

# EQUITY ASPECTS OF THE MALAYSIAN TAX SYSTEM: SOME OBSERVATIONS AND SUGGESTIONS

Iresh Narayanan

[Several studies have concluded that the Malaysian tax system falls regressively on the lower income groups. This paper reviews some taxes that contribute to this regressiveness and offers some suggestions to ameliorate the situation.

*Beberapa kajian telah memberi keputusan bahawa sistem pencukaian Malaysia adalah regresif keatas kumpulan-kumpulan berpendapatan rendah. Artikel ini membincangkan beberapa cukai-cukai yang berkesan regresif dan menbentangkan beberapa cadangan untuk memperbaiki keadaan tersebut.]*

## INTRODUCTION:

Several studies on the incidence of the tax system of Peninsular Malaysia have concluded that it impinges heavily on the poor.<sup>1</sup> While some methodological reservations must be made with regard to these studies, the consistency of their findings suggests that the broad pattern of incidence tends to worsen the economic well-being of the poor.

Such findings, however, appear to have had little impact on local policy-makers. The official view seems to be that there is limited scope for substantial income redistribution via changes in the prevailing tax system. Instead, correction of tax inequities is seen as best attempted through more egalitarian patterns of public expenditures. Although this view may carry some force, it should not be an excuse to ignore

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<sup>1</sup>McLure (1972); Snodgrass (1972) and Ismail Salleh (1977). A study by Andic (1977) on the tax system pro-poor, but his results are suspect. A lengthy discussion on this is out of place here. However, suffice it to say that his calculations of the tax burden on the poor omitted several regressive elements in the tax system, such as the forward-shifted incidence of the corporate tax, the Employees' Provident Fund contribution, and the inheritance tax.

glaringly unjust features of the tax system. Clearly, altering the form of an existing tax to a more equitable one or replacing it altogether will, at the minimum, ensure that the tax system will not make the poor poorer. Moreover, the impact of enlightened expenditure policy will be further enhanced by such changes in the tax system — no matter how marginal these changes may appear.

This paper has two objectives. First, it seeks to highlight some elastic major taxes that burden the poor unduly; second, it suggests a limited number of short-term measures aimed at evolving a more equitable system, without adversely affecting revenues or distorting the inherent incentive system within the economy. The suggested changes are offered in the belief that the most effective, short-term method of alleviating the plight of the poor via the tax system is to raise their real incomes by removing inequitable taxes. To offset the revenue involved, measures aimed at taxing the consumption of the rich are suggested.

Taxing the consumption of the rich has two distinct advantages. First, it avoids adverse effects on savings and work effort, which may arise if the income of the rich is taxed severely.<sup>2</sup> Second, it discourages conspicuous consumption that aggravates tensions already prevalent in a society with income inequities. Similarly, raising the real incomes of the poor through the removal of taxes bearing heavily on their consumption generates an immediate positive effect and a welcome respite while long-term measures are being planned and executed.

## ELEMENTS OF REGRESSION IN THE TAX SYSTEM:

### Export Tax on Rubber

Perhaps the singlemost regressive tax as far as the poor are concerned is the export tax on rubber. In an early work, Tan developed two measures; one to estimate the proportion of the export tax borne by the producer, and the other to estimate the income that would have prevailed if the tax had not been in place.<sup>3</sup>

<sup>2</sup>If the work-leisure choice is not significantly affected, then an income tax is superior to commodity taxes on pure efficiency grounds.

<sup>3</sup>Tan (1967), pp. 91—93.

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The proportion of tax borne by the producer is estimated by

$$B_p = \frac{-ae_{dx}}{(e_{sx} - ae_{dx})}$$

here  $e_{dx}$  is the elasticity of foreign demand for the export good;  $e_{sx}$  is the elasticity of supply of the good; and  $a = (1-t)$ , where  $t$  is the tax rate.

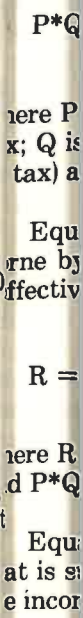
It is clear from equation (1) that when demand is completely elastic (i.e.  $e_{dx} = 0$ ), the export tax falls entirely on the consumer. On the other hand, if the elasticity of supply is zero, the producer bears the full tax. In general, the producer's share of the tax increases as the elasticity of demand increases, or as the elasticity of supply decreases.

