 were eligible for an additional bonus of \$50 per acre on the successful completion of replanting.

The financial position of the government schemes as at 31 December 1961 was as follows:

- (a) Government grant \$47.5 million; total spent \$24.9 million: balance \$22.6 million transferred to Fund B.
- (b) Government grant \$5 million; total spent \$4 million.
- (c) Government grant \$75,000; total spent \$70,000.
- (d) Government grant \$30 million; total spent \$7.4 million.
- (e) Government grant \$20 million; none spent. It was decided to postpone the launching of this scheme until 1962 for difficulties were encountered in obtaining the necessary land.
- (f) Government grant \$9 million; total spent \$3 million.

Overall, of the total grant of \$112 million, only \$40 million (or 36%) had been spent by 31 December 1961.

Domestic Borrowing

Domestic loan finance is an important source of government finance in Malaya and Singapore. In Malaya, the level of the domestic debt expanded steadily between 1951 and 1960, principally as a result of a gradual expansion in the annual flow of funds available from the Employees' Provident Fund (EPF), a semi-governmental authority established in 1951. In December 1951, the domestic debt amounted to less than \$60 million, and consisted primarily of short-term debt (defined to include securities not exceeding three years in duration). By December 1960, the domestic debt amounted to \$1,098 million, of which long- and medium-term debt amounted to 76% and short-term debt to 24% (Tables 38 and 39). Thus the major part (75%) of the increase in the total domestic debt between 1951 and 1960 assumed the form of an increase in long-term debt. The EPF itself held more than 50% of the Malayan government's domestic debt outstanding at the end of 1960, the major part of its holding consisting of long-term securities. In addition to the EPF, various other government authorities held a further 30% of the domestic debt, so that the holdings of the private sector were small.

Because more than 80% of the government's debt was held by semi-governmental authorities, and because these authorities normally held their portfolio investments until maturity, there was little trading in domestically issued long- and short-term government securities. It may be argued that the limited amount of trading discouraged the private sector from holding domestic government securities, particularly as many private firms could buy and sell securities on the London money market without any significant delay, and without any foreign exchange difficulties or uncertainties. It is, however, difficult to prove this point, for the issue of government securities in Malaya was closely related to the level of advance deposits held by the various semi-governmental

authorities at the Treasury—the unannexed portion of each domestic loan issue was small. In general, the Malayan government did not seriously attempt to increase its indebtedness outside of the semi-governmental authorities in the decade after 1950.

The government's failure to raise domestic loan finance from the private sector was due partly to the continued influence of British Colonial Office directives and attitudes on economic policy decisions in Malaya, and partly to the operation of colonial monetary institutions.

The Colonial Office had long discouraged colonial administrations from relying on deficit finance. The emphasis placed by the Colonial Office on budgeting for a small surplus was not so much a denial of Keynesian economics as a means of ensuring that the colonial government lived within its means, and thus did not have to look to Britain for emergency financial assistance. The scope for raising domestic loan finance was considered to be negligible. In consequence, the Colonial Office concluded that the main source of loan funds available to any colonial administration would be that which could be raised externally, primarily in Britain. Appreciating that the supply of finance available in Britain was limited and that there were many other demands for such finance, the Colonial Office indicated to the colonial administrations that external loan finance could not be depended on as an annual addition to the flow of budgetary finance. In addition, because loan finance had to be serviced and eventually redeemed, the Colonial Office argued that revenue-producing works alone should be financed out of loan funds.

The Malayan administration, directed by Colonial Office appointees, adapted the Colonial Office policy to the Malayan environment. Government expenditure was closely tailored to tax revenue, non-tax revenue (including domestic loans raised from the semi-governmental authorities) being used principally to enhance the nation's external reserves. Budget deficits emerged only in periods of exceptionally poor revenue performance (see Table 8, p. 48).

Because the Colonial Office frowned on the use of loan finance, the Malayan government was reluctant to seek such finance outside of the semi-governmental authorities. Two important corollaries followed. First, it was not until almost 1960 that the Malayan government began to appreciate that the rising level of loan finance raised in Malaya (primarily from the EPF) effectively represented an annual addition to the flow of budgetary finance which would continue for many decades, that it was quite reasonable to finance general government expenditure from this source, and that endeavours should be made to enhance the flow of such finance. In other words, it was almost a decade before the

Table 38 Malaya: central government domestic debt, 1960-7
(\$ million)

Item	End of period										
	1960	1961	1962	1963	1964	1965	1966	1967			
Treasury bills	112.9	106.0	109.3	148.2	221.5	449.8	578.1	643.8			
Treasury deposit receipts	140.2	140.2	102.7	56.2	30.5	0.1	0.1	0.1			
2-year securities	—	—	15.0	51.1	53.7	32.1	14.5	—			
3-year securities	—	—	—	—	—	13.0	54.2	54.2			
5-year securities	20.5	31.5	75.3	106.6	98.0	97.0	97.3	155.3			
7-year securities	—	—	—	—	—	—	—	24.5			
Long-term securities	815.0	933.1	1,069.0	1,223.1	1,365.1	1,579.3	1,752.4	2,107.9			
National defence bonds	—	—	—	—	—	10.3	10.3	10.3			
Advance subscriptions	8.9	20.8	7.6	2.0	10.4	2.0	3.4	0.7			
Total	1,097.5	1,231.6	1,378.9	1,587.2	1,779.2	2,183.6	2,510.3	2,996.8			

Source: Bank Negara Malaysia 1968: Table 19.

Table 39 Malaya: central government domestic debt, 1960-7. Classification by maturities and subscribers
(\$ million)

Debt by maturities and subscribers	End of period							
	1960	1961	1962	1963	1964	1965	1966	1967
Short-term ^a								
Governments and agencies	262.0	267.0	234.6	257.5	316.1	397.0	650.3	698.8
Financial institutions	213.3	221.9	179.4	134.1	122.5	64.5	33.2	42.2
Miscellaneous investors	48.1	44.6	52.8	117.4	184.3	417.2	579.0	619.4
	0.6	0.5	2.4	6.0	9.3	15.3	38.1	37.2
Medium-term ^b								
Governments and agencies	20.5	31.5	75.3	106.6	98.0	97.0	97.3	179.8
Financial institutions	5.7	12.7	50.1	73.5	63.4	62.2	62.0	44.8
Miscellaneous investors	7.9	10.7	13.8	18.6	20.3	22.2	23.0	102.3
	6.9	8.1	11.4	14.5	14.3	12.6	12.3	32.7
Long-term ^c								
Governments and agencies	815.0	933.1	1,069.0	1,223.1	1,365.1	1,589.6	1,762.7	2,118.2
Financial institutions	667.7	774.3	902.6	1,024.8	1,151.9	1,344.6	1,544.6	1,845.6
Miscellaneous investors	79.7	84.4	87.0	104.0	108.7	121.4	91.3	127.1
	67.6	74.4	79.4	94.3	104.5	123.6	126.8	145.5
Total debt								
Governments and agencies	1,097.5	1,231.6	1,378.9	1,587.2	1,779.2	2,183.6	2,510.3	2,996.8
Financial institutions	886.7	1,008.9	1,132.1	1,232.4	1,337.8	1,471.3	1,639.8	1,932.6
Miscellaneous investors	135.7	139.7	153.6	240.0	313.3	560.8	693.3	848.8
	75.1	83.0	93.2	114.8	128.1	151.5	177.2	215.4
Annual increase in total debt								
		134.1	147.3	208.3	192.0	404.4	326.7	486.5

Percentage distribution of total debt

<i>a. Maturity 100%</i>									
Short-term	23.9	21.7	17.0	16.2	17.8	22.8	25.9	23.3	
Medium-term	1.9	2.6	5.5	6.7	5.5	4.4	3.9	6.0	
Long-term	74.2	75.7	77.5	77.1	76.7	72.8	70.2	70.7	
<i>b. Holders 100%</i>									
Government and agencies	80.8	81.9	82.1	77.7	75.2	67.4	65.3	64.5	
Financial institutions	12.4	11.3	11.1	15.1	17.6	25.7	27.6	28.3	
Miscellaneous investors	6.8	6.8	6.8	7.2	7.2	6.9	7.1	7.2	

a Short-term securities have been defined to include securities of up to three years duration, together with advance subscriptions.

b Medium-term securities are those of five- and seven-year duration.

c Long-term securities are those with a duration of ten or more years.

Source: Bank Negara Malaysia 1968: Table 20.

government realised that domestic loan finance was not just an extremely short-term source of finance which should be kept in semi-liquid form in London. Second, little had been done to adapt the Malayan governmental structure to meet the exacting task of raising loan finance outside of the semi-governmental authorities; there was no department or section of a department responsible for drawing together detailed information on the economic and engineering feasibility of development schemes against which loans could be raised. The events of 1957–60 well illustrate the cost of this deficiency. Following a fall in the prices of rubber and tin in 1956, government revenue slumped, and the government was forced to budget for a sizeable deficit in 1957 and again in 1958. This deficit was initially financed by a reduction in the level of the government's external reserves in 1957. As the government's external reserves fell towards what was regarded as a precariously low level, the government sought to raise loan finance. It turned first to London, but the Malayan crisis coincided with stringent credit conditions in England, and the British government indicated that the prospect of loan raising in London had to be ruled out. The Malayan government then turned to New York, making a generalised plea for financial assistance. The government quickly learned, however, that the New York money market would not lend for general expenditure purposes; loan finance could be raised only against the security of detailed blueprints of development projects. Having failed to raise external loan finance, the government was forced to restrain its expenditure in order to protect its external reserves, for external reserves were regarded as a necessary cover for the continuation of essential government services in the face of further unforeseen emergency situations.¹ The government's action intensified the severity of the recession and delayed recovery.

On the surface, the surprising point which emerged from the 1957–60 crisis was that, having failed to raise external loan finance, the government did not appear to have considered the possibility of raising loan finance from the private sector of the domestic economy. On reflection, however, this apparent failure was not an oversight. Under the Currency Board system, the problems of raising and servicing privately held domestic debt were similar to those associated with raising and servicing external debt. Since the private sector of the economy was able to purchase well-secured and well-traded paper on the London money market

¹ Essential government expenditures are those which must be maintained regardless of the state of the economy; for example, recurrent expenditure on general administration, law, order, defence, health, and educational services.

without any restraint, the government probably reasoned that, if it were unable to raise foreign loan finance, it would also be unable to attract the private sector in Malaya to take up lightly-traded, domestically-issued, government bonds secured only against general expenditure purposes. Funds were available within the private sector for investment (particularly within the banking system, the insurance companies, private provident funds, and finance houses) but, largely because of the openness of Malayan monetary arrangements, the government believed that it could not attract these funds into government bonds unless the bonds were secured against specific projects which promised a satisfactory yield. While such projects existed, the governmental structure had failed to produce detailed project blueprints which could be used to secure loan finance. It is, however, surprising to record that the government did not attempt to test the logic of this reasoning by increasing the availability of domestically issued government securities over and above the amount which it knew would be absorbed by the semi-governmental authorities.

The annual increase in the investible funds of the EPF and of other semi-governmental authorities permitted the Malayan government to raise, at intervals, the ceiling placed on the level of domestic debt. Four factors explain why the government was able and prepared to raise finance from this source. First, because the government exercised a high degree of control over the semi-governmental authorities, it was able to gain control over their surplus funds without specifying the use to which the funds would be put. Second, in contrast to borrowing from the private sector, interest payments on debt held within the government sector simply amounted to an inter-governmental book accounting transaction. Such payments did not, therefore, represent a drain on the government's coveted sterling balances (sterling being equivalent to cash under the Currency Board system). Third, by permitting complete convertibility with sterling, the Currency Board system required that the sinking fund backing for domestic debt should be accumulated in sterling. In the case of debt held by the semi-governmental authorities, the requisite sterling sinking funds effectively added to the nation's external reserves, for the government exercised sufficient control over the semi-governmental authorities to dictate redemption dates or to ensure conversion rather than redemption on maturity. The government was not, however, able to exercise similar control over government debt held by the private sector, and it was feared that, depending on the size of the debt to be redeemed and the state of government finances at the time of redemption, privately held debt may have seriously jeopardised

the continuation of essential government services in Malaya. Finally, interest and sinking fund payments on domestic debt added to contractual balance of payments obligations. The government was wary of an increase in such obligations for, under the Currency Board system, the larger the share of foreign exchange commitments which do not vary with income, the larger must be the reduction in income following a fall in export earnings before the demand for and supply of foreign exchange are once more equated. In contrast to privately held domestic debt, interest payments on debt held by the semi-governmental authorities did not add to contractual balance of payments obligations and, by effectively increasing the nation's external reserves, sinking fund payments on such debt permitted a greater use of the nation's uncommitted external reserves in times of crisis than would otherwise have been the case.

In contrast to the steady expansion of the domestic debt which occurred in the decade after 1950, there has been a dramatic expansion since 1960; at the end of 1967, the domestic debt amounted to \$3,000 million; almost three times as much as that outstanding at the end of 1960 (Table 38). Moreover, while short-term debt decreased from virtually 100% to 24% of total domestic debt between 1951 and 1960, this form of debt has maintained its share of total domestic debt since; the level of short-term debt rose from \$253 million in 1960 to \$644 million in 1967. Further, a major part of the increase in the level of the domestic debt since 1960 was absorbed by the private sector, which increased its share from less than 20% in 1960 to almost 35% in 1967 (Table 39). It is therefore of interest to ask why the Malayan government has permitted such a substantial increase in the level of its domestic indebtedness, and why the private sector has been prepared to hold domestically issued government debt.

The change in the government's attitude has been due principally to its determination to pursue an ambitious program of economic development in the decade after 1960. The successful implementation of this program was, however, seriously threatened by a fall in the price of natural rubber which threatened to prevent an expansion in the yield of tax revenue after 1960, by a substantial rise in the level of recurrent government expenditure, and by a need to devote more attention to problems of defence following Indonesian confrontation. These events forced the government to realise that the task ahead required the full development of all potential sources of finance.

While the government's determination to implement a more ambitious development program forced it to look for supplementary sources of

finance, the directions to which it looked were significantly influenced by the activities of the newly-established (1959) Central Bank. It is interesting to examine the activities of this body in its initial years.

ROLE OF THE CENTRAL BANK

The enacting legislation stated that the main functions of the Central Bank were to issue currency, to promote monetary stability and a sound financial structure, to influence the credit situation to the advantage of the domestic economy, and to act as a banker and a financial adviser to the government.

In principle, the responsibilities of the Central Bank were all-embracing. In practice, various statutory regulations severely restrained the ability of the Bank to fulfil its obligations. The Bank's power to issue currency, for example, was withheld until the Currency Board mechanism was wound up. There was a valid reason for withholding this power. The Central Bank had been granted the responsibility for issuing currency within Malaya; the Currency Board issued currency for circulation in Singapore, Sabah, Sarawak, and Brunei, as well as Malaya. There was, therefore, a significant difference in the territorial coverage of the two authorities. The Central Bank Ordinance did not preclude the Central Bank from extending its jurisdiction beyond Malaya to the other territories if the governments of those territories so wished. But the Central Bank feared that, if Malaya withdrew from the Currency Board arrangements, monetary relationships between Malaya and the other territories would be severed. There were broadly three reasons behind this concern. First, the Central Bank felt that unilateral withdrawal may have implied to the other territories that the Bank was more concerned with monetary conditions in Malaya than in the broader region. Second, because many Malayan banks were integrally related to Singapore banks, the Central Bank questioned whether monetary policies pursued in Malaya would be effective without the close co-operation of the Singapore banks. Third, by pursuing different paths, the Central Bank feared that a separate parity may have to be established between the dollar and sterling (or gold) in Malaya from that ruling in the other territories and, even if this did not happen, general uncertainty as to the effects of a severance of monetary relations may have adversely affected business confidence in the future of the region at a time when such disruption could least be afforded. The Central Bank therefore preferred to forgo its power to issue currency until the other territories had had time to consider their political and economic relationship to Malaya.

The movement towards merger between 1961 and 1963 bore out the wisdom of the Central Bank's patience. However, it was not until December 1964, fifteen months after the formation of Malaysia, that the Malaysian government decided to withdraw from the Currency Board arrangements. Statutory regulations required eighteen months to elapse before a decision to withdraw became effective. In the meantime, Singapore withdrew from Malaysia. The necessary rearrangements which followed led to a further delay, and it was not until June 1967 that the Central Bank assumed the power to issue currency.

Apart from the long delay in gaining the power to issue currency, the financial resources of the Central Bank were extremely limited. Permission to make a fiduciary issue had been granted in 1960. This issue, equivalent to \$240 million for Malaysia excluding Singapore, would have permitted a reduction in the external cover held against the currency component of the domestic money supply from 100% to approximately 80%. If advantage had been taken of this provision, the resources of the Bank would have been increased. But at the time the Bank reasoned that, while a fiduciary issue would ease the problem facing the government of financing its expenditure, it would delay co-operation between the government and the Central Bank in the development of domestic money and capital markets; in other words, the Bank feared that the availability of this once-for-all source of finance would divert the government's attention away from the immediate need to assist in the development of domestic money and capital markets which would ensure a continuous, year-by-year flow of finance to the government. Moreover, the Bank realised that a broadening of these markets would assist in the expansion of the private sector of the economy by mobilising savings and by stimulating the search for potential domestic investment outlets. In addition, the development of money and capital markets provided the means by which the Central Bank could gradually extend its control over the nation's external reserves, and by which it could sharpen the policy instruments which would permit it to exert more influence over commercial bank activity. The Bank therefore chose to delay taking advantage of the permitted fiduciary issue.

In its formative years, then, the Bank had limited resources and it lacked the ability to issue currency. In these circumstances the Bank realised that, if it were to be an effective partner of the government in the determination of economic policy in Malaya, it would first need to gain the confidence and thus the co-operation of the commercial banks. Consequently, the Bank's initial objective was to mould an extremely close liaison with the commercial banks.

Shortly after its establishment, the Central Bank asked the commercial banks to observe a specified minimum liquid assets ratio (equal to 20% of their total deposit liabilities, excluding the deposits of other banks). Most of the commercial banks were highly liquid, the average liquid assets ratio for all commercial banks being almost 50%. Consequently, the requirement was essentially a regulatory rather than a corrective measure. The objective was to ensure the viability of the commercial banks; the Central Bank did not, at this stage, intend to vary the ratio to influence bank lending policies. Later in the same year, the Central Bank, with the aid of the official organ of the commercial banks, the Malayan Exchange Banks' Association, encouraged the commercial banks to work towards the establishment of uniform deposit interest rates. This move followed a period of intense competition among the commercial banks for deposits. As the scramble for deposits proceeded, deposit and overdraft interest rates rose and, in response, some commercial banks began to extend advances into highly speculative fields. The Central Bank feared that, should one commercial bank become over-committed, the confidence of the public in the whole banking structure would be adversely affected. The commercial banks themselves were individually concerned at the developments which were taking place and, realising that all banks would be expected to observe the rate structure suggested by the Central Bank, readily co-operated. The Central Bank had the power to impose a local assets ratio on the commercial banks, but it did not do so for two reasons. First, although the commercial banks' local assets amounted to only 65% of deposit liabilities at the beginning of 1959, the Central Bank noted that the commercial banks were increasingly taking advantage of suitable local investment opportunities. Second, the Central Bank appreciated that, in the absence of more developed local money and capital markets, it could not justifiably impose a local assets ratio on the banks.

The regulation of commercial bank activity continued to be the main responsibility of the Central Bank in 1960. As the United Kingdom bank rate rose in the first half of 1960, the Central Bank, again acting in close co-operation with the Malayan Exchange Banks' Association, raised deposit interest rates in Malaya in order to prevent a loss of funds to England which might have left some domestic banks over-committed (Table 40). In response to the rise in deposit rates, overdraft rates were increased. When the United Kingdom bank rate fell in the latter half of 1960, the Malayan deposit and overdraft rates were maintained. The main object of this decision was to enhance the liquidity of the commercial banks, particularly of the newly-established indigenous banks which, in

Table 40 Malaya: commercial bank interest rates, 1959-67
(per cent per annum)

Date of change	Fixed deposits					Minimum advance rates		
	1 month	3 months	6 months	9-12 months	Savings deposits	Against government securities etc.	Against stocks and shares	Against property
1 October 1959	—	3½	3½	3¾	2½	5	5½	6
1 July 1960	—	4	4	4	2½	6	6½	7
28 July 1961	—	5	5	5	2½	7	7½	8
2 February 1962	—	4½	4½	4½	2½	6½	7	7½
30 August 1962	—	4	4	4	2½	6½	6¾	7¼
1 January 1964	2	4	4	4	2½	6½	6¾	7¼
25 November 1964	2½	5	5	5	2½	7	8	8
1 August 1965	2½	5	5	5	3	7	8	8
						General rate	Preferential rate ^a	
1 October 1966	2½	5	5	5	3	7½	7	
20 November 1967	3	5½	5¾	6	3	8	7½	

^aThe preferential rate applies to advances to central and State governments and to statutory authorities, and advances against government and municipal securities and against local agricultural produce.

Source: Bank Negara Malaysia 1968: Table 9.

marked contrast to the long-established, British-dominated exchange banks, were operating on very low liquidity ratios. The consequent rise in deposits permitted a substantial increase in advances in 1961 (Table 41). Faced with high borrowing rates, urged on by intense inter-bank competition, and impressed by the protection offered by the Central Bank, the commercial banks again began to extend advances into more speculative fields. The Central Bank was disturbed by this tendency, and issued a directive to the commercial banks which stated that they should be more selective in their lending policies and that loans for speculative purposes should be curbed.

When the United Kingdom bank rate rose in mid-1961, the Central Bank raised Malayan deposit rates, since it realised that, unless this was done, deposits would have been lost at a time when advances were running at a high level. At the same time, overdraft rates were raised. As the United Kingdom bank rate fell sharply in the latter part of 1961, Malayan deposit rates remained unchanged, for in view of the high level

of advances, the Central Bank deemed it desirable that the liquidity of the Malayan commercial banks should be increased. The Bank, fearing that its interest rate policy may have again encouraged the commercial banks to contemplate doubtful advances, raised the liquid assets ratio from 20% to 25% in an endeavour to restrain lending in speculative directions. With the guarantee of co-operation from the commercial banks in Singapore, the Central Bank judged that its action would meet with a measure of success, for the average liquid assets ratio of the commercial banks in Malaya had fallen from almost 50% in 1959 to 38% at the end of 1961, and many banks were operating on a much lower ratio. For the purposes of calculating the liquid assets ratio, the commercial banks were permitted to include their holdings of domestic government securities with maturities of longer than three months to a maximum of 5% of their deposits. The previous liquid assets ratio had excluded government securities other than short-term (three-month) Treasury bills. Thus, by manipulating the liquid assets ratio, the Central Bank sought to discourage the commercial banks from making doubtful advances but, at the same time, sought to encourage them to increase their lending to the government sector.

In the early part of 1962, it was apparent that an increase in the level of advances would enhance the level of domestic activity without engendering inflationary pressures. To increase advances, the Central Bank had a choice of two weapons: it could either lower the liquid assets ratio or lower interest rates (or use some combination of both). The Central Bank chose to lower interest rates for two reasons. First, the Bank feared that, if less importance were attached to liquidity but deposit and overdraft interest rates were maintained at the ruling high levels, the commercial banks might well be encouraged to extend advances to more speculative activities once again. Second, the Central Bank now appreciated the magnitude of the contribution it could make towards domestic economic development by mobilising available financial resources, both domestic and foreign; the maintenance of a high liquid assets ratio on the part of the commercial banks was a prerequisite for the continued development of local money and capital markets.

For similar reasons, deposit and overdraft interest rates were lowered further in August 1962. The Central Bank consolidated its position *vis-à-vis* the commercial banks in 1963 and 1964, the only significant policy change being an increase in interest rates in November 1964 following a rise in interest rates in the major financial centres of the world. By chance, this enforced restraint on domestic lending activity happened to coincide with economic conditions in Malaya.

Table 41 Malaya: statement of assets and liabilities of commercial banks, 1960-7
(\$ million)

Item	End of period							
	1960	1961	1962	1963	1964	1965	1966	1967
Assets								
Cash in hand	64.5	57.8	70.6	66.2	68.5	82.6	84.3	87.6
Balances	514.2	490.1	520.5	513.6	626.3	633.7	798.7	629.6
With Bank Negara Malaysia	52.6	67.0	60.0	74.9	64.5	68.6	82.0	96.0
With other banks in Malaysia	87.1	96.1	102.8	119.1	122.1	110.5	267.5	332.0
With banks outside Malaysia	374.5	327.0	357.7	319.6	439.7	454.6	449.2	181.6
Malaysian government securities	93.1	93.2	93.0	135.0	109.3	182.6	310.2	578.6
Treasury bills	33.9	32.1	17.6	41.2	29.0	105.7	225.6	437.8
Other securities	59.2	61.1	75.4	98.3	80.3	76.9	84.6	140.8
Other Malaysian securities	7.8	9.4	8.6	18.2	23.4	24.7	32.8	32.0
Securities of other countries	6.0	5.3	5.2	6.0	6.7	3.1	10.1	12.4
Loans and advances	554.8	710.0	794.7	937.3	1,083.7	1,141.1	1,286.2	1,432.9
Loans to customers other than banks	466.7	653.5	737.0	870.9	1,020.2	1,028.8	1,157.6	1,291.7
Trade bills								
Payable in Malaysia	48.1	28.0	31.3	29.7	19.3	68.4	79.4	81.4
Payable outside Malaysia	40.0	28.5	26.4	36.7	44.2	43.9	49.2	59.8
Fixed and other assets in Malaysia	119.2	145.1	213.8	190.2	209.9	182.5	224.5	230.4
Other assets outside Malaysia	10.0	6.1	12.1	15.2	8.6	13.9	13.7	12.8
Total Assets	1,369.6	1,517.0	1,718.5	1,886.2	2,136.4	2,264.2	2,760.5	3,016.3

Liabilities										
Capital and reserves										
Deposits										
Demand										
Government and agencies	28.0	32.6	38.8	46.1	52.4	65.8	100.6	109.6		
Other	1,075.0	1,185.9	1,255.4	1,397.7	1,531.7	1,744.4	1,982.2	2,244.2		
Fixed	527.9	550.3	576.4	626.9	664.7	713.8	795.0	791.8		
Government and agencies	68.8	76.0	74.8	68.9	85.1	92.3	104.3	107.1		
Other	459.1	474.3	501.6	558.0	579.6	621.5	690.7	684.7		
Fixed	399.5	474.3	484.9	542.8	600.0	727.2	841.9	1,011.8		
Government and agencies	113.7	103.5	97.9	107.3	131.5	170.2	198.9	267.0		
Other	285.8	370.8	387.0	435.5	468.5	557.0	643.0	744.8		
Savings	142.1	153.8	182.2	218.0	256.8	291.0	340.2	434.0		
Government and agencies	0.3	0.3	0.4	0.3	0.1	0.4	0.3	0.3		
Other	141.8	153.5	181.8	217.7	256.7	290.6	339.9	433.7		
Other	5.5	7.5	11.9	10.0	10.2	12.4	5.1	6.6		
Balances held	165.3	185.6	251.5	298.1	439.9	323.2	507.4	515.4		
For banks in Malaysia	77.5	82.4	93.2	115.5	122.8	103.1	253.7	323.4		
For banks outside Malaysia	87.8	103.2	158.3	182.6	307.1	220.1	253.7	192.0		
Other liabilities in Malaysia	94.0	107.5	164.7	125.7	106.8	114.2	148.0	127.8		
Other liabilities outside Malaysia	7.3	5.4	8.1	18.6	15.6	16.6	22.3	19.3		
Total Liabilities	1,369.6	1,517.0	1,718.5	1,886.2	2,136.4	2,264.2	2,760.5	3,016.3		

Source: Bank Negara Malaysia 1968: Table 4(a) and (b).

From the beginning then, the Central Bank sought to forge a close relationship with the commercial banks, to encourage commercial bank activity, to influence the direction of bank lending, and to foster sound banking standards and practices. The Bank's ability to manage the money and credit situation to the national advantage was limited, because the Bank did not have the power to issue currency and its limited financial resources restrained its ability to act as lender of last resort to the banking system. There were, in addition, two further restraints on its powers. First, the ability of the Bank to influence the price of credit was restrained by the openness of monetary arrangements in Malaya. When interest rates rose in the world financial centres, the Central Bank was forced to raise interest rates in Malaya to avoid a loss of deposits; the only time the Central Bank was able to exercise discretionary power over interest rates in Malaya was when interest rates were falling on the world money markets. Second, the success of any policy action the Central Bank considered necessary was heavily dependent on the attainment of close co-operation from the commercial banks in Singapore. This co-operation had been forthcoming, but it was obviously unwise to expect too much of the loose relationship between the Central Bank and the Singapore Exchange Banks' Association in its formative years.

Despite the severe limitations on its functions, the achievements of the Central Bank were remarkable. The period since 1960 has witnessed a substantial expansion in the deposit liabilities of the commercial banks (Table 41). Before 1960, a rise in deposit liabilities was directly associated with an improvement in the balance of payments. The significant feature of the substantial rise since 1960 has been that it occurred in the face of a deterioration in the state of the balance of payments (Table 3). This asymmetrical development was directly due to the activities of the Central Bank. The basic reason for the expansion of deposits was the response of the well-established commercial banks to a call by the Central Bank to revise their conservative views as to the creditworthiness of domestic loan proposals. But apart from using moral persuasion, the Central Bank stimulated inter-bank competition for advances by encouraging new (mostly indigenous) banks to establish and old banks to expand and thus, at the same time, forced a reappraisal of established views on domestic loan proposals. The result was that advances increased still more rapidly than deposits.

Advances continue to be heavily concentrated on trading activities (particularly the financing of overseas trade) but commerce has not increased its share of total advances since 1960 (see Table 42). In view of the implied difficulties the banks faced in finding suitable domestic

Table 42 Malaya: classification of loans and advances of commercial banks, selected years

Purpose	31 Dec. 1960		31 Dec. 1963		31 Dec. 1965		31 Dec. 1967	
	\$m.	% of total	\$m.	% of total	\$m.	% of total	\$m.	% of total
Agriculture	37.0	7.3	97.9	10.4	97.5	8.5	128.6	9.0
Mining and quarrying	8.2	1.6	36.3	3.9	31.9	2.8	47.2	3.3
Manufacturing	53.3	10.4	103.2	11.0	174.2	15.3	213.4	14.9
Construction	19.1	3.7	63.1	6.7	83.4	7.3	142.6	10.0
Commerce	215.0	42.1	361.5	38.6	423.7	37.1	502.0	35.0
Professional and private individuals	94.6	18.5	194.4	20.7	206.9	18.1	232.8	16.2
Others	83.2	16.3	80.9	8.6	123.5	10.8	166.3	11.6
Total	510.4	100.0	937.3	100.0	1,141.1	100.0	1,432.9	100.0

Source: Bank Negara Malaysia 1960-8; Bank Negara Malaysia 1968: Table 5.

investment outlets before 1960, the surprising point that emerges from the table is that the banks have since been able to expand advances to activities outside of the commercial sector on a scale which has permitted loans to these activities to rise in step with the unprecedented rise that has occurred in total outstanding advances since 1960.

The main source of finance for the increase in advances was a decrease in the short-term foreign assets of the commercial banks. Other contributing factors were a decrease in the external reserves of the government sector, and more careful cash management on the part of the government, the public (due to an improvement in the geographical distribution of banking facilities in Malaya), and the commercial banks (due principally to a more efficient cash issuing and procuring procedure following the transfer of the cash transaction function from the Currency Board to the Central Bank). The net result was that the commercial banks provided the means for a significant expansion in the level of domestic activity after 1960 despite a deterioration in the state of the balance of payments.

While gratified by these developments, the Bank was not prepared to confine itself to the regulation of commercial bank activity; it wished to make a more direct contribution to domestic economic development. The Bank appreciated the key role that local capital and money markets could play in the development process. Together with its growing control over the commercial banks, it was the development of these markets which enabled the Bank to mould an extremely close relationship with the government.

While banking facilities were well developed in Malaya (particularly in respect of international trade transactions), there was no organised market for short- or long-term public and private securities when the Bank was established in 1959. The Bank found that trading at the long end of the market for government securities was handicapped by a shortage of marketable securities, and that trading at the short end was limited by a statutory ceiling on the level of outstanding Treasury bills (3, 6, 9, and 12 months, \$150 million in aggregate) and by a strong demand by semi-governmental authorities (particularly the various statutorily established rubber funds) for such securities. While not optimistic about its ability to develop either market in a short period of time, the Bank had a predisposition towards the development of the long end, largely because some three-quarters of the outstanding domestic government debt in 1959 consisted of long-term securities. The Bank made its position clear in its first Annual Report (1959) when it was stated that there were

obvious obstacles to attempts to develop a money market by a central bank which is not in a position to act fully as a lender of last resort and in an economy which has automatic exchange facilities with sterling. It would appear, therefore, that only gradual progress can be made towards the development of a money market in the Federation. The same might be said for the development of a market for long-term Government securities but, in this case, unlike a short-term money market, considerable improvement could be expected to follow the formation of a Stock Exchange (Bank Negara Tanah Melayu 1960: 10).

Apart from these considerations, the Bank was aware that a large part of the overseas balances of non-government institutions was held long-term in London, and it reasoned that development of the long end of the market would help in attracting these funds back to Malaya, a process which would permit greater centralisation of control over the nation's external reserves.

The Bank, then, initially concentrated its attention on increasing the attractiveness to non-governmental investors of long-term government securities. In 1959, the Bank encouraged the government to issue more attractively priced, medium-term (5-year) securities, to transfer management of the domestic long-term debt from the Accountant General to the Central Bank, to eliminate stamp duty on the transfer of government securities, and to permit government securities to be tendered in payment of estate duty. In 1960, the Bank reduced the maturity period for long-term securities from 21–23 years to 16–20 years, and increased the availability of 5-year securities. The Bank continued to concentrate on

the medium to long end of the market in 1961 and 1962. The supply of 5-year securities was increased and, in 1962, 2-year securities were introduced. At the same time, the liquid assets ratio was raised from 20% to 25% and, in an endeavour to encourage the commercial banks to increase their holdings of government securities, the banks were permitted to include government securities of longer than three months' duration in their liquid asset ratio calculation to a maximum value of 5% of deposit liabilities.

As the price of natural rubber fell in 1961 and again in 1962, the government turned to the Bank for assistance in its urgent search for supplementary sources of finance. The Bank began by appraising its contribution to the flow of long-term government finance through its attempt to increase trading in these securities and found that it had not really made a significant, distinct contribution; while banks and insurance companies had been attracted to the medium-term securities, the bulk of the long-term debt continued to be held by the EPF and by a few other institutional investors who usually held until maturity (Table 43).

The Bank had given some encouragement to the short end of the market. It had, for example, offered rediscounting facilities for Treasury bills. But, by the end of 1962, the level of Treasury bills outstanding was slightly below the level outstanding at the end of 1960 (Table 38). The Bank was aware of the substantial liquid balances held by the commercial banks overseas, and it realised that, if these balances were switched out of sterling into domestically-issued government securities, a substantial increase in the flow of government finance would result. But the Bank was hesitant about conversion, for it contended that the commercial banks should maintain 'a degree of liquidity abroad demanded by the Federation's import trade' (Bank Negara Tanah Melayu 1960: 5). By the end of 1961, however, the Bank was revising its attitude on this issue. The revision was partly a result of the Bank's desire to provide as much assistance to the government in its search for finance as possible, and partly a result of a realisation that, while these balances existed, the Bank's ability to influence domestic banking activity and to increase central control over the nation's external reserves was limited. While not ignoring the continued development of the long end of the market, the Bank now began to concentrate more intensively on developing the short end.

The preparatory groundwork for development of the short end of the market was undertaken in 1962. The Bank encouraged the commercial banks to increase their holdings of Treasury bills and, in 1963, the level of outstanding Treasury bills rose to the statutory limit (Table 38). The

Table 43A Malaya: central government domestic debt outstanding at end of 1963;
detailed classification by maturities and subscribers
(\$ million)

Holder	Treasury bills	Treasury deposit receipts	2-year bonds	5-year bonds	Long-term bonds	Advance deposits	Total
Federal and State government funds and agencies							
Employees' Provident Fund	—	—	—	—	846.8	1.8	848.6
Post Office Savings Bank	3.9	—	—	—	102.1	—	106.0
Rubber Industry Replanting Board	21.0	54.0	18.0	69.7	0.3	—	163.0
Rubber Industry Anti-inflationary Cess Fund	0.3	—	—	—	—	—	0.3
Malayan Rubber Fund	4.5	—	—	—	—	—	4.5
State governments	13.5	2.0	0.2	2.0	31.5	—	49.3
Federal government sinking funds	—	—	—	—	7.3	—	7.3
Federal government general investments	—	—	1.1	1.8	13.1	—	16.0
Municipalities	0.6	—	—	—	19.8	—	20.4
Railways	11.7	—	—	—	3.8	—	15.5
Rural and Industrial Development Authority	1.5	—	—	—	—	—	1.5
Other government agencies	—	—	—	—	—	—	—
Sub-total	57.0	56.0	19.3	73.5	1,024.7	1.8	1,232.4

Financial institutions									
Bank Negara Malaysia	31.9	—	0.1	0.2	16.1	—	—	—	48.3
Commercial banks	36.9	—	29.9	16.2	54.1	—	—	—	137.0
Insurance companies	0.2	—	0.1	1.8	18.2	—	—	—	20.3
Co-operative societies	—	—	—	0.3	15.7	—	—	—	16.0
Finance companies	18.2	—	—	—	—	—	—	—	18.2
Sub-total	87.2	—	30.1	18.5	104.1	—	—	—	239.9
Miscellaneous local investors									
Commercial firms	0.4	0.1	1.0	1.5	5.2	—	—	—	8.1
Other provident and trust funds	0.1	—	—	3.6	22.3	—	0.1	—	26.0
Nominees and trustee companies	0.8	0.1	0.1	4.4	30.9	—	—	—	36.3
Private individuals	—	—	—	1.7	6.6	—	—	—	8.3
Unclassified	2.7	—	0.6	3.4	17.4	—	—	—	24.1
Sub-total	4.0	0.2	1.7	14.6	82.4	—	—	—	102.9
Foreign government									
	—	—	—	—	12.0	—	—	—	12.0
Total	148.2	56.2	51.1	106.6	1,223.1	1.9	—	—	1,587.1

Table 43B Malaya: central government domestic debt outstanding as at 30 September 1966;
detailed classification by maturities and subscribers
(\$ million)

Holder	Treasury bills	Treasury deposit receipts	2-year bonds	3-year bonds	5-year bonds	Long-term bonds	Advance deposits	Total
Federal and State government funds and agencies								
Employees' Provident Fund	—	—	—	—	—	1,231.5	19.0	1,250.5
Post Office Savings Bank	3.9	—	—	—	—	154.7	2.5	161.1
Rubber Industry Replanting Board	—	—	—	—	59.0	0.3	—	59.3
Rubber Industry Anti-inflationary Cess Fund	—	—	—	—	—	—	—	—
Malayan Rubber Fund	1.5	—	—	—	—	—	—	1.5
State governments	12.5	—	—	2.0	1.0	31.8	—	47.3
Federal government sinking funds	—	—	—	5.0	—	16.2	—	21.2
Federal government general investments	—	—	1.6	1.0	1.4	5.5	—	9.5
Municipalities	0.2	—	—	—	—	18.4	—	18.6
Railways	1.0	—	—	—	—	3.7	—	4.7
Other government agencies	1.2	—	—	—	0.6	0.6	—	2.3
Sub-total	20.3	—	1.6	8.0	62.0	1,462.7	21.5	1,576.0

Financial institutions									
Bank Negara Malaysia	27.0	—	4.3	1.6	0.7	26.8	—	—	60.6
Commercial banks	422.5	—	3.0	13.3	20.7	32.8	—	—	492.3
Insurance companies	3.6	—	—	0.3	1.3	19.7	—	—	24.7
Co-operative societies	—	—	0.1	0.1	0.3	16.9	—	—	17.4
Finance companies	54.1	—	—	—	—	—	—	—	54.1
Sub-total	507.2	—	7.4	15.3	23.0	96.2	—	—	649.1
Miscellaneous local investors									
Commercial firms (including finance companies)	—	—	0.4	10.3	1.4	7.0	—	—	19.2
Other provident and trust funds	0.9	—	—	0.5	3.3	52.6	1.1	—	58.5
Nominees and trustee companies	—	0.1	5.0	1.0	3.4	33.4	—	—	42.9
Private individuals	—	—	—	0.2	1.0	8.0	—	—	9.3
Unclassified	6.8	—	0.1	0.2	3.1	14.6	—	—	24.8
Sub-total	7.7	0.1	5.5	12.2	12.3	115.6	1.1	—	154.6
Foreign government									
	—	—	—	—	—	12.0	—	—	12.0
Total	535.2	0.1	14.5	35.5	97.3	1,686.5	22.6	—	2,391.7

Source: Data supplied by the Malaysian Treasury.

staggering development of the short end of the market began in 1964. In that year, the Central Bank took over control of the issue and management of Treasury bills from the Treasury, succeeded in increasing the statutory limit on outstanding Treasury bills from \$150 million to \$300 million and, most important of all, revised the content of the commercial bank liquid assets ratio requirement so as to exclude foreign balances from consideration. This latter adjustment forced the commercial banks to sell their sterling balances to the Central Bank in exchange for local cash and to buy domestically issued Treasury bills. To ease the problem of transition from a general to a local liquid assets ratio, the ratio was reduced from 25% to 20%, and the banks were permitted to count longer-term government securities as liquid assets up to 10% of their savings deposit liabilities. It was stipulated, however, that not less than 10% of total deposit liabilities should be in actual liquid assets comprising cash in hand, Malaysian Treasury bills, net balances with other banks in Malaysia, and balances with the Central Bank exclusive of statutory reserve balances.

The Bank was aware that, to fulfil the local liquid assets requirement, the demand for Treasury bills would exceed the permissible ceiling. In consequence, the statutory limit was doubled from \$300 million to \$600 million in 1965, and raised to \$1,000 million in 1966. Following the constitutional separation of Singapore from Malaysia, the content of the liquid assets ratio was revised at the end of July 1967 to exclude liquid assets issued in Singapore. The uncertainties which continued to surround the pound sterling after devaluation in November 1967 led to a substantial flow of funds into Malaya in the first half of 1968. Much of this money was invested in short-term (particularly three-month) Treasury bills which earned $5\frac{1}{2}\%$ per annum. The governing authorities realised that these were mostly speculative balances which would be withdrawn at short notice. To avoid large fluctuations in the level of outstanding Treasury bills, the Central Bank reduced the rate of interest on Treasury bills to $4\frac{1}{2}\%$ per annum in June 1968 in an endeavour to reduce the inflow of speculative balances. Most outstanding Treasury bills were of three months' duration. The Central Bank had learned from experience that problems of short-term debt management would be eased if the holdings of longer-term Treasury bills were increased. To this end, the Central Bank differentiated the rate of interest on Treasury bills by maturity in August 1968 (4% on three-month bills, $4\frac{1}{2}\%$ on six-month bills, 5% on nine-month bills, and $5\frac{1}{2}\%$ on twelve-month bills).

As indicated in Table 38, the level of outstanding Treasury bills has risen rapidly; in 1965 and again in 1966, finance raised from the issue of short-term securities almost matched finance raised from the issue of long-term securities as a source of government finance. The commercial banks co-operated with the Central Bank in this venture. They realised that the locally-issued bills were as attractively priced as bills issued on the London money market, and the increase in the external cover held against the domestic currency issue to a level well above the statutorily required level strengthened the confidence of the commercial banks in the ability of the Central Bank to rediscount bills and to act as lender of last resort.

In October 1968, the Central Bank amended the liquidity requirement for the commercial banks in order to encourage them to increase their holdings of longer-term government securities and to grant more housing loans. Thus it was provided that, in respect of savings deposits, the minimum liquidity ratio of 20% would be abolished provided the commercial banks held 50% of their savings deposit liabilities in long-term government securities and in housing loans. The banks were to maintain a minimum liquidity ratio of 20% against other deposit accounts apart from savings deposit liabilities. This change, together with the reduction in the rate of interest on Treasury bills and the endeavour to rearrange the maturity composition of the existing Treasury bill issue, would seem to indicate that the Central Bank will give relatively more importance to the development of the long end of the market for government securities in the future.

Table 43 provides a detailed outline of the structure and ownership of the domestic funded debt at the end of 1963 and in September 1966 respectively. Together with Tables 38 and 39, they show the growth of the holdings of Treasury bills by commercial banks and other financial institutions, and the growing interest of financial institutions and other non-government investors in longer-term securities.

Until quite recently, the Singapore government made much less use of domestic loan finance than the Malayan government. In the decade after 1950, the Singapore government absorbed less than one-half of the annual flow of finance available from the Central Provident Fund (CPF), Singapore's counterpart to the EPF in Malaya. The balance of the funds available from the CPF were either invested in Malayan government securities or in sterling securities. However, since 1960, the Singapore government has absorbed almost all of the surplus funds available from the CPF and, assisted by the Malayan Central Bank during the brief merger period, has been able to raise increasing amounts of finance by

way of Treasury bills since 1964. At the end of 1965, outstanding Treasury bills issued by the Singapore government amounted to \$40 million compared with \$450 million issued by the Malayan government. There still remains substantial scope for an expansion of Treasury bill issues, and for encouraging financial and other institutions domiciled in Singapore to increase their holdings of domestically-issued government securities at the expense of foreign securities. To tap this source effectively, the government may have to establish a Central Bank. It would be in Singapore's long-term interest if such a bank modelled itself on, and worked closely in co-operation with, the Malayan Central Bank.

NATIONAL PROVIDENT FUNDS

In the near future, the scope for increasing short-term debt remains substantial, particularly in Singapore. In the longer run, it is more likely that the issue of long-term government securities will once more become the most important source of domestic loan finance. There is scope for a further increase in the level of domestic long-term debt held by private financial and other institutions and companies. But the major source of long-term finance will continue to flow from the semi-governmental provident funds. It is therefore instructive to consider these institutions in more detail.

Semi-governmental provident funds, organised on a national basis, were established in Malaya (the EPF) and in Singapore (the CPF) in 1951 and 1953 respectively. The government permitted private provident funds already established to continue, except where the benefits provided did not compare favourably with those provided by the EPF and the CPF.

The number of private provident funds has decreased continuously since the inception of the national schemes. Annual contributions to the two major private funds in Malaya—the Malayan Estates Staff Provident Fund and the Malayan Planters' Provident Fund—amounted to 50% of total contributions paid to all private schemes in 1965, but to only 5% of the contributions received by the EPF. Moreover, since most of the private schemes have been operating for many years, the annual withdrawal rate is high; in 1965, withdrawals largely offset the addition to funds provided by way of contributions, a position which contrasts markedly with that of the EPF and of the CPF. Consequently, there has been little growth in the total value of assets held by the private provident funds over the past ten years. The investments of the two major private funds in Malaya amounted to only 5% of the value of EPF

investments at the end of 1965; following a survey by the Central Bank of Malaysia, the assets of all private provident funds were estimated to amount to \$200 million for Malaya and to \$150 million for Singapore at 31 December 1964. During the 10-year period 1956-65, the surplus funds available each year from the EPF rose steadily from \$70 million to \$160 million (see Table 44A) and that available from the CPF rose from \$25 million to \$55 million (see Table 44B). By substituting local for sterling securities, the private provident funds can add to the supply of domestic finance; the development of capital and money markets, combined with Central Bank directives, has hastened such portfolio adjustments, particularly since 1963. But the major future source of provident fund finance available for investment in government securities will be provided by the EPF and the CPF. The following sections analyse the factors which influence the annual flow of surplus finance from these two bodies: obligations to members, coverage, and contribution requirements.

Responsibilities, Membership, Contributions

The major responsibility of the national provident fund is to provide a lump-sum benefit to contributors on retirement or permanent incapacitation, or to dependants on the death of a contributor. Membership of the funds is compulsory for all employees apart from those who contribute to an approved private scheme. The coverage does not, however, extend to self-employed persons (including the numerically large category of peasant farmers), outworkers, or maritime fishermen.

In the early years, administrative considerations dictated the extent of coverage of the EPF. As with income taxation, early administrative difficulties combined with a desire to ensure a measure of initial success led to a concentration on those sectors of the workforce most susceptible to regimentation, in particular, government employees. Despite an increase in membership during 1955, it was not until the EPF became a separate statutory body and assumed responsibility for accounts from the Postmaster-General in 1957, that significant progress was recorded in the annual rate of contributor registration. The amendments of 1963 and 1964, which led to the inclusion of employees earning more than \$400 per month and employees working in establishments of fewer than five employees, extended the coverage of the scheme from 1.3 million in 1962 to 1.6 million employees in 1966 (that is to approximately 75% of the labour force in Malaya).

The coverage of the Singapore CPF differs only in that attempts are being made to provide provident fund benefits to domestic servants on a compulsory basis. Despite increased enforcement measures, CPF

Table 44A Malaya: Employees' Provident Fund statistics, 1956-66

Item	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966
Revenue (\$m.)	76.1	85.9	91.9	103.5	115.3	126.2	135.2	154.3	170.4	190.1	210.3
Contributions	65.7	71.2	72.2	79.1	84.7	90.4	93.2	105.4	114.0	125.0	135.7
Interest ^a	10.4	14.7	19.7	24.4	30.6	35.8	42.0	48.9	56.4	65.1	74.6
Expenditure (\$m.)	5.6	9.0	13.7	14.9	14.5	15.7	16.2	22.0	27.3	30.8	35.4
Withdrawals	4.3	7.7	12.1	13.1	12.5	13.5	14.0	19.1	24.1	27.3	31.3
Expenses	1.3	1.3	1.6	1.8	2.0	2.2	2.2	2.9	3.2	3.5	4.1
Net income (\$m.)											
Total	70.5	76.9	78.2	88.6	100.8	110.5	119.0	132.3	143.1	159.3	174.9
Increase (p.a.)	12.8	6.4	1.3	10.4	12.2	9.7	8.5	13.3	10.8	16.2	15.6
Contributors											
Number ('000)	850	867	922	993	1,143	1,232	1,250	1,430	1,488	1,554	1,631
Credit at EPF (\$m.)	275.9	354.1	413.4	490.1	593.8	693.5	799.5	926.4	1,064.4	1,219.9	1,390.0
Credit per head (\$)	324.8	408.6	448.6	493.3	519.6	563.1	639.6	647.9	715.3	785.0	852.2
EPF investments (\$m.)											
Local	179.4	322.8	368.0	520.5	619.3	725.8	845.0	974.5	1,115.1	1,273.9	1,446.6
Government	134.3	282.5	331.6	472.3	558.0	655.5	762.2	870.6	998.4	1,148.4	1,312.1
Other	—	—	—	2.4	15.1	24.0	36.5	57.5	70.3	79.0	87.9
Foreign	45.1	40.3	36.4	45.8	46.2	46.3	46.3	46.4	46.5	46.5	46.6

^a On investments, etc.

Source: Employees' Provident Fund 1958-68.

Table 44B Singapore: Central Provident Fund statistics, 1956-66

Item	1956	1957	1958	1959	1960	1961	1962	1963	1964	1965	1966
Revenue (\$m.)	26.1	30.2	33.4	35.4	38.2	42.0	49.1	51.8	59.3	65.3	73.2
Contributions	25.2	27.9	29.5	29.8	30.6	32.6	35.5	37.6	42.5	46.9	51.5
Interest ^a	0.9	2.3	3.9	5.6	7.6	9.4	13.6	14.2	16.8	18.4	21.7
Expenditure (\$m.)	1.0	1.7	2.6	4.2	4.7	5.2	6.2	7.0	9.0	10.7	12.5
Withdrawals	0.4	1.0	1.9	3.4	3.9	4.4	5.2	5.8	7.6	9.3	11.0
Expenses	0.6	0.7	0.7	0.8	0.8	0.8	1.0	1.2	1.4	1.4	1.5
Net income (\$m.)											
Total	25.1	28.5	30.8	31.2	33.5	36.8	42.9	44.8	50.3	54.6	60.7
Increase (p.a.)	—	3.4	2.3	0.4	2.3	3.3	6.1	1.9	5.5	4.3	6.1
Contributors											
Number ('000)	230	265	284	304	321	338	352	370	394	418	442
Credit at EPF (\$m.)	34.1	61.9	91.0	119.6	149.2	181.0	215.8	258.2	306.3	359.0	416.0
Credit per head (\$)	148.3	233.6	320.4	393.4	464.8	535.5	613.1	698.1	777.9	859.7	940.4
EPF investments (\$m.)	32.7	60.7	90.6	121.4	154.4	188.4	232.6	277.1	324.7	380.9	440.7
Singapore	25.6	41.7	65.6	92.4	127.6	147.8	218.1	261.4	309.0	365.7	426.1
Malaysian	2.1	2.3	4.1	4.8	2.3	2.3	2.3	3.6	3.6	3.5	3.0
Foreign	4.9	16.7	21.0	24.1	24.5	38.4	12.2	12.1	12.1	11.7	11.6

^a On investments, etc.

Source: Central Provident Fund 1958-68.

Annual Reports have repeatedly indicated that the introduction of domestic employees into the scheme has met with very little success. A reappraisal of policy appears necessary and a logical alternative, involving minimal departure from the existing scheme, would be the adoption of the EPF approach to this problem—that is the substitution of a voluntary relationship for the existing compulsory membership provisions.

Contributions are of a bi-partite, employee-employer nature. There is no direct government contribution apart from that associated with its function as an employer of labour. Any deficit on the operations of the EPF or CPF is to be financed by contributors. However, the exemption from income taxation of income earned by the EPF and the CPF, and of amounts paid on withdrawal, together with the classification of contribution payments as an expense in the earning of income for income tax purposes, provides the basis for a significant indirect government contribution.

The rate of contribution payable by an employee and an employer is assessed by reference to the level of monthly wages earned by the employee. 'Wages' are defined as the aggregate of all monetary considerations received in return for 'normal' hours of work. The definition includes monetary allowances incurred for an employee's benefit, but excludes overtime earnings, *ex gratia* payments, and benefits in kind.

In Malaya, employee and employer contribution rates are identical and rise by absolute amounts as the level of monthly wages earned by an employee increases (Table 45). When the rate structure is converted into relative terms, two anomalies emerge which, given the compulsory nature of contributions, deserve attention.

First, the contribution rate fluctuates widely and haphazardly with marginal changes in wage rates. There are thirty wage brackets, and a fixed value contribution payment is applied to each bracket. Consequently, as wages increase, the rate of contribution payable decreases towards a minimum rate of 5% until a new, higher income bracket is reached, whereupon a sudden and often substantial increase in the contribution rate is initially experienced. The extent of rate fluctuation is much greater at lower than at higher contribution levels.