To illustrate, let us examine a typical "small-country" case. Since the exporting country is a very small supplier of the total world output of the commodity, it faces an infinitely elastic demand for the commodity it exports, at the price fixed in the export market. It is evident from equation (1) that  $B_p$  will take on a value of unity in this case; the entire tax is therefore paid by the producer. Diagrammatically, this is shown in Figure 1.  $S_x$  and  $D_x$  represent the domestic supply and demand schedules of the exported commodity. At the world market determined price of  $OP_x$ , total output of  $OQ_4$  is produced, of which  $Q_1$  is consumed locally and the remaining  $Q_1Q_4$  is exported. Imposition of an export tax equal to  $bc$  per unit exported will be entirely absorbed by the producer in this instance. The infinitely elastic (world) demand schedule faced by the producer (at price  $OP_x$ ) implies that any attempt to pass the tax forward to consumers through a price increase will not succeed. This is because even a small price increase will result in foreign consumers shifting away from the producer's output to other cheaper sources. Thus the producer is forced to absorb the tax himself.<sup>4</sup> This is reflected by the net (after tax) price received by the producer, shown as  $OP$ .

The export tax reduces exports from  $Q_1Q_4$  to  $Q_2Q_3$ . Revenue from the tax is shown by the area  $abcd$  and is paid by the producer. However, the tax has further effects. First, the export tax benefits domestic consumers of the export commodity by lowering the domestic price (from  $OP_x$  to  $OP$ ). This comes about because the tax makes it more profitable for the producer to sell more of his output domestically. Given that the local demand has not changed, this

<sup>4</sup>Backward shifting to factors of production is also possible. However, since smallholders provide much of the inputs themselves, this strategy is not feasible for them.

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Total loss (in surplus) incurred by producer as a result of the tax is shown by the shaded area  $afcd$ . Of this, the shaded area  $abcd$  accrues to the government as revenue from the tax; the area  $afdc$  represents an implicit transfer from the producer to the domestic consumer by way of a lower price for the commodity; and the triangles  $gad$  and  $bhc$  are losses to society as a whole. Only the tax paid by the producer ( $abcd$ ) shows up in government accounts.

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st-tax income (given by the area  $OeCQ_3$ ) to the tax revenue (of  $abcd$ ). This is because the tax induces losses in producer surplus that exceed the tax revenue, as noted above. Such additional losses are not recorded in official figures of tax receipts. The income in the absence of the tax is approximated by the second equation discussed by Tan, and given as:

$$P^*Q^* = PQ \left[ \frac{a(e_{sx} - e_{dx})}{(e_{sx} - ae_{dx})} \right] \left[ edx \frac{a(e_{sx} - e_{dx})}{(e_{sx} - ae_{dx})} - edx + 1 \right]$$

where  $P$  is the market price of the export in the presence of the export tax;  $Q$  is the quantity exported at  $P$ ;  $P^*$  is the equilibrium price (prior to tax) and  $Q^*$  is the equilibrium quantity at  $P^*$ .

Equations (1) and (2) can be combined to yield the money burden borne by the producer<sup>5</sup>. In the literature, it is also referred to as the "effective" tax rate. Thus

$$R = \frac{B_p T}{P^* Q^*}$$

where  $R$  is the "effective" tax rate;  $T$  is the total tax receipts collected, and  $P^*Q^*$  is the total proceeds in the absence of the tax.

Equation (3) above indicates the proportion of the pretax income that is surrendered by way of the export tax. It may also be viewed as the income-tax equivalent of the export tax.

Utilising these equations for a hypothetical but plausible example of a farmer with four acres of rubber land, cultivating low-yield trees, it was concluded that the export tax extracted between 15–16 percent of a smallholder's income between 1960–1961. Thus the farmer was, in effect, paying an income tax rate that was equivalent to that paid by those earning between \$34,250 – \$39,250 annually, although his income varied between \$1,107 – \$1,446 a year.<sup>6</sup>

Only in recent years has the government recognised the plight of rubber smallholders hit by rising costs and lower incomes. Some

<sup>5</sup>The money burden refers only to the tax paid by the producers. It excludes the subsidy element and the "excess burden" discussed previously.