Second, the rate structure is regressive. For wage levels below \$100 per month, the rate of contribution payable is higher than the rates applicable throughout the rest of the structure. Although low wage earners would find it difficult to set aside such a large part of their monthly earnings for the future, it is probable that the regressive aspect of the rate structure is not important to individual wage earners. However,

Table 45 Malaya: contribution rates, Employees' Provident Fund, 1952-68

Wage bracket (\$ per month)	Monthly contribution		Rate of contribution per wage bracket (%)	
	Employee \$	Employer \$	Lower wage level	Upper wage level
Less than \$10	—	—	—	—
11 — 30	1.50	1.50	13.64	5.00
31 — 40	2.00	2.00	6.45	5.00
41 — 50	3.00	3.00	7.32	6.00
51 — 60	3.50	3.50	6.86	5.83
61 — 70	4.00	4.00	6.56	5.71
71 — 80	4.50	4.50	6.34	5.63
81 — 90	5.00	5.00	6.17	5.55
91 — 100	5.50	5.50	6.04	5.50
101 — 120	6.00	6.00	5.94	5.00
121 — 140	7.00	7.00	5.79	5.00
141 — 160	8.00	8.00	5.67	5.00
161 — 180	9.00	9.00	5.59	5.00
181 — 200	10.00	10.00	5.52	5.00
201 — 220	11.00	11.00	5.47	5.00
221 — 240	12.00	12.00	5.43	5.00
241 — 260	13.00	13.00	5.39	5.00
261 — 280	14.00	14.00	5.36	5.00
281 — 300	15.00	15.00	5.34	5.00
301 — 320	16.00	16.00	5.32	5.00
321 — 340	17.00	17.00	5.30	5.00
341 — 360	18.00	18.00	5.28	5.00
361 — 380	19.00	19.00	5.26	5.00
381 — 400	20.00	20.00	5.25	5.00
401 — 420	21.00	21.00	5.24	5.00
421 — 440	22.00	22.00	5.23	5.00
441 — 460	23.00	23.00	5.22	5.00
461 — 480	24.00	24.00	5.21	5.00
481 — 500	25.00	25.00	5.20	5.00
500 +	25.00	25.00		

Source: Employees' Provident Fund 1966.

since employers pay contribution rates identical with those paid by employees, it is likely that the rate structure discriminates against the use of cheap, unskilled labour.

Apart from these anomalies, it should be mentioned that contribution payments set in terms of absolute amounts tend to lose their effectiveness in periods of rising prices. There has been no change in employee-employer contribution rates in Malaya since the inception of the provident fund scheme.

The rate structure in Singapore differs from its counterpart in Malaya in several respects. First, employers pay a flat rate of 5% on that part of their total wage bill which is paid to employees registered as CPF contributors. Administratively this is a simpler method of determining the liability of employers, and it has an additional advantage in that it does not encourage employers to discriminate against the use of low-wage labour when drawing up production plans.

Second, employees are not required to contribute if they earn less than \$200 per month. The benefit to such employees on withdrawal from the CPF is completely employer financed. The contribution rate for employees earning more than \$200 per month is set at 5% of their their monthly wage income.

In the latter part of 1968, amendments were made to the CPF Ordinance which increased the employee and employer contribution rates to 10%. The amendments provided that the basic 5% level (which had been effective from the date of inception of the CPF) would rise to 6.5% in the first year, to 8% in the second year, and to 10% in the third year. For persons earning more than \$1,500 per month, the CPF contribution by both employers and employees is now set at \$125 per month.

It was stated in a preceding paragraph that employer contribution rates were identical with employee contribution rates in both Malaya and Singapore. While this is statutorily correct, the effective contribution rate of employers is reduced by 40% in the case of corporate firms (and by a figure between 6% and 50% in Malaya—6% and 55% in Singapore—for unincorporate firms), since provident fund payments are classified as an expense in the earning of income for income tax purposes. Individuals are also able to claim a deduction for income tax purposes for provident fund payments, but only those earning a very high income are subject to income tax, and are therefore able to take advantage of this provision.

Income and Expenditure

Despite the lack of any change in contribution rates, the extension in the coverage of the EPF has led to a continuous increase in the level of annual contributions. Since the EPF has been in operation for little more than a decade, withdrawals have been few in number and low in

average value and have not, in any one year, far exceeded 20% of annual contributions. In fact, interest earned on investments has more than covered withdrawals and a rising level of administrative costs. Consequently, the annual increase in the investible funds of the EPF has been substantial (Table 44).

An important question to ask is whether the EPF will continue to make surplus funds available to the government on a scale comparable with that recorded in past years. A comparison of prospective contribution and withdrawal payments suggests that, for the next fifteen years at least, it is likely to do so.

Several factors indicate that the steady climb in the annual level of contributions will continue in the future. First, the coverage changes introduced since 1962 have led to a significant rise in the number of contributors and in the annual flow of contribution payments (Table 44). Second, during the decade 1966 to 1975, the labour force in Malaya is expected to increase by 36%. Without any further extensions in the coverage of the provident fund scheme, the number of contributors would still increase. Third, there is scope for further extensions in the coverage of the provident fund; self-employed workers are not as yet covered, but are equally in need of provident fund facilities. Finally, improvements in enforcement techniques would considerably enhance the contribution flow which, by 1975, can be expected to rise towards \$200 million per annum.

The level of withdrawals may be expected to increase. But, by 1975, the EPF will have been operating for only just over twenty years, and the average contribution life of members is not likely to exceed ten years. Since most members can be expected to contribute for twenty to forty years, withdrawals will not rapidly reduce the flow of surplus finance from the EPF until after 1980. In fact, it would seem improbable that the annual value of withdrawals would rise much beyond \$70 million by 1975. Interest received on investments held is likely to more than double this figure by 1975 so that, during the decade 1966-75, the government can expect surplus funds from the EPF to rise steadily from \$175 million towards \$250 million per annum. By increasing the withdrawal age from 55 to 65 years or by transforming the form of benefit payable from a lump-sum basis to an annuity basis, any significant increase in the annual value of withdrawals may be delayed. At the end of 1965, the domestic long-term debt of the Federal government amounted to \$1,590 million. On a conservative estimate, surplus EPF funds available for investment in domestic government securities between 1966 and 1985 will amount to \$6,000 million. Table 46 attempts to forecast

Table 46 Malaya: forecast of flow of funds from
Employees' Provident Fund, 1964-85
(\$ million)

Item	1964	1965	Annual average			
			1966-70	1971-75	1976-80	1981-85
Revenue	170	190	235	330	458	615
Contributions	114	125	144	180	225	275
Interest on investments	56	65	91	150	233	340
Expenditure	27	31	44	73	110	159
Withdrawals	24	27	40	67	102	148
Expenses	3	4	4	6	8	11
Net income	143	159	191	257	348	456

Source: Data supplied by the Malaysian Treasury.

the flow of funds available from the EPF until 1985. The figures are subject to a wide margin of error due to the assumptions made. It has been assumed, for example, that there will be no change in contribution rates, in withdrawal regulations, or in interest rates paid on investments, that average per capita contribution payments will remain constant at the 1964 level (that is the wage level will remain stable), and that the number of contributors will expand in step with the population growth rate. So far as the net flow of surplus funds available from the EPF is concerned, these assumptions provide a conservative picture.

The situation in Singapore is similar to that in Malaya. The level of annual contributions has risen steadily. Withdrawals amount to barely 20% of annual contributions, and the net flow of surplus funds has increased continuously (Table 44B). The decision to double contribution rates over the period 1968-70 will gradually double the level of annual contributions without significantly affecting the level of withdrawals. Thus, as in Malaya, the flow of contributions and of interest receipts from investments will continue to outstrip the growth of withdrawals and administrative expenses at least until the decade after 1990. Between 1966 and 1985, the CPF will make available almost \$3,000 million for long-term investment purposes.

National Provident Funds and Contributors

During the second reading of the EPF bill, the Financial Secretary indicated that the long-term hope was for a comprehensive social security scheme, but tight restraints were written into the original EPF and CPF Ordinances to prevent the funds from becoming a drain on

government revenue. Despite early ambitions, the obligations of the respective funds to contributors have not been significantly broadened since their inception.

Contribution rates were standardised rather than adjusted to individual risks, an acceptance of what Peacock (1952: 41) has referred to as the first 'canon of social justice': the principle of collective risk. But this measure represented the extent to which 'canons of social justice' were pursued.

The major form of benefit provided is a lump-sum payment available on the fulfilment of strict conditions. A contributor cannot, for example, withdraw his provident fund balance even if he has been unemployed for several years. The payment is directly related to the contribution history of the contributor. There is no standardisation of benefit rates nor is there any stipulated minimum benefit rate. Moreover, no attempt has been made to provide facilities which would enable a contributor to spread the payment over a period of years, if he so wishes.

Amendments are at present being made to both the EPF and the CPF Ordinances to permit long-standing contributors to draw on part of their accumulated balances in order to make a down payment on a house or flat (in Malaya, for example, provision is to be made to permit contributors who have reached the age of 50 years to draw one-third of their money to buy a house or some land). But, despite this incursion, the role of the respective funds as social welfare schemes is a marginal by-product of what has become their primary role: that of mobilising savings for investment in domestic government securities. In effect, provident fund deposits represent a compulsory long-term loan to the government. If inflation occurs over the contribution period, the real value of the lump-sum payment is reduced and, to the extent that such depreciation is not offset by interest payments, contributions represent a form of direct taxation.

There does seem to be a need for a reappraisal of the responsibilities of the funds to their members. Too little attention has been devoted to this issue. The funds could, for example, offer members the choice between a lump-sum or an annuity payment. This innovation would in no way conflict with the role of the fund as a source of government finance; in fact, by spreading lump-sum payments into the future, the flow of surplus funds would, in the short term, be enhanced. If no other benefits are to be provided, the funds should at least guarantee the capital value of contributor deposits against erosion by inflation. The CPF has gone a long way in this direction, interest on contributor balances having been increased recently to $6\frac{1}{2}\%$ per annum.

National Provident Funds and the Government

The governments of Malaya and Singapore have clearly recognised the importance of the national provident funds as a source of government finance. They may also have noted that the ability to vary employee-employer contribution rates implies that the funds could be developed into important countercyclical policy instruments. To ensure close co-operation between the government and the EPF, two provisions have recently been incorporated into the EPF Ordinance. The first stipulates that the fund shall not invest outside Malaya, and that at least 70% of its reserve balances should be invested in domestic government securities; the second provides for the Minister of Finance to appoint all members to the governing board of the EPF. Since the board is responsible for the determination of the rate of interest to be paid on contributor balances and employee-employer contribution rates, indirect government control has been firmly entrenched.

By co-operating closely with the recently established Central Bank, the Malayan government has been able to increase its dependence on domestic loan finance. It is likely that the government will be able to continue to depend on this source of finance for at least another decade. While it is probable that the increase in outstanding Treasury bills will slacken off in the early 1970s, the prospect for increasing long-term debt remains substantial.

Singapore is only beginning to explore the full extent of its capacity to raise domestic loan finance. The Singapore development plan for the period 1966-70 indicated that the semi-governmental authorities would be the main source of domestic loan finance. However, in 1968, the government embarked on an extensive campaign to raise loan finance from the private sector with the issue of \$75 million worth of tax free registered stock and bearer bonds. In addition, the government substantially increased the level of Treasury bills on call. However, effective and co-ordinated exploitation of domestic loan finance in Singapore may have to await the establishment of a Central Bank.

External Finance

There are three main sources of external finance available to Malaya and Singapore: external reserves, external borrowing, and foreign grants.

EXTERNAL RESERVES

The level of external reserves held by government bodies and by the banking system in Malaya and Singapore is set out in Table 47. The aggregate figures are incomplete, as the external reserves of insurance companies, private provident funds, agency houses, and other private organisations are not available.

The interesting point is that external reserves are held separately by a number of government and private bodies. There is no central control over the aggregate level and use of external reserves as, for example, in Australia, where the Reserve Bank has been given a prerogative for effecting all dealings in foreign exchange.

It is possible that, even where control is vested in one body, reserves may be maintained at levels in excess of requirements. But central control does focus attention on the reasons for maintaining reserves from a national viewpoint, and facilitates the use of reserves for the achievement of national objectives. The position in Malaya and Singapore differs in two fundamental respects. First, since various bodies hold reserves to meet their own specific contingencies, it is likely that, from a national viewpoint, reserves will be excessive in relation to requirements. Thus two bodies may hold reserves when, because of seasonal demand and other factors, the reserves of one alone may be sufficient. Second, there is no guarantee that reserves will be used to fulfil national objectives. It is possible that, during a recession, the effect on the economy of a fall in the level of government reserves may be more than offset by an increase in the reserve holdings of commercial banks, provident funds, and other private bodies.

Table 47 Malaysia: gold and foreign exchange reserves, 1960-7
(\$ million)

Item	At cost as at end of period									
	1960	1961	1962	1963	1964	1965	1966	1967		
Reserve position in IMF	—	—	10.4	22.0	22.6	42.1	61.9	97.0		
Monetary authorities	1,089.0	1,068.4	1,149.4	1,181.9	1,242.8	1,332.5	1,377.8	1,302.0		
Government and agencies	1,164.5	1,338.0	1,298.5	1,236.5	1,035.8	958.9	755.8	510.5		
Net official reserves	2,253.5	2,406.4	2,458.3	2,440.4	2,301.2	2,333.5	2,195.5	1,909.5		
Net foreign assets of commercial banks	335.4	258.3	235.0	176.3	176.5	278.8	246.2	55.3		
Total net reserves	2,588.9	2,664.7	2,693.3	2,616.7	2,477.7	2,612.3	2,441.7	1,964.8		

Source: Bank Negara Malaysia 1968: Table 26.

Why are reserves held separately by several bodies instead of being controlled by one central authority? The answer to this question is embedded in the monetary history of Malaya and Singapore.

Despite developments in recent years, Malaya and Singapore continue to operate within the basic framework of the Currency Board system of money creation. As indicated in Chapter 1, the main means by which the domestic money supply can be increased are by a surplus on the balance of payments or by an increase in the willingness of the commercial banks to expand domestic assets (made possible by a decrease in the external balances of the commercial banks, by an increase in their overseas indebtedness, or by a lowering of the ratio of liquid assets to deposits). There are other important supplementary means of increasing the money supply, of course. The government could, for example, reduce its external reserve balances, a fiduciary issue could be made, or all sectors of the economy could be encouraged to make a more efficient use of their cash balances.

In explaining why external reserves are held separately by a number of government and private bodies, it is interesting to explore what would happen under this monetary system if a deficit emerged on the balance of payments. This deficit would be financed by surrendering domestic currency to the Currency Board, a process which would enable the Board to reduce its foreign exchange holdings and thus permit payment to be made for the excess of imports over exports. So far as the domestic economy is concerned, the important point is that the money supply would have contracted. It is possible that some of the other factors which affect the domestic money supply (bank credit, for example) may expand and perhaps prevent any contraction in the domestic money supply; this has happened in Malaya since 1961. But if this response is not forthcoming, domestic income must fall until a level is reached where, in the intended sense, the annual demand for foreign exchange is equal to the annual supply of foreign exchange. Provided the Malayan community is prepared to surrender the use of domestic currency, balance of payments equilibrium is automatically achieved without the need to resort to the use of increased tariffs, quantitative import restrictions, or devaluation. The important point is that the brunt of the process of adjustment is borne by the level of domestic income and employment, both of which would fall further than would be the case if use had been made of policy measures to restrict the supply of imports.

The extent of the fall in domestic income is determined by two factors—first, the division of the initial fall in export income between residents and non-residents. The greater the extent to which the fall in income is

borne by profits which would otherwise have been repatriated to foreign shareholders, the smaller is the net fall in domestic income at the end of the multiplier process. Second, the lower the value of the multiplier (that is the higher the value of the marginal propensity to import, to save, and to tax), the smaller is the fall in domestic income. In Malaya and Singapore, a high and positive relationship between changes in export income and foreign profit remittances and a high marginal propensity to import have served to moderate the effect on the level of internal activity of downward swings in export income (see Harvie 1964).

The speed with which the money supply contracts and adjustments are made towards a new equilibrium level of income depends on a different set of factors. If bodies in addition to the Currency Board are prepared to reduce their external reserves, if the velocity of circulation of money increases, or if advantage is taken of the power to make a fiduciary issue, the process of adjustment to the new equilibrium will be prolonged. If, in the meantime, the balance of payments improves, any downward income (and employment) adjustment would be avoided.

The analysis so far has been confined to the effects on the economy of a trade-oriented recession due either to a fall in export earnings or to a rise in import demand as a result of population growth, changes in tastes, etc. If a change in the level of internal activity were induced by factors which, in the short run at least, contribute little towards an expansion of export income or of import replacement activities, the effect on the economy would be similar. Thus, if the government increases expenditure on development projects but does not reduce its holdings of external reserves, the consequent rise in import demand must be paid for by surrendering domestic currency for sterling; that is, domestic liquidity becomes tighter. Whether, as a result of the increase in government expenditure, domestic income rises or falls, depends on the response of the private sector. If the banks do not attempt to support the private sector of the economy by reducing either the level of their external reserves or their ratio of liquid assets to deposits, income will fall (rise) provided the import component of the increase in government expenditure exceeds (is less than) that of the fall in private expenditure;¹ the main difference is that, at the new level of economic activity, the share

¹ If the cut-back in private expenditure reduces export earnings, it is possible that, even if the import component of the increase in government expenditure is less than that of the fall in private expenditure, income may still fall.

of the government sector will have increased at the expense of that of the private sector.²

By encouraging financial institutions in Malaya to exchange foreign securities for domestic government securities and by using part of the external reserves so obtained, the Central Bank has weakened (temporarily, at least) the nexus between the balance of payments and the domestic money supply that prevailed before 1960. Nevertheless, the concern of this section is to indicate why external reserves are held separately by a number of government and private bodies. Since these reserves were largely built up before 1960, it is necessary to refer back to this period to explain why this development occurred.

One of the major side-effects of the operation of the Currency Board system in Malaya (particularly before the establishment of the Central Bank) and Singapore was the emphasis it placed on the need to be able to gain control over foreign exchange in order to be assured of the ability to meet commitments regardless of the state of the domestic economy. This characteristic provides the clue to the reason why bodies apart from the Currency Board held external reserves. The potential difficulty of obtaining domestic credit accommodation during recessed periods compelled insurance companies, provident funds, and similar bodies to hold external reserves in order to satisfy contractual obligations even at the depth of a recession. Commercial banks and agency houses held reserves for the purpose of ensuring a steady flow of finance to profitable lines of activity despite a general shortage of liquidity. Further, since a fall in export income would tend to lead to a magnified fall in the level of domestic income and employment, the government was forced to consider whether it should attempt to implement effective countercyclical policies.³ The government could not determine the aggregate supply of money, for it did not possess control over either of the components of the money supply—currency or bank deposits. Emphasis

² The level of private activity will be maintained (or increased) only if banks and other bodies apart from the Currency Board are prepared to draw down their external reserves, or if there is an increase in the velocity of circulation of the domestic money supply or a fiduciary issue.

³ Effective countercyclical fiscal policies may be defined as those which provide a significant contribution towards sustaining the pre-recession level of domestic income and employment. Even in boom periods, the Malayan economy is characterised by a degree of unemployment and underemployment. Effective countercyclical policies need not imply that labour displaced during a trade recession is re-employed by the government; all that is necessary is that government action should contribute towards the maintenance of the level of employment.

therefore had to be placed on fiscal policy. The government could, for example, have sought to maintain its expenditure at pre-slump levels despite a fall in revenue. But whether the government's action was countercyclical or not depended on the method of financing the budget deficit. If the government drew on its reserves of cash held locally with the commercial banks (if, in other words, there was no reduction in the level of external reserves held by bodies apart from the Currency Board), the government's action would be to no avail; by helping to maintain the demand for imports, the private sector would be forced to surrender control over currency and thus to curtail its activities more rapidly than would have been the case if the government had not budgeted for a deficit. If the government were to carry out effective countercyclical action by prolonging the process of adjustment in the hope that export income would rise in the meantime, the government had to hold external reserves, and it had to be prepared to run these reserves down in recessed periods. Thus, the potential effect of the Currency Board mechanism on the level of domestic activity in recessed periods explains why external reserves were held separately by a number of government and private bodies.

Two advantages of the Currency Board system deserve mention. First, the mechanism prevents the territories within which it operates from importing more than they can afford to pay for, and does so without the need to resort to the use of commercial policy measures such as devaluation, tariffs, and quantitative import restrictions. Unless the territories can arrange a continuous supply of external loan finance, possess a high level of external reserves outside of the Currency Board which they are able to use, permit a fiduciary issue, or increase the velocity of circulation of domestic currency, the demand for foreign exchange cannot exceed, for any length of time, the annual addition to its supply. If demand does exceed supply, domestic currency must be surrendered to release external reserves to pay for imports; the contraction in the domestic money supply eventually forces income down to a level where the demand for and supply of foreign currency are equal. But this does not mean that the balance of payments always moves automatically towards equilibrium. If the balance of payments is in surplus, an increase in the domestic money supply is possible. Whether the money supply increases and eliminates the surplus by stimulating the demand for imports depends on the willingness of the public, the banks, and the government sector to hold domestic currency. If the community prefers to increase its holdings of external reserves, the surplus will continue as long as export earnings are maintained; there is no limit to the extent

that external reserves can be built up in favourable years. Conversely, if credit is expanded locally, domestic inflationary pressures may result. These pressures will continue until demand is diverted away from home-produced goods on to imports. The monetary mechanism, then, ensures that the territories live within their means without the use of commercial policy measures.

The second advantage of the Currency Board mechanism is a corollary of the first. By eliminating the possibility of a continuing deficit in the balance of payments, foreign investors are assured that the value of invested capital will not be threatened by a need to devalue the exchange rate (except, of course, if sterling itself is devalued), and that invested capital and profits can be repatriated without exchange controls. Under the Currency Board system, the principal end is to maintain confidence in the stability of domestic currency. The relationship between the state of external transactions, reserve holdings, and the level of internal activity is incidental to the major task. The currency mechanism is designed to check a run on currency (and thus on its equivalent, external reserves). This objective is achieved at the expense of variations in the level of domestic income.

Although the importance of both advantages should not be underrated, particularly as Malaya and Singapore are endeavouring to attract additional foreign investment, the Currency Board system involves the community in certain sacrifices. One disadvantage centres on the effects of the system on the level, composition, and use of the nation's external reserve holdings. Since reserves are held separately by a number of bodies, there is no guarantee that the level and structure of reserve holdings will correspond to national requirements. It is possible, for example, that the external reserves of Malaya and Singapore are in excess of national needs (that is, if reserve holdings were transferred to a central body in each territory, there would be scope for some reduction which would not affect the convertibility of domestic currency). Further, the Currency Board system offers no assurance that external reserves will be used to offset short-run fluctuations in the level of internal activity or to enhance domestic expansionary forces.

The problems can be more clearly illustrated by referring to Malayan experience in the decade after 1950. During this decade, Federal government expenditure rose from \$530 million to \$915 million and the government's external reserves increased from 45% to more than 100% of government expenditure. Reserve holdings were adequate to support countercyclical fiscal policies for a lengthy period. But the willingness of the government to draw on its reserves during recessions was condi-

tioned by the automatic impact of the Currency Board mechanism on domestic liquidity. The potential difficulty of obtaining domestic financial accommodation forced the government to rely heavily on its external reserves in order to guarantee the continued provision of essential government services regardless of how long a particular recession lasted. In each recession during this decade, the government cut expenditure (particularly development expenditure) towards the reduced level of revenue. Little use was made of external reserves for fear that they would be exhausted before the end of the recession, and that the continued provision of essential services would thereby be threatened. The Currency Board mechanism circumscribed the extent to which the government was prepared to pursue effective countercyclical fiscal policies during recessions. In contrast, the government did attempt to pursue countercyclical policies during boom periods; on these occasions, the government invariably increased its external reserves and reduced the liquidity of the commercial banks by switching its local cash balances held with the commercial banks into sterling.

While the impact of the Currency Board mechanism was dominant, two further factors restrained the willingness of the government to use its external reserves. First, the government was reluctant to sell sterling investments before maturity for fear of suffering a capital loss. Second, decisions regarding the withdrawal of investments from London were conditioned by the effect of such policies on the international status of sterling. The decade after 1950 was characterised by continued pressure on the viability of sterling. To a country which held substantial sterling balances, the mere suggestion of possible devaluation was sufficient to ensure full co-operation in measures designed to ease the strain on sterling. Although domestic crises in Malaya often coincided with an easing of the pressure on sterling, gentlemen's agreements imposed restraint on the extent of the use of external reserves in any one period.

The commercial banks were also anxious to increase or protect their external reserves in the decade 1951-60. While the banks were prepared to expand domestic advances during export booms, they also managed to increase their external balances. In recessed periods, the banks, like the government, were reluctant to draw on their external balances to buoy up the level of domestic activity. In general, the responses of the government and of the banking system moderated expansionary (and inflationary) forces during booms and increased the speed of adjustment towards lower levels of income during recessions.

On the surface, the economic problems of the decade 1961-70 appeared to be still more serious than those of the preceding decade. In Malaya,

it was projected that the total population would increase by 34% during this period; the position in Singapore was broadly similar. Assuming that holders of foreign exchange would be reluctant to decrease these balances, that there would be no significant change in the velocity of circulation of money, and no fiduciary issue, an expansion in the level of domestic activity could be sustained only if there were a net balance of payments surplus over this period. If such a surplus did not occur, a domestic liquidity shortage would curtail expansion. It was increasingly realised, however, that the potential for a significant expansion in the export earnings of both Malaya and Singapore in the decade after 1960 would be slight. While a substantial increase in the volume of agricultural exports could be predicted with confidence, it was expected that falling prices, particularly for rubber, would prevent any marked rise in export earnings. Moreover, it was considered that the expected fall in the price level for agricultural produce would reduce the profitability of agricultural development and thus restrain any expansion of net private capital inflow. While there was scope for increasing the domestic output of products currently imported (particularly in Malaya—rice, for example), it was expected that population growth would neutralise the effect of such developments on the demand for imports. Thus it was expected that the net balance of payments surplus over this period would be small, and could not be expected to create sufficient finance to sustain an expansion of domestic employment opportunities in Malaya or Singapore commensurate with the growth of the labour force.

Despite this gloomy prospect, the governmental authorities in both Malaya and Singapore indicated their determination to attempt to raise the domestic growth rate in order to avoid a substantial rise in the level of unemployment. In Malaya, the Central Bank appreciated that there was considerable scope for increasing the sterling cover against which domestic currency was issued, despite the prospect of stagnant export earnings and a potential adverse movement in the balance of payments. A move towards centralisation of control over the nation's external reserves was the means by which this objective could be achieved. By inducement (an increase in the supply of domestic government securities and an improvement in the range of and return on such securities) and by regulation (local liquid asset ratio requirements for commercial banks, and domestic portfolio investment requirements for public and private provident funds, for the post office savings bank, for insurance companies, and for other financial institutions), the Central Bank has forced the commercial banks and other financial institutions to sell a large proportion of their foreign exchange holdings to the Bank in exchange

for domestically issued government securities. The switch in the ownership of the nation's foreign exchange reserves is indicated in Table 48. Apart from a substantial rise in 1965 as a result of a temporary improvement in the balance of payments, the net foreign assets of commercial banks have fallen quite dramatically since 1960. Similarly, the foreign exchange holdings of insurance companies, co-operative societies, private provident and trust funds, nominee and trustee companies, finance companies, commercial firms, and other local investors have fallen. This point is not indicated in Table 48 for, owing to the large number of these firms, information on their external reserves has not been collected on a regular basis. However, Tables 39 and 43 both indicate a substantial rise in the holding of domestic government securities by these firms, and it can be safely concluded that a large part of this rise has been due to an exchange of domestic government securities for foreign securities. The success of Central Bank policies is indicated by the steady rise in the proportion of total foreign exchange reserves held by the monetary authorities. The slight fall in 1967 was due to the effect of devaluation of the pound sterling; at the end of September 1967, the external reserves of the monetary authorities were approximately \$30 million above the level recorded in December 1966. The foreign exchange reserves of the monetary authorities represent the external cover for the domestic currency issue, and the steady increase in these reserves has enabled the Central Bank to support an expansion of the domestic money supply. Thus, although external reserves continue to be held separately by several private and public bodies, the proportion held by the governing authorities has increased substantially since 1960, and the governing authorities have, for the first time, succeeded in making extensive use of these reserves to counter the potentially adverse effect of a deterioration in the balance of payments on the domestic economy. In fact, the governing authorities have gone still further; their activities have permitted significant economic growth to take place. Contrary to expectations early in the 1960s, a deficiency of monetary resources has not restrained economic growth or increased the level of unemployment. The Currency Board system encouraged a *laissez-faire* approach to the holding and the use of the nation's external reserves; it did not preclude central control. Direct government intervention was, however, necessary if the holdings of the nation's external reserves were to be centralised, and used to counteract cyclical fluctuations and foster economic growth. The Central Bank, in co-operation with the government, has effected this switch within the basic framework of the Currency Board mechanism of currency creation.

One final issue that needs to be considered is what factors determine an adequate level of external reserves. The two dominant factors are (a) the relative importance of trade in determining the level of domestic income, and (b) the expected severity and length of future balance of payments disturbances. In a country where the marginal propensity to import is high, a further consideration is whether the task of counter-cyclical policies is to maintain the domestic demand for home-produced and imported goods or for home-produced goods alone. If imports consist of basic foodstuffs and intermediate-use goods, the former task may be considered imperative. But it is more likely that certain imports will be regarded as dispensable, so that the primary objective of counter-cyclical policies will be to sustain the level of domestic output as far as possible. To assist in the achievement of this end, temporary restrictions may have to be imposed on the flow of imports.

Fluctuations in the course of the export earnings of Malaya and Singapore since 1950 have been severe, but not prolonged. The expected steady fall in the export price of rubber suggests that future fluctuations will be less severe, but perhaps more prolonged.

The contribution of exports to gross domestic product has fallen since 1960, but not as markedly as one would expect, given that the price of natural rubber has fallen by 50% over this period—in 1965, exports still accounted for 42% of gross domestic product (see Table 2, p. 16). The contribution of exports to gross domestic product has been sustained at a high level partly because there has been a substantial rise in the level of rubber production since 1966, and partly because the price of tin has been abnormally high during this period. While a fall in the price of tin can be expected, it is nevertheless clear that foreign trade will continue to play a dominant role in domestic income determination.

While imports into Malaya consist essentially of foodstuffs and manufactures, a high proportion of these imports could be regarded as dispensable in an emergency situation. Rice imports, for example, consist of high quality rice strains demanded by the Chinese community and by higher income groups in general. For a short period at least, it is probable that domestic rice varieties could be substituted for imported rice without creating any serious dislocation.

Given that foreign trade will continue to make a significant contribution towards gross domestic product, external reserve holdings must be substantial; countercyclical fiscal and monetary policies may have to be pursued for two to four years. If reserves were used to meet a recession which lasted from two to four years, it would be prudent to set an upper limit to the extent of reserves that can be called upon in any one year.

For Malaya, the annual upper limit may, for example, be set at \$150 million. To support a reduction of this magnitude in each of four consecutive years, aggregate reserves would need to approximate \$600 million.

Apart from this exercisable cover, most countries maintain a hard core of external reserves which they would endeavour to hold throughout the severest of crises; in preference to using these reserves, a country may devalue, impose drastic import restrictions, or raise tariffs to a prohibitive level. Most countries no longer hold an external reserve cover against the domestic currency issue, but the hard core part of the nation's external reserves is akin to such a cover. For this reason, it is felt that there is no need for Malaya to abolish the statutory provision which requires an external cover to be held against the domestic currency issue. It is, however, felt that, by means of fiduciary issues, the reserve cover could steadily be reduced towards 50% of the domestic currency issue. In June 1968, the amount of currency in circulation approximated \$850 million, so that the external cover to be held against the domestic currency issue would approximate \$400 million. On this basis, the aggregate external reserve requirement for Malaya would be \$1,000 million, the equivalent of just over four months' imports. This requirement would permit present external reserve holdings (\$1,800 million at the end of June 1968) to be reduced by approximately \$800 million. Since, however, Malaya is presently experiencing a period of trade imbalance which is regarded as a temporary phenomenon, external reserves should temporarily be reduced below \$1,000 million towards, perhaps, \$700 million: one of the reasons for holding external reserves is to use them during such periods. This would increase the extent to which the present level of reserves could be reduced from \$800 million to \$1,100 million.

There is, however, one problem. As indicated in Chapter 1, the separation of Singapore from Malaysia has led to the development of separate currencies in these countries. To put beyond any doubt the Singapore government's concern to maintain confidence in its newly-issued currency, it has announced that it will hold a full 100% foreign exchange backing for the domestic currency issue. Anxious to avoid any situation which may precipitate a run on its currency, the Malaysian government has been forced to follow suit. At least until confidence has been firmly established in both currencies, it is probable that a full 100% cover will be held against the domestic currency issue. For this period, Malaya's reserve requirement would therefore rise to \$1,450 million and the scope for decreasing the present level of external reserves would

fall to \$350 million (though, when allowance is made for the fact that Malaya is at present experiencing a period of recessed trade, external reserves could temporarily be reduced by a larger figure, say, \$650 million).

Since 1960, the governing authorities have been able to expand domestic activity despite stagnation in the level of export earnings; the resulting increase in imports was financed largely by a decrease in the external balances of the commercial banks. The commercial banks have now exhausted these balances. There is still scope for reducing the external reserves of other financial institutions but, if the governing authorities are to continue to buoy-up the level of domestic activity in the face of a further deterioration in the balance of payments, considerable use must now be made of the external reserves held by the monetary authorities and by the government. If this were done and if more strenuous efforts were made to increase borrowing abroad (public and private), it is possible that the nexus between the balance of payments and the money supply will not recur until towards the end of the period 1971-5. By then it is to be hoped that Malaya's balance of payments will be in a healthier position, and that sufficient co-operation will be established between Malaysia and Singapore on monetary matters to permit advantage to be taken of the scope for making fiduciary issues.

In Singapore, estimated external reserve requirements amount to \$600 million, an estimate based on a reserve decline of \$60 million per annum for four years and a 100% foreign exchange backing for the domestic currency issue. Singapore's external reserves at 31 December 1965 exceeded \$1,150 million, so that the scope for reducing external reserves exceeds \$500 million.

FOREIGN BORROWING

The use made of external borrowing as a source of government finance in Malaya and Singapore has been very limited (see Table 8, p. 48). The external debt of the government sector in Malaya amounted to \$836 million in December 1967, the equivalent of 9% of gross domestic product and 22% of total government sector debt. Annual service charges and amortisation of this debt amounted to less than 2% of export receipts in 1967, and to less than 3% of government revenue. A similar situation prevails in Singapore. External debt servicing is not a serious problem in either Malaya or Singapore.

Most loans have been raised in London but interest in loans from other financial centres, and particularly from international lending bodies such as the IBRD, has increased in recent years.

Short-term Borrowing

The extreme variability of export earnings emphasises the need for short-term financial accommodation in Malaya and Singapore. Yet, prior to the decision by Malaya to become a member of the International Monetary Fund (IMF) following the achievement of independence in 1957, colonial regulations virtually precluded Malaya and Singapore from raising short-term external loan finance.

The Crown Agents in London were responsible for the issue of loans on behalf of all colonial governments. Since the Crown Agents conducted business solely on the London market, the borrowing capacity of the colonial governments was restricted to the supply of funds available in this centre.

The Crown Agents made it clear to the colonies that loans could not be raised for general expenditure purposes. Additional regulations prohibited the colonial governments from floating short-term Treasury bills on the London market. Consequently, during the period of colonial status, Malaya and Singapore were forced to rely on the liquid portion of their external balances for temporary financial accommodation. The Joint Consolidated Fund, which held and invested colonial government reserve balances, provided limited overdraft facilities, but neither Malaya nor Singapore made use of this source of finance.

The achievement of independence did not alter the short-term borrowing status of Malaya and Singapore in London. It did, however, permit Malaya to become a member of the IMF, and Articles of Agreement were signed in 1958. Malaya's IMF quota is \$352 million. IMF subscriptions are equal to quotas. The subscription is payable partly in gold (normally 25%) and partly in the member's currency (normally 75%). In June 1968, Malaya's gold subscription amounted to \$85 million, or 24% of its quota. Until the Fund needs to use Malayan currency, Malaya is permitted to lodge a non-negotiable note, bearing no interest, in respect of the amount of its currency contribution.

Drawings from the Fund assume the form of a member's purchase of the currencies of other members in exchange for an equivalent amount of its own currency. Drawing rights are limited by provisions governing both the rate of increase and the total amount of the Fund's holding of a member's currency expressed as a percentage of its quota. Without special action by the Fund to grant a waiver of its normal rules, drawings are limited to amounts that will not cause the Fund's holdings of the member's currency to increase by more than 25% in any twelve-month period nor exceed 200% of its quota. If 25% of a member's sub-

scription has been paid in gold, a drawing of this amount—referred to as the gold tranche—would cause the Fund's holdings of the member's currency to equal 100% of its quota for, in exchange for this drawing, the member must deposit with the Fund domestic currency equivalent to 25% of its quota. Adding this deposit together with the currency deposited in fulfilment of the member's quota requirement, the Fund's holding of the member's currency would equal the member's quota. A drawing of an additional 25% of the member's quota is referred to as drawing the member's first credit tranche. Without waiver, four credit tranches may be claimed, each equivalent to 25% of the member's quota. A drawing that would cause the Fund's holding of the member's currency to equal 200% of the member's quota would represent the exercise by the member country of its gold tranche and its four credit tranches; it represents a drawing equal in total value to 125% of the member's quota. This is referred to as the country's gross Fund position, for it represents the maximum amount that the country can borrow without waiver. On the basis of this calculation, Malaya's gross Fund position is equivalent to \$440 million. However, a country's gold tranche and gross Fund position increase if other Fund members purchase that country's currency: both increase by the amount of the purchase. In effect, the country whose currency is borrowed substitutes an increased reserve position with the Fund (the reserve position being broadly equivalent to the gold tranche and being available to the member country on the same conditions as the gold tranche) for part of its holdings of foreign exchange. At the end of June 1968, other countries had purchased \$12 million of Malayan currency. Thus Malaya's reserve position with the Fund was \$97 million, and its gross Fund position, \$452 million. As the borrowing country or countries repay, Malaya's reserve position at the Fund will move back towards \$85 million, its gross Fund position will move towards \$440 million, and its external reserves outside of the IMF will rise by the amount of the repayment.

In addition to the normal borrowing rights of member countries, those member countries that experience an export shortfall can draw as much as 50% of their quota under special compensatory financial arrangements. This provision is designed to compensate for shortfalls in export proceeds below the medium-term trend (the estimated 5-year moving average centred on the shortfall year) with the qualification that outstanding drawings under this provision may not increase by more than 25% of the country's quota within any twelve-month period. If the member country were able to take full advantage of this provision together with normal borrowing rights, it would mean that the country could borrow

up to 175% of its quota (that is to the point where the Fund's holding of that member's currency amounted to 250% of the member's quota). Advantage can be taken of the special compensatory financial provisions at any stage. There is no provision, for example, that would require the member country to make use of its normal credit tranches before applying for compensatory financial assistance.

The Fund's resources are available to eligible members on a short-term basis. A member's purchases of currency from the Fund must be repaid in a convertible currency within three to five years. If, however, the external monetary reserves of the borrowing country are greater than its IMF quota, then the country has an obligation to repurchase (with convertible currency) its own currency held by the Fund in excess of 75% of its quota in any year in which its monetary reserves increase, or in which it purchases foreign exchange from the Fund and does not draw equally on its own reserves. In other words, if a member country is to retain a short-term advance from the IMF for three to five years, it must be prepared to reduce its external reserves by the amount of the advance. If the member country's reserves cannot be held down to this level for the period of the advance, then it incurs a prior obligation to repay part or the whole of the IMF advance. In effect, the Fund requires conjoint use of both its own and the member country's reserves.

The major function of the IMF is to provide financial assistance to member countries suffering temporary adverse fluctuations in their current account trade balance. The Fund has, however, established strict procedures regarding the use of borrowing rights by member governments. The gold tranche—approximately the first 25% of a member country's quota—is generally available for borrowing on demand. Apart from obtaining assistance under the special compensatory financial arrangements, further drawings can be made only if the Fund is convinced that there are no other sources of short-term finance available to the country (such as external reserves), and that domestic economic policies designed to overcome the country's difficulties are being pursued. The higher the drawing in relation to the quota, the greater is the degree of justification required by the Fund. A country cannot rely on the availability of Fund finance unless it is prepared to adopt policies judged to be appropriate by the Fund.

As a condition for borrowing funds in excess of 25% of the member country's quota, it is reasonable to require developed countries to pursue policies designed to resolve balance of payments difficulties within a short period of time. The net effect of such measures on the level of domestic income, employment, and investment activity is likely to be

small; resources are merely reallocated at the margin in an endeavour to achieve a closer relationship between the demand by residents for goods and services and the level of domestic production of goods and services (and thus between the demand for and supply of foreign exchange). But the application of similar policy requirements to the less developed countries is fraught with difficulties. In these countries, the problem is not so much one of resource reallocation at the margin as one of stimulating and nurturing economic growth. Compared with the developed countries, the ratio of investment to domestic income is low in the less developed countries. The problem is to raise this ratio. However, investment activity (public and private) is restrained by a lack of real resources. A decision to hold back demand to ease a temporary balance of payments difficulty may simply amplify the difficulties and uncertainties surrounding investment decisions. Thus, while a reversal of economic prospects may occur within a few years, investment activity may have suffered a severe shock in the meantime, and its revival may be delayed well into the period of trade recovery. In these circumstances, steady growth is not easily attained. It is therefore suggested that the Fund should not be over-anxious to force retrenchment at the first sign of recession in countries where the sustaining of investment activity is difficult and yet imperative. To this end, it may be provided that, where less developed countries pursue sound fiscal and monetary policies and are prepared to draw on their external reserve balances, the IMF could make 75% (instead of 25%) of the particular country's quota available on demand. If the recession proves to be more recalcitrant than expected, it appears that these countries would be able to adjust fiscal and monetary policies to rectify the situation.

Apart from a temporary reversal in 1965, Malaya has suffered an adverse movement in its balance of payments since 1961. The basic cause of this development has been a fall in the price of its major export: natural rubber. However, as a result of a massive replanting program, it is expected that, towards the end of the decade 1966-75, an improvement in the state of the balance of payments will occur as production increases begin to swamp the adverse effect of further price decreases on export earnings. This prospect would seem to place Malaya in an ideal position in respect of obtaining temporary financial assistance from the IMF both by way of normal borrowing rights and special compensatory financial assistance. But the government authorities in Malaya have not made use of this source of finance. It is interesting to ask, why not?

The main reason would appear to centre on the willingness of the IMF to lend to Malaya. The IMF has sent representatives to survey the Malayan economy in each year since the formation of the Central Bank in 1959. These representatives have found little difficulty in pointing out to the Malayan government that it has not, as yet, fully exploited its scope to raise external loan finance or to reduce external reserves in excess of requirements. Reading between the lines, it seems reasonable to conclude that, apart from taking advantage of the compensatory financial provisions, the Malayan government would find it difficult to raise finance from the IMF beyond its gold tranche. It is reasonable to expect the Malayan government to reduce its reserves, but, as the government does this, the IMF should be prepared to permit Malaya to make use of its Fund balances should this be considered desirable by the Malayan government.

It is a matter for conjecture as to what the IMF would consider to be a reasonable level of external reserves for Malaya. It is felt that account should, however, be taken of the need at the moment to maintain a 100% foreign exchange cover against currency circulating within the domestic economy. Thus Malaya should be able to exercise its credit tranches with the Fund if its external reserves were reduced to \$1,200 million, and if the governing authorities indicated that they were prepared to reduce these reserves still further and were to continue policies designed to centralise control over the nation's external reserves. If this is done and there is then an increase in the currency component of the domestic money supply, Malaya's external reserves will rise. Had Malaya borrowed from the Fund, it would be expected to repurchase its own currency deposited with the Fund in these circumstances. This would, however, be unfortunate, for it would lead to a contraction of the domestic money supply and thus to a contraction in the level of domestic economic activity. It is therefore suggested that the Malayan government be required to repurchase its currency deposited with the Fund and in excess of 75% of its quota only to the extent that its external reserves increase in any one year by more than the increase in the currency component of the domestic money supply.

Before concluding this section, mention should be made of the scheme to increase international liquidity by establishing within the IMF special drawing rights (SDRs) for member countries, as this proposal is almost certain to be ratified by the Fund in the near future.⁴ Under this scheme,

⁴ This account of the SDR scheme draws on the account given in the Commonwealth of Australia publication, *The Australian Economy 1968* (Canberra, 1968).

participating countries will be allocated SDRs in proportion to their quotas in the Fund. Members accepting an allocation of SDRs will not have to pay any subscription in gold or currency to the Fund as they do when accepting a quota or an increase in quota under existing Fund arrangements (or in what in future is to be called the Fund's General Account which is to be distinguished from the Special Drawing Account to be established for the conduct of operations and transactions involving SDRs). Instead, the Fund will simply enter the value of SDRs allocated to participating members as a credit in their respective Special Drawing Accounts.

This difference between the two arrangements has considerable significance. When quotas are established or increased under existing Fund arrangements, members transfer gold from their reserves to the Fund to pay their gold tranche subscription and thereby establish an equivalent reserve position in the Fund. These transactions do not add to their reserves; they simply change their composition. In consequence, these transactions do not add to international liquidity. The same is true when the transactions are reversed and a member draws its gold tranche. It is only when members draw on the credit tranches that additions are made through the Fund to the total holdings of a nation's external reserves and to international liquidity. Drawings under existing Fund arrangements are, however, fully repayable within three to five years, and when members repay their drawings in the credit tranches (or 'repurchase their own currency' as the Articles of the Fund express it) they extinguish the temporary addition their drawing made to their external reserves and to international liquidity.

Since members accepting SDRs do not have to transfer any of their external reserves to the Fund in exchange for the SDRs allocated to them, the creation of SDRs represents an addition to the external reserves of participating countries; the participating countries do not have to give up any part of their existing external reserves in order to gain SDRs.

When participating countries need to use their SDRs for balance of payments reasons, they will not in the normal course draw currencies from the Fund as they do, and will continue to do, when exercising their ordinary drawing rights. They will either transfer SDRs direct to another country, or to other countries, willing to accept them and to provide an equivalent amount of convertible currency in exchange, or they will approach the Fund which will designate a country (or countries) whose balance of payments and external reserves—including SDR holdings—would make it (or them) eligible to exchange SDRs for

convertible currencies. Whether the transfer of SDRs is made direct or through the agency of the Fund, it will be effective only when recorded by the Fund in the Special Drawing Account.

To be able to use its SDRs, a participating country will require no more than a balance of payments need to do so. No other conditions will be attached. It will not, for example, have to give any undertakings to the Fund as to the measures it intends to take to correct its balance of payments.

A country will be under no obligation to buy back SDRs or reconstitute its SDR holdings within any particular period provided that the average use of its SDRs in any 5-year period does not exceed 70% of the cumulative total of the SDRs allocated to it. In other words, participating countries must, on average, hold 30% of the SDRs allocated to them. They can, of course, use all of their SDRs for a time but, if they do, they must buy back enough of them in any period of five years to reduce the average use to 70%. The extreme case would be that of a country which used all of its SDRs over a 3½-year period but did not repurchase any SDRs during this period. This country would then have to reconstitute its SDRs in full to reduce its average use to 70% within the prescribed 5-year period.

Unless it so desires, no country will be obliged to accept from other countries any additional SDRs once its total SDR holdings are equal to three times the amount it has received under allocations. This provision puts a limit on any member's obligations to draw on its own holdings of gold or foreign exchange to meet other members' balance of payments needs.

Countries will pay a charge at the rate of 1½% per annum on the amount of SDRs they have used—that is on the amount by which their holdings of SDRs fall short of their cumulative allocation. Countries holding more SDRs than have been allocated to them will receive interest at the rate of 1½% per annum on the excess. Both charges and interest will be paid in SDRs—that is additional SDRs to the value of interest payable will be allocated to countries with excess holdings, while SDRs equivalent to the charges due will be subtracted from those countries with holdings less than their cumulative allocations. In effect, interest payments simply mean that SDRs will be transferred from 'SDR deficit' to 'SDR surplus' countries.

Malaya and Singapore should endeavour to take full advantage of this proposed amendment. However, if both countries maintain external reserves around the level presently held, it is more likely that they will be asked to accept SDRs, so that their holdings of SDRs will exceed the

amount they would be allocated on the basis of their IMF quota. It need hardly be pointed out that the countries which will gain most from the SDR scheme are those which are able to utilise close to 70% of the cumulative total of SDRs allocated to them in every 5-year period. The less developed countries that will gain most are those which depend heavily on international trade, which experience recurring balance of payments problems, and which are making full use of their present external reserve balances. Malaya and Singapore both depend heavily on international trade and have experienced recurring balance of payments difficulties but, as has been indicated, they both maintain external reserves in excess of requirements. In part, the surfeit of external reserves is due to the currency 'confidence test' being waged between the two countries. If one currency strengthens *vis-à-vis* the other, currency (and thus the backing for currency, foreign exchange) will be transferred from the weaker to the stronger currency country. However, what must be emphasised is that this action simply represents a reallocation between the two countries of the existing external reserves held by them. What may be overlooked in this struggle is that by co-operating on monetary matters, by making fiduciary issues, and by utilising present external reserve balances, both countries could enhance their external reserves through the exercise of SDRs.

Since normal credit tranches, special compensatory financing credit tranches, and SDRs, are all based on IMF quotas, Malaya and Singapore should perhaps explore the scope for increasing their Fund quota. Quotas are set at a level broadly proportional to the economic strength of members and, for revision, an 80% majority vote by Fund members is required.

Long-term Borrowing

The external debt of the government sector (including public authorities) of Malaya at the end of 1965 is set out in Table 48. Most loans have been raised in London, but the supply of external loan finance has amounted to only a fraction of the increase in Malaya's sterling balances in almost each year since 1950. A similar situation has prevailed in Singapore. Both Malaya and Singapore have been net long-term lenders to the United Kingdom.

One of the main advantages of the Currency Board system, stressed again and again by apologists, centred on the enhanced external borrowing capacity imparted by the assurance of monetary stability. Caine, for example, has argued that 'it is not . . . at all unreasonable to suspect that the self-denial (at the time largely unconscious self-denial) of not using

for immediate capital investment the resources coming under Government control as a result of additional issues of currency, may have increased rather than diminished the Governments' ability to finance new capital expenditure' (1958:27). The borrowing experience of Malaya and Singapore does not, however, fully justify such statements.

Table 48 Malaya: external debt, 1950-67
(\$ million)

Year	Federal government	Public authorities	Total external debt	Annual change
1950	115.2	5.5	120.7	
1951	115.2	19.2	134.4	13.7
1952	115.2	27.8	143.0	8.6
1953	131.3	40.5	171.8	28.8
1954	241.7	50.1	291.8	120.0
1955	286.2	60.7	346.9	55.1
1956	321.1	60.7	381.8	34.9
1957	316.0	60.7	376.7	-5.1
1958	308.1	60.7	368.8	-7.9
1959	334.2	69.2	403.4	34.6
1960	359.6	77.5	437.1	33.7
1961	373.3	91.6	464.9	27.8
1962	394.9	120.7	515.6	50.7
1963	442.9	158.2	601.1	85.5
1964	438.0	177.9	615.9	14.8
1965	510.4	209.9	720.3	104.4
1966	500.5	261.0	761.5	41.2
1967	527.5	308.0	835.5	74.0

Source: Data supplied by the Malaysian Treasury.

Most of the increase in government expenditure commitments in the decade after 1950 was financed out of domestic revenue. It may be concluded, therefore, that the failure of Malaya and Singapore to exploit sources of external loan finance more fully was due to a lack of demand for additional finance. In fact, the reverse was the case. In many post-war years the government was forced to curtail expenditure plans because of financial difficulties. External borrowing was of only limited assistance in mitigating the restraining impact of tax revenue on expenditure plans, for this source of finance was expensive and difficult to secure, and its extensive use was discouraged by Whitehall.

Prior to the achievement of independence, local legislation prevented Malaya and Singapore from raising external loan finance outside of London. Loans could be raised in London only for the finance of specific projects, and each project had to be prepared in detail before being accepted by the Crown Agents as a potential loan commitment. The Crown Agents then submitted loan applications to the Capital Issues Committee. As dominion and colonial development plans became more ambitious, the demand for finance grew, but the available supply of finance in London was limited. The Capital Issues Committee was given the responsibility of equating demand and supply; its main task was to pare loan proposals wherever possible. Projects were normally accepted only if they offered the prospect of producing sufficient revenue to finance associated recurrent expenditures, including sinking fund contributions. In effect, commercial bank credit competed with external loan disbursements for a limited number of well-secured domestic investment outlets. Both sources of finance by-passed large areas of domestic financial need.

Even when projects were approved as potential loan commitments, the ability to float such loans depended on the credit situation in London. In drawing up the second Malayan development plan (1956-60), the Malayan government placed limited dependence on loan raisings in London. The United Kingdom government agreed to support such loans, but added two provisos: first, that the ability to raise the loans would be dependent on the state of the London market and, second, that British support for such loans would depend on the maintenance by Malaya of 'sufficient financial stability to command the confidence of overseas investors' (Federation of Malaya 1957:9). In effect, the United Kingdom government said that it could not guarantee that the Malayan government would be able to raise the proposed \$85 million in London, but that its prospects would be better if it did not interfere with the Currency Board system of money creation, and if it maintained sterling reserves at a reasonably high level. Faced with a financial crisis in 1957-8, the Malayan government looked to London for assistance but, as indicated in the preceding chapter, the United Kingdom authorities made it clear that, because of financial stringency in England, there was no prospect of raising the envisaged loans. Difficulties increased as the financial crisis deepened and when the Malayan authorities realised that little of an external debt amounting to \$80 million which was due for redemption in 1959 would be converted. As a last resort, the government applied to the United States for a loan of \$450 million, \$300 million for general development purposes and \$150 million for military expendi-

ture in connection with the Emergency. The request was turned down, but sufficient lessons should have been learnt during this period to place the scope for and requirements of external borrowing into perspective. First, loan finance could not be raised at the flick of a finger; it could not be relied on as a stop-gap measure during periods of domestic financial crisis. Second, loans could not be raised against general (and particularly unproductive) expenditure commitments. Third, the maintenance of an extremely high credit standing made little difference to Malaya's borrowing capacity.