<sup>6</sup>Tan assumed  $e_{sx} = 0.4$  and  $e_{dx} = -5.0$  for smallholdings. The rate of export tax amounted to 14.9% of the prevailing price of R.S.S.1 rubber in 1960 and 13.6% in 1961.

changes have, therefore, been incorporated into the export tax structure designed to alleviate their hardship. While the tax rates have fallen as a consequence of these changes<sup>7</sup>, the tax continues to generate inequities within the agricultural sector and in comparison across sectors.

Small holders can be divided into two groups: those cultivating the more recently introduced high-yield trees, and others still depending on the older low-yield trees. Because low-yield trees are also concentrated among the smaller smallholders, the latter group suffers a much higher incidence of poverty.<sup>8</sup> Table I estimates the "effective" tax rate borne by both groups owning a hypothetical four acre plot each, for 1980. The methodology follows Tan.

The export tax, calculated according to the rate in 1980, constituted about 7 percent of the smallholder's net income.<sup>10</sup> The "effective" rate is much lower than that obtained by Tan although the rubber price in 1980 was higher than that which prevailed in 1960-1961. This is explained by the changes in tax rates introduced by the government in recent years. However, inequities within the sector remain. To begin with, those cultivating higher yielding trees (and therefore, with a higher income base) were paying the same proportion of their income in taxes as those with a lower income. This contradicts the norm of progressive taxation.

Furthermore, as the tax falls more heavily on the less efficient producers, who are also unfortunately the bulk of the poorest, the tax subverts official attempts to raise the income of the poorer households.

The tax also discriminates against the smallholders relative to other small peasant farmers, or even urban workers earning similar incomes. Farmers cultivating padi, for example, and who earn a similar annual income, pay no tax. So is the case for other small-scale cultivators of fruits and vegetables. Hence the tax discriminates on the basis of crops cultivated — not ability to pay. When compared to the average urban worker, the rubber smallholder is seriously

<sup>7</sup>See Asher and Booth (1983) pp. 92—93 for details of these changes.

<sup>8</sup>Young *et al.* (1980) pp. 225-226.

<sup>9</sup>This size reflects the average for low-yield holdings. Those cultivating newer trees typically have larger sized plots. More than 60 percent have plots exceeding 5 acres (Young *et al.* 1980; p. 225).

<sup>10</sup>See the 1980 Budget (1979) p. 29.

**TABLE I**  
**"EFFECTIVE" TAX RATE BORNE BY RUBBER SMALLHOLDER**  
**OWNING FOUR ACRES, IN 1980**

|                                                    | Low-Yield Farm <sup>1</sup> | High-Yield Farm <sup>2</sup> |
|----------------------------------------------------|-----------------------------|------------------------------|
| Output                                             | 1,800 lbs.                  | 3,600 lbs.                   |
| Income ex-tax <sup>3</sup>                         | \$ 1,517.0                  | \$ 3,034.0                   |
| Cost <sup>4</sup>                                  | \$ 161.0                    | \$ 163.0                     |
| Income                                             | \$ 1,356.0                  | \$ 2,871.1                   |
| Port Tax <sup>5</sup>                              | \$ 113.4                    | \$ 226.8                     |
| Income in absence of tax <sup>6</sup>              | \$ 1,531.8                  | \$ 3,063.8                   |
| er's Margin <sup>7</sup>                           | \$ 161.0                    | \$ 163.0                     |
| Income                                             | \$ 239.4                    | \$ 478.8                     |
| Portion of tax actually<br>paid (95%) <sup>8</sup> | \$ 1,131.4                  | \$ 2,422.0                   |
| Effective tax rate <sup>9</sup>                    | \$ 107.0                    | \$ 215.5                     |
|                                                    | 7.03%                       | 7.03%                        |

1. Average output: 450 lbs./acre.  
2. Average output 900 lbs./acre (Young *et al.* 1980, p. 227).

3. Calculated using the average prices for unsmoked sheets paid by dealers to holders — 84.28 cts./lb. (Monthly Statistical Bulletin, March 1984, p. 152). The price of R.S.S. 1 was about 141.7 cts./lb. The difference is due to quality differences, transport and management.

4. Adapted from Tan (1967).

5. The tax was based on the price of R.S.S. 1 prior to the Budget of 1981. A rate of 6.3% was derived using the 1980 rate structure.

6. Derived using formula (2) discussed in the text. The following values were used:  $E_{dx} = -3.73$ ;  $t = 4.45\%$ .

7. From Cheam, cited in Lim Sow Ching (1976), p. 77.

8. Estimated using formula (1) discussed in text.

9. Formula (3) discussed in text.

disadvantaged. An urban worker with an identical annual income required to pay no tax on his income. Stated differently, to pay 10 percent of his income in taxes, an urban worker must earn approximately \$18,250 a year in 1980.<sup>11</sup>

Not surprisingly, the tax worsens existing income differences. To illustrate, the pre-tax income ratio of the two types of holdings was 2.14 in favour of the high-yield holding. After tax, the income difference rose to 2.14 (See Table I).

Several implications emerge. First, the export tax on rubber not helped the 400 thousand households growing rubber, three-fifths of which were considered poor. The tax depresses their income position vis-a-vis other farmers within agriculture and relative to the average urban wage-earner. Doubtless, present government efforts to get smallholders to replant with high-yield trees is a positive step, but it remains a long-term solution.

The reliance on the rubber export tax may have been inevitable in some previous period when the country's tax base was small and alternative sources of revenue were few. However, given the fact that the importance of this tax in total revenue is likely to decline in the future (with the pre-eminence of petroleum revenues since 1974), the abrogation of this tax on smallholders is long overdue.<sup>12</sup>

It will prove tricky to exempt only the poorest sections of rubber growers from the tax. Theoretically, the poor may be identified using either land size or income as the criterion. The government might set up a machinery to buy the output from these producers directly in order to ensure that tax reductions do indeed reach the farmers and are not absorbed by intermediaries.

Another alternative is to abrogate the tax altogether and compensate revenues from the richer sections of the rubber industry through other measures not related to rubber price, but rather, incomes. For example, a "Rubber Profits Tax" similar to the tin profits tax in the agricultural existence could be considered — the tax being collected from estates only when profits from exports exceed a prescribed amount.

<sup>11</sup>Assumed married but with no children. This calculation ignores further exemption on EPF and life insurance payments.

<sup>12</sup>Indonesia has abolished the tax on rubber exports while Thailand reduced its tax in 1981. Hence Malaysian producers are at a competitive disadvantage.

## Taxes on Consumption

Taxes on consumption, in general, are recognised as being regressive since the marginal propensity to consume of the poor is believed to be greater than that of the rich. Thus such taxes impinge more heavily on those who consume more — namely, the poor. Yet, virtually all governments raise substantial revenues by way of taxes on consumption. The focus, therefore, is not on the merits or demerits of consumption taxes in general, but on the composition of such taxes. By imposing levies on goods consumed primarily by the rich, the regressive impact of these taxes can be ameliorated to some extent.

In theory, goods with high income elasticities should be taxed heavily, since the consumption of these goods rises with incomes, while goods with low income elasticities (like basic foodstuffs) should be exempt from such levies. But whether levies on income elastic goods will raise substantial revenues as well depends on the price elasticities of the items concerned.

In 1980, the Malaysian tax system derived 34 percent of total tax revenues from taxes on consumption. Furthermore, the bulk of the total revenue from excise duties was obtained from tobacco products, (74) cigarettes, liquors, and alcoholic beverages, including beer, and sugar. The tendency has been to burden these commodities (excluding sugar), with higher rates of levy<sup>13</sup>. Available evidence indicates that these commodities have low income elasticities, and probably low price elasticities as well (See Table II).

Consider, for example, the levies on tobacco and alcoholic beverages. While import duties are presumably on varieties largely consumed by the rich, the same cannot be said for the excise duties on domestically-produced substitutes. About 41 percent of total expenditure on these items came from the (poorer) agricultural sector in 1973.<sup>14</sup> Furthermore, since these items are income inelastic, the burden falls largely on the poor, within both the agricultural and non-agricultural sectors.

High rates of tax on these commodities are usually accepted without much protest, because society views it as a tax on "sin" and such taxes are seen as curtailing the consumption of these harmful

<sup>13</sup>See The 1980 Budget (1979); The 1983 Budget (1982).