In general, the Malayan government not only found it difficult to secure external loan finance, but the Colonial Office actively discouraged the Malayan government from seeking such finance, and a general increase in interest rates increased the cost of this source of finance. In a country operating within the framework of a Currency Board system, any increase in contractual balance of payments obligations could only be viewed with anxiety. Although successive development plans attached considerable importance to external borrowing as a source of finance, the government managed to raise only \$50 million in external loan finance between 1951 and 1960, and almost all of this was raised prior to 1955 (Table 8, p. 48).

The achievement of independence in 1957 permitted Malaya to borrow outside the United Kingdom, but enabling legislation was not passed until May 1963. The recurring weakness of sterling (the currency to which the Malayan dollar was tied) discouraged borrowing in New York and other financial centres, for a sudden devaluation of sterling would have made such borrowing exorbitantly expensive. All factors combined to produce a strong preference for financing expenditure commitments by taxation rather than by borrowing; the growth of government expenditure was restrained by the growth of domestic finance, the potential contribution of external borrowing to economic development being heavily underplayed. The argument that, by ensuring monetary stability, the Currency Board mechanism increased the external borrowing capacity of the Malayan government, deserves to be reassessed.

The strong desire to maintain government expenditure on development projects despite a fall in rubber prices has renewed interest in external borrowing, particularly since 1962. Loans have been secured from the IBRD, the United States Development Loan Fund, and the United Kingdom Export Credit Guarantee Department. Loans floated on the London market in 1963 (\$45 million) and the New York market in 1965 (\$76 million) were oversubscribed, but Malaya cannot afford to rest on the laurels of past achievements. The added responsibilities

imposed by such factors as the formation of Malaysia, the problem of high population growth, and the question of defence commitments, underline the pressing need to explore and exploit all potential sources of external finance. The machinery for effecting the requisite financial effort should be moulded and tested for adequacy in advance of need.

Apart from the public authorities, the government sector of Malaya and Singapore has made only limited use of international lending agency facilities. Like the IMF, the IBRD and its associate bodies, the International Development Association (IDA) and the International Finance Corporation (IFC), will lend only to countries which they consider pursue policies realistic in relation to the country's resource base, and which they judge to be creditworthy. Like the IBRD, the IDA concentrates its lending on the development of basic services. A project submitted for IDA financing is expected to meet the same technical, economic, financial, and administrative standards as the World Bank would require. The main difference is that loans are repayable in whole or in part in local currency. The main function of the IDA is to assist countries unable to expand their external debt further because of servicing difficulties. The IFC is designed to stimulate the growth of private enterprise in member countries. Its main function is to provide finance in association with private investors.⁵ Malaya and Singapore rank high in respect of the two tests for assistance from these agencies—both pursue policies realistic in relation to their resource base, and there can be little dispute over the creditworthiness of either country. Unfortunately, practical limitations have restrained the exercise of potential borrowing rights by both countries.

In order to raise loans from international lending bodies, even more comprehensive and detailed information is required than in the case of loan raising in the main financial centres of the world. The IBRD lends on a project basis and insists that not only must technical, financial,

⁵ The IBRD and its affiliate, the IFC, combined to provide loan and share capital equal to \$26.5 million to the Malayan Industrial Development Finance Limited. The MIDFL was established in March 1960 by local and foreign investors to assist in the expansion of private industry in Malaya. The IFC subscribed \$0.5 million in new shares issued by the MIDFL. The IBRD loan, equal to \$26 million, will provide foreign exchange for the company's lending to Malayan industry. The function of the MIDFL is to provide long-term capital in any form considered appropriate to the needs of its clients—equity capital, medium- or long-term loans or other action designed to provide financial and technical assistance for the expansion or creation of industrial capacity. It is hoped that the expansion of its financial resources will enable the MIDFL to adopt a more active policy of industrial development.

managerial, and other aspects of any project be worked out in detail, but that the selected project should be amongst the best of all alternatives, have a high social value, and a high priority within any co-ordinated, national development program. Moreover, the Bank will lend only if it is convinced that the borrower cannot obtain finance from other sources on reasonable terms. Such rigorous requirements lay bare the reason for Malaya's failure to secure loans from international bodies. Apart from the public utilities, detailed blueprints which would satisfy the requirements of international lending bodies are rarely prepared. The Economic Planning Unit, which has the responsibility for drawing up complete specifications in Malaya, is seriously understaffed, and has not been able to devote purposeful attention to this particular issue. If Malaya and Singapore are to exploit their international credit standing, it may be necessary to set up a separate department designed to investigate a wide range of potential loan commitment projects. Moreover, if the department is to achieve results, it may be necessary to staff it with engineering, technical, and other consultants selected, for example, by the international lending bodies. Malaya and Singapore will be able to explore international and bilateral lending agencies and markets more fully only when they have built up a stock of carefully evaluated development projects.

It can be argued that the lending policies of the IBRD and the IDA restrain the borrowing rights of Malaya and Singapore. Both bodies have stressed that loans will be granted mainly for the provision of basic economic overhead capital—electric power, transportation, telecommunications, water supply, flood control, and related activities. Yet economic services are already reasonably well developed in Malaya and Singapore. Much, of course, remains to be done. But, equally important, much must be done in the field of social investment—housing, education (particularly technical education), and health services—merely to keep abreast of population growth. Furthermore, if the dependence of Malaya on the export of rubber and tin is to be reduced, a substantial fillip must be given to agricultural diversification and to industrialisation. The IBRD has been reluctant to lend for such purposes because potential outlays in these directions would quickly exhaust the resources of the Bank. However, Malaya has succeeded in raising three loans from the IBRD for reasonably well defined land development schemes (\$135 million in 1965 towards work on the Muda river irrigation project, \$30 million in 1967 towards the Kemubu river irrigation project, and \$42 million in 1968 towards the first phase of the Jengka land development project being undertaken by the Federal Land Development Authority).

Apart from private capital flows, the respective governmental authorities should be able to arrange further financial accommodation from the IBRD, the IDA, and the IFC, and rely more heavily on facilities offered by such bodies as the Asian Development Bank, the United States and Japanese Export-Import Banks, the U.K. Credit Guarantee Department, and the Commonwealth Development Corporation. But, in general, success in raising loan finance from these bodies will depend on the enterprise and skill of the respective governmental authorities in drawing up a case for which the international bodies would find it difficult to refuse assistance.

There is a need to cast aside many of the apprehensions the Malayan government has had about external loan finance in the past. Malaya is aware of the flexibility permitted even under a Currency Board system of money creation, and there is every prospect that its balance of payments problem will not seriously hamper economic development in the more distant future. Many nations (including, for example, Australia) have found external borrowing an extremely cheap source of development finance, for world inflation has, over time, eroded the real value of the associated contractual obligations. There would appear to be a more than even chance that world inflation will continue into the future. One way which Malaya could move in order to offset the effect of further adverse movements in the terms of trade on the domestic economy would be by raising more external loan finance. The more extensive use of loan finance raised from the more advanced nations of the world would seem to be one way that the less developed countries can check the gradual redistribution of real wealth away from them in favour of the more advanced nations.

FOREIGN GRANTS

Financial grants have been provided to Malaya and Singapore on a limited scale by the United Kingdom and the British dominion territories. Prior to independence, most economic assistance was provided under the Colonial Development and Welfare Scheme. But Asia received less than 10% of total disbursements under this scheme between April 1946 and March 1959. C. D. and W. grants flowed mainly to the less developed British colonies in Africa and the Caribbean.

Allocations from United Kingdom departmental grants for colonial services have been the most important source of grant finance, but these grants were made largely in connection with defence expenditure during the period of the Emergency.

Following the achievement of independence, the form of grants has changed from emphasis on financial assistance to emphasis on technical assistance. Both Malaya and Singapore have availed themselves of skilled manpower and other forms of technical and educational assistance offered by British dominion territories under programs such as the Colombo Plan. In addition, both countries have sought planning advice from the IBRD and the IMF and have retained close relations with the United Kingdom at the personal and technical assistance levels.

I I

State and Local Government Finance

STATE GOVERNMENT TRANSACTIONS

The Malay peninsula, slightly less than half the area of Australia's second smallest state, Victoria, is divided into eleven separate States, each with its own royal hierarchy (Sultanate), Parliament, and complex administrative machinery. The constitution virtually precludes the amalgamation of existing States; a law altering the boundaries of a State cannot be passed without the consent of the States affected.

Aggregate State government expenditure more than doubled between 1950 and 1957. The provision of social services, particularly in the fields of education and health, represented the main expenditure head, and was the principal cause of the massive rise in the level of State government expenditure after 1950. During this period, the State governments depended on Federal grants for more than half of their revenue. Following a review of the financial provisions of the Federation of Malaya Agreement of 1948, the Federal government assumed direct responsibility for education and health expenditures in 1958. This redistribution of functional responsibilities was expected to produce a closer relationship between State government revenue and expenditure. Compared with social services, expenditure on economic and community services—roads, bridges, irrigation and drainage facilities, extension services to the agricultural sector, water supply, and sewerage—had risen less rapidly and represented only 38% of total State government expenditure in 1957. While the Federal government appreciated that the growth potential of the main sources of State government revenue was limited, it was expected that the States would be able to sustain the modest annual expansion in the level of their expenditure on economic and community services which had occurred since 1950. However, as a result of a change in the Federal government's attitude to its role in the development of the economy, increased attention was given to the

problems of the smallholder sector of the economy relative to those of the estate sector after 1960. To effect this policy reorientation, the Federal government found that it had to place increasing dependence on State government initiative, for the switch in emphasis effectively increased the relative importance of State government functions in total government operations. In consequence, State government expenditure, which was almost halved between 1957 and 1958, rose rapidly to heights which eclipsed the peak reached in 1957 (see Table 12, p. 58) and, in 1965, the State governments were responsible for one-quarter of total government expenditure. With little expansion of State government revenue, substantial budget deficits have re-emerged.

Federal government grants have been the main source of deficit finance but the pattern has been broadened since 1960 to include loan finance (Table 12). As was the case before 1957, the implication of the present financial position of the State governments is that they do not possess tax powers commensurate with their responsibilities for providing government services. The question which needs to be explored is whether the State governments are making reasonable use of their present tax powers. If they are, the choice confronting the government sector in Malaya is whether expenditure objectives may be achieved more effectively: (a) by maintaining the existing financial pattern; (b) by transferring more State government functions to the Federal government; or (c) by increasing the fiscal autonomy of the State governments by means of a redistribution of tax powers from the Federal government to the State governments. If, on the other hand, it can be shown that the State governments have not seriously attempted to explore the potential of their present tax powers, a strong case can be made for encouraging them to do so. The financing of Federal government expenditure is becoming increasingly difficult, and the burden is unnecessarily increased if the Federal government is required to subsidise lower tiers of government which, for a variety of reasons, fail to tap their own sources of finance effectively. It may very well be that the ease of obtaining Federal grants deters State governments from the politically distasteful and historically unpopular task of exploiting their own revenue sources more fully. This issue has been reserved for more detailed consideration in Chapter 12. The concern of this chapter is to investigate how far State governments have made use of their present tax powers.

State Tax Revenue

There are four main State taxes: taxes on land, taxes on specific natural resources (royalties), excise taxes (including entertainment duties), and

licence taxes. While total State tax revenue has almost trebled since 1950, land tax revenue has barely doubled, with the result that its share of total tax revenue had fallen from 50% in 1950 to 35% in 1965. The main cause of the rise in State government revenue has been a rise in forest royalty income as a result of a substantial increase in the extraction of forest products since 1950. The coverage of State excises is restricted to one product, toddy, an intoxicating liquor extracted from the growth shoots of the coconut palm. The relative importance of excise revenue in State tax revenue has declined slightly since 1950. Entertainment and licence taxes are levied on a wide range of activities and, largely because of population growth, the relative importance of revenue from these levies has been broadly maintained.

Three major problems plague State taxes. First, for most levies, tax rates have not been changed since 1950. In the course of time, the real value of revenue derived from these levies (most of which are set at specific rates) has been eroded. Second, tax coverage and tax rates vary considerably among States. Third, there are large-scale problems of tax avoidance and evasion. Auditor-General reports on State accounts attest to numerous irregularities (particularly in the issue of licences) and to substantial backlogs in the collection of due revenue (particularly land rent).

Similar problems arise in respect of State government non-tax revenue. The States, for example, are responsible for the maintenance of drainage and irrigation projects and are permitted to collect such fees as they see fit from those who benefit from the schemes. Yet, in most States, revenue collections cover only a fraction of maintenance costs. Most beneficiaries have been prepared to pay higher fees when they have seen the fruits of drainage and irrigation projects but, because State governments are heavily dependent on rural voters, politicians have avoided upward fee adjustments for fear that such action would erode the basis of their political support.

The failure of the State governments to utilise their tax powers more effectively has encouraged the Federal government to assume responsibility for some taxes which would otherwise be regarded as State taxes (State lotteries and most motor vehicle taxes) or as shared Federal-State tax responsibilities. In 1962, for example, the Federal government appropriated State tax rights over iron ore because differences in the royalties levied by each of the main iron ore-producing States made the task of collecting Federal export tax revenue more difficult. The Federal government has realised that, if the States were given complete control over major taxes, a widening gap would result between actual and potential revenue yield.

If the States are to halt (let alone reverse) this centripetal trend, an attempt must be made to eliminate the glaring deficiencies apparent to the Federal government in the administration of States taxes. One step which could assist in reviving Federal government confidence would be the voluntary establishment by the State governments of a central body (an Interstate Tax Advisory Committee) responsible for advising the States on tax policies, for achieving a greater degree of co-ordination and co-operation among States in the exercise of State tax rights, and for establishing a training scheme aimed at producing staff capable of tackling problems of tax avoidance, evasion, and delinquency. In addition, the States could, through the Committee, present a joint case to the Federal government in discussions on Federal-State tax rights and on Federal-State grants.

While it may be argued that the States have not fully utilised their tax powers, it should also be added that the growth potential of most State tax heads is very limited. Even if excise, entertainment, and licence tax rates were doubled, the resulting increase in revenue would not significantly reduce the heavy dependence of the State governments on Federal grants. Moreover, the cost of collecting a unit of State revenue is, on average, more than ten times as high as that of collecting a unit of Federal government revenue. Although the States should explore the scope for expanding the role of land taxes more fully (and a more detailed analysis of the structure, performance, and problems of land taxation is made later in this chapter), a redistribution of tax functions between the centre and lower tiers of government would be required if the independent tax powers of the State governments were to be significantly increased. Such a redistribution would be appropriate, however, only if the State governments succeeded in rationalising the structure and performance of their present tax rights.

One further financial issue concerns the borrowing rights of State governments. The Federal government is responsible for raising loan finance on behalf of all levels of government. This arrangement has many advantages. Loans can be raised more easily in international financial centres against the credit-standing of the Federal government than against the credit-standing of any of the State governments alone. Further, as the State governments have discovered in recent years, loans can be raised from the Federal government without the need to provide the meticulous blueprints of investment projects which would be required if the State governments were to raise loan finance from other sources. Consequently loan finance, used sparingly for many decades because of the mistaken belief that loan projects should pay for them-

selves, has emerged as an important source of State finance since 1960. Nevertheless, too much reliance should not be placed on this source of finance. With increasing demands being made on Federal government revenue, it is possible that the ability to obtain loan finance from the Federal government may be more limited in the near future. Expenditure commitments undertaken on the assumption that there will be a continuous flow of Federal loan finance may then have to be retrenched. To be assured of more than a trickle of Federal loan finance, the State governments should start preparing more detailed blueprints of investment projects. Apart from the uncertainty factor, heavy dependence on Federal loan finance involves a further sacrifice of independent State action—decisions as to which projects are to be accepted as a loan commitment are a Federal rather than a State responsibility. There is no escape from the impasse that, if State spending powers are not to be drastically curtailed, greater endeavours must be made to exploit the potential of present State revenue heads.

LOCAL GOVERNMENT TRANSACTIONS

Four types of local governmental authority may be distinguished in Malaya. The first group includes the municipalities of Kuala Lumpur, George Town, Malacca, and Ipoh. All four bodies are financially autonomous and, apart from Kuala Lumpur, fully elected.¹ Second, most of the large towns have fully elected, financially autonomous town councils which differ from the municipalities only in that their scale of operation is much smaller. Third, many of the smaller towns have local councils and, finally, in the rural areas, a large number of rural district councils have been formed.

Local government expenditure amounted to one-third of State government expenditure in 1965. Most of this expenditure was undertaken by the municipalities. In fact, the expenditure of the four municipalities equalled that of all 375 other local authorities in 1965. Moreover the ratio of capital to total expenditure was much higher for municipalities (46%) than for other local authorities (20%). While municipalities are able to undertake important capital development projects such as sewerage and water supply, the transactions of most local authorities are confined to current account items, road and market maintenance being the main expenditure heads.

¹ Following Kuala Lumpur's designation as the national capital of independent Malaya, its elected municipal council was replaced by a nominated council in April 1961.

The pattern of local government finance is similar to that of State finance—considerable dependence is placed on Federal and State government grants. Taxes on land and buildings amounted to 75% of total tax revenue in 1965, the only other important tax head being licence charges.

In contrast to the State governments, the municipalities and some of the councils in larger towns have made serious attempts to explore the potential of taxes on land and buildings. Licence fees cover a wide range of activities. While imposed for regulatory purposes, the fees normally include a tax component. As in the case of land taxes, tax coverage is wider, tax rates are higher, and enforcement measures are more thorough in the larger than in the smaller towns, and in the urban than in the rural areas.

Some local authorities achieve better budgetary results than others. The contrast is particularly marked between large and small towns and between urban and rural areas. It is easier to collect revenue in urban areas and, in addition, services can generally be provided to users at a lower cost. In fact, the municipalities and some of the councils in larger towns manage to achieve a close relationship between revenue and expenditure even though they provide a wider range of services than most other local authorities. Moreover, despite the importance of the rural vote, the locational distribution of Federal and State government expenditure has increased, rather than reduced, the disparity in the range and standard of services provided in the various local authority areas. Initiative from below has guided the distribution of Federal and State government expenditure. It is easier to assess community demands, to draw up co-ordinated development programs, to stress an urgent need for action, and to enlist community support in urban than in rural areas. Within the urban sector, the Federal and State governments both tend to give greater weight to the voice of the larger towns than they do to the voice of the smaller towns.

If social and community services are to be provided more adequately in the rural areas and in the smaller towns, the role of local authorities must be strengthened, for they are best able to obtain an accurate assessment of local demands. Federal and State government subsidy payments to local authorities in backward areas will have to be increased, but sufficient care should be exercised to preserve an impression of self-help, self-achievement, and local autonomy. As a result of improvements in the provision of basic community services, the taxable capacity of ratepayers may increase. The local authorities should not be subsidised in such a way that they feel no pressing need to capitalise upon such

increases. Maximum emphasis on self-help is a prerequisite for the healthy development of local government.

Because the provision of services and the collection of revenue is more costly and difficult where population is widely dispersed, rural authorities would normally need to depend more heavily on Federal and State government assistance than would urban authorities. This difference in performance has important implications for the division of tax powers between State and local authorities. Since local authorities in urban areas can be expected to perform more functions than their rural counterparts, their tax powers should similarly be greater if an adequate degree of local autonomy is to be achieved. Land tax is the main source of State and local government revenue. It is therefore proposed that, in the urban areas, local authorities should be responsible for imposing taxes on land and on buildings, and supplementary State taxes should be kept low. In the rural areas, however, the State governments should be the main tax agents, local authorities being restrained from imposing heavy taxes on land outside village areas. Rural budgets will normally be smaller than urban budgets. The rural authorities should, however, be encouraged to make suggestions to the Federal and State governments regarding the educational, health, and other needs of their communities. It would then be the task of the Federal and State governments to achieve a desired degree of equality in the provision of services to urban and rural citizens.

LAND TAXATION

The revenue performance of land taxes levied in Malaya has not been impressive. Property taxation is well developed in a handful of the larger cities—Kuala Lumpur, George Town, Malacca, Ipoh—but elsewhere land taxes are of minor consequence. Rural land, in particular, is very lightly taxed.

As indicated in the preceding section, land tax rights are shared by State and local governments. The constitution prevents the Federal government from imposing any taxes on land. Moreover, there is no legislation which permits the Federal government to receive a share of State and local government land tax revenue. Land tax is the one important tax head over which State and local governments have complete control. The tax base for State levies differs from that used by local authorities.

State Land Taxation

Each of the eleven States of the Malay peninsula formulates its own land tax policy; there is no machinery for co-ordinating tax policies among

States. But although tax rates vary, the structure of taxation is broadly similar in all States.

The first feature which requires clarification is the structure of land ownership rights. All unalienated land is State land. Alienated land may be leased from the State under one of several titles. Although increasing use has been made of short-term (33 to 99 years) leaseholds in recent years, most alienated land is held in perpetuity.

State land taxes are based on land area. All States have title registries and each title specifies land area involved.² Taxes based on land area and supported by adequate title registries are more easily administered than most other land taxes; the difficult problems of land valuation and revaluation, for example, are avoided.

Within each State, a distinction is drawn for tax purposes between rural and urban land, tax rates being much higher on urban land. Most States draw a further distinction between land—rural and urban—reserved for Malays and other land, lower taxes being imposed on land within Malay reservations. Tax rates on rural land (within or outside Malay reservations) differ according to the use made of the land. The majority of States distinguish five land-use categories—rice, rubber, other crops, mining, and kampong land. Within each category, the tax assessment is set at a fixed amount per acre. Normally small lots (10 acres or less) are subject to lower per acre tax rates than larger holdings. In most States, holdings with good accessibility (whether by road, rail, or water) bear higher tax rates than holdings with poor accessibility and, in general, tax rates are lower in the poorer eastern States than in the western States. In no State is there provision for the payment of taxes in kind. Taxes on rubber land account for approximately 75% of total land tax receipts.

Table 49 shows State tax rates for different categories of rural land for the year 1965. Several points stand out. First, taxes on rubber land are heavier than taxes on other land-use categories. In effect, an attempt has been made to take account of the income-producing capacity of land. But the attempt is very rudimentary. Administrative problems multiply rapidly as the number of rate classifications increase. As Wald has pointed out, 'as a practical matter . . . there cannot be as many rate classifications as there are different grades of land. At best, the classified

² State title registries are built up on a *mukim* (sub-district) basis. Each title shows the owner, acreage involved, annual rental (land tax) payment, nature of cultivation (rice, rubber, kampong land, etc.), condition of cultivation (no rubber to be grown, etc.), and any restrictions on title (State mineral right reservations, etc.).

Table 49 States of Malaya: land rents by categories of land use, 1965

States	Rent per acre per annum (\$)				Restrictions on rent revision (years)	Restrictions on rate increase (%)
	Rice land	Rubber land	Mining land	Kampong land		
Johore:						
Malay reservation	0.50	0.50	5.00	3.00	30	no limit
Other	1.00	1.00	5.00	4.00	30	no limit
Kedah:						
Malay reservation	1.00	1.00-4.00	1.00	1.00-3.00	30	50
Other	1.00	1.50-5.00	1.00	1.00-3.00	30	50
Kelantan:						
Malay reservation	1.00	0.40-1.00	1.00	1.00-1.50	15	25
Other	1.50	1.00-4.00	1.00	1.50-4.00	15	25
Malacca:						
Malay reservation	3.50	5.00	—	12.00-18.00	30-33	50
Other	4.00	5.00	—	15.00-30.00	30-33	50
Negri-Sembilan:						
Malay reservation	1.00	1.50-6.00	2.00	2.00-3.00	30	50
Other	1.00	2.50-10.00	2.00	4.00-6.00	30	50
Pahang:						
Malay reservation	1.00-1.50	1.00-9.00	2.00	2.00	30	50
Other	1.50	1.50-5.00	2.00	3.00	30	50
Penang:						
Malay reservation	1.00	3.00	—	4.00	33	50
Other	1.00	3.00	—	4.00	33	50
Perak:						
Malay reservation	1.00	1.50-6.00	2.00	1.50-6.00	30	50
Other	1.50	2.50-10.00	2.00	3.00-12.00	30	50
Perlis:						
Malay reservation	1.00	1.00-1.60	—	1.00	30	50
Other	1.00	2.50	—	2.00	30	50
Selangor:						
Malay reservation	1.00	1.50-6.00	2.00	1.50-6.00	30	50
Other	1.50	2.50-10.00	2.00	3.00-12.00	30	50
Trengganu:						
Malay reservation	1.00	2.00-4.00	1.00	2.00	no limit	no limit
Other	1.50	2.50-5.00	1.00	3.00	no limit	no limit

Source: Data supplied by the Land Departments of each State.

rate area tax can recognise only a few broad economic categories of land' (1959: 13). It may be argued, however, that the number of rate classifications in Malaya could be increased without adding significantly to administrative problems. No distinction, for example, is drawn between different categories of rice land—wet and dry paddy, single and double crop wet paddy. If State taxes continue to be based on land area, a greater effort could be made to tax in accordance with the income-producing capacity of land. The present tax structure is poor in yield, equity, and incentive effects.

Second, concessional land tax treatment is granted by most States to certain forms of agricultural activity. Rice land, for example, has been taxed very lightly in the expectation that low tax rates would stimulate production and so reduce Malaya's dependence on imported supplies. In recognition of the fact that a 6–7 year gestation period is required before rubber trees commence to produce output, reduced tax rates have been granted for newly planted (and replanted) rubber land. In the post-World War II period, endeavours have been made to diversify Malaya's agricultural structure, and in support of this policy many States have extended concessional land tax treatment to such crops as pineapples, copra, cocoa, tea, and coffee. The issue which needs to be raised is whether concessional land tax rates do have a significant impact on resource allocation in Malaya. The variation of tax rates will affect the pattern of production if such taxes represent an important item in total production costs. But, in Malaya, rural land tax rates are set very low—for most crops, the expectation of a marginal (1%–5%) fall in market price (or rise in costs net of land taxes) would more than offset the 'incentive' effect of a 50% reduction in land tax rates. Moreover, the main crops in Malaya—rubber and rice—are not close production substitutes. Despite the expectation of a continued fall in price, rubber remains more profitable than most alternative crops. In these circumstances, a reduction in per acre land tax rates for selected crops would not have a material effect on the pattern of production. Concessional tax treatment therefore involves a loss of government revenue for which there is little compensating gain.

Why, then, are land tax rates set so low? This question can best be answered by surveying the historical development of land taxation in Malaya.

The early taxes, imposed in the middle of the nineteenth century, followed the Indian 'permanent settlement' pattern—tax rates were fixed in perpetuity. During the second half of the nineteenth century, revenue from land sales matched the importance of land taxes as a

source of government finance. But, as the opening of new land began to taper off after 1910, the impact of a steady fall in the value of money on tax rates which were set in 1850 was starkly revealed in the form of a serious threat to State government finances. To remedy this situation, the Federated Malay States (Pahang, Perak, Negri-Sembilan, and Selangor) introduced land rent revision clauses in 1911 and at the same time co-ordinated their Land Laws. Shortly afterwards many of the unfederated Malay States followed suit with the result that, although tax rates varied, the structure of land taxation was basically the same in all States.

The rent revision clause introduced by the separate State governments applied only to land alienated after 1911. There was (and there remains) no provision for the upward adjustment of tax rates on land alienated before 1911. This point is central to an appreciation of the reasons for the present low level of State land tax rates. Much land had been alienated before 1911. To recoup losses due to the gradual erosion of revenue derived from this land, tax rates on new alienations had to be set high. But, compared with land taken up before 1911, much newly alienated land was marginal. To subject only this land to high tax rates and to future upward rate adjustments involved considerable scope for unfairness in the treatment of taxpayers, and the State governments were unwilling to foster such injustice. The importance of the rural vote in the post-World War II period has further reduced the possibility of discriminatory taxation based on the date of land acquisition. Consequently, present land tax rates are heavily influenced by the level of tax rates set in the latter half of the nineteenth century.

Land taxes were adjusted upwards in 1911, the extent of revision being determined by the financial needs of the separate State administrations. Most State Land Laws stipulated a minimum period of thirty years before rates could be revised again. But the year 1940 coincided with the imminent invasion of the Malay peninsula by the Japanese. As a result, rate revision was held in abeyance. An attempt to re-assess tax rates was made in 1947, but it was not until 1951 that the first general revision occurred. The revision achieved little. In most cases, State Land Laws prevented upward adjustments in excess of 50% of ruling rates, and few States were prepared to adjust rates up to the maximum level, partly for fear of incurring political displeasure and partly because the free flow of Federal grant finance removed the need for self-help. The situation has not changed since 1951. Unless the law is altered, the next major revision of rents cannot be made until after 1980. The burden of State land taxation, which has never been heavy, has been whittled

away to insignificance. Moreover, the attitude has developed that little can be done to improve the situation, for the difficulties are too great and too complicated. But as pointed out in the recent report on land administration in Malaya, 'laws are made by man for the benefit of man. They are not immutable. They must necessarily be changed from time to time to meet changing conditions and circumstances. Their dominant purpose is to introduce order, to stimulate progress, to regulate conduct and to benefit the people' (Federation of Malaya 1958: 4).

With the transformation of land taxes into token payments, it would be reasonable to expect a corresponding decline in the standard of land tax administration. This has happened in almost all of the States. At consecutive budget times, strong endeavours have been made to hold down the level of expenditure on land tax administration. The arguments in favour of retrenchment are strong. Rice land and land within Malay reservations are the two land-use categories for which enforcement effort is most anaemic. Any increase in administrative effort would need to be concentrated here. But these are the very categories from which, at existing tax rates, revenue yield is barely sufficient to offset associated administrative costs. Although it can be argued that an increase in administrative expenditure today will increase revenue tomorrow, the counter-argument is that, given the present structure of land taxation (tax base and tax rates), the gain in revenue would not adequately compensate for the increase in administrative costs. In fact the States clearly appreciate that, for any given increase in administrative costs, a greater increase in receipts can be obtained by concentrating effort on endeavours to expand (or alter) the flow of Federal-State grant and loan finance.

Land Tax Departments in all States are consequently plagued by the problem of inadequate staff and, more particularly, by the problem of an acute shortage of trained staff. Staff switches between land tax and other departments are frequent, and there are insufficient super-scale positions to enable the best clerks to be retained. There are often long delays in the mailing of assessments with the result that tax payment arrears have reached serious dimensions. In addition, delinquency has become a major problem in the post-World War II period. Penal sanctions are light and can be ignored with impunity, and few States are able to apply consistent enforcement pressure to ensure taxpayer compliance. Moreover, the potentially explosive issue of illegal squatting on Crown land is dealt with very leniently. The *nominal* burden of State land taxation is low—in practice, collection deficiencies reduce the *real* burden still further.

Local Government Land Taxation

In contrast to State land taxes, local authority levies are based not on land area but on land (including building) value. The levies, introduced into Malaya from India by the East India Company in the latter part of the eighteenth century,³ adhere strictly to British rating practice—annual rather than capital value forms the tax base. Annual value is usually defined in Malaya as the estimated gross annual rent at which any holding might reasonably be expected to be let from year to year, on the assumption that the landlord bears not only repair, insurance, and maintenance costs required to maintain the property in a state to command that rent, but also public rates and taxes. Four points need to be emphasised. First, the aim is to determine and tax the rental which would be charged under normal competitive supply and demand conditions rather than actual rental income, since the latter may be distorted by a host of temporary factors. Second, annual rental value is based on current rather than probable future property use. A dwelling house is valued as a dwelling house, no account being taken of the fact that it may, for example, be about to be converted to some other purpose, such as a service station or shop. Third, the tax base places an annual value not only on location and other inherent qualities of taxable property, but also on value added by past improvements. Finally, payment responsibility is placed on the owner rather than the occupier. This provision is designed to assist revenue collection and to make the recovery of arrears more certain than would be the case if the authorities were to proceed against individual occupiers.

In contrast to the position in many other countries, no differential has been established in Malaya between the tax treatment of land and buildings. Most local authorities draw a distinction between urban and rural land, lower tax rates being imposed on rural land where fewer facilities are provided. But, in general, the number of differential rate classifications are few. Rarely, for example, is a distinction drawn between residential and non-residential property. Tax policy for unoccupied land varies among local authorities, but most grant concessional treatment.

³ The first British settlement in Malaya was made by the East India Company on Prince of Wales Island in 1786. The laws applicable to the East India Company's possessions in India (including land tax laws) were automatically extended to Prince of Wales Island. The spread of British settlement in Malaya gradually extended the coverage of Indian rating principles. The East India Company had originally derived its rating principles from British practice.

A major point of difference between large and small local authorities centres on the level of tax rates. Compared with the municipalities, tax rates are much lower within most town and rural district council areas. Moreover, whereas the municipalities are prepared to vary tax rates from year to year in the light of budget requirements, most local authorities tend to maintain a fixed percentage rate for many years.

Compared with State government land taxation, the debatable issues and problems of local authority levies are far more complex. The first issue is the question of the tax base. By comparing annual with capital value taxes, the limitations of the present base are clarified. Annual value taxes are based on current property use; capital value taxes are based on current and prospective property use. The main advantage of capital value taxation is that local authorities automatically share in the gains derived by property owners as towns develop. If, for example, a town is developing rapidly, people may buy property not so much for its current use as for the use they expect to be able to make of the property in the future. The true capitalised value of the property therefore exceeds the capitalised value of its current rental. 'In effect, taxing capital value is a means of reaching both current income and wealth, whereas taxing annual value permits reaching only the former' (Wald 1959: 26). The economic effects of annual and capital value taxes therefore differ. In particular, capital value taxes discourage speculative property transactions, a problem which has reached sizeable dimensions in many Malayan towns. The Federal Finance Minister, for example, in introducing a short-lived tax on capital gains in 1965, stated that it was obvious that 'in the circumstances of Malaysia's prosperity . . . considerable gains from the sale of property . . . have been obtained by some taxpayers. These gains in some cases, have not attracted any tax except quite nominal stamp duties' (Malaysia 1964: para. 114). In the same speech, the Finance Minister hinted that, in some cases, development programs had been seriously retarded because speculators had held land off the market in the expectation of being able to sell at a higher price in the future.

The second issue is whether a differential need be established between the tax treatment of land and buildings. A tax imposed solely on unimproved land value would encourage building activity and discourage land hoarding and speculation. Conversely, an equal revenue tax imposed on buildings (improved value) would discriminate against building activity. A tax on land and building value represents a compromise tax. But if both components are taxed at the same rate, as is the case in Malaya, building activity will be discriminated against more heavily than land

speculation because buildings normally form the more important element in total value. Thus, if land speculation is to be discouraged, it may be necessary to impose a higher tax on unimproved than on improved property value. Or, if more revenue is to be raised but building activity is not to be discouraged, tax rate increases may need to be concentrated on the unimproved value component. Tax rate differentials can therefore be used to encourage or discourage certain forms of activity provided land tax administrators draw a distinction between improved and unimproved property value. Wald has pointed out that 'because it is relatively easy to identify the specific assets to be taxed or left untaxed, the capital value approach lends itself more readily to selectivity in the definition of the tax base than does the annual rental value approach' (1959: 27). The Malayan tax administrators have not made any attempt to divide rental income into unimproved and improved value components.

The third issue is whether tax rates should differ according to property use. Should higher taxes be imposed on non-residential than on residential property? Should a tax rate distinction be drawn between industrial, commercial, and certain special categories of non-residential property (e.g. theatres)? Should taxes on unoccupied land be derated? Land taxes rank as a deductible expense for income tax purposes so that firms subject to income taxation gain some relief for land tax payments. The full land tax burden is borne only by firms (and individuals) outside the income tax net. It is for this very reason that higher taxes on non-residential than on residential property may be justified. Land taxes are one of the few taxes levied directly on small firms, and the additional levy on non-residential property may be regarded simply as a 'business activity' charge. In many instances, the levy would be related only indirectly to the earning capacity of firms (the case of professional people—lawyers, doctors, dentists, accountants—is one clear example). But for firms outside the income tax net, land and buildings normally represent a major fraction of total capital assets and a reasonable measure of ability to pay. Part of the tax burden may be passed forward to consumers (or backward to factors of production) but, because competitive forces are strong among small firms, it is likely that the owners of small enterprises bear a high proportion of this tax.

Revenue requirements and policy objectives will determine whether concessional treatment is to be extended to certain forms of activity (for example, new industrial enterprises). Care should be exercised, however, for considerable assistance is already extended under the Federal Income Tax Ordinance; competition among local authorities in granting concessions may lead merely to an unnecessary loss of revenue.

The case for reduced assessments on vacant land (and unoccupied premises) lacks purpose except in the instance where town planners refuse an owner permission to develop his land.

The major problem of local authority taxation centres on the determination of annual rental value. The aim of the assessment procedure is to distribute the tax burden among properties in an equitable manner. To achieve this objective, considerable responsibility is thrown on to the administrative machinery. But in almost all local authorities, the administrative machinery is not geared to fulfil its responsibilities. No official records are kept of rents paid by tenants for various properties. Actual rental is rarely an accurate measure of true rental value, the relationship being distorted by such factors as rent control, inflation, and differences in the bargaining power of tenants and landlords. Nevertheless, in many instances, rental data will provide important circumstantial evidence as to the level and trend of true rental value. Further, in relation to the magnitude of the task, the number of qualified assessment officers is pitifully low—almost all local authorities are forced to rely on unqualified staff.

In these circumstances, it is inevitable that there will be numerous assessment anomalies. Common standards of appraisal are rarely applied. There is no mechanism—apart from general revaluation—by which property values may be adjusted in step with longer-term changes in economic conditions (such as increased land values due to the expansion of towns). Except in the municipalities and some of the larger towns, general revaluations are rare; for most local authorities, the last general revaluation was carried out before World War II. As new properties are added, glaring discrepancies become apparent—many instances can be quoted where markedly different valuations have been placed on similar houses in a single street. Rather than revaluing listed properties (and consequently incurring the animosity of most taxpayers), local authorities keep assessment lists roughly in line by under-valuing new properties. Because of a lack of specialised assessors, large commercial and industrial properties are often under-assessed (see Love 1959: 56). And, compared with rented property, owner-occupied property is consistently under-valued, the degree of under-valuation being greater the higher the value of the property. Thus, in most local authority areas, valuation lists are out of date and contain numerous assessment errors. The net effect of these errors is to create favoured groups of taxpayers who do not contribute their fair share towards necessary local authority expenditures. In particular, since a proportionately higher tax burden is borne by occupiers of rented property and by small property

owners, the tax base tends to be regressive; without revaluation, tax rate increases would magnify this regressivity.

As in the case of State land taxes, local authority levies are, for the most part, characterised by rigid rate structures and inadequate enforcement measures. Many local authorities argue that, by maintaining constant tax rates, the need for a general revaluation is postponed; existing inequities, in other words, are not magnified. But the cost is high, for existing inequities are perpetuated, revenue does not gain from rising property values, and the tax is drained of all flexibility.

Recommendations for Change

Apart from rubber growers, the rural community of Malaya is largely beyond the present tax net. Fiscal adjustments since 1945 have been concentrated on expanding the yield of income taxes and import duties; with the exception of the sharp rise in levies on rubber during the Korean War boom, taxes on agricultural produce and land have remained virtually unchanged. Income taxation has not extended beyond the highly commercialised plantation segment of the rural community. For the most part, land taxes are the only significant levy on the large non-plantation agricultural sector. But present rates of land taxation impose less of a burden on agriculture than they did pre-war when the rates were not regarded as being excessive. It would seem that land taxes could be increased considerably without unduly burdening the taxpayer. In view of the bias in Malaya's current development program towards rural development, it is more than reasonable to expect a measure of sacrifice on the part of the rural community (non-plantation as well as plantation) in step with that made by other sectors of the economy.

As indicated above, the jurisdiction of many local authorities does not extend into rural areas. Where it does, there is a substantial difference between the standard and range of urban and rural services. It can be argued that local authorities are best able to ascertain taxable capacity and requirements of the rural sector. But at their present stage of development in Malaya, local authorities cannot be expected to cope satisfactorily with the demands of the rural community. It is therefore proposed that the State governments should primarily be responsible for rural land taxation and development, and the local authorities for urban land taxation and development.

State Land Taxation. Rural land taxation is most in need of rehabilitation. But in making suggestions for change, priority must be given to considerations of administrative feasibility for, while it may be possible to increase the number of personnel engaged in the administration of

land taxes, a significant increase in the number of qualified personnel is less likely in the short term.

Of the issues which need to be settled, the question of the tax base is foremost. Several alternatives preferable to a primitive area tax may be suggested. A tax on the value of output, for example, must be ranked highly, for it can be adjusted to take account of taxpayers' ability to pay. For similar reasons, a tax on the market value of land has considerable appeal. But each alternative requires a high standard of administrative competence. In the absence of an increase in the number of qualified land tax administrators, the State governments are perhaps best advised to concentrate their attention on improving the present area tax base, despite the fact that such a tax can achieve only rough justice even when highly refined and well administered.

To be effectively implemented, an area tax requires a detailed knowledge of the potential productive capacity of land. As indicated above, land suited to rubber production should be taxed as such, regardless of current use. The assistance of technical experts may be required if land is to be zoned on the basis of inherent productive capacity. Little would be achieved if each State applied separately to the United Nations or other bodies for technical assistance. It is therefore proposed that the important task of assessment should be made the responsibility of the Interstate Tax Advisory Committee suggested earlier in this chapter. By placing responsibility in the hands of one body, assessment procedures could be standardised for all the States. Moreover, provision should be made for regular reassessment (once every ten years, for example).

If land taxes are to be rejuvenated, the State governments must be prepared to raise tax rates at the expense of incurring political displeasure. This point has three implications. First, rent revision clauses must be rewritten. The time has come when concessions extended to owners of land taken up before 1910 should be swept away; increases in tax rates cannot be justified unless the tax burden is distributed fairly among taxpayers. In Penang, for example, most land was alienated before the end of the nineteenth century. The ruling tax rate on this land is 15 cents per acre per annum. A commission on land administration in Malaya pointed to the comparatively small amount of revenue which Penang, one of the most prosperous parts of Malaya, received from lands, and added: 'it is . . . open to question whether persons should hold their land under the old titles, and receive all the unearned increment which the advancement of the community gives them, without making some appropriate contribution to the revenue' (Federation of Malaya 1958: 42). To introduce more flexibility into land taxation, provision

should be made for regular rate revision (probably every five years). In addition, the restraint imposed on the maximum extent of adjustment for any rate revision should be removed.

Second, the objectives of concessional tax rate treatment need to be reassessed. A case can be made for extending a limited amount of assistance to smallholders and to holdings with comparatively poor accessibility. In the same vein it may be argued that, because the average income per head of Malays is lower than that of Chinese and Indian residents, concessional treatment is justified for land within Malay reservations. However, such treatment does little to encourage the Malays to improve their lot and, by discriminating on account of race, the concession may add to communal disharmony. If, in the face of rising population, a premium is to be placed on increased productivity, this concession should be eliminated. Should the State governments extend concessional treatment to specific crops? Self-sufficiency is a national rather than a State objective. If for national reasons it is desirable to encourage the production of crops which may not make the best use of available land, concessional treatment should be granted by the Federal government rather than by the State governments. Thus, if rice production is to be encouraged and reduced tax rates are considered to be the best method of achieving this end, State governments should be reimbursed by the Federal government for any resulting loss of land tax revenue. Unless sanctioned by the Federal government, the State governments have no need (and certainly cannot afford) to extend concessional treatment to specific crops.

The most politically unpalatable problem centres on the extent of the increase in tax rates. To give but one instance, an increase in the tax paid for double crop rice land from \$2 to \$20 per acre per annum could well be justified. The percentage increase in tax payable would be greatest on rice land, since this is the most undertaxed land-use category. The existence of a central government rice stockpile encourages one to argue that rice growers should be permitted to pay tax in kind. If the stockpile paid a higher price for better quality rice, payments in kind could be used to stimulate improvements in the methods and quality of rice production.

Following the present practice, per acre tax rates within each land-use category would be standardised. A significant bonus would therefore be granted to more efficient producers.

Apart from tax rate co-ordination among States (a task of the Interstate Tax Advisory Committee), no basic change is proposed in the nature or level of State urban land taxation.

In all States, the administration of land taxes needs to be strengthened. If due revenue is to be collected, if records are to be kept up to date, and if adequate field and other cross-checks are to be made, the number and quality of land tax administrators need to be raised. The most pressing land administration problem centres on the backlog in the issue of titles. In Perlis, for example, many owners have ignored title boundary marks, extensive use is made of temporary occupation licences, and there is much illegal squatting. If regularised, it is estimated that land tax revenue in Perlis would increase by 50% (Federation of Malaya 1958: 56-62). In step with improved administration, penal sanctions would need to be strengthened.

Local Government Land Taxation. If local authorities are to be responsible to their constituents rather than to State governments, they need to develop an important source of finance over which they have complete control. Land taxes are ideally suited to this purpose—the tax base is localised, and tax rates can be adjusted to provide a significant, dependable source of finance broadly geared to the taxpayers' capacity to pay.

As in the case of State taxes, administrative considerations restrain the scope for local authority tax innovations. A case could be made for converting the tax base from rental to capital value. But since it would be difficult to incorporate within capital value a conjectural loading for prospective changes in land values,⁴ the gain from immediate conversion would not adequately justify associated costs. As revaluations are made, capital as well as rental values could be recorded, a distinction being drawn between improved and unimproved property values. In this way the path would be laid for a conversion to capital values at some future stage.

Property valuation and revaluation are the most difficult and problematical issues of local authority land taxation. The equitable administration of the tax requires the maintenance of a reasonably accurate and complete register of rental values. At present, few local authorities can increase tax rates without fear of intensifying unfairness in the treatment of taxpayers. Revaluation therefore deserves priority attention. Since few local authorities could afford to undertake complete revaluation, supplementary assistance should be sought (and granted on a loan basis in

⁴ This point is argued most succinctly by J. R. and U. K. Hicks who stated that 'in practice the development element in capital value has proved hard to catch. It is hardly possible, in practice, for an official to set a *higher* value upon a property than the amount which he can substantiate by unimpeachable evidence; if he attempts to do so, even on strong grounds, he can be almost certain that his decision will be set aside on appeal' (1955: 135).

accord with need) from Federal and State governments. The problem of obtaining the services of revaluation experts could be made the responsibility of the proposed Interstate Tax Advisory Committee. Local authorities should undertake complete revaluation at least once every decade.

In many local authorities, tax rates are low, but whether they need to be increased could be determined only after revaluation has taken place: it may very well be that the rise in book values following revaluation would permit some local authorities to reduce tax rates. A strong case can be made for imposing a higher tax on non-residential than on residential property. Some firms may be able to shift the tax forward to consumers, but for firms outside the income tax net (small firms), the forces of competition would restrain the scope for tax shifting. Similarly, a case could be made for a higher tax on unimproved than on improved property values, but this differential may have to await conversion of the tax to a capital value base. Concessional treatment for unutilised land and buildings mainly encourages speculative activity and should be abolished. Finally, there is a need for a higher degree of tax rate co-ordination among local authorities. This objective could be fostered by inviting the Interstate Tax Advisory Committee to collate and disseminate at regular intervals comparative data on local authority tax rates.

An expansion in the number of local authority land tax administrators would be a very sound investment. To avoid unnecessary duplication, State and local authorities could co-operate through the Interstate Tax Advisory Committee in developing training facilities suited to Malayan requirements. Without an improvement in the staff situation, the role of land taxes as a source of government finance will decline, as the avoidance of further unfairness in the treatment of taxpayers can be perpetuated only if there is no significant increase in the burden of tax.

Federal-State Financial Relations

Malaya, while sharing many of the features of recently formed federations such as Nigeria and the West Indies, is distinct in that the division of the country into separate States is not based on any major form of racial diversity or geographic insularity. The potential for racial conflict between the politically dominant Malays and the economically dominant Chinese is prevalent within almost all of the eleven States. Consequently, more attention is devoted to preserving nation-wide communal interests rather than specific State interests.

The communal division of the population largely explains the high degree of centralisation of government power in Malaya. The Malays, although politically dominant in each of the eleven States, realise that it is easier to retain indefinite control over one central government than over eleven separate State governments. In addition, they recognise that, with central control over a wide range of policies, the redistribution of income from the richer to the poorer, more backward, and predominantly Malay States is possible. These highly pronounced unitary forces prompt one to ask why a federal rather than a unitary form of government was adopted. An answer to this question can be found in the origins of the present federal system.

Before World War II, Malaya was divided into three parts: the Federated Malay States, the several unfederated Malay States, and the Straits Settlements. The treaty which brought the Federated Malay States together in 1893 was brief; apart from emphasising the precarious nature of small areas existing on their own and the need for such small areas to combine for common benefit, little else was mentioned. The treaty did not even define the respective functions of the Federal and State governments. A Federal Council was created in 1909 and legislative (but not executive) power was transferred from the States to this body. With the rapid development of the rubber and tin industries in the

Federated Malay States, it became increasingly necessary for the Federal Council to undertake expenditure on an interstate basis and, as a result, there was a steady transfer of executive power from the States to the central authority after 1909. Expenditure was concentrated on infrastructure developments designed to assist the expansion of the rubber and tin industries; the direct needs of the majority of inhabitants in the States were overlooked. Twenty years later, stringent central control had practically eliminated any display of initiative on the part of the States. At the request of the rulers, an attempt was made to define Federal and State functions in 1927 and, in consequence, a number of Federal departments were transferred back to the States. But financial control remained at the centre, block grants being made to each State to meet budget deficits. Within the limits of their financial resources, the States were free to allocate expenditure as they wished and, in the ensuing years, increased attention was paid to local problems previously neglected.

The unfederated States of Kelantan, Kedah, Perlis, and Trengganu were brought under British protection in 1909 and a series of agreements were signed by which British advisers were appointed to each State. A British adviser was appointed to Johore in 1914. In each territory, legislative and executive authority rested with the State government. The unfederated Malay States did not support a closer association with the Federated Malay States; they had observed the reduction in legislative and executive power of the separate Federated Malay States and preferred to preserve the degree of independence they had attained.

The Straits Settlements of Singapore, Penang (including Province Wellesley), and Malacca, which were united to form a Crown Colony in 1866, were governed from Singapore by a governor and a nominated executive and legislative council.

POST-WAR DEVELOPMENTS

Malayan Union Agreement, 1946

On resuming power after World War II, the British Military Administration sought to integrate the many separate political units. Under the pre-war governmental structure, similar enactments would have been required in at least six legislatures if uniform legislation were to be achieved throughout Malaya. The British recognised that unless this governmental structure were reformed, progress in the direction of self-government would be hampered. To achieve an integrated Malaya, the British encouraged the Malay Sultans to transfer their sovereignty

to the British Crown. A Malayan Union was then created by the British on 1 April 1946, embracing the former Federated and unfederated States and the Settlements of Penang and Malacca. Singapore remained a separate Crown Colony, but this decision was not 'to preclude or prejudice in any way the fusion of Singapore and the Malayan Union in a wider Union at a later date should it be considered that such a course were desirable' (Malayan Union and Singapore 1946: 3).

Under the provisions of the Malayan Union Agreement, the States could make laws on subjects declared by the Governor to be of a purely local nature or on legislative matters delegated to them by the Union legislature, but any such law could be altered or repealed by the Union legislature and would be declared void if repugnant to Union legislation. In effect, the Union Agreement sought to convert the States into local authorities on the British pattern.

The life of the Malayan Union was short. Opposition from Malays grew rapidly after the proposals had been accepted by the British Parliament early in 1946. The aim of the Union, progress towards self-government, was favoured by the States and an integration of the separate political units was not a matter of dispute. But the Malays objected to the manner in which the changes were implemented; there was not, in their words, the 'degree of local consultation to which they considered themselves entitled' (Malayan Union 1946: 6). The Malays found the changes objectionable on two other grounds. First, the citizenship provisions, which effectively created a communally egalitarian society, brought into prominence fears of non-Malay political domination. Second, the Malays objected to the complete loss of the pre-war powers of the Malay rulers, contending that the individuality of the States would be lost in the larger body within which the States were to be merged. The British were forced to allay Malay anxiety and, on 1 February 1948, a federal constitution was substituted. The new agreement contained provisions very similar to the Union Agreement, but it was acceptable to the Malays because the citizenship clauses protected their pre-war preferential position and because the agreement indicated that the individuality of the States would be recognised. The British did not object to these revisions, for the new constitution still offered prospects for a high degree of cohesion and a basis for common loyalty.

Malaya, then, differs from many other federations in that the basis of potential conflict within the country—communal problems—cuts across any type of territorial division. This was the primary reason for the adoption of a centralised form of government. The strength of allegiance of residents to particular States, nurtured during the long period of

divided rule, largely explains why a Federal system was adopted in preference to the British unitary suggestion.

Federation of Malaya Agreement, 1948

The constitutional division of power between the Federal and State governments under the Federation of Malaya Agreement made explicit the financial implications of the Malayan Union Agreement. The preamble proclaimed that the major purpose was to form a Federation 'with a strong central government' (Federation of Malaya 1948: 2). The list of matters over which the Federal government had power to legislate was extremely wide, covering indeed all major fields of government activity. The States were given residual legislative powers. Executive power, however, was divided between the two tiers of government in order to give weight to the second objective of the agreement: the principle of maintaining the individuality of the States.

State revenue heads were specifically detailed in the agreement and included certain excise taxes (for example toddy), revenue from lands, mines, and forests, specified licence fees, entertainment duties, and charges for goods and services supplied by the States (for example, water). All items not mentioned were to be Federal revenue heads. These included the main sources of tax revenue: trade and income taxes. Considerable debate occurred over whether excise and sales taxation should be Federal or State revenue heads, but the Financial Secretary considered that the imposition of different taxes on articles sold throughout Malaya would be unwise, and the matter was left to be reconsidered at a later date.

The agreement recognised that the expenditure to which the States were committed would exceed their revenue. Thus provision was made for block grants to be made by the Federal government to balance State budgets. The States spent 31% of public funds in 1950 but collected only 13% of total revenue raised in Malaya—they were dependent on outright grants from the Federal government for 55% of their revenue. While State revenue showed little growth potential, State expenditure, concentrated mainly in the field of community services, showed high growth potential. Thus not only was there a substantial excess of State expenditure over revenue, but it was inevitable that, with the passage of time, the extent of imbalance would increase.

In exchange for block grants, the Federal government was given extensive powers of control over State budgets. Estimates of revenue and expenditure, for example, had to be submitted to the Federal government for approval. Further, it was provided that any excess of State revenue

(including Federal grants) over expenditure at the end of each financial year would revert to the Federal government.