<sup>14</sup>Calculated from the Household Expenditure Survey 1973 (no date). This represents the latest data on consumption patterns.

**TABLE II**  
**INCOME ELASTICITIES OF SELECTED ITEMS<sup>1</sup>: 1973**  
**(PENINSULAR MALAYSIA)**

| EXPENDITURE GROUP                                             | HOUSEHOLDS |       |
|---------------------------------------------------------------|------------|-------|
|                                                               | URBAN      | RURAL |
| Food                                                          | 0.57       | 0.33  |
| Beverages and Tobacco                                         | 0.51       | 0.55  |
| Clothing and Footwear                                         | 1.16       | 1.17  |
| Gross Rent, Fuel and Power                                    | 1.04       | 0.92  |
| Furniture, Furnishings and Household Equipment and Operations | 1.44       | 1.56  |
| Medical Care and Health Expenses                              | 0.81       | 0.66  |
| Transport and Communications                                  | 2.01       | 1.94  |
| Recreation, Entertainment, Education and Cultural Services    | 1.53       | 1.52  |
| Miscellaneous Goods and Services <sup>2</sup>                 | 1.13       | 1.55  |

Source: Kwok (1979:83)

Notes: <sup>1</sup>Estimated using the Two-Stage Least Squares method. Total expenditures were used as a proxy for "permanent income".

<sup>2</sup>Consists primarily of food expenditures away from home.

goods.<sup>15</sup> However, the argument is tenuous, at least in the short-run. Most of these goods are price inelastic, within the relevant price range, especially if tax induced price hikes are not dramatic. In the short-run, such price increases will reduce consumption only minimally, while total expenditures on these goods will be greater than before. Thus, while the consumption of these goods remains largely unchanged, consuming households may spend more of their income on these commodities, leaving less resources for other purposes. In the long-run, if the tax-induced prices are steep enough, the objective of reducing consumption may be achieved, but the immediate consequences of such a strategy give rise to great concern.

<sup>15</sup>The 1983 Budget (1982, p. 41), for example, states: "From a health point of view liquor ...should be discouraged. In view of this.....the.....duty on liquor (is) increased...." <sup>19</sup>Revealed the 1983.

Clearly, as alternative sources of revenue become available, the duties on cheaper varieties of alcoholic beverages and tobacco products must be lowered. The aim of curtailing the consumption of these products on health or moral grounds, is best achieved through consumer education. In the United Kingdom, for example, there is evidence that the demand for tobacco fell in the wake of the anti-smoking publicity there.<sup>16</sup>

In general, the government has avoided taxing basic foodstuffs. Hence it is surprising to find that sugar — an item featuring prominently in the budget of a poor household — remains subject to tax. In fact, sugar is subjected to both import duty and excise tax. While the import duty may be justified for its protective role, the excise tax merits serious reconsideration.<sup>17</sup>

In general, domestic sugar prices remain high relative to world prices, not only because of limits on imports, but also because of our purchase contracts at high prices from sources abroad.<sup>18</sup> Ironically, every time sugar contracts are due to be negotiated, world sugar prices have been high, only to fall again once these contracts have been signed! Thus Malaysia has had to buy at the prices stipulated in these contracts, though world prices have dipped.<sup>19</sup> The obvious way out of this dilemma is to insert a "sliding price" clause when the next round of negotiations is due. Such a clause will tie the price Malaysia agrees to pay with world supply and demand conditions — enabling Malaysian consumers to benefit from substantial reductions in sugar prices, should they occur, and bear the burden of high prices during peak demand. This is not to suggest a price that moves with every small fluctuation in the world sugar market; rather, the clause should come into effect only when world prices fall below or go above a pre-negotiated margin.

<sup>16</sup>See Atkinson and Skegg (1973).

<sup>17</sup>The local sugar industry has been ailing for a considerably long period of time, despite protection. Perhaps it is time to review the protection given. Reducing the excise tax will enable the level of protection to be lowered also, thereby lowering domestic prices.

<sup>18</sup>Malaysia imports sugar to cover the short-fall between domestic production and consumption.

<sup>19</sup>Revealed during discussions with the Ministry of Trade and Industry officials, 17 June 1983.

## SOME SUGGESTIONS:

It is difficult to identify goods that should be taxed heavily in order to reduce the regressivity of the indirect tax system, except in general terms. Obviously, detailed empirical studies on price and income elasticities are necessary for this purpose. In particular, care should be taken not to over-burden semi-luxury goods that often provide the incentive for people to work and save. Hence goods like transistor radios, irons, electric kettles, televisions, etc., though obviously not widely used by the very poor, certainly fall within the potential consumption basket. However, even within these broad categories, expensive or luxury orientated models are available, and could be taxed for revenue purposes. In this connection, it is surprising that the government announced the withdrawal of all duties on imported cameras, watches, fountain pens, and lighters in the budget of 1982, and added imported perfumes, cosmetics, cine-camera projectors, sound recorders, etc., to the list in 1983. These are imported items, almost entirely consumed by the rich.

The official reason given for the move was to encourage tourism since these items are believed to be popular with tourists. It was argued that the duties made them more expensive in Malaysia, relative to neighboring Singapore or Hong Kong, where these are duty free.

Several questions are worth considering in this connection. Did the predicted increase in tourism indeed materialize? More important, did this measure contribute significantly to such an increase? It is our understanding that any gain has been marginal. Singapore and Hong Kong remain major havens for tourists on shopping sprees, and many goods remain considerably cheaper there, despite the removal of duties in Malaysia. There appears no justification, therefore, for removing taxes on these luxury items. On both equity and revenue grounds, the reinstatement of these duties becomes imperative. The existing network of duty-free shops deserves to be strengthened to cater to tourists.

The wide popularity of video cassette recorders (VCRs), and the concentration among the middle and higher income groups makes it an ideal source of tax revenue. An annual licence for the operation of VCR is both easy to enforce and collect. Such a tax is justified, since VCRs have reduced the cost of family entertainment substantially, and have eroded the revenue traditionally received via the entertainment tax. It seems fair that the richer families pass some of this savings from nonessential consumption good to government coffers.

Rough calculations based on an annual fee of \$12, and

assumption that a third of TV owners in 1981 had VCRs, yields an expected revenue of 4.4 million dollars. This takes into account the slight decline in the number of sets bought after the fee is imposed.

Much speculation persisted prior to the last budget speech about a foreign travel tax designed not only to cut foreign travel (and hence conserve foreign exchange), but also to generate revenue. The wisdom of such drastic measures needs careful thought. Yet there is scope to raise revenue from travellers who can afford relatively expensive modes of travel. The airport tax for domestic travel was recently raised from \$2 to \$3 — hardly a significant amount and low by any standard. It is suggested that the tax for internal flights be raised to \$5 or \$7. Assuming the latter figure is charged and the current passenger figures hold, an additional \$8 million can be expected.

Similarly, the rate for international flights can be raised to \$12 or \$15, and this may be expected to generate an additional \$11 million. The net gain from revised airport charges will be about \$19 million.

Gasolene taxes have never been popular with the public, yet a tax on premium grades will be almost exclusively borne by the richer groups in society. Being price inelastic in the short-run, it is an ideal source of revenue. The price reductions for premium and regular grades in mid-1983 make it possible to impose a small tax on gasolene without undue hardship on the consumer. A one cent tax on both grades of petrol will still enable consumers to enjoy prices lower than that which prevailed before the price reductions were announced. Furthermore, our prices will continue to remain the lowest in the ASEAN region.

Finally, the introduction of a capital gains tax must be considered seriously. Despite the positive relationship between capital gains and income, we have avoided imposing any tax on such gains. Initially, the reluctance was due to the genuine fear that such a tax would impede the development of domestic money and capital markets. However, such fears have less force now, and it is worthwhile investigating a tax on some obvious forms of capital gains. The experience of developed countries can be studied with profit in this regard.

## CONCLUSION:

It is evident from our discussion that some room exists to manipulate the form of many existing taxes to ensure a more equitable tax system. Admittedly, devising an overall tax system that satisfies the conflicting concerns of equity, revenue, efficiency, and

stabilisation, can be perplexing — if not impossible. But a tax system need not be any more regressive than it absolutely has to be, on account of other non-equity considerations. Even marginal modifications can have significant, positive effects on equity. The effort has been an attempt to suggest some potential areas for such changes.

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