Defects of the 1948 Financial Provisions

The success of a federal system depends on an acceptable division of resources and functions between the centre and the States so that efficiency in the use of scarce resources is encouraged and extreme inequity in the treatment of individuals in different States is avoided. Given the heavy dependence of the States on Federal grants, it is necessary to consider the effects of the principles which have governed their allocation.

Under the 1948 Federation of Malaya Agreement, State deficits were met by lump-sum grants determined annually. The Agreement did not prescribe any method by which such grants were to be determined. Inevitably, annual wrangling occurred and, because the Federal government was an interested party, the total allocation depended heavily on the Federal government's financial position and prospects. Although such grants were made in an arbitrary manner without any recognition of definite allocative principles, the size of grants to the several States during the period 1948-55 was related to population. Nevertheless there were several anomalies: Kelantan, with 9% of the population, received less than 5% of the total grant allocation in this period, a fact which illustrates the importance attached to the bargaining power of the individual States. If the intention had been to distribute Federal funds according to population, this should perhaps have been made explicit.

This undefined form of Federal assistance gave rise to three major problems. First, the States were encouraged to widen rather than narrow the gap between expenditure and revenue. The States reasoned that the greater the deficiency the better were their prospects of maintaining (if not increasing) their respective shares in the total Federal handout. Outright grants did not foster any sense of financial responsibility on the part of State governments; inefficiency as well as efficiency in the use of funds could secure large grants. In addition, because the benefit of any net savings on State account accrued to the Federal government, the State governments were encouraged to spend at the end of each financial year in excess of their immediate needs. This factor strengthened the tendency to spend on questionable projects. Second, the allocative system did not give any incentive to States to exploit their own sources of revenue. In fact, the States found it easier and more rewarding (both politically and economically) to concentrate their efforts on attempting to obtain larger Federal grants than on attempting to collect their own

revenue; there were no changes in State tax rates between 1948 and 1954, and revenue collection arrears increased in each year after 1948. Third, despite extensive powers of review, the Federal government found it difficult to control State expenditure. The allocation of expenditure between economic services (a joint Federal-State responsibility) and community services (a State responsibility) was the result of acrimonious political bargaining rather than of national economic evaluation. The grant system militated against the careful allocation of scarce resources within the public sector. Moreover, because of uncertainty as to the future level of grants, the system discounted long-term outlays.

Attempts toward Solution

1955 Proposals. Following a disparaging report on Federal-State financial relations by the 1954 IBRD Mission to Malaya (IBRD 1955: 222ff.), a committee was set up late in 1954 to review the allocation of revenue between the centre and the States under the 1948 Federation Agreement. The committee accepted most of the recommendations of the IBRD Mission. The suggested adjustments were designed to establish an allocative system which would increase that part of State revenue (defined to include grants) accruing directly to the State governments independently of any action on the part of the Federal government. The proposed system was based on fixed principles to avoid the annual wrangling which had been a characteristic feature of previous Federal-State financial relations. The committee also sought to define State expenditure responsibilities more precisely so as to establish a closer relationship between the limited sources of State revenue and those fields of expenditure which were the legislative responsibility of the States. Thus, the principle of financial autonomy for the States was adopted to supplement the principle of partnership under a strong central government embodied in the 1948 Agreement.

The committee recognised that national emergencies and problems of economic growth, economic fluctuation, and income redistribution were essentially Federal government responsibilities and that, if the Federal government were to cope with these problems, it must have full control over the major sources of tax revenue. In this respect, the committee endorsed the provisions of the 1948 Agreement. State revenues were to be those identifiable with and collected within the State and for which no national policy considerations were likely to arise. The committee expressed an interest in extending the list of declared State revenue heads, but rejected such a move arguing that 'the field was too limited in scope and the practical difficulties too great' (Federation of Malaya

1955a: 3). Hence, to deal with the fundamental problem of imbalance between State expenditure and declared revenue, reliance had to be placed on reallocating functional responsibilities between the Federal and State governments and on Federal grants.

In respect of Federal-State functional responsibilities, the committee sought to clarify the intention of the 1948 Agreement. The committee considered that State expenditure on educational, medical, health, drainage, irrigation, and new village services should be financed completely by specific Federal grants. These expenditures were considered to be of national importance and it was concluded that the Federal government should be responsible for ensuring adequate and uniform standards throughout Malaya. Thus the committee sought to emphasise to the States that, while they had full executive power in these fields, their policy-making power was subordinate to that of the Federal government.

Having given the Federal government responsibility for financing a large part of State expenditure, the next problem was to derive a sound and equitable means of bridging the remaining State budgetary gap. To this end, two forms of assistance were proposed: general grants to all States and special grants to particular States.

There are two principles upon which grants may be based: derivation and need. Under the derivation principle, States receive grants in proportion to Federal tax collections from their citizens. This principle favours relatively wealthy States but it is not easily applied, for the taxes collected within a State are not necessarily borne by the residents of that State. As pointed out by J. R. Hicks, 'derivation can easily become enmeshed in tax metaphysics' (1961: 73).

The second principle, that of need, may be interpreted in two ways: national interest or State need. The benefit of grants made for activities which are recognised to be in the national interest may accrue unevenly among States. The objective of such grants is not to even up development among the States, but to undertake projects considered to be of value to the nation as a whole. It is conceivable that grants made on this basis may widen the discrepancy between advanced and backward States. Grants based on State need are deliberately designed to achieve a high degree of equality among States in the provision of certain services. However, where backward States are politically influential (as in Malaya), the line of demarcation between national interest and State need becomes blurred; the politically dominant Malays, for instance, interpret equality among States in the provision of government services as being in the national interest.

Grants based on the derivation or need principle may assume the form either of conditional or unconditional grants. Conditional grants enable the Federal government to exercise a measure of control over the direction of State expenditure. Matching provisions (whereby the State is required to make a contribution before advantage can be taken of Federal assistance) may be incorporated in an endeavour to stimulate local initiative. Matching provisions, however, discriminate among States; wealthier States can raise revenue more easily than poorer States and are therefore able to take greater advantage of such grants. The degree of discrimination may be reduced by graduating matching provisions inversely with the relative wealth of States. Unconditional grants are designed to enhance the degree of State autonomy.

In suggesting a basis for Federal-State grants in Malaya, the committee recognised the two main principles—derivation and need—and the two main forms of grant—conditional and unconditional. The committee realised that it was impossible to determine with any accuracy the origin by State of most sources of Federal tax revenue. But the committee had already decided not to add to the independent sources of State revenue. Sensing a need to pacify the wealthy States, the committee decided that the petrol duty should be shared by the Federal and State governments (in a 70:30 ratio), and that the State governments' share should be allocated in the same proportion as duty was raised in the areas covered by the respective governments. Since petrol distribution was undertaken by two companies only, problems of administration were considered to be minimal. No conditions were attached to the grant.

Grants based on the needs principle assumed three forms. First, as discussed above, it was considered to be in the national interest that expenditure on educational, medical, health, drainage, irrigation, and new village services should be financed by specific Federal grants. The decision to eschew matching provisions for these grants illustrates how conscious the committee was of the need to assist backward States. In contrast, the IBRD Mission had suggested that the Federal and State governments should share the cost of educational, medical, and health services.

Second, it was considered necessary to ensure that each State had sufficient finance to permit it to provide minimal standards for services over which the States exercised full legislative power. For this purpose, the committee recommended an unconditional per capita grant (equal to \$16) calculated on the basis of the adult population of each State. The object of this grant was to promote the balanced development of State functions while preserving a degree of State budgetary autonomy. The

rate could be varied marginally from year to year, and was to be determined by the High Commissioner after consulting Federal and State governments. The committee did not specify any principles for determining the per capita grant.

Third, the committee recognised that some States lagged behind others in economic and social development. It therefore recommended that supplementary, unconditional assistance be given to these States (Kelantan, Trengganu, Perlis, and Pahang) to enable them to raise the standard of public services other than those financed completely by Federal grants. In the case of each State, the amount of assistance was to be equal to 25% of the per capita grant. It is interesting to note that the committee did not specify why it considered that the need for grants by certain States should be greater than the need of other States; it evidently realised that attempts to measure relative need by reference to criteria such as relative poverty and/or relative sparsity of population would raise a host of contentious and complicated side issues; the more densely populated but richer western States could make a case for assistance because of relatively greater traffic congestion problems, for example.

To assist States in their adjustment to the new system, a transitional grant was given to those States which would otherwise face serious financial embarrassment. The purpose of this grant was to ease the impact on the States of requisite downward expenditure adjustments. It was provided that such grants would be reduced progressively each year.

The committee's proposals, brought into effect on 1 January 1956, provided the States with revenue of a stable and continuing nature.¹ The striking feature of the proposals was the emphasis given to the need to even out differences in the standard of public services among States. The committee refrained from placing emphasis on forms of assistance which would have permitted the more advanced States to gain most; no attempt was made to increase the independent sources of State revenue, grants based on the derivation principle accounted for only 22% of the recommended level of Federal-State grants, and no matching provisions were attached to any of the grants. The proposals reflected the prevailing political climate. Because of weaker round-table bargaining strength, backward States had not gained relative to advanced States under the financial provisions of the 1948 Agreement. In the field of community

¹ The legislation, however, scaled down the grant for each adult person from \$16 to \$12.

services, for example, the disparity in the level of development among the various States had steadily widened. The Malays were conscious of the need to raise the standard of public services in backward, predominantly Malay, States, and progress towards self-government had enhanced the political power of the Malays. The committee translated Malay feelings into concrete proposals.

Apart from expenditure heads financed by specific Federal grants, the States were no longer obliged to submit annual estimates to the Federal government for approval. The new arrangements were designed to enhance State autonomy, initiative, and financial responsibility; a decision as to whether a particular service should or should not be expanded was to be made without reference to the Federal government. Further, the States were no longer required to remit any excess of State revenue over expenditure to the Federal government, a serious obstacle to forward planning thereby being removed.

The 1955 provisions, then, relieved the States of the problem of bargaining with the centre for grants, and the contentious issue of revenue allocation was placed on a semi-scientific basis. But, following implementation of the committee's proposals, it quickly became apparent that the two main deficiencies of the 1948 Agreement remained. First, the policy-making powers of the State governments in the field of community services continued to be greater than implied in the constitutional provisions; the Federal government still had 'to pay the piper for tunes called by the States' (IBRD 1955: 224). Second, the Federal government continued to finance State deficits with the result that the States looked to the Federal government for assistance as a matter of course; this arrangement did not give the States any incentive to exercise economy in the allocation of scarce funds.

1957 Proposals. Following the United Kingdom decision to grant independence to Malaya, a Constitutional Commission was formed and its report, published in February 1957, reconsidered Federal-State financial relations (Colonial Office 1957). The Commission opposed any extension of State tax powers, arguing that such a trend would cause a wasteful duplication of staff and 'would almost certainly hamper the conduct of business on a national scale and retard the development of unity in the nation' (ibid.: 59). It was readily perceived that heavy dependence would have to be placed on grants unless the functional responsibilities of the two tiers of government were rearranged. It was in this latter sphere that the Commission made a significant contribution. It considered that, wherever possible, legislative and executive power should go hand in hand. To achieve this objective, the Commission

recommended that expenditure on educational, medical, and health services should become Federal responsibilities. There was no objection from the State governments to this recommendation.

The rearrangement of functional responsibilities reduced but did not eliminate State budgetary problems; grants were still an important feature of Federal-State financial relations. The Commission summarily dismissed tax sharing arrangements. Reading between the lines of the 1954 Committee Report, it assumed (incorrectly) that the petrol duty allocation was designed to finance State road maintenance expenditure. On investigation, it was discovered that there was no close relationship between the cost to the States of maintaining their roads on the one hand, and the amount of petrol sold and thus the amount of petrol revenue raised in the States on the other. The Commission therefore concluded that it was undesirable in principle to allocate to the States the proceeds of any particular tax—a confusion of the essence of the two allocative principles: derivation and need. The 1954 Committee Report indicated that the petrol duty allocation was based on the principle of derivation, not need. It would be purely coincidental if grants based on each principle turned out to be identical. The Commission's task would have been eased if reference had been made in the 1954 Committee Report to its progenitor—a report to the Nigerian government on revenue allocation (Nigeria 1951). This report clearly delineates the main allocative principles, a crucial step which the 1954 Malayan Committee Report unfortunately overlooked.

In place of tax sharing, the Commission advocated an unconditional grant based on State road mileage. The Commission did, however, recommend that 10% of the export duty on tin should be returned to the States in which tin was produced (notably Perak and Selangor); reimbursement was considered to be partial compensation for the permanent loss of a valuable State asset, and it was thought to provide the States with an incentive to promote the development of tin mining.

In considering the per capita grant, the Commission indicated that it could not understand why no account was taken of children; population statistics by State were just as comprehensive for children as for adults. The answer, however, is not difficult to discover. Because of a paucity of population statistics in Nigeria (particularly acute in the case of children), the authors of the Nigerian report favoured a per capita grant based on the adult male population. Apart from minor adjustments, the 1954 Malayan Committee transcribed the Nigerian report. The 1957 Constitutional Commission rectified this anomaly; the base of the per capita grant was extended to include children and the value of the grant

was lowered, but the Commission declined to state principles for the determination of the grant despite a pungent attack on the 1954 Committee for its failure to do so.

The Commission favoured the abolition of the development grant, for the States were not expected, let alone encouraged, to spend the grant on capital items. In order to encourage the States to undertake capital development projects, power was given to the Federal government to make discretionary, conditional grants (or loans). Provision was made for special grants to meet extraordinary emergency requirements, and a State Reserve Fund was established to assist States which faced difficulties in balancing their budgets.

Under its terms of reference, the Commission was obliged to recommend machinery for consultation between the Federal and State governments. The Commission favoured a consultative organisation (termed the National Finance Council—NFC) consisting of the Prime Minister, one other Federal minister, and the Chief Secretary of each State. 'We do not think', the Commission reported, 'that it would be right, or indeed practicable, to give any executive functions to the body which we recommend . . . or to allow its powers to affect or diminish the ultimate responsibilities of the Federation and the States within their respective spheres' (Colonial Office 1957: 63). The Federal government was required to consult the NFC when calculating State grants, assigning part of the Federal taxes to the States, drawing up annual Federal-State loan requirements, and undertaking national development projects. The NFC was required to meet annually (if not more regularly) to consider issues of interest to both the Federal and State governments.

The Commission's suggestions on finance were written into the Federal Constitution of 1957. The decision in 1962 to remit to producing States a share of the Federal export duty collected on iron ore has been the only change since then.

By readjusting Federal-State functional responsibilities and by giving the Federal government power (within reasonable limits) to embark on any development or conservation scheme declared to be in the national interest, even where the scheme involved direct interference with State rights, the Commission Report strengthened the unitary features of the Malayan Federation. In the allocation of funds, increased emphasis was placed on State needs. General grants based on fixed indices (population and road mileage) were given to all States; such grants favoured backward States relatively more than advanced States. By strengthening unitary features, grants-in-aid were effectively transformed into a discretionary Federal responsibility; in contrast to the 1954 Committee

Report, the Commission refused to impose any specific ties on the Federal government in respect of these grants. The restraints on the power of the Federal government to redistribute income among States are indeed few.

THE WAY AHEAD

The attempts to devise a workable system of revenue allocation have met with limited success. Bargaining, particularly for allocations apart from the per capita and road grants, continues to be an integral feature of Federal-State financial relations, and the Federal government has been very lenient in its treatment of deficit States. Increased loan advances from the Federal government since 1960 have added to the dependence of the States on Federal handouts, and have had two side effects: they have enabled the States to ignore the revenue potential of their own tax heads and they have weakened incentives for economy.

There is no simple answer to the problem of revenue allocation in a federation but, in searching for improvements, two principles—efficiency in the allocation of scarce resources and the desire to avoid unnecessary inequity in the treatment of individuals—should be borne in mind.

State revenue has increased slowly since 1950 but, as indicated in Chapter 11, there is considerable scope for expansion in respect of the major sources of State revenue, particularly land taxation (including betterment charges). Federal grants can be manipulated to encourage the States to explore the revenue potential of their own tax heads, and it is recommended that this be done. To this end, two suggestions appear appropriate. First, an attempt should be made to estimate the land tax (including betterment charge) potential of each State and, for this purpose, the NFC should invite the judgment of an independent, impartial committee consisting, for example, of land tax experts from the World Bank and/or the United Kingdom. Because land tax is the major potential source of State revenue, it alone would serve as an adequate measure of State tax effort. Second, the per capita and the road maintenance grant to each State should be reduced (in stages) by the extent that a State's land tax potential exceeds its land tax effort. In this way, a 100% premium would be granted to encourage the States to explore their land tax and betterment charge potential.

The object of this latter proposal would be circumvented if the Federal government were to continue to give additional assistance to permit States to balance their budgets. Three supplementary suggestions should therefore be made. First, development grants should be tied specifically to capital expenditure on development projects; it should be made

clear to the States that associated recurrent expenditure should be financed from betterment charges and from general State revenue. Second, special assistance should be given to States to enable them to raise public service standards or to balance budgets, provided that their land tax effort is satisfactory and that they have avoided extravagant expenditures. This provision is incorporated in recognition of the fact that, assuming the same tax rates, the potential land tax yield of some States would be less than that of others; fiscal capacity differs markedly among States. Finally, States which manage to balance their budgets without fully exploiting their land tax effort (and without, therefore, receiving their full per capita and road grants) should be expected to provide a matching contribution to Federal grants made for development purposes.

The proposals have several advantages over existing arrangements. First, the proposals endeavour to increase the independent revenues—and thus the autonomy—of the State governments. The States would be encouraged to rely more on their own resources, and the total amount of revenue raised in Malaya would be increased. Second, by restricting the conditions for development grants, the States would have an incentive to work out where capital funds are to be spent in advance, and to assess their ability to service such capital projects. Third, the Federal government could still use its discretion in helping poorer States in the interests of the Federation as a whole; it has the means to iron out national inequalities as it sees fit. The proposals would reduce the reliance of the States on the Federal government as the easiest way of obtaining additional finance and, by clarifying allocative criteria, Federal grants would be made on a more objective basis. Finally, the proposals do not restrict the Federal government in determining the amount of grants to be made to States. It is recognised that the Federal government should have ultimate responsibility for deciding how to deal with the financial situation from time to time. The NFC would continue to be the body through which the Federal and State governments would discuss grant allocations.

13

Fiscal System and the Economy

The aim of this final chapter is to draw the preceding chapters together by considering the impact of the fiscal system on businesses, on consumers, on the level of economic activity, and on the rate and direction of economic growth.

FISCAL SYSTEM AND BUSINESSES

In the final analysis it is individuals who gain from government expenditure and who bear the burden of taxation. Nevertheless, through the fiscal system, the government influences the profitability of business enterprises (and thus the level and structure of production), the volume and direction of business investment, and the size and form of business organisation.

Profitability of Business Enterprises

Business firms¹ pay more than 90% of taxes levied in Malaya and Singapore. This does not, of course, mean that owners of businesses bear the burden of the taxes levied on them; the tax burden may, for example, be shifted forward to consumers in the form of higher prices, or backward to factors of production in the form of lower returns (monetary or non-monetary) for services rendered. The extent to which businesses are able to shift the taxes forward or backward depends on the structure of the tax system, and on the competitiveness of product and factor markets. The following paragraphs consider the degree to which the main taxes levied in Malaya and Singapore can be shifted.

The main taxes levied in Malaya are import and excise duties, export taxes, income tax, and land taxes. The shiftability of import and excise duties has been considered in Chapter 6. Two-thirds of total import

¹ Defined to include all enterprises whether industrial, commercial, or agricultural.

and excise duty revenue raised in 1965 was derived from levies on end-product consumer goods. Duties on end-product consumer goods may be borne by foreign producers, domestic importers, or domestic consumers. Most of the revenue raised is derived from levies on products with low price elasticities and/or high income elasticities of demand. It is probable, therefore, that the tax burden is passed forward to consumers, and that the taxes have little effect on the operations of domestic importing and distributing businesses. Duties on intermediate goods represent an addition to the costs of domestic producers using the taxed commodities as inputs. Levies on three products—unmanufactured tobacco, petroleum (including heavy fuel oil), and motor vehicles—account for 90% of this revenue. Because the price elasticity of demand for tobacco products is low, it is probable that the whole of the duty on unmanufactured tobacco is passed forward to consumers. Similarly, it is likely that a large part of the revenue raised from duties levied on petroleum, motor vehicles, and other goods used as inputs in the production process are also passed forward to consumers. In short, the burden of import and excise duty taxation borne by domestic businesses is negligible.

In the case of export taxes (including mineral production royalties) the answer to the question, 'who bears the tax burden?' is markedly different. As indicated in Chapter 8, the world demand for Malayan rubber, tin, copra, palm oil, and other taxed exportables is elastic, with the result that domestic producers are 'price-takers' rather than 'price-setters'. Malayan producers could pass the tax burden forward to consumers only at the risk of losing their share of the export market for taxed commodities. Since the extent to which the tax burden can be shifted back to factors used in the production of output is limited, the burden will be borne primarily by producers.

There is a clear division within each of the main export industries (rubber, tin, copra, and palm oil) between large- and small-scale producers. Large producers can claim a measure of relief for export tax paid under income tax provisions, and it is probable that they are able to pass a higher proportion of the export tax burden back to labour in the form of a reduction in the rate of increase of wages or of non-monetary amenities. The export tax burden therefore weighs more heavily on the small, predominantly indigenous, producer than on the large, predominantly foreign, producer.

Plantation (mainly rubber) and mining (mainly tin) activities accounted for almost 50% of business income assessed for income tax purposes in 1964 (see Table 17A, p. 82). Market conditions in these industries are such that it is reasonable to assume that the greater part of the tax burden

is borne by producers. Since income tax is a variable cost, the tax burden will have a discouraging effect on current production in the short term. Moreover, it will affect production in the longer term, for the tax reduces funds available for reinvestment.

Because there are comparatively few competing firms and because demand is expanding, it is probable that a high proportion of the income tax revenue raised from manufacturing, building, contracting, repair work, communications, and entertainment activities can be shifted forward to consumers. In the commercial field (which accounted for 28% of business income assessed for income tax purposes in 1964) competition is more intense. Most commercial firms are unincorporate and are subject to the progressive personal income tax rate structure. In addition, tax evasion and avoidance in this sector of the economy is believed to be high. If, in these circumstances, entrepreneurs attempt to pass the tax burden forward, they may lose sales, for competitors may have no need to follow suit. Nevertheless, Malaya's trade sector has been buoyant in the post-war period and, faced with a sellers' market, it is probable that commercial enterprises have been able to shift forward a high proportion of the direct tax burden.

State land taxes are levied on rural and urban land at a flat rate per acre. The major part of rural land tax revenue is derived from rubber land; rice land is virtually untaxed. As in the case of export taxes, the land tax burden is borne principally by producers. However, in contrast to the export tax, one would not expect the land tax to discourage production, for land tax rates are low. State urban land tax revenue is derived from commercial and industrial enterprises, and from households. It is probable that a high proportion of the burden of the tax borne by commercial and industrial enterprises is passed forward to consumers. Similarly, it is likely that a high proportion of local authority rates levied on businesses is shifted.

Because of an absence of an agricultural export sector, the proportion of taxes shifted by business firms is higher in Singapore than in Malaya. Singapore depends more heavily on import, excise, licence, and land taxes than does Malaya. For each of these levies, the degree of tax shiftability is high. Income tax, the only other important source of tax revenue, is derived mainly from commercial activities. The taxes on *entrepôt* activities can be shifted forward to consumers (as in the case of manufactured goods imported for re-export to neighbouring territories) and/or to producers (the case, for example, of rubber imported from neighbouring territories for re-export to world markets). The degree of tax shiftability for non-*entrepôt* commercial activities is also high due

largely to the general buoyancy of the Singapore economy in the post-war period.

Apart from export producers, it can be concluded that the burden of taxes on business firms in Malaya and Singapore is not high. By increasing the prices of taxed commodities and by transferring resources from the private to the public sector, the taxes affect the pattern of demand and thus the aggregate structure of production. However, before any conclusions can be reached about taxes and the profitability of business enterprises, account must be taken of the disposal of government revenue. Within the non-export sector, government expenditure on road, rail, power, and other public utilities serves to reduce, if not eliminate, the tax burden borne by firms. Within the export sector, a distinction must be drawn between large- and small-scale producers—estates and smallholders.

Estates are subject to both income and export taxes but, to the extent that relief from other taxes paid is claimed under income tax provisions, problems of double taxation are reduced. Fiscal incentives have been used extensively to assist the estate sector. First, as indicated in Chapter 2, a high proportion of government capital expenditure has been devoted to improving transport, power, and other overhead facilities for estates. Second, the government has provided direct grants for rubber replanting and estates have made full use of this concession. Third, temporary tax relief (in the form of accelerated depreciation allowances) has been granted for many forms of estate investment. In these ways, government expenditure and tax concessions have significantly reduced the tax burden on estates.

The majority of smallholders producing for export are beyond the income tax net. However, all pay export taxes and rubber smallholders also contribute to a replanting scheme. Rubber replanting grants represent the main form of government assistance extended to smallholders. But, to date, smallholders have not taken full advantage of government assistance for replanting; in fact, revenue collected from smallholders specifically for replanting activities has virtually covered the cost of replanting grants made to them so far. All smallholders have gained from government expenditure on infrastructure developments but, in general, transport, power, and other overhead facilities are less developed for smallholdings than for estates. The first Malaysia plan provided support for this statement when it pointed out that 'Most smallholders do not have easy access to markets, technical knowledge and skills. . . On the Malayan East Coast . . . there are many people who lack adequate access to modern techniques and to credit, markets, storage facilities and

transport. Some of these problems also prevail on the Malayan West Coast, especially in rural areas' (Malaysia 1965: 6). In general, the tax burden on smallholders producing for export is heavy.

Business Investment

To the extent that the tax burden is not shifted and to the extent that the fiscal system causes a decrease in demand for the produce of the private sector, business investment activity may be adversely affected.² Fiscal incentives may be used to compensate for any adverse effect of the fiscal system, and to encourage the flow of private funds into investment avenues considered to be of special importance for development. But it should be borne in mind that such incentives cannot counteract severe economic, political, and social checks on investment; despite the provision of liberal fiscal incentives for business investment in Singapore, the possibility of increased social tension acts as a deterrent to private investors interested in long-term development projects.

Many less developed countries have used fiscal incentives to encourage the expansion of industrial relative to agricultural activities. In contrast, Malaya has used incentives to stimulate the expansion of both sectors. Singapore has had little choice; it has had to concentrate on developing an industrial sector *per se*.

In both countries, four forms of fiscal incentive have been used: grants (mainly for rubber replanting), tax relief, loans, and expenditure on economic, social, and administrative infrastructure. These forms of assistance have been considered separately in preceding chapters; the task of this section is to consider their impact on agricultural, industrial, and commercial activities.

For analytical purposes, it is useful to divide agricultural activities in Malaya into two sectors: export (rubber, palm oil, and tin) and non-export (mainly rice). The export sector may then be divided into two sections: estates (defined to include not only agricultural estates but also large-scale mineral producers) and smallholdings.

² By concentrating expenditure on development, the government may spend a higher proportion of the tax revenue on imports than would have been the case if the tax revenue had been left in the hands of the private sector. Alternatively, the excess of savings over investment in the public sector may be greater than would be the case in the private sector, so that the fiscal system may lower domestic demand compared with the situation if there were no public sector. Under the prevailing monetary arrangements in Malaya and Singapore, the government could use the excess savings to purchase foreign currency and thus build up its external reserve balances.

Fiscal incentives have been used extensively to assist the estate section. Government expenditure on the development of roads and public utilities has reduced estate production costs and thus increased profits, and the government has not imposed any control over the disposal of the direct grants offered by the government for replanting activity, and of income tax relief for planting, replanting, and other estate investment activity. These measures however, have been most successful. They have achieved two results. First, they have succeeded in maintaining the viability of the natural rubber industry in Malaya despite a substantial fall in the price of natural rubber since 1956. The strength of this sector will give the Malayan people more time to effect the gradual reduction of the dependence of the economy on this product. Second, while it may be argued that the government has financed a large part of estate investment, particularly by way of replanting grants, the important point is that the estates have been more than prepared to match the government contribution; the incentives have helped to sustain the level of estate investment activity despite the fall in the price of natural rubber and the growing uncertainty as to the future of natural rubber.

Within the smallholder section of the export sector, the government has met with less success in its attempt to stimulate investment activity, although some improvement has occurred since 1965. There is a need for more detailed research to determine how government assistance could best be adapted to encourage smallholder investment activity.

The non-export agricultural sector consists solely of smallholdings. Apart from paying low land taxes, most non-export smallholders are beyond the tax net. Consequently, tax manipulation can be ruled out as a substantive means of incentive assistance for this sector; if incentives are to be offered, dependence has to be placed on subsidies. Before 1960, the main forms of government assistance consisted of a rice price-support program, the provision of irrigation facilities, fertilisers, and improved quality seeds, and the extension of the economic, social, and administrative infrastructure. The rice price-support program, however, was not adjusted to encourage producers to grow better quality rice; progress on irrigation works was slow, agricultural extension services were inadequate, feeder roads remained tracks, and the development of social capital in the rural areas was ignored. An election setback in rural Malay areas in 1959 prompted a shift in development emphasis during the third Malayan plan period (1961-5). Subsidies to the non-export rural sector were increased. But to people who are not strongly influenced by the profit motive and the desire to accumulate, the incentive value of outright subsidies is limited. If this sector is to be encouraged to make more

use of assistance offered, the potential gains should perhaps be related more closely to effort. The prices offered under the rice price-support program, for example, should be graduated in step with the quality of rice produced, and charges (designed to cover running costs and capital repayment) should be made on a systematic basis for irrigation, fertilisers, seeds, and other extension services. If the incentives offered are to encourage increased production and a more equitable distribution of income, the small-scale farmer has to be encouraged to enter the money economy on a more extensive scale and, in the initial stages, this can, perhaps, be achieved by making the attainment of traditional subsistence income slightly more difficult.

A central objective of economic policy in Malaya and Singapore is 'diversification through industrialisation', but in both countries there are obstacles to industrial development. First, although income per head in Malaya and Singapore is high by Asian standards, the internal market is relatively small. In addition, little protection is afforded to domestic producers against competition from well-established foreign producers. Second, by Asian standards, labour is expensive. Wages paid in the industrial sector have been influenced by wages paid in the most buoyant and profitable sector of the economy—rubber. Moreover, there is a shortage of qualified managers, technicians, and trained workers. Third, rubber, tin, and commerce offer attractive, well-established, alternative avenues for investment, and the absence of a tax on capital gains has offered strong incentives to real estate, land, and inventory speculation. To compensate for these detractors, the government has offered a range of incentives to industrialists of which the main forms are subsidies (for example, the development of industrial estates, tax holidays for certain forms of industrial venture, investment and export subsidies, and relief from import duty taxation), tariff protection, and accelerated depreciation provisions.

The first two forms of assistance (subsidies and tariff protection) have two features in common: the utilisation of the fiscal incentives offered is left to the free choice of the investor, and relief is not available on a standard basis for all firms. In contrast, relief under the third form of assistance (accelerated depreciation concessions) is specifically tied to the amount of investment undertaken, and is available on a standard basis for all firms. Thus the forms of assistance can be divided into two categories, and it must be asked whether the present emphasis in the pattern of assistance (heavy dependence on the first category) is best designed to achieve stated objectives.

The provision of access roads, power, water, and other overhead facilities, and the development of industrial estates, have stimulated industrial development in both Malaya and Singapore. This form of assistance is a necessary prerequisite for industrialisation. But the creation of industrial estates, which has been given prominence in both countries, is expensive. Since the same standard of services cannot be offered to all industrial enterprises, it is necessary to ensure that those firms which do gain access to the estates make maximum use of the facilities offered. The main industrial estate in Malaya—Petaling Jaya—has been alienated to light industrial enterprises. There is little interdependence between firms. Moreover, the firms do not generate significant forward and/or backward linkage effects. It is questionable whether many of the enterprises which gained access to the estate required the benefits conferred on them; most firms could have been located outside the estate without suffering any significant increase in production costs. From the national viewpoint, Petaling Jaya was an expensive industrial development project, but was probably justified as it was the first of its kind in Malaya and many valuable lessons were learnt. The Jurong estate in Singapore represents a deliberate attempt to rectify the deficiencies of Petaling Jaya, emphasis being placed on engineering, electrical, and chemical industries, and room being provided for future expansion.

In addition to accelerated depreciation allowances, exemption from income tax is granted for a limited period of time to new firms representing an industry which is not carried on in the territories on a suitable commercial scale but for which there are favourable prospects for development. It may be argued that a procedure which leaves room for voluntary decisions as to the use of fiscal concessions represents a form of encouragement to private investors. The significant point, however, is that while direct tax relief creates the possibility of an increase in private sector investible funds, it does not ensure the domestic investment of such funds. Moreover, the incentive value of the relief depends on the extent of the tax gain, which will be greater the higher the profits which accrue during the period of relief, the higher the tax burden in the absence of relief, and the lower the potential degree of tax shifting and of tax evasion. Firms which make a large profit relative to capital investment in the first years of production are likely to be those deliberately established in order to take advantage of temporary concessions (cigarette, toothpaste, and cosmetic firms, for example). Investment of this nature is often of limited value to long-term economic development. The justification for granting tax relief to such firms is questionable, since it is probable that they would obtain high profits in the absence of

assistance. Since income tax rates in Malaya and Singapore are moderate, and since the degree of tax shifting is high, the incentive value of income tax relief is limited.

Investment allowances represent an alternative form of fiscal subsidy. From the viewpoint of industrial development, the advantage of this form of relief is that it is directly tied to investment activity. The allowances increase the incentive to invest, reduce the risk of investment, and provide a contribution towards the difference between higher future replacement costs and historical costs. But investment allowances involve the payment of a subsidy by the country to a select group of taxpayers.

Similar results to those achieved by investment allowances can be obtained at lower cost to the community by concentrating fiscal incentives on accelerated depreciation allowances. By ensuring the quick recovery of a substantial part of total capital outlay, accelerated depreciation allowances reduce the risk of investment activity. But, in contrast to investment allowances, the tax gain is temporary rather than permanent. A firm can prolong the period of relief only by continually reinvesting.

Since accelerated depreciation allowances do not involve a substantial loss of tax revenue, they can be made available on a permanent rather than on a temporary basis to all, rather than selected, enterprises. Moreover, accelerated depreciation allowance rate differentials can be used to channel productive resources into activities considered to be of high priority. As in the case of other tax incentives, the value of the relief depends on the expectations of entrepreneurs as to the future rate of tax. It may be argued that the incentive value for unincorporate businesses is small for, by stimulating investment activity and increasing earning capacity, such firms automatically move into higher tax rate brackets. Since the majority of unincorporate firms pay tax at a lower rate than corporate firms, the relative importance of this disincentive effect is reduced.

The governments in both Malaya and Singapore have recently introduced incentives which effectively amount to a tax credit for successful export firms. In Malaya, the size of the tax credit is dependent not only on the export performance of the firm, but also on the amount the firm spends on domestically produced materials and on low-priced labour. The primary objective of this legislation is to increase the contribution of the manufacturing sector to national product. If this were achieved, exports of manufactured goods would rise, as the domestic market in both countries is too small to absorb a large increase in the output of manufactured goods, and the use of domestic inputs would

also rise. It would therefore seem more appropriate to concentrate incentives on the primary rather than on the corollary objective—that is on increasing value added within the manufacturing sector. To this end, it was suggested that accelerated depreciation allowances (other than the allowance which could be claimed in the year of asset acquisition—the initial allowance) should be tied to a minimum domestic value added requirement. In addition, it was suggested that a tax credit should be introduced, and that the size of the tax credit should be progressively related to the domestic value added by the claimant firm.

In countries where labour is abundant and capital is scarce, it has been argued that fiscal incentives should be designed to encourage labour intensive rather than capital intensive production techniques. However, three points may be advanced against this argument. First, the success of industrialisation programs in Malaya, and particularly in Singapore (where prospective urban unemployment problems are more serious and the need to industrialise more pressing), depends primarily on their ability to develop industries on a commercially competitive basis. In many instances, industries do not only have to capture their home market from well established imports, but they have to be able to compete successfully on international markets to ensure profitable levels of production. Compared with neighbouring countries, labour costs are relatively high in Malaya and Singapore. Thus, to compete with overseas suppliers, the industrial sector will have to aim at achieving high labour productivity and will have to keep abreast of modern technology.

Second, it is possible that the backward and forward linkage effects associated with capital intensive investment may, in the longer term, have a greater impact on aggregate employment opportunities in industry than would the immediate adoption of labour-using methods.

Finally, the industrial sector in Malaya and Singapore consists of two sections: a technically advanced, efficient, large-scale section, and a numerically large, technically backward, largely inefficient, small-scale section. Industrial development programs cannot ignore the potential of the latter section. Significantly, its potential can be realised only by modernisation and, to a large extent, modernisation will require an increase in the amount of capital per worker.

In a country where capital is scarce in relation to labour, it is imperative that measures should be designed to stimulate an increase in the ratio of investment to gross domestic product. In addition, there is a need to ensure the full utilisation of installed capacity. For this reason, increased capital allowance relief should be granted to firms prepared to undertake multiple shift operations.

Size and Form of Business Organisation

Export taxes favour efficient producers. Compared with estates, small-holdings are inefficient, and one would expect the tax to encourage the consolidation of holdings. This has not, however, occurred on any significant scale, and one can only conclude that, in the agricultural sector, the net effect of the fiscal system on the size and form of businesses is insignificant compared with other forces (religious laws of inheritance, etc.).

Because of the differential between company and personal income tax rates, the present tax structure favours small, unincorporate businesses. One of the objects of increasing the burden of personal taxation is to reduce this differential. No attempt, however, has been made to adjust the tax structure in order to favour corporate firms, even though it is recognised that these firms are able to attract equity capital and bank credit more easily than unincorporate firms, and that they reduce problems of tax administration. The need to encourage entrepreneurial potential at the present stage of development in Malaya and Singapore suggests that the fiscal system should not discriminate against one or the other form of business organisation.

FISCAL SYSTEM AND CONSUMERS

Table 50 compares the tax burden of a rubber smallholder, a rice grower, and an urban dweller. The rubber smallholder is assumed to have 4.5 acres of tappable rubber land. Since 70% of all farms specialising largely in rubber production average less than 8 acres, this smallholder can be regarded as typical. At a rubber price of 50 cents per pound, the smallholder's net income would approximate \$520 per annum. It has been assumed that the net income of the rice grower and of the urban dweller is also \$520 per annum.³ Further, it has been assumed that the burden of import (including excise) duties and licence fees borne by each individual is equal to \$13—a figure slightly greater than the national average. These taxes are mostly imposed on goods which are not necessities—liquor, tobacco, and entertainment, for example. If a person chooses to forgo the consumption of these commodities, payment of the taxes can be avoided. Thus it is difficult to determine the precise indirect tax burden borne by any individual. But, as pointed out in Chapter 6, the incidence of indirect taxes tends to be

³ This assumes that the rice grower works 4 acres of land, that his yield per acre is 1,000 pounds of rice, and that the price of rice is 20 cents per pound (or \$45 per bag of 168 katis).

Table 50 Malaya: a comparison of the tax burdens borne by a rubber smallholder, a rice grower, and an urban dweller, 1965
(\$)

	Income	Export duty	Research cess	Replanting cess	Land tax	Betterment charges ^a	Indirect taxes	Urban rates ^b	Total	Tax payments as % of income
Income \$520										
Rubber smallholder ^c	520	36	18	81	16	20	13		184	35.4
Rice smallholder ^d	520	—	—	—	6	60	13		79	15.2
Urban dweller	520	—	—	—	2	20	13	60	95	18.3
Income \$1,000										
Rubber smallholder ^e	1,000	110	18	81	16	20	13		258	25.8
Rice smallholder	1,000	—	—	—	6	60	13		79	7.9
Urban dweller	1,000	—	—	—	2	20	13	60	95	9.5

^a Includes water rates.

^b Assumes that the annual value of the urban dweller's house is \$300 and that rates are set at 20% of annual value.

^c Assumes a rubber price of 50 cents per pound.

^d Assumes that the smallholder produces 1,000 pounds of rice per acre, that the price per bag of 168 katis is \$45, and that the smallholder works six acres of land.

^e Assumes a rubber price of 100 cents per pound.

regressive. Since a level of income of \$520 per annum is lower than the average per capita income (\$900), the indirect tax burden has been set at a level slightly above the national average to allow for the regressivity of this levy. So far as the main finding of the table is concerned, a higher or lower indirect tax burden would have no significant effect.

The point highlighted in Table 50 is the heavy tax burden borne by the rubber smallholder. Assuming that he does not take advantage of the rubber replanting grant, his total tax burden amounts to 35% of his income. By comparison, the tax burden of the rice grower and the urban dweller is light. To sharpen the contrast, it is significant to point out that a typical taxpaying unit in Malaya and Singapore—a married person with three children—is not subject to an average income tax burden of 35% until the family's gross income reaches \$63,500! Moreover, most income taxpayers live in urban areas, and urban dwellers have gained more from government expenditure on goods and services than have rural dwellers.

If it is assumed that the price of rubber and rice increase so that the gross income of the rubber smallholder, the rice grower, and the urban dweller rises to \$1,000, the tax burden borne by the rubber smallholder (measured as a percentage of income) falls, but that borne by the rice grower and urban dweller falls still more. It is debatable whether the present tax burden differential is justified.

Three general points emerge from a consolidation of the above findings. First, at all levels of income, the burden on rubber producers exceeds the burden on other income recipients. The degree of discrimination, however, is greatest for small producers; estates can claim income tax relief for export tax payments, and have been able to make more use of grants extended by the government for replanting. Second, as the income of a typical taxpaying unit rises, the relative tax burden tends to fall rather than rise until the stage is reached where, at eight or more times the national average level of income, this typical taxpaying unit becomes subject to income taxation. The failure of the tax burden to rise through this income range is due to the fact that the share of income which the typical taxpaying unit spends on taxed commodities tends to vary inversely with the level of income. It is not possible to arrive at a more definite conclusion without a substantial amount of statistical research. What is clear is that the burden of import, excise, and land taxes is regressively distributed. What is not clear is whether the burden of direct taxes shifted forward by entrepreneurs is also regressively distributed. However, since indirect taxes form a larger proportion of the total tax burden, it seems fair to conclude that the tax burden is

regressively distributed over this income range. In general, the non-export producing, middle-class section of the community is very lightly taxed. Third, as family income rises still higher, the burden of taxation increases due to the personal income tax levy. However, because personal income tax rates are only moderately progressive, the tax burden increases slowly and, compared with India and Ceylon for example, wealthy families in Malaya and Singapore are lightly taxed. In summary, the burden of taxation is distributed in a rather inequitable manner in Malaya and Singapore.

Five main recommendations have been made to rectify the deficiencies of the present tax structure as it affects an average-sized family. These are:

- (a) that the smallholder rubber replanting cess should be abolished;
- (b) that personal income tax brackets should be narrowed to increase the burden of direct taxation;
- (c) that permissible personal income tax deductions should be reduced so that the direct tax net can be extended to a higher proportion of the population;
- (d) that a low, moderately progressive, personal (poll) tax should be introduced;⁴ and
- (e) that land taxes (and betterment levies) should be adjusted more closely to the productive capacity of property.

The recommendations are designed to increase dependence on progressive, largely non-shiftable, personal taxation, and to reduce the degree of occupational discrimination in the distribution of the tax burden among taxpayers. The net effect of the suggestions would be to increase the tax burden of urban dwellers relative to that of rural dwellers. This is considered to be fair, because per capita income is higher in urban than in rural areas, and urban dwellers have benefited more from government expenditure than have rural dwellers.

FISCAL SYSTEM AND ECONOMIC FLUCTUATIONS

The national income of Malaya and Singapore has varied widely from year to year in step with the wide fluctuations that have occurred in the export prices of rubber and tin. Booms and recessions have been imported from abroad; apart from in exceptional circumstances (as occurred, for instance, during the transition to self-government in Singapore in

⁴ Income, export, and land tax payments could be set off against this levy to determine net tax liability.

1959-60), domestic factors have not caused fluctuations in the level of domestic activity in either Malaya or Singapore.

In developed economies, private investment is the most important variable influencing the level of gross domestic product. With the assistance of highly sophisticated fiscal and monetary policies, the governments in these countries can influence the level of private investment activity and thus the level of domestic activity. In contrast, the most important independent variable in Malaya and Singapore—exports—is (in the short term, at least) completely beyond the control of the government. Emphasis in stabilisation policies must therefore be given to measures designed to mitigate the impact on the domestic economy of exogenous disturbances which affect the export sector.

The effects of a rise in export earnings due, for example, to a rise in the price of rubber, were outlined in Chapter 1. The main effect would be an increase in per capita income and consequently in the demand for goods and services. Since the scope for increasing domestic production of foodstuffs and other domestic requirements is limited in the short term, and since time must elapse before a rise in import orders could be fulfilled, the major immediate problem would be demand inflation. If the seriousness of this problem were to be reduced, tax policies would need to be sensitive to fluctuations in export price.

A fall in export earnings necessitates a different emphasis in countercyclical policy. Although the main effect would be a decline in per capita income, the primary issue confronting the government would be a rise in urban unemployment for, within the agricultural sector of the economy, any cyclical slack would principally result in an increase in underemployment. Countercyclical policies would therefore need to be concentrated in urban areas. Despite the fact that the government sector in Malaya and Singapore is large by less developed country standards, government action could not be expected to compensate for the decline in per capita income. What, then, has been the countercyclical contribution of the government sector in Malaya and Singapore?

Tax revenue in Malaya has shown a high positive correlation with movements in foreign trade. The flexibility of the tax system is due principally to built-in stabilisers. The government has, however, normally taken advantage of fortuitously high income periods to adjust tax rates upwards. Export and income taxes are the two main automatic stabilisers. Supplementary assistance is derived from import duties and national provident fund contributions.

Above a price of 60 cents per pound, the rubber export tax is set on a sliding scale related to price. Thus, at a price below 60 cents per pound,

the rubber export tax yield is determined by volume alone; at a price above 60 cents per pound, the yield is determined both by the volume and the price of rubber exports. The export tax on tin is a specific rather than an *ad valorem* levy, but it has been adjusted to ensure that the impact of the levy remains constant regardless of the price of tin. An attempt has therefore been made to adjust export taxes to syphon off part of excess domestic purchasing power during booms with the result that the levies cushion the impact on the economy of a sharp rise in export income unaccompanied by any increase in domestic output.

From 1956 to 1960, Malaya experimented with a special anti-inflationary cess charge. The cess was levied when the price of rubber exceeded \$1 per pound and was refunded when the price fell below this level for eight consecutive weeks. But the cess was not an effective stabilisation device, for refunds were made during periods of relatively high rubber prices. The cess was integrated with the export tax proper in 1961.

For many rubber smallholders, the special replanting cess represents an addition to their total tax burden. The cess is a specific charge and is therefore inflexible with respect to price fluctuations. However, to the extent that smallholder production responds to price changes, the replanting cess has a countercyclical effect.

The sensitivity of income tax revenue (particularly company tax) to foreign trade fluctuations has been high. As indicated above, tin and rubber accounted for almost 50% of total business income assessed for tax purposes in 1965. In addition, fluctuations in export trade have influenced the level of commercial corporate income. Consequently, company tax revenue has fluctuated more than proportionately with changes in gross domestic product. Personal income assessed for taxation purposes has varied in step with company income but, despite the fact that the personal tax is a progressive levy, the fluctuation in revenue yield has been less severe. This is principally because of the fact that the importance of income derived from trading activities in total assessed income is lower for personal than for company taxation. Because there is a minimum of one year lag between the receipt of income and the collection of tax, the effectiveness of both personal and company tax as a countercyclical device is reduced.

The main import duties are specific rather than *ad valorem* levies. Consequently, duty revenue fluctuates with import volume rather than import value. Malaya is dependent on imports for 36% of domestic supplies, but expenditure on taxable imports has not fluctuated significantly with changes in gross domestic product. Consequently, import duty revenue has not shown a high degree of cyclical sensitivity.

The yield of land taxes and licence fees—the other main revenue heads in Malaya—has been inflexible in the face of cyclical fluctuations.

Apart from budgetary revenue, mention must be made of the countercyclical potential of the national provident funds. Under these schemes, levies tied to wage payments are collected from employers and employees. Thus, if wages rise during high income periods (and plantation rubber wages vary under statutory regulation with the price of rubber), fund contribution payments increase.

Until recently, government expenditure policies were not influenced by the dictates of functional finance. Government expenditure was not held in check during boom periods, but revenue normally exceeded expenditure with the result that external reserves increased. After an initial time lag, expenditure was normally reduced during recessions; the government was not prepared to permit a significant reduction in its external reserves for countercyclical purposes. With the assistance of the Central Bank, the government has succeeded in pursuing countercyclical fiscal policies since 1961.

It is probable that the magnitude of short-term fluctuations will be less severe in the future than in the past, for synthetics are narrowing the degree of volatility in the price of natural rubber. Nevertheless, in an export dominated economy, it is necessary to retain a high degree of sensitivity in the tax structure. A difficulty with this form of taxation is that, during periods of falling prices, the fall in tax revenue is intensified. The more sensitive the tax structure is in the downward direction, the more conservative are the government's estimates of future revenue, and the less likely it is that fiscal policy during recessions will be influenced by the dictates of functional finance. While downward flexibility is important for the maintenance of income in the private sector of the economy, rising urban unemployment is the most critical problem facing the government during recessions. A strong case can therefore be made for creating a tax structure where downward flexibility in tax receipts is not as great as upward flexibility; such a structure would help to allay fears of future budgetary problems arising from current deficit spending.

An attempt has been made in this book to indicate how the upward sensitivity of the tax structure could be increased and its downward sensitivity reduced. The export tax on rubber is cyclically adjusted, but it is also set to ensure a minimum level of revenue at low price levels. Apart from the abolition of the smallholder replanting cess, no change has been recommended in the export levies on rubber. The adjustments in the structure of income taxation have been designed to add to the upward sensitivity of this tax and, at the same time, to increase tax

collections at all export price levels. An extension of the import duty net to include luxuries, adjustments in the structure of provident fund contribution rates, and the more extensive use of external reserve and loan finance, would facilitate the pursuit of countercyclical fiscal policy.

FISCAL SYSTEM AND ECONOMIC GROWTH

The governments in Malaya and Singapore have given considerable attention to the problem of maintaining sound budgetary finance. Emphasis on non-inflationary finance, however, is a necessary but not a sufficient contribution on the part of the government to the problem of economic growth. It is also important to ensure that the tax system is adjusted to raise revenue in a form least prejudicial to the sound functioning of the economy, to curtail non-essential consumption and investment expenditure, and to provide incentives for desired private investment activity. Moreover, since the task of raising revenue is difficult, as much as possible should be achieved with every dollar spent by the government: that is it is necessary to curtail non-essential consumption and investment spending within the public sector as well as within the private sector. Finally, the government should ensure that institutional arrangements are adapted to suit the needs of the domestic economy.

Incentives for private investment activity have already been discussed in this chapter; this section is therefore confined to other aspects of the fiscal system relevant to economic growth.

Emphasis in this book has been placed on indicating how the relative role of direct taxes in the tax structure could be increased. To compensate for disadvantageous side effects, it has been recommended that a tax on specified capital gains should be introduced, that there should be no significant increase in the maximum marginal personal income tax rate, that incentives for business investment should be increased but should largely be tied to a minimum domestic value added requirement, that a measure of tax relief should be given to manufacturing firms which succeed in making a substantial contribution towards domestic product, and that the government should exercise care in the spending of public funds.

The adverse impact of export taxes on domestic production has been discussed. In the estate sector, government grants have largely compensated for the impact of the tax on incentives to invest but, in the smallholder sector, it is probable that the levies have discouraged resources from moving into rubber production. For this reason, it has been suggested that the smallholder replanting cess should be abolished.

By raising the cost of consumption relative to savings, indirect taxes strengthen the incentive to save. But in Malaya and Singapore, indirect taxes are imposed largely for revenue purposes—they are imposed on goods with low price elasticities and/or high income elasticities of demand. In these circumstances, it is possible that the levies have forced a reduction in the willingness to save. It has been suggested that a uniform *ad valorem* tariff should (with certain exceptions) be introduced. The objectives of this suggestion are to restrict spending on imports in general (and spending on inessential imports in particular), and to encourage the domestic production of those goods which can be produced in Malaya and Singapore at least excess cost over the price of comparable imports. The adjustments have been made at the import level for three reasons: (a) wholesale or retail sales taxation would be more difficult to administer and would, in any case, amount to little more than a supplementary tax on imports; (b) by avoiding the taxation of domestic production, the tax would provide an incentive to domestic investment; and (c) under current monetary arrangements, the level of the uniform tariff could be varied to reduce the impact of balance of payments deficits on the level of domestic activity. Because the levies are not directly related to income, disincentive effects on the desire to work and to enter the money economy would be minimal.

The role of land taxes in the development of the economy has been neglected in Malaya. These taxes are based on the size of holdings; additional income does not give rise to added tax liability. If anything, the taxes stimulate the desire to earn income and to enter the money economy. The government is placing increasing emphasis on the development of the smallholder agricultural sector. Yet, because rural banking facilities are not well developed and because the tax burden on the non-export sector is negligible, increased savings created in the development process are either hoarded or dissipated on luxuries and speculative investments. The recommendation made is that land taxes (and betterment charges) should be adjusted more closely to the productive capacity of property to ensure that owners make economic use of property and that the government shares in the resulting increased output.

Although numerous recommendations have been put forward in this book for changes in the fiscal structure, an attempt has been made to avoid those which would involve a significant departure from its present orientation. The experiences of India and Ceylon, where radical changes were legislated only to be negated a few years later, support the need for continuity in tax policy. An attempt has also been made to avoid suggestions which would involve a substantial increase in administrative effort.

It may be noted, however, that insufficient attention has been given to the recruitment and training of tax administrators in the past, with the result that there is now a significant backlog which will grow as the taxable capacity of the economy expands. To satisfy the equity requirements of the tax structure, revenue legally due to the government should be collected and, to fulfil this requirement, a much higher priority should be placed on the recruitment and training of tax administrators.

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ABOUT THE AUTHOR

Dr C. T. Edwards is a graduate of the University of Melbourne and the Australian National University. In 1963-4 he spent a year in Malaya and Singapore carrying out field research in connection with this book, and returned briefly in 1967. He is at present Senior Lecturer in Economics in the School of General Studies, Australian National University.



